UnclaimedProperty
PROFESSIONALS ORGANIZATION

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Date: December 22, 2014
RE: UPPO Submission to Recorder Trost
Item 5 of 5: Restricted Stocks

UPPO's June 20, 2014 submission to the ULC's UUPA drafting committee included the following request and proposed language:

"Non-Transferable Securities
UPPO proposes changes to expressly exempt stock which cannot be sold or transferred, including restricted securities. This is because there is no benefit provided either to the owner or to the state as a result of transferring custody of the securities to the state. To the contrary, requiring escheat of such securities would burden states, which are not equipped to track and maintain information concerning ownership of such stock.

Amend the definition of "Property" to add the following clarifications:

Proposed Language:

"Stock" does not include:
(a) securities which are unpriced and which cannot be delivered to the state via The Depository Trust & Clearing Corporation or a similar custodian;
(b) securities which are unpriced and for which there is no agent to effect transfer; or
(c) restricted stock.

"Restricted stock" refers to stock of a company that is not transferrable until certain conditions have been met; the owner's rights are not yet vested. Restricted stock is not subject to escheat unless and until the conditions for applying the restrictions have been satisfied and such stock is available to be transferred. Documentation of restrictions must be maintained by the issuer.

"The Depository Trust & Clearing Corporation" is a United States based central custodian of securities, providing post-trade, clearing and settlement services to the financial markets."

With the objective of fostering a better understanding regarding restricted securities specifically, UPPO offers the following information provided by UPPO Securities subgroup member and unclaimed property attorney, Jennifer Borden:

Restricted stock or securities refers to stock of a company that is not transferable until certain conditions have been met. Upon satisfaction of those conditions, the stock will become transferable by the person holding the award. Restricted securities are acquired from the issuer in an unregistered, private transaction. Restricted stock typically bears a "restrictive" legend, which clearly provides that the shares cannot be sold in the public marketplace unless they are exempt from the SEC's registration requirements. Rule 144 under the Securities Act of 1933 provides the exemptions allowing shareholders to transfer restricted securities. Rule 144 requires several conditions to be met before it can be invoked.

Restricted stock is often used as a form of employee compensation, in which case it typically vests, or becomes transferrable, only upon the satisfaction of certain conditions, such as continued employment for a period of time, and sometimes the achievement of particular earnings goals or other financial targets. Restricted stock is a popular alternative to stock options[1], particularly for executives, due to favorable accounting rules and

[1]Restricted stock should not be confused with stock options. Stock options give the owner of the option the right, but not obligation, to buy or sell stock at a specified price at a specified time.

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treatment for income tax purposes[2]. Gaining popularity with Fortune 1000 companies beginning in 2004, restricted securities have also become popular among technology companies and venture capital backed firms, as they offer a convenient way to insure key employees have incentive to stay and devote their best efforts to the success of the company awarding the stock for a guaranteed period of time.

Sample vesting conditions:

Typical conditions that are required to be met before restricted stock awards become vested often include the following:

- A vesting period, which is typically a one year period where the employee must continue to work for the company. This period is intended to prevent employees from leaving the company when the key employees' work is most needed. This is usually followed by a more gradual vesting over a four-year schedule representing incremental growth stages.
- Double trigger acceleration provisions, which provide that the restricted stock vests, or the vesting period is accelerated, if the company is acquired by a third party and the employment of the grantee is terminated within a certain time frame. This protects employees from being forced out by new management after a change in control.
- Market standoff provisions provide that holders of restricted stock may not sell for a certain period of time (usually 180 days) after an initial public offering. This is intended to stabilize the stock price of the company after the IPO by preventing a large sale of stock on the market by key employees.

When a company awards restricted stock, the stock cannot be sold or transferred by any party unless and until all of the conditions have been met. Restricted stock is not liquid. The right to receive the stock is not fixed and certain. Accordingly, even though restricted stock is reflected on the books and records of the company issuing it[3], there is no obligation, and no ability, to make a payment relating to, or allow transfer of, restricted stock unless and until the vesting conditions are satisfied.

Background:

Prior to 2006, stock options were a popular form of employee compensation because it was possible to record the cost of compensation as zero, whereas accounting standards for awards of restricted stock recognized compensation cost equal to the fair market value of the restricted stock. However, changes to generally accepted accounting principles (GAAP) which became effective in 2006 led to restricted stock becoming a more popular form of compensation. Accordingly, many public and private companies, including much of the Fortune 1000 switched from offering stock options to restricted stock around this time. In effect, equity compensation programs were changed to reflect the impact of the new option expensing rules that were enacted after executive compensation practices came under increased congressional scrutiny in the United States in the

[2] Under Section 83 of the Internal Revenue Code, the value of property transferred in connection with the performance of services is included in gross income, and is recognized on the date on which the property is no longer subject to a substantial risk of forfeiture, or the date on which the property becomes transferable, whichever is earlier. In the case of restricted stock, the former date is generally known as the "vesting date" and is the date when the employee recognizes income for tax purposes, assuming that the restricted stock is not transferable at an earlier date. Employees pay income tax on the value of the restricted stock in the year in which it vests, and then pay capital gains tax on any subsequent appreciation or depreciation in the value of the restricted stock in the year in which it is sold. See, Adkins, G. Edgar, of Grant Thornton, "Restricted stock: the tax impact on employers and employees". A grantee of restricted stock may make an "83(b) election" to recognize the income from the restricted stock award based on the fair market value at the time of the grant, as opposed to the value at the time of vesting. By contrast, income is accelerated for employees who participate in certain nonqualified deferred compensation plans, including stock option plans. Therefore, restricted stock can produce a desirable result for income tax purposes, particularly when the restricted stock is granted at a low value. However, it is risky in that the tax paid on the stock award is non-refundable, even if the stock does not ultimately vest.

[3] Restricted stock is generally incorporated into the equity valuation of a company by counting the restricted stock awards as shares that are issued and outstanding. Therefore the market capitalization of a company with restricted stock outstanding will be overstated as the restricted stock has a lower value than unrestricted stock due to the vesting conditions attached to it. Additionally, the value must be discounted to account for its illiquidity.

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wake of widely-reported corporate abuse[4]. Accordingly, the amount of restricted shares reflected on the books and records of corporations has grown significantly over the last decade.

Analysis:

Unclaimed property statutes do not apply to contingent liabilities. Rather, they only apply to obligations that are fixed and certain. See, e.g., *Insurance Company of North America v. Kane,* 392 A.2d 325(1978). In this early case, the court held that if an owner does not fulfill the requirements of the contract that purportedly entitles the owner to payment, then there is no obligation for the insurer to pay the insured, and therefore no obligation exists to escheat. In *Mason & Dixon Lines v. Eagerton,* 555 F. Supp. 434 (Ala. 1982), the court held that liabilities had to be unqualifiedly due and owing in order to be escheatable. In recognizing that the contract that gave rise to potential obligation to pay was key, the court held that "[a]ny attempt to abrogate [these] contractual limitations by statute might be met with the constitutional prohibition against impairing the obligation of contracts." These cases follow the seminal case of *State of New Jersey v. The Sperry & Hutchinson Co*., 153 A.2d 691 (1959). In this landmark case, the court held that inchoate rights are merely contingent liabilities for the holder, and are not subject to being escheated.

Following these cases, the state cannot escheat if the owner has not fulfilled the requirements for payment. Accordingly, if a shareholder's rights to stock have not vested, there is no right for the state to escheat. Put simply, if the issuer has not received the benefit of the bargain, for example, if the shareholder left employment before the vesting period concluded, or the executive never reached the earnings goals required for the restricted stock to be vested (put differently, for the restrictions to be lifted), then there is no value for the state to escheat.

The fact that the issuer's books and records reflect outstanding shares does not make the shares escheatable. Rather, the SEC requires the stock to be noted as restricted in order to prevent transfers that would violate the terms of the award. As such, requiring the transfer agent to remove restrictions in order to transfer the shares to the custody of the state would be unlawful. Before removing restrictions, the transfer agent typically must have an opinion letter from the issuer's counsel indicating that the restrictions are appropriate to be lifted in order to allow transfer. Short of this, any lifting of restrictions would likely violate Rule 144 under the Securities Act of 1933. Although Rule 144 provides several exemptions to allow the transfer of restricted shares, enabling escheatment is not one of the permissible exemptions.

As an example of why escheatment of restricted stock would be inappropriate, consider the following hypothetical. Employee accepts an award of restricted stock which will vest after she has been with the company for one year, <u>and</u> company reaches earnings per share ("EPS") of $25. The employee leaves the company after 11 months, when EPS is $10. The restricted stock remains on the issuer's common file. Five years later, pursuant to an audit, the transfer agent is forced to remove the restrictions. The shares are remitted to the state in the employee's name, with no record of the restrictions. The employee can now claim the shares from the state, notwithstanding that the employee did not fulfill the terms of the award, and even though she is clearly not entitled to the value. The former employee has now been unjustly enriched, a result certainly not envisioned by abandoned property statutes.

Assume that the transfer agent was allowed to transfer the shares to the custody of the state without removing the restrictions, which seems administratively infeasible given SEC rules. The state official charged with processing the claim should not be expected to evaluate the stock and the conditions for its award, nor should the state's resources be dedicated to requesting and considering the letter from the issuer's counsel allowing for the lifting of the restrictions, and making subsequent instruction to the transfer agent. Finally, consider that most states now promptly liquidate shares. All of these administrative and legal requirements would be necessary whether or not the former employee claimed the shares. As there would be no way to liquidate the shares given the restrictions, the only thing accomplished by the escheatment is the addition of burden to the

[4] The American Jobs Creation Act of 2004, P.L. 108-357, added Sec. 409A, which accelerates income to employees who participate in certain nonqualified deferred compensation plans, including stock option plans. In 2004, FASB issued Statement no. 123(R), Share-Based Payment, which requires expense treatment for stock options for annual periods beginning in 2005. (Statement no. 123(R) is now incorporated in FASB Accounting Standards Codification Topic 718, Compensation—Stock Compensation.)

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state, with no financial benefit to the state. Clearly this is not a result envisioned, or sanctioned by the unclaimed property statutes.

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