Adding Performance Stock Unit Awards to Your Long-Term Incentive Compensation Program

As a newly-public technology or life sciences company matures, it is customary to eventually expand its long-term incentive compensation program to include performance-based awards. Typically, this development is expected by the company's institutional shareholders as a way of more effectively aligning their interests with the interests of the company's executives and other employees. As a practical matter, for mature companies it also is effectively required by the proxy advisory firms that evaluate a company's executive compensation program and formulate voting recommendations on such matters as the shareholder advisory vote on named executive officer compensation (the "Say-on-Pay") vote, among other proposals.

While a company may continue to use stock options in its LTI program, the major proxy advisory firms (and many institutional shareholders) do not consider them to be "performance-based" equity vehicles. Further, the various available design alternatives for converting options to performance-based awards (such as performance contingent options, indexed options, or premium-priced options) each present administrative, accounting, or legal complexities that diminish their attractiveness to companies and/or the ultimate recipients of such awards – your executives. In our experience, and as preferred by the major proxy advisory firms and a significant portion of the institutional investor community, at least half of the economic value of the equity awards granted to the named executive officers of a mature public company should be full-value awards subject to one or more pre-established financial, operational, or strategic performance goals.

This Thoughtful Pay Alert summarizes the features and attributes of the most commonly-used form of performance-based award – performance-based restricted stock unit awards "("PSUs") and the various tax and disclosure requirements applicable to such awards.

Performance Share Awards

Generally, there are two common types of performance-based awards used by technology and life sciences companies – performance share awards ("PSAs") and performance stock unit awards ("PSUs"). A third form of performance-based award that we see from time to time are market stock unit awards ("MSUs"). For a detailed discussion of MSUs, please see our Thoughtful Pay Alert, *Market Stock Unit Practices in the Technology Sector (Dec. 12, 2016)*. The common characteristic of each of these award types is that an executive's rights to the shares or units granted pursuant to the award are contingent on the achievement of one or more pre-established performance goals.

PSAs or PSUs?

Typically, PSAs are granted as full-value share awards for a target number of shares of the granting company's common stock which are to be earned (and vest) based on the achievement of the target performance level of one or more pre-established performance goals over a multi-year (for example, three-year) period. While PSAs are commonly earned based on the achievement of financially-based performance metrics, they can also be linked to non-financial metrics, including individual performance and strategic goals. Depending on an award's design, it may also provide that a specified number of shares may be earned through the achievement of a threshold level of performance (generally, 50% of target performance) up to a specified number of shares that may be earned for maximum or "over-achievement" performance (generally, ranging from 150% to 200% of target performance). If the award provides for the opportunity to earn shares in excess of the target number of shares, it is customary to reserve the maximum number of shares that may be issued in the event of maximum performance. Typically, these awards will also provide that the number of shares that will be earned for performance between the threshold and target levels and the target and maximum performance levels will be determined on an interpolated basis.

A PSU is similar to a PSA except that, instead of actually issuing the shares at the time of grant, the company makes a commitment to issue to an executive (or other employee) a number of shares of its common stock (or the cash equivalent) equal to the number of units earned, if any, upon the completion of the performance-period and following certification of the performance results by the compensation committee. Since the executive (or other employee) does not have the right to vote the shares and to accrue dividend equivalents on the shares to be paid (if at all) against the actual number of shares earned, in recent years most technology and life sciences companies have switched from granting PSAs to granting PSUs.

All of the relevant terms and conditions of a PSU will be set out in the award agreement, including details on the performance metrics, the related performance levels and their measurement, the performance period, how the underlying units are to be earned (including the minimum performance achievement required to earn units and the range of earnout possibilities relative to actual performance), and assuming multiple metrics, the relative weighting for each, if applicable.

Like PSAs, PSUs are earned upon the achievement of one or more performance metrics and typically entail a similar threshold to maximum payout structure. As discussed below, however, the nature of these metrics will depend on whether the company is in the technology sector or the life sciences sector. While earned units may be payable in cash or stock, typically, each earned unit will be settled for one share of the company's common stock. As with PSAs, the actual number of units (and ultimately,

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shares) earned will vary depending on the level of achievement of the pre-established performance goals.

Design Considerations

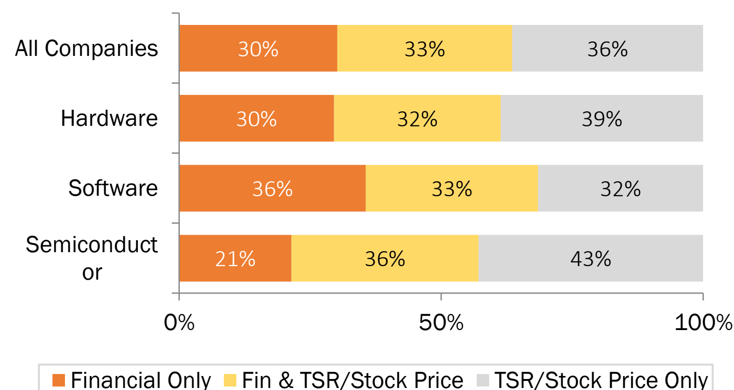
Selecting Performance Goals

One of the primary advantages of granting performance-based awards rather than time-based awards is that the company can establish very specific and relevant targets that align with the shareholders' vision for the company's future and where the majority of the executives' compensation is directly aligned with what shareholders, the board of directors, and management seeks to achieve. Typically, the plan administrator (usually the compensation committee of the board of directors) has unfettered discretion to select the performance goal(s) that must be achieved for the units underlying the PSU to be earned, as well as the required performance levels to earn such units, and how many shares ultimately will be received for each earned unit for each level of achievement. Since the major proxy advisory firms and institutional investors disfavor the use of the same performance goals for both a company's short-term and long-term incentive compensation programs (which is considered "double dipping"), most companies tend to select performance metrics for their performance-based awards that differ from the metrics used in their annual bonus plan.

The performance metrics selected to earn the PSU award usually vary depending on whether a company is in the technology or life sciences sector.

Technology Companies. In the case of technology companies, the goals are typically based on the achievement of a financial or operational measure which has threshold, target, and maximum performance levels. Most performance goals are intended to further a company's medium-to-long term business objectives and can vary among award cycles (as well as from executive to executive). While the goals may be objective or subjective, quantifiable or qualitative, absolute or relative (that is, compared against a third-party index or a pre-selected group of peer companies) typically technology companies will select one or more objective financial (such as revenue or earnings before interest, taxes, depreciation, and amortization ("EBITDA")) and/or operational (such as a number of product or service subscriptions or the completion of a specified transaction) goals. These goals may be company-wide or linked to a specific business unit, division, or function and/or individual goals (although individual performance goals tend to be less common in a long-term incentive compensation program). Based on recent research we conducted on the executive compensation programs of public reporting technology companies throughout the United States, the most common performance goal categories were as follows:

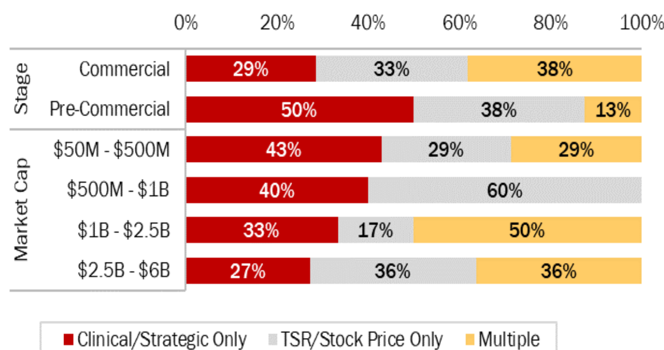
Technology Companies – Prevalence of Performance-Based Equity Award Performance Goals



Frequently, a technology company may combine the selected performance goals with other internal company metrics that are critical to the company's long-term success and overall strategy. In recent years, we have seen an increase in the inclusion of environmental, social, and governance ("ESG") metrics as part of the array of goals included in technology company performance-based awards.

Life Sciences Companies. In the case of life sciences companies, the goals are typically based on the achievement of product development and regulatory approval milestones as the company strives to bring a product or service to market. Once that product or service has been commercialized, then the company may begin to add financial goals to future award cycles. Based on recent research we conducted on the executive compensation programs of public reporting life sciences companies throughout the United States, the most common performance goal categories were as follows:

Life Sciences Companies – Prevalence of Performance-Based Equity Award Performance Goals



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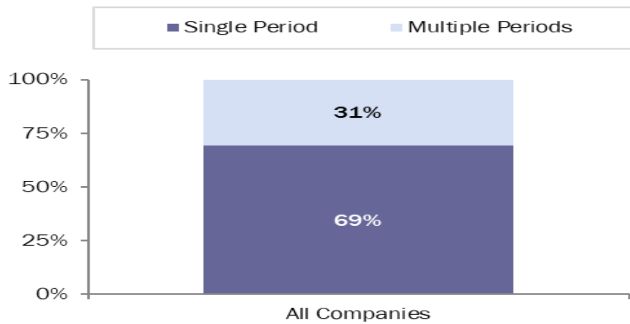
Adding Performance Stock Unit Awards to Your Long-Term Incentive Compensation Program (Continued)

Determining Performance Period

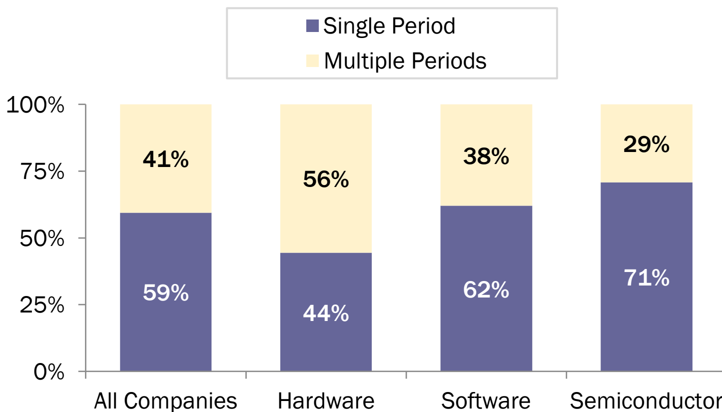
Typically, the performance period for PSUs is between one and three years depending on a company's vision and compensation strategy. Since most performance awards are granted as "long-term" incentive compensation, the standard "default" performance period is three years. However, where a company is unable to reliably project its performance over a multi-year period (which can happen in a volatile economy or if the company is experiencing a rapid growth phase in the case of technology companies) or is engaged in a development and/or approval process which will necessarily unfold over a lengthy time period (which is generally the case with a development-stage life sciences company), it is not unusual to use a single performance period (generally of one year). Our recent research on technology and life sciences companies reflects the following trends:

Performance Period

Life Sciences Companies

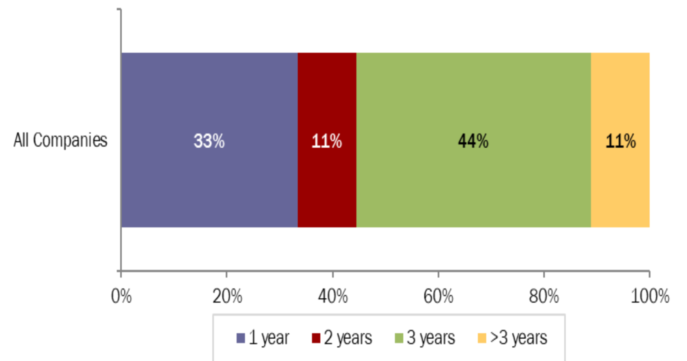


Technology Companies

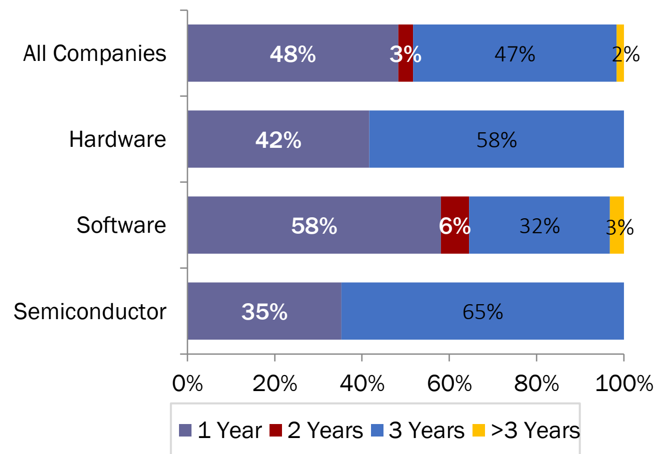


Length of Single Performance Period

Life Sciences Companies



Technology Companies



Where a company uses a one-year performance period, there are two common alternative designs:

- a one-year performance period with any earned shares subject to an additional time-based vesting requirement of anywhere from two to four years to increase the focus on long-term value sustainability and retention; or
- multiple (typically three consecutive) one-year performance periods with the performance objectives for each period to be established at the beginning of each year and any earned shares "banked"; to be distributed to executives at the end of the entire three-year performance period.

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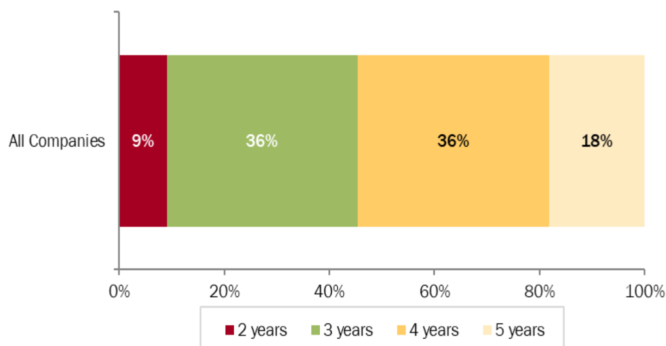
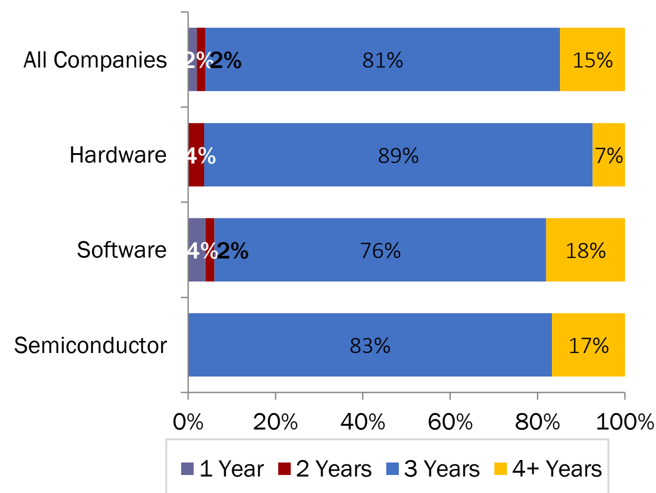
Where a company selects a one-year performance period, our recent research on technology and life sciences companies shows the following additional time-based vesting periods are most commonly used:

Total Vesting Period

Life Sciences Companies



Technology Companies



Occasionally, companies may use a combination of the two foregoing design approaches (for example, a one-year financial metric and a three-year relative TSR metric). Accordingly, determining the appropriate performance period is one of the first design issues that should be addressed in developing a performance award program.

Some companies design their performance-based awards to have "overlapping" performance periods which (typically) measure the performance goals on a sequentially aggregated basis over three years. In other words, the first performance period measures the results of the selected metrics for the first year of the performance period, the second performance period measures the performance goals over the first two years of the performance period, and the final performance period measures the results of the selected metrics over the full three-year performance period. While often seen in technology company performance awards, this design is uncommon in life sciences companies given the chronological sequence of the product or service milestones.

In the case of a technology or life sciences company that is a public reporting company, the design of the performance period will also have implications for the nature and detail of the required disclosure about the performance levels established for its performance awards. The performance levels for an award with a single year performance period are more likely to need to be disclosed for the year the award is granted than where an "in-flight" award has a multi-year performance period (where such disclosure would only need to be made after the completion of the performance period). This disclosure timing requirement is often a significant consideration in the design of the performance period for performance-based awards.

Treatment Upon Termination of Employment

If an executive terminates his or her employment before the end of the performance period, typically the performance award is forfeited. Where an executive terminates employment after the end of the performance period but prior to certification and settlement, he or she may be entitled to receive the earned shares (if any) depending on the terms of the underlying equity compensation plan. Where an executive retires, dies, or becomes disabled before the end of the performance period, special rules as set forth in the underlying equity compensation plan may address how the award is to be treated.

Tax Considerations for PSUs

Under normal federal income tax rules, an executive receiving a PSU is not taxed at the time of the grant. Instead, the executive is subject to taxation at the end of the performance period (and any related vesting period) unless the award allows the executive to defer receipt of the earned shares. At the end of the performance period (and any related vesting period), the units underlying the PSU award which have been earned will be converted to shares of the company's common stock as of the date of settlement) (which is considered the vesting date) with the fair market value of the shares treated as ordinary income and subject to both income and employment taxes based on the executive's individual tax situation.

Upon a later sale of the shares, assuming the executive holds the shares as a capital asset, the executive will recognize capital gain income or loss; whether such capital gain would be short-term or long-term depends on the time between the beginning of the holding period at vesting and the date of the subsequent sale.

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Disclosure Considerations for PSUs

Where a technology or life sciences company is a public reporting company subject to the Securities Exchange Act of 1934 (and is neither an emerging growth company or a smaller reporting company), it is required to discuss and analyze in the Compensation Discussion and Analysis contained in its definitive proxy statement (which is incorporated by reference into its Annual Report on Form 10-K) the performance metrics (including target levels) that it has selected and used to implement its short-term and long-term performance-based awards (including performance-based awards such as PSUs).

Under the SEC's rules, companies are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm for the company. In other words, in the case of a PSU subject to a multi-year performance period where achievement of the performance goals will not be known until the end of the performance period, while the company should disclose its performance metrics, it is not required to disclose the target performance levels for those awards while the performance period is ongoing. Instead, the company must discuss how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target levels or other factors.

Compensation Recovery ("Clawback") of Awarded Shares

Later this year, technology and life sciences companies will be required to have adopted a compensation recovery ("clawback") policy covering their incentive-based compensation that is subject to financial reporting measures (including performance-based awards such as PSUs) such that, upon a financial restatement, any erroneously-awarded shares must be returned to the company. See our Thoughtful Pay Alert, *SEC Adopts Compensation Recovery ("Clawback") Policy and Disclosure Rules (Nov. 8, 2022)* and our Thoughtful Pay Alert, *Effective Date for New Compensation Recovery ("Clawback") Policy Listing Standards to be Extended Until October (June 8, 2023)*.

Need Assistance?

Compensia has extensive experience in helping companies analyze the requirements of the SEC's "pay-versus-performance" disclosure rule, as well as drafting the required disclosure. If you would like assistance in considering the introduction of performance-based awards into your executive compensation program, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact the authors of this Alert, Mark A. Borges at 415.462.2995 or mborges@compensia.com, Rachel Cohen at 669.263.9808 or rcohen@compensia.com, or Hannah Orowitz at (332) 867.0566 or horowitz@compensia.com.

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