Baker McKenzie.

Management Equity

White Paper Conference- 2021

Jeremy Edwards, Partner, Baker & McKenzie LLP
Jeremy.edwards@bakermckenzie.com

1

Introduction and Background

UK Update

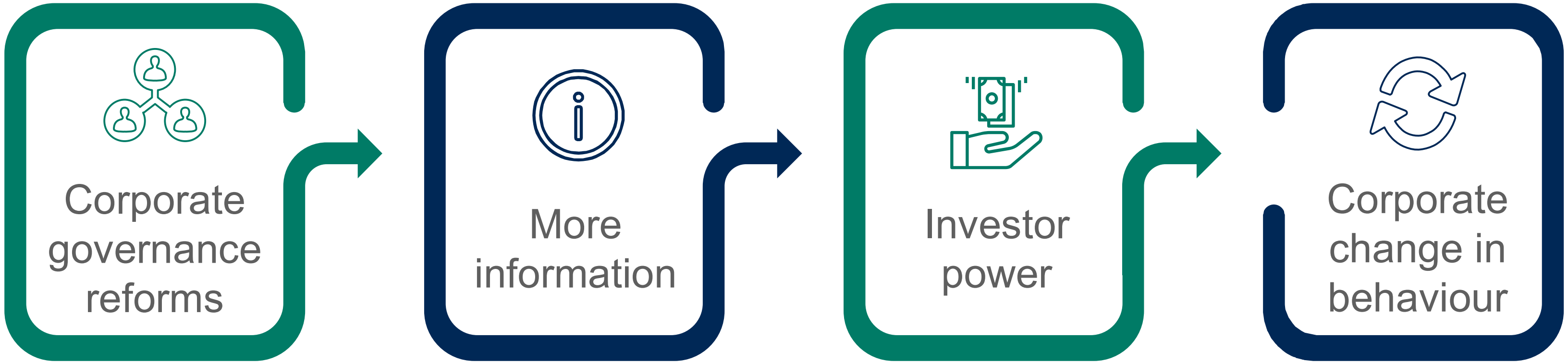
Latest thinking on Management Equity

War for Talent
Need for leadership
Towards the new economy

Corporate Governance Trends (Public)
COVID- 19

UK Experience

Power to the Shareholders



Future EU Laws: The Role of Remuneration in the Sustainability Agenda

What is it?

- Study on directors' duties and sustainable corporate governance;
- Published by European Commission in July 2020;
- Examines the factors that drive public companies to focus on "short-termism";
- Board remuneration structures that "incentivise the focus on short-term shareholder value, rather than long-term value creation for the company" are seen as important drivers.
- Share-based executive remuneration but without integration of ESG KPI's, are said to keep focus on short-term financial return.

Future EU Laws: The Role of Remuneration in the Sustainability Agenda

Why is this important?

According to the EC, this results in:

- Companies sacrificing investments in areas such as R&D, CAPEX and employee development, since directors are not incentivised to take business decisions that contribute to sustainability.
- This has a knock-on effect on sustainability, as it slows down the company's transition to sustainable value creation (think Paris Agreement).
- Ultimately, the longer-term sustainability risks are ignored, as well as the future impact on the business, shareholders, investors and wider society.

Future EU Laws: The Role of Remuneration in the Sustainability Agenda

What will the EU do?

The study proposes three EU-level solutions that could help rebalance the "shareholder primacy" status quo.

Non-legislative "soft" options:

Option A: A Commission-led and funded campaign, aimed at companies to encourage them to link board remuneration to long-term, sustainable value creation.

- The EU's conclusion is that this option may create an element of social pressure, but that its meaningful impact will be limited.

Option B: A Commission recommendation for Member States to introduce in their respective national frameworks:

- A provision to restrict executives' ability to sell shares they receive as pay; and
- A provision to make compulsory the inclusion of non-financial ESG metrics, linked to a company's sustainability targets, in executive pay schemes.

Given its status as a recommendation only, there is a question as to whether all Member States would decide to take action under option B. Also, the relative flexibility of this option risks a patchwork approach occurring across the EU.

Future EU Laws: The Role of Remuneration in the Sustainability Agenda

What will the EU do?

Legislative "hard" option:

Option C: Commission proposal to amend the Shareholder Rights Directive to align executive remuneration policy with long-term and sustainability goals, in particular by:

- Regulating executives' ability to sell the shares they receive as pay; and
- Making compulsory the inclusion of non-financial, ESG metrics, linked to a company's sustainability targets, in the executive pay scheme.

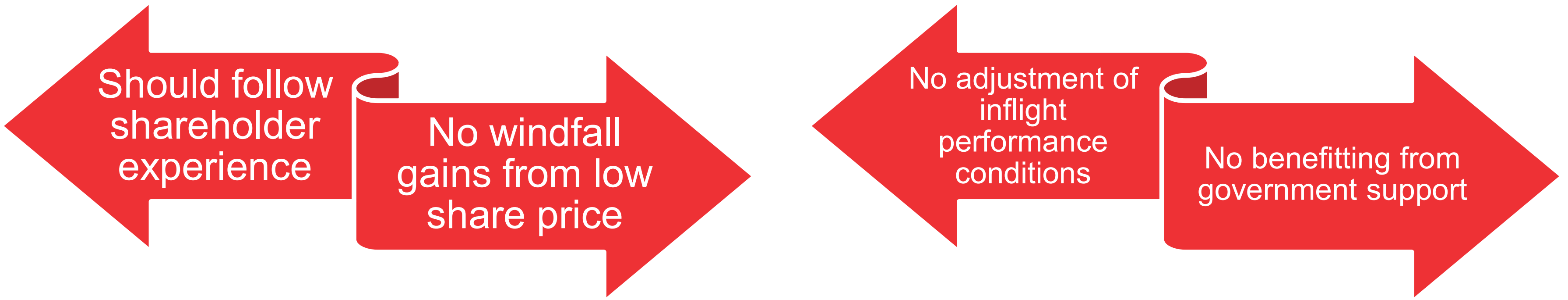
The business environment in which European companies operate has become increasingly more sustainability-focused. Recognising the crucial role companies play in helping to combat climate change, the EC appears very much in favour of going down the "hard" option route.

2

Executive Remuneration in the Light of COVID-19

Executive Remuneration in the light of COVID- 19

Institutional shareholder reaction



Executive Remuneration in the Light of COVID-19

Investment Association Guidance- 27 April 2020

- Where dividend payments have been suspended or cancelled, Boards and Remuneration Committees should consider how this should be reflected in their approach to executive pay
- Remuneration Committees are not expected to adjust performance conditions for annual bonuses or in-flight long-term incentive awards to account for the impact of COVID-19- but consider use of discretions
- Shareholders will expect Remuneration Committees to use their discretion to reduce vesting outcomes where windfall gains have been received

Executive Remuneration in the Light of COVID-19

Investment Association Guidance- 27 April 2020

- Where companies make LTIP grants, consideration should be given to the individual circumstances of the company and the impact of COVID-19 on the company when setting grant sizes and performance conditions
- Where companies seek additional capital from shareholders or take money from the government (e.g., by furloughing employees), shareholders expect this to be reflected in executives' remuneration outcomes
- Approach to new Remuneration Policies

Executive Remuneration in the Light of COVID-19

Investment Association Updated Nov 2020 Principles

- The IA expects the pandemic to intensify shareholder scrutiny of executive compensation.
- The IA cautions that "Remuneration Committees should be careful not to isolate executives" from the impact of the pandemic and advises companies against compensating their executives for any reduction in pay as a result of COVID-19.
- Instead, RemCos are urged to strike the right balance between incentivising management and reflecting the reality of shareholders, employees and the society at large in the wake of COVID-19.

Executive Remuneration in the Light of COVID-19

ISS Policy Guidance: Impact of the COVID-19 Pandemic – April 8 2020

- Boards urged to provide contemporaneous disclosure for rationales for making any changes to performance metrics, goals, targets (etc.) in 2020
- ISS not general supportive of changes to LTIPs. Any change will be assessed under existing benchmarking policy frameworks
- Generally supportive of decisions to reduce dividend payments/share buy-backs

Executive Remuneration in the Light of COVID-19

"Everything in Governance is Affected by [COVID]. This is Glass Lewis' Approach" - March 2020

- GL will not be susceptible to "crocodile tears for maintaining or even increasing executive compensation levels"
- "heavy burden of proof for boards and executives to justify their compensation levels in a drastically different market for talent"
- GL expects a marked increase in shareholder concerns and the quality of disclosures concerning exercise of board discretion
- "Companies with strong pay structures will be challenged to abide by them, and firms with less robust programs will be forced to choose between lying in the bed they've made or changing arrangements and all but guaranteeing shareholder ire"

Executive Remuneration in the Light of COVID- 19

- "Glass Lewis' Approach" – November 2021 Updated Guidelines

- The guidelines have been updated to clarify that remuneration committees retain a level of discretion to ensure that remuneration outcomes for executive directors align with company performance, in addition to shareholder and employee experience.
- The guidelines highlight that remuneration committees should consider exercising downward discretion where:
  - A company has suffered an exceptional negative event that has had a material negative impact on shareholder value; or
  - A company's decisions regarding working conditions have had a material negative impact on employees.
- In cases of substantial misalignment between executive pay outcomes and the experience of shareholders or employees in the past fiscal year, Glass Lewis may recommend that shareholders vote against a company's remuneration report solely on this basis.

3

Management Equity (Private)

Key Considerations for Equity Plans

Ascertain the key details of the equity plan(s) including the relevant company (or companies), the number of shares the awards are over and whether any awards are tax-advantaged. This diligence exercise can take some time so make sure to build it into the timetable.

Establish how the awards will be treated in the context of the proposed transaction and whether the Target Company will need to exercise any discretion (e.g., to accelerate vesting). Ensure the buyer acquires 100% of the share capital on completion (or an agreed lesser percentage).

If you are acquiring the Target Company consider how the treatment of the equity awards will impact the retention and morale of employees. If the awards will lapse, consider establishing a retention plan to remunerate the employees in a similar way.

Evaluate the tax consequences for both the company and employees. If using an earn-out, for example, ensure this is treated as capital rather than income.

Follow the exercise procedure under the plan rules (build into the timetable) and ensure to include appropriate contractual protection in relation to any tax/liability that may arise in relation to the awards.

Post-Transaction Equity Plans

Management/impacted employees should always be separately advised by an independent law firm and the plan documents and all investment presentations should include customary disclaimers highlighting the risks of equity investments (if relevant) and waivers etc.

Establish which employees will be covered. Often such plans are only offered to roughly 20-30 individuals (top tier management).

Consider employee communication. Often this will be sent to employees prior to completion, so ensure that the Purchaser is given opportunity to comment on this.

Consider structure:

- Hurdle/growth shares*
- Options/RSUs/warrants*
- Phantom/cash*
- Vesting period – balance between incentivising and not too long term
- Cessation of employment conditions etc.
- Timing of payment. Delaying income tax charge typically delays ability to get capital treatment.

Who will pay for plan? If the Seller is funding all/some of the plan, make sure that this is reflected properly in the SPA/closing accounts

Post-Transaction Equity Plans

Type	Advantages	Disadvantages
Hurdle/ growth shares	■ CGT may be available for participants ■ In general, no social security for company (assuming pay market value) ■ Cheaper than conventional "sweet equity" plans ■ Employee ownership ■ Possibility for longer non-competes from participants	■ Tax treatment is more complex ■ Structure harder for participants to understand ■ Additional complexity in transaction documents ■ Hurdle feature may drive down valuation ■ Impact on participant behaviour? ■ Greater administration burden
Options/ warrants/ RSUs	■ No shares issued up front so leaver provisions easier to implement/operate ■ No tax charge until vesting/exercise	■ Income tax due on vesting/exercise on amount by which market value exceeds exercise price. If exercise price/vesting on exit – no tax advantage over cash scheme ■ Social security contributions generally payable ■ Consider how this fits into existing capital structure ■ Administrative burden upon vesting/exercise
Phantom/ cash plans	■ Easy to document and administer (including with respect to tax withholding obligations) ■ Greater flexibility ■ Easy to understand ■ No shares issued so leaver provisions easier to implement/operate	■ Income tax/social security due on amount received. ■ Greater employment right risk for many companies as administered through local payroll. Consider translation requirements.

Questions

Baker
McKenzie.

bakermckenzie.com