EXECUTIVE COMPENSATION – THE ESSENTIALS

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A. INTRODUCTION

Executive compensation traditionally involves a balance of various elements of cash and deferred compensation.

Employers must consider compensation philosophy and structure alignment both during employment, in terms of its role in motivating key behaviors and outcomes, as well as after the employment relationship ends, in terms of post-termination conduct.

The former consideration is the historic consideration in compensation. However, as traditional mechanisms like non-compete clauses lose their footing in the legal arena, companies may consider pivoting to strategies that incentivize loyalty and adherence without crossing the lines of enforceability. This involves not only rethinking compensation structures but also adopting a more nuanced approach to contractual drafting and post-employment enforcement.

In this paper we will review the general components of executive compensation which exist outside of base salaries, cash bonuses and benefits and then turn to drafting considerations in those areas.

B. FORMS OF EQUITY

Often referred to as “long-term incentive compensation”, Stock Options, Restricted Share Units, Performance Share Units and Phantom Shares are various forms of “equity”, often used to incentivize employees to stay with the company and align their interests with those of the shareholders, as the value of their compensation is tied to the company's performance.

They are typically granted by way of written Grant Agreement, the overall terms of which are often subject to another larger agreement governing equity, often referred to as a long-term incentive plan or omnibus plan. These agreements may be updated as often as annually and may contain riders for the different jurisdictions in which the company operates in order to adhere to local laws and tax requirements.

Keep in mind, you can call something anything and while these are the traditional meanings of these plans in Canada, the terminology used may vary.

1. **Stock Options**

Stock options are a form of compensation that gives an employee the right, but not the obligation, to buy a specified number of company shares at a fixed price (the "strike" or "exercise" price) within a specific timeframe, often after a vesting period.

Stock options are contracts that grant an employee the right to purchase company stock at a predetermined price. They can be granted at any time during the employment relationship. They are generally granted at the share price in place at the time of the grant. The options become of value if and when the share price increases. Stock options typically have a vesting schedule, meaning they are earned gradually over time, and become exercisable after they vest.

Upon vesting, the employee can “exercise” their right to purchase the share by paying the grant price for those shares. There is typically a window (most often 10 years from the date of grant) in which to exercise the right to purchase the shares.

If the share price does not go up or even goes down, the stock options are said to be “underwater” meaning they are of no value.

Companies use stock options as a form of compensation to incentivize employees, and to align their interests with those of the company. Typically, upon leaving a company vested options must be exercised (sometimes even prior to departure in the case of resignation) within a short window though occasionally the expiry date will remain in place. Unvested options may be lost.

Taxation of stock options is a complex question which depends, *inter alia,* on the type of corporation issuing the options, the timing of the grant, and the price of the grant relative to fair market value at the date of the grant.

There may or may not be provision in Stock Option Grant Agreements for cashless exercise. Often shares when exercised result in actual share ownership and, if the company is private, continued share ownership subject to the terms of the Shareholders Agreement. Whereas shares in public companies can be sold on the applicable exchange, there may be no market for private company shares and onerous restrictions on transfer.

By their nature, the grant of a stock option is to incentivize enhancement of the share value. As should be clear based on the foregoing, there is no guaranteed value to these grants.

2. **Restricted Share Units**

Restricted Share Units (RSUs) are a form of equity compensation where employees receive a promise of company stock (or cash equivalent) that vests over time, meaning they become fully owned after meeting certain conditions. Vesting may be only timed based (most common) or may have other performance criteria attached to vesting. Often these will cliff vest after a period of time (most often 3 years).

RSUs are not taxed when they are granted, but rather when they vest, and the employee receives the underlying shares or cash. The fair market value of the shares (or cash equivalent) at the time of vesting is considered income and is subject to tax.

Unlike stock options, RSUs do not require employees to pay for the shares they receive, and the value of the RSUs is tied to the performance of the company's stock, not a set price. Accordingly, no matter what happens with the company stock price, RSUs will always have some value to the employee.

By virtue of their structure (in cliff vesting) these are primarily a retention tool.

3. **Performance Share Units**

Performance Share Units (PSUs) are a type of equity compensation that companies grant to employees, promising shares of stock based on the achievement of specific performance goals (such as revenue, earnings per share, stock performance, increased sales) over a set period. Vesting will only occur if the specific performance goals for the terms of grant are met. If they are met, the shares are granted.

While primarily performance based, it is common to encounter hybrid PSUs with time-based vesting also.

The terms of grant specify the performance goals and may provide for a sliding scale of shares awarded based on performance, meaning employees may receive more or fewer shares than initially targeted.

PSUs are taxed as ordinary employment income when they vest.

Performance shares can be designed in any way the company wishes with the performance goals completely “bespoke”. These should be used to focus employees on the achievement of those performance related goals.

4. **Phantom Shares**

Phantom shares are a form of deferred compensation that grant employee benefits similar to stock ownership without actually issuing real company stock, but instead providing a cash payout tied to the company's stock value. Phantom shares are granted tied to stock price at the date of grant, and pay out in cash on vesting the differential between the share price at the date of grant and the date of vest. The payment is in cash like a bonus. Any gains from phantom shares are ordinary income upon vesting from a tax perspective.

C. NON-EQUITY DEFERRED CASH COMPENSATION

Less commonly, but where there is no share capital, there may be a simple grant of cash attached to the achievement of an event, the passage of time or a performance milestone. Signing bonuses or simple retention bonuses are also often arranged in this fashion. These are also creatures of contract, the terms of which are to be examined carefully and will be taxed as employment income on payment.

D. CARRIED INTEREST PLANS

The Carried Interest Plan is a less frequently used tool in executive compensation, but it is found in the private equity/venture capital/hedge fund space and in real estate development.

A carried interest plan is a performance fee arrangement where the employees, most often investment managers or real estate development executives, receive a share of the profits from a fund's investments, after investors have received their initial investment back plus a stated amount of return.

Carried interest plans are designed to align the interests of the executive with the investors by incentivizing them to maximize fund performance/return on investment. Payout timelines are typically lengthy and usually without any stated timeline as disposition of the investment is often the crystalizing event.

Often there are “funds” set up for a set period of time or investment amount, or for a specific project. Each fund will have a different set of contracts associated with it and will include terms and conditions for entitlement to payment by the executive.

E. DEFERRED COMPENSATION PLANS

Generally speaking, compensation deferral arrangements are not permitted. In Canada, the "3-year rule" for income deferral generally allows for the deferral of bonus or similar payments, but not ordinary salary, for a maximum of three years after the year the services were rendered, as long as the payment is made before the end of the third calendar year. If money is “earned” it must be paid. The above-noted long-term incentives work because the entitlement to be paid is not earned until a future point in time. But, there are a limited number of ways to defer income which has been earned.

The exception to the normal rule to this are a Registered Deferred Profit-Sharing Plan (“DPSP”) and a Deferred Share Unit Plan (“DSU”).

A DPSP is an employer-sponsored profit-sharing plan that is registered with the Canada Revenue Agency (CRA). The purpose of a DPSP is to permit an employer to share business profits with its employees. The plan can be set up for all employees or a certain group of employees and is typically subject to a period of vesting. However, specified shareholders and individuals related to the employer cannot participate in a DPSP. The CRA will not register a profit-sharing plan as a DPSP unless it meets certain conditions for registration under the *Income Tax Act*. Only employers can contribute to a DPSP, and annual contributions are subject to specific limits set out in the Act. The contributions must be made to a trustee for the benefit of employees; contributions do impact allowable RRSP contribution room. Employers can claim a tax deduction for contributions made to a DPSP.

Employees do not pay tax on the contributions that are made to a DPSP for their benefit. The contributions and investment earnings accumulate tax-free while they are in a DPSP but are included in income for tax purposes when withdrawn. DPSP contributions made on behalf of an employee in a particular year reduce the employee's registered retirement savings plan contribution room for the following year. Funds in a DPSP cannot be withdrawn during employment. After employment ends vested funds can be transferred to other registered plans or taken as a lump sum subject to tax and withholdings.

A DSU must also meet with CRA requirements and is also inaccessible to the executive during employment. A DSU is the right to receive payment based on the fair market value of the shares of the company (either in cash or shares) at a later date. Participation in DSUs allows executives to postpone receiving a portion of their bonus compensation, until a later date, typically their departure from the company, by retirement or otherwise, potentially reducing their current tax burden or allowing for retirement savings. The deferred compensation is held in an investment vehicle until that time.

Both DPSPs and DSUs operate as incentives to executives to not voluntarily leave prior to retirement as to do so will typically trigger the payment of the deferred compensation prematurely.

F. OTHER EXECUTIVE COMPENSATION VEHICLES

In addition to the foregoing, other common elements in an executive compensation package may include car allowances, perquisite allowances and supplementary executive pension plans.

Car allowances and perquisite allowances are simply other forms of cash income and generally taxable.

Supplementary executive pensions may or may not be registered and are often not secured by a trust fund. This means that they are often funded by company operating funds and are a vulnerable element of deferred compensation. Formulas for entitlements may or may not mirror the standard pension plan and each plan must be examined in order to understand how it works as there is no one form.

G. POST TERMINATION COMPENSATION AND RESTRICTIVE COVENANTS

The big “minefield”. You may find restrictive covenants in any of the above-noted executive compensation plan agreements. Equity grants typically are accompanied by a Grant Agreement. Often there will be some other form of master incentive plan agreement too. If there are stock options which result in share ownership in a privately held company, there is a Shareholders Agreement. Deferred cash compensation is also subject to written terms. Carried Interest Plans will have plan terms /fund terms and/or partnership agreements. The terms of these grants matter in many ways, but do not loose sight of the restrictive covenants they may contain and impact on an executive’s re-employment.

Non-competition clauses, once a staple in employment agreements, have become increasingly fraught with legal and practical challenges, especially in jurisdictions like Ontario, where their enforceability is significantly constrained. As a result, businesses are now turning to more innovative strategies to ensure post-employment compliance and retain their top talent.

There has been a movement in the business community to use non-competes, not as a bar to competing per se, but as a financial deterrent where competition equates to forfeiture of a further payment. This emerging trend is “the new golden handcuff of long-term incentive compensation.”

While previously, the majority of companies seemed find ways to draft governing documents to ensure employees would not obtain any payment after termination (or at least following the minimum period required by statute), now increasingly we are seeing continued payment as long as the executive “plays by the rules”.

These restructured incentives involve tying continued payment of compensation post-termination—such as stock options or performance-based bonuses—to continued adherence to certain post-employment conditions such as non-competition, non-solicitation or confidentiality agreements. While this approach sidesteps outright bans on competition, the legal landscape remains murky. There are no cases that have considered whether or not this violates the amendments to the Ontario *Employment Standards Act*, 2000 .

H. POST-TERMINATION ENTITLEMENT TO PAYMENT

It is therefore necessary to consider the plan documents for each element of compensation to determine the entitlement of the executive following termination.

The Supreme Court of Canada in *Matthews v. Ocean Nutrition Canada Ltd.* 2020 SCC 26 provides a summary of the law in this area as follows:

> “[49] Insofar as Mr. Matthews was constructively dismissed without notice, he was entitled to damages representing the salary, including bonuses, he would have earned during the 15-month period (*Wallace*, at paras. 65-67). This is so because the remedy for a breach of the implied term to provide reasonable notice is an

award of damages based on the period of notice which should have been given, with the damages representing “what the employee would have earned in this period” (para. 115). <u>Whether payments under incentive bonuses, such as the LTIP in this case, are to be included in these damages is a common and recurring issue in the law of wrongful dismissal</u>. To answer this question, the trial judge relied on *Paquette* and *Lin* from the Court of Appeal for Ontario. I believe he took the right approach.

[50] In *Paquette*, the employee participated in his employer’s bonus plan, which stipulated that employees had to be “actively employed” on the date of the bonus payout. That language is broadly comparable to that found in the LTIP which, at clause 2.03, requires the claimant to be a “full-time employee” of the company. In *Paquette*, but for the employee’s termination, the employee would have received the bonus within the reasonable notice period. The motion judge in that case, however, concluded that the employee was not entitled to the bonus because, while he may have been “notionally” employed during the reasonable notice period, he was not “actively” employed and so did not qualify under the terms of the plan.

[51] The employee’s appeal was allowed. The Ontario Court of Appeal relied principally on its prior decision in *Taggart v. Canada Life Assurance Co.* (2006), 50 C.C.P.B. 163, concerning a similar question related to pension benefits. In that case, Sharpe J.A. rightly cautioned that courts should not ignore the legal nature of employees’ claims. “The claim is not”, he said, “for the pension benefits themselves. Rather, it is for common law contract damages as compensation for the pension benefits [the employee] would have earned had [the employer] not breached the contract of employment” (para. 16). Consequently, “a terminated employee is entitled to claim damages for the loss of pension benefits that would have accrued had the employee worked until the end of the notice period” (para. 13). With respect to the role of a bonus plan’s contractual terms, Sharpe J.A. explained that “[t]he question at this stage is whether there is something in the language of the pension contract between the parties that takes away or limits that common law right” (para. 20).

[52] The Court of Appeal in *Paquette* built upon the approach in *Taggart*, proposing <u>that courts should take a two-step approach to these questions. First, courts should “consider the [employee’s] common law rights” (para. 30). That is, courts should examine whether, but for the termination, the employee would have been entitled to the bonus during the reasonable notice period. Second, courts should “determine whether there is something in the bonus plan that would specifically remove the [employee’s] common law entitlement” (para. 31). “The question”, van Rensburg J.A. explained, “is not whether the contract or plan is ambiguous, but whether the wording of the plan unambiguously alters or removes the [employee’s] common law rights” (para. 31).</u>

[53] I agree with van Rensburg J.A. that this is the appropriate approach. It accords with basic principles of damages for constructive dismissal, anchoring the analysis around reasonable notice. As the court recognized

in *Taggart*, and reiterated in *Paquette*, <u>when employees sue for damages for constructive dismissal, they are claiming for damages as compensation for the income, benefits, and bonuses they would have received had the employer not breached the implied term to provide reasonable notice </u>(see also *Iacobucci v. WIC Radio Ltd.*, 1999 BCCA 753, 72 B.C.L.R. (3d) 234, at paras. 19 and 24; *Gillies v. Goldman Sachs Canada Inc.*, 2001 BCCA 683, 95 B.C.L.R. (3d) 260, at paras. 10-12 and 25; *Keays*, at paras. 54-55). Proceeding directly to an examination of contractual terms divorces the question of damages from the underlying breach, which is an error in principle.

[54] Moreover, the approach in *Paquette* respects the well-established understanding that the contract effectively "remains alive" for the purposes of assessing the employee's damages, in order to determine what compensation the employee would have been entitled to but for the dismissal (see, e.g., *Nygard Int. Ltd. v. Robinson* (1990), 46 B.C.L.R. (2d) 103 (C.A.), at pp. 106-7, per Southin J.A., concurring; *Gillies*, at para. 17).

[55] **Courts should accordingly ask two questions when determining whether the appropriate quantum of damages for breach of the implied term to provide reasonable notice includes bonus payments and certain other benefits. Would the employee have been entitled to the bonus or benefit as part of their compensation during the reasonable notice period? If so, do the terms of the employment contract or bonus plan unambiguously take away or limit that common law right?"**

[emphasis added – bold and underlines]

The Court went on to conclude that: "language requiring an employee to be "full-time" or "active", will not suffice to remove an employee's common law right to damages. "It went on to say, "exclusion clauses must clearly cover the exact circumstances which have arisen".

Further, while the issues have not been determined by a court to the writer's knowledge at this juncture, it is reasonable to surmise that the plan must comply with statutory obligations in terms of obligations on termination from service.

Here in Ontario, for provincially regulated employees that would mean the *Employment Standards Act, 2000* section 60 which requires that during the statutory notice period of termination, an employer cannot reduce an employee's wage rate or alter any other term or condition of employment, ensuring the employee receives the same compensation and benefits they would have had employment continued. The definition of "wages" means:

(a) monetary remuneration payable by an employer to an employee under the terms of an employment contract, oral or written, express or implied,

(b) any payment required to be made by an employer to an employee under this Act, and

(c) any allowances for room or board under an employment contract or prescribed allowances,

but does not include,

(d) tips or other gratuities,

(e) any sums paid as gifts or bonuses that are dependent on the discretion of the employer and that are not related to hours, production or efficiency,

(f) expenses and travelling allowances, or

(g) subject to subsections 60 (3) or 62 (2), employer contributions to a benefit plan and payments to which an employee is entitled from a benefit plan.

Once granted, compensation which simply must "vest" is not discretionary and in the opinion of the writer is required to be provided. Plans which exclude these payments are arguably in violation of the legislation opening up the possibility of a claim for the common law notice period also.

Over the last decade, we have seen an increasing number of plans which expressly state that vesting continues for any period required by employment standards legislation and that entitlement being recognized upon termination.

If a company wishes to avoid continued vesting during a common law reasonable notice period, it should adhere to the guidelines set out by the Supreme Court of Canada in *Matthews v. Ocean Nutrition* (above).

I. MANAGING THE GOALS OF EXECUTIVE COMPENSATION

It is very important that whatever incentive an employer is offering, be it a straight bonus plan or long-term incentive plan, that the company consider what it is they are trying to achieve before they design it and what behaviours the company is trying to motivate. Each approach has its own mechanics and implications, especially in balancing the immediate goals of retention against the longer-term objectives of fostering compliance with post-employment obligations. If the goal of the plan is employee retention, payment if they leave is out of alignment with that objective; however, if the goal is restricting future activities, continued vesting and payment may be just the right approach. Possibly, as an option, there are multiple plans with different objectives built into each.

When drafting restrictive covenants however, companies should avoid overly broad or onerous obligations that could invite legal challenges such as in defining the scope of a non-compete and the definition of "business". Get the reach in terms of geographic scope correct as well as paying attention to duration, and whether the person needs to be in a similar role. Courts generally accept narrowly tailored restrictions. Non-solicitation provisions should be connected to those with whom there was "material contact" as opposed to including a handshake at a party.

J. CONCLUSION

Understanding the compensation offered to an executive at the time employment commences or an executive's entitlement to compensation after employment ends requires a deep dive into the documents and an understanding of how to interpret those documents. The law in this area remains in evolution and in particular in the area of cross-border issues in need of development. This is the high-stakes poker of employment law.