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Designing Equity at Retirement

How favorable treatment of equity at retirement can be a win-win for employees and employers

By Mike Rourke

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Here in 2021, we sit near the midpoint of the baby boomer generation approaching retirement. As these individuals progressed through their careers, companies were phasing out corporate-sponsored pension plans. Within those pension plans, the term retirement was clearly defined. In contrast, many organizations have failed to adopt a formal retirement definition, or have elected to use discretion, to determine the appropriate treatment of unvested equity awards upon an executive's (and other eligible employee's) retirement. The absence of a retirement definition will cause a "retirement" to be treated as a garden variety voluntary termination of employment, typically resulting in the forfeiture of unvested equity awards.

An executive's retirement materially differs from other forms of termination. Generally, retirement is not an employer-initiated termination. It is not a job-hopping millennial voluntarily terminating employment for greener pastures at your closest competitor. Rather, a retirement occurs when an executive terminates employment after meeting certain specified conditions, such as age and service requirements. For employees, retirement is the carrot at the end of one's working career. After years of commitment, it is the opportunity to step away from the working world to enjoy well-deserved free time and, hopefully, competitive retirement benefits.

Historically, competitive retirement benefits were delivered to executives though a company's tax-qualified pension plan. With the dramatic decline in the prevalence of these plans, executives are now required to self-fund their retirement benefits through contributions to 401(k) plans and company-sponsored nonqualified deferred compensation plans. A minority of companies supplement these retirement benefits through company-funded restoration plans and defined contribution SERPs. These circumstances have given rise to companies considering or implementing favorable treatment of outstanding equity awards upon an executive's retirement.

A real-life example concerning the adequacy of retirement benefits involved a former CEO and current board chair of a Fortune 500 company. The board chair advised that his company lacked competitive retirement benefits because the company did not cover employees under a tax-qualified pension plan or supplemental retirement plan, while many competitors maintained legacy plans. In addition, he noted that with annual grants of restricted stock, stock options and performance awards, participants do not vest in the equivalent of one full year's award until after the third year of receiving a grant (based on three-year vesting schedules). Without some form of favorable retirement treatment, participants would miss out on often substantial vesting opportunities at the end of their careers. For these reasons, the board chair concluded that vesting treatment of unvested equity awards was one of the few levers the company could pull to reward individuals for *earning* retirement.

Without clearly defined retirement vesting terms, one of two things generally happens to unvested equity. The first is that awards are forfeited (as most award agreements call for forfeiture if employment ceases prior to vesting date, with certain exceptions). This can be problematic for a variety of reasons, including discouraging or delaying retirement or enabling a lack of adequate notice. Employers want to avoid having a retirement-eligible employee "check out" and occupy a seat while waiting for additional vesting of previously granted awards and/or waiting to be terminated not-for-cause to potentially receive cash severance. The second is that the company, through the exercise of discretion, accelerates vesting, in full or in part, upon an executive's retirement. However, such exercise of discretion may be problematic for several reasons. The exercise may give rise to unanticipated accounting charges that could run through a company's summary compensation table. Also, compensation committees will need to be mindful of treating similarly situated employees in the same manner upon retirement to avoid potential litigation. A well-constructed retirement vesting provision avoids the foregoing issues while still providing executives a path toward retirement.

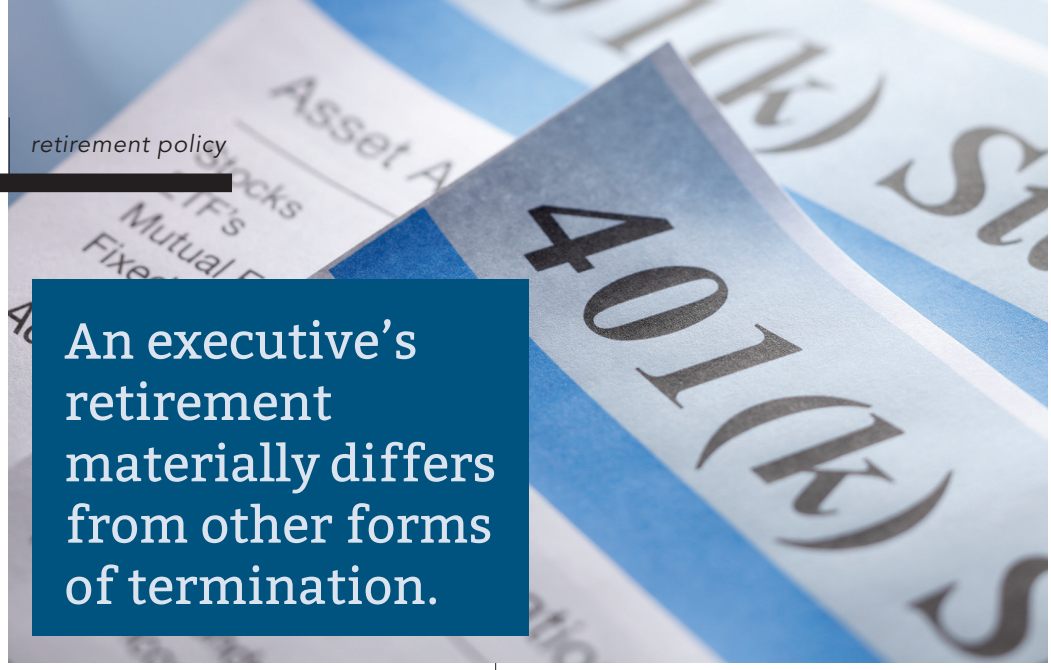
The following step-by-step process is a useful guide to designing retirement provisions for equity awards.

Step 1 – Defining Retirement Eligibility

Drawing a line in the sand somewhere is important, but the approach taken should consider your employee base, as well as your ability to attract and retain talent. Many organizations historically defined retirement simply as an "age-only" requirement (e.g., age 65). However, there has been a shift toward a "points system," where each year of age and each year of service count as one point (e.g., age + service = 72, often with a minimum age requirement), or even a combination of the two approaches (e.g., 72 points or age 65). Combination approaches have the benefit of balancing rewarding those with long tenure, while still encouraging potential "late career" hires to join your organization.

Step 2 – Defining Retirement Qualification ("Good Leaver" Policy)

A cautionary tale: For some organizations, the notion of establishing retirement vesting terms was brought about after the company was "burned" by a retiree. For example, the company allowed for full accelerated vesting upon retirement, and retirement was defined as age 55 + 10 years of service. There was no "good leaver" policy in place, and a long-tenured senior executive in his or her late 50s informed the CEO of their retirement shortly after receiving their annual equity grant. These individuals gamed the system to receive the full value of their equity grant and essentially provided two weeks' notice instead of a lengthy retirement notice period.



An executive's retirement materially differs from other forms of termination.

To avoid the foregoing possibility, companies should consider developing a "good leaver" policy as part of any retirement vesting provision. Under this policy, a retirement-eligible employee should provide ample notice (e.g., six months) to qualify for retirement treatment. This notice period should be established to allow for necessary succession planning. Retirement opens up opportunities for the next level of talent to advance in their career. If the next level of talent is not ready for the challenge, the notice period may provide enough time to hire an outside candidate. Additionally, some organizations require another qualifier in order to receive favorable equity vesting treatment upon retirement: a retirement-eligible employee must be employed for a certain period post-grant (e.g., six to 12 months). This approach helps mitigate, but certainly does not eliminate, the potential for participants to game the system. It may be easiest to explain using the "cautionary tale" example above. Imagine Company A's fiscal year ends December 31, 2022, and annual grants are made March 31st each year. The executive gives six month's retirement notice in October 2022, and within the six-month period receives a bonus payout in Q1 2023 and a March 31, 2023 equity grant, which would vest in full. Most companies would not be comfortable with that approach. To avoid this possibility, a company may require both advance notice *and* the post-grant employment period.

Step 3 – Choosing Vesting Treatment

Calling for forfeiture of all outstanding equity upon retirement is probably too punitive, while full accelerated or continued vesting is often viewed as too generous. The answer likely lies somewhere in between. It is also important to consider standard vesting provisions for annual grants, in addition to vesting provisions for other forms of termination (i.e., retirement treatment should be equally or more favorable than not-for-cause treatment).

With time-vested awards like stock options and restricted stock, it is most prevalent to allow *full continued vesting at retirement*. While accelerated vesting is also common (eases the administrative burden of tracking future vesting and allows the employer to "move on" from the employment relationship), continued vesting provides a key benefit to the employer. In order to receive continued vesting treatment, employees should have to adhere to restrictive covenants, which should be listed in the award agreement. To the extent enforceable by state law, these can include non-compete, non-solicitation, non-disclosure, non-disparagement, confidentiality, release of claims, etc. This can help prevent an employee from retiring from your organization and setting up shop at a competitor. By tying continued vesting to adherence to restrictive covenants, the company can stop providing the shares should a breach occur (this is much easier than attempting to clawback awards that were already accelerated).

Vesting of performance-based awards is more complex than vesting of time-based awards. Generally, retirement vesting provisions provide that unvested performance awards vest pro rata based on actual performance measured at the end of the performance period. This encourages the retiree to help "right the ship" prior to departure while acknowledging the fact they worked for only a portion of the performance period and everyone else "rowed the boat" for the full period. Tying outcomes to actual performance is fair for all of those involved, while pro rata vesting acknowledges the difference in time/effort toward achieving those results.

Summary

Defining retirement and formalizing vesting treatment minimizes risk by keeping compensation committees out of the world of complete discretion. It is also important to remember that retirement is the acknowledgement of years of dedication and effort. That being said, there are opportunities to provide some beneficial treatment to those qualifying for retirement while also considering the needs of the organization. "Good leaver" provisions such as a retirement notice period and a post-grant employment period encourage effective succession planning and minimize attempts to game the system. With continued vesting for time-based awards, companies can also enforce restrictive covenants post-retirement during the vesting period. There are several nuances to this seemingly simple concept, but establishing guidelines proactively can be a win-win for retirees and the companies they have served. CS

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