Pearl Meyer

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Treatment of Unvested Stock Awards Upon Retirement

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It is common practice among US publicly traded companies to provide management with stock-based incentives as a component of compensation. Depending on company size, maturity, and industry, those stock-based incentives may take the form of stock options, time-vested restricted stock, and/or performance-contingent stock awards. In addition to providing for competitive total compensation opportunities, stock-based incentives also accomplish other important objectives including aligning executive interests with those of shareholders, motivating and rewarding the achievement of multi-year performance objectives, and fostering a long-term business perspective.

One other key objective effectively achieved through stock-based incentives is retention of top talent. Since these awards carry multi-year vesting requirements, executives must remain with the organization through the vesting period—typically three to four years in duration—in order to fully benefit from the value delivered through these awards. Successful succession planning and leadership development efforts are predicated on the retention of management talent.

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Treatment of Unvested Equity upon Retirement

Having retained an executive through a full career, what happens to unvested stock-based incentives when an employee retires? Assuming a vesting-based award is granted each year, there will come some point in time when the executive will make an exit decision with “money on the table.” Although practice varies based on company size and industry, when that exit decision is a qualifying retirement, many companies may provide for favorable treatment of stock-based incentives, including accelerated or continued vesting of all or a portion of unvested awards. According to a National Association of Stock Plan Professionals survey, more than 60% of surveyed companies provided for some form of favorable vesting of stock-based incentives upon a qualifying retirement.

Favorable treatment can take the form of acceleration of vesting of stock awards at retirement or, more commonly, continuation of vesting of stock awards following retirement. Among those companies that do provide favorable treatment, a common practice is to allow for full vesting of unvested stock options and restricted stock, whereas the vesting of performance-contingent stock awards is pro-rated based on time in the role prior to retirement.

Key Considerations in Implementing Retirement Vesting

Most companies that implement favorable vesting treatment of unvested stock-based awards upon a qualifying retirement do so only for future awards. Any retirement provision should be built into the award agreement. Modifying previously granted and still unvested and outstanding awards would likely trigger negative accounting consequences.

There are other important considerations when putting retirement vesting provisions in place. The following are key implementation steps.

1. *Assemble an implementation team.* Having a cross-functional team including human resources, legal, finance, and accounting, along with appropriate outside advisors and counsel is important given the myriad factors that need to be addressed. At a minimum this will involve legal documentation, individual and company tax implications, accounting expense and treatment, disclosure ramifications for "Named Executive Officers" and the modeling of compensation and award program design parameters. Arrangements should be made so that awards are tracked by a system or team following the employee's departure.
2. *Understand market practices.* Recognizing that compensation committee approval of favorable vesting treatment will be required, identifying the typical practices at comparable companies can assist with obtaining committee support.
3. *Determine eligible population*. It is common to extend favorable vesting to all employee stock award recipients, although some companies may limit this consideration to senior management, depending on stock incentive program structure and affordability constraints.
4. *Define retirement.* A key consideration is what constitutes a qualifying retirement. As noted above, a first step is to identify how comparable companies define retirement and whether you have any retirement definitions for other benefits programs. Often, retirement will be defined as a combination of age and service levels. A common approach is to establish a "rule of" definition. For example, a "rule of 70" would allow for favorable vesting where the sum of an employee's age and service is at least 70. So, that could be age 65 with 5 years of service or age 60 with 10 years of service. Normally, there is a minimum retirement age of at least age 55. Modeling should be done to understand what portion of the current population would be deemed retirement-eligible upon program implementation, as there are tax and accounting consequences.
5. *Establish vesting treatment.* For companies that use more than one type of stock award (e.g., stock options and performance share awards), a determination will need to be made as to whether favorable vesting will be applied to one type or multiple types of stock awards. Additionally, a determination will need to made as to whether vesting is continued or accelerated, and whether full or partial vesting occurs. Again, market practices of comparable companies can provide helpful information.
6. *Consider a notice period.* A notice period is a qualifying requirement in which participants must provide written notice to the company as to their intent to retire. Notice periods typically range from six months to one year and can be differentiated for senior management versus the broader employee base. Requiring written notice of intent accomplishes multiple objectives. Most important, knowing the timing of an upcoming retirement can facilitate succession planning, allowing for the identification, development, and mentoring of a successor to the retiring employee. A notice period can also mitigate the potential for an individual to receive a stock award and then abruptly retire with all or a portion of that award, without providing any service to the organization. Thus, an organization may decide to not provide any additional stock

awards once the executive has provided notice as to their intent to retire. Alternatively, the organization can implement a policy that stipulates that the favorable vesting only applies to stock awards made at least six months or one year prior to the date of retirement.

Ongoing monitoring of the retirement vesting program is critical to ensure the benefits to the organization are commensurate with the associated costs. To the extent not already in place, non-compete and non-solicit provisions can also be built into the award agreements to further communicate the true intention of this program as a retirement benefit.

In summary, favorable stock award vesting provisions for qualifying retirements, when properly designed and implemented, can help organizations achieve multiple objectives. Among such benefits are facilitating the attraction of top talent through a competitive stock award vesting provision, enabling the retention of key leaders, and allowing for timely succession planning and the development of the next generation of management. Additionally, by having a defined approach to stock award vesting treatment for long-service employees, companies can mitigate the need for customized vesting or special awards which could be inconsistently applied and create unnecessary exposure to external scrutiny among shareholders and proxy advisory firms.

About the Author

Steve Van Putten is a senior managing director with Pearl Meyer and leads the firm's efforts with respect to thought leadership and intellectual capital development. Steve's primary focus and expertise is on advising compensation committees and senior management on executive and director compensation matters. He has over 30 years of board-level experience consulting to Fortune 500 companies on executive pay.

About Pearl Meyer

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