UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BOKF, N.A. Plaintiff, v. CAESARS ENTERTAINMENT CORPORATION, Defendant.	No. 1:15-cv-01561-JSR
UMB BANK, N.A., Plaintiff, v. CAESARS ENTERTAINMENT CORPORATION, Defendant.	No. 1:15-cv-04634-JSR
TRILOGY PORTFOLIO COMPANY, LLC and RELATIVE VALUE-LONG/SHORT DEBT PORTFOLIO, A SERIES OF UNDERLYING FUNDS TRUST, Plaintiffs, v. CAESARS ENTERTAINMENT CORPORATION. and CAESARS ENTERTAINMENT OPERATING CO., INC., Defendants.	No. 1:14-cv-07091-JSR

FREDERICK BARTON DANNER, Individually and On Behalf of All Others Similarly Situated, Plaintiffs, v. CAESARS ENTERTAINMENT CORPORATION. and CAESARS ENTERTAINMENT OPERATING CO., INC., Defendants.	No. 1:14-cv-07973-JSR

EXPERT DECLARATION OF ALAN NADEL

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

TRILOGY PORTFOLIO COMPANY, LLC, *et al.* ,

Plaintiff,

v.

CAESARS ENTERTAINMENT CORPORATION and CAESARS ENTERTAINMENT OPERATING COMPANY, INC. ,

Defendants.

No. 1:14-cv-07091 (JSR)

FREDERICK BARTON DANNER, Individually and on Behalf of All Others Similarly Situated,

Plaintiff,

v.

CAESARS ENTERTAINMENT CORPORATION and CAESARS ENTERTAINMENT OPERATING COMPANY, INC. ,

Defendants.

No. 1:14-cv-07973 (JSR)

EXPERT DECLARATION OF ALAN NADEL

I. Introduction

1. I have been asked by counsel for defendant Caesars Entertainment Corporation ("CEC") for my opinions regarding the Caesars Entertainment Operating Company, Inc. 2014 Performance Incentive Plan (PIP) adopted by Caesars Entertainment Operating Company, Inc. (CEOC), and the features thereof.

2. Based on both my professional experience and my analysis of this issue, which includes thousands of instances over the past 42 years in which I reviewed or designed incentive compensation arrangements, I have concluded that the PIP was designed to operate as an employee incentive compensation plan consistent with the manner in which such plans typically do.

3. In addition, I respond below to certain mischaracterizations of my deposition testimony in these actions.

II. Qualifications

4. I am a Managing Director of Strategic Apex Group LLC, an executive compensation and corporate governance consulting firm I established in 2004 (including its predecessor, Alan Nadel & Company LLC). For 42 years I have served a diverse range of companies on matters relating to executive and board of directors compensation, employee benefits, retirement programs, employee stock ownership plans (ESOPs), and income tax and estate planning, first as a regulator and since 1977 as an advisor.

5. For the past 28 years my practice has focused primarily on the design and implementation of management and board member pay, including strategic, financial, funding, accounting and tax considerations, as well as various aspects of corporate governance. I have also represented various companies and senior executives in negotiations concerning

employment agreements, severance programs and change-in-control arrangements. My clients have included public and private companies, domestic as well as international.

6. Prior to establishing my firm, I was a partner at Ernst & Young LLP from 2002 to 2004, focusing primarily on executive compensation. From 1983 to 2002, I was with Arthur Andersen & Company, S. C. , where I established Andersen's Compensation and Benefits Consulting practice and served as its Managing Partner – Human Capital, advising companies of all sizes on matters relating to various aspects of executive compensation and other forms of remuneration. I also was Managing Partner – Special Services for Andersen's New York Metro area Tax Division. I was a Manager with Price Waterhouse working from 1977 through 1981 on executive pay and employee retirement benefits for clients throughout the U. S. In 1972, I started my career at the Internal Revenue Service as a Revenue Agent focusing on income tax audits and later specializing in tax qualified retirement plans.

7. I am a Certified Public Accountant (New York) and a Chartered Global Management Accountant, and hold an M. B. A. in Taxation (Baruch College), A. P. C. (M.S.) in Actuarial Science (New York University) and B.S. in Mathematics (John Carroll University).

8. I am a coauthor of <u>Accounting for Equity Compensation</u> (1st and 2nd editions) and <u>Equity Compensation for Limited Liability Companies</u>. I am a contributing author for the <u>Compensation Committee Handbook</u>, The <u>Employee Benefits Handbook</u>, <u>Employee Benefits in M&A</u>, <u>The Stock Options Book and Executive Compensation in ESOP Companies</u>.

9. I am a member of the corporate faculty for board of directors training at the UCLA Anderson School of Management and previously have been a guest lecturer at Columbia University (Graduate School of Business), New York University (School of Law,

LLM program), Yale University (Law School) and the City University of New York (Baruch M. B. A. program)

10. I have developed and led in-house training for a number of companies, including AT&T, Goldman Sachs, Morgan Stanley, Merrill Lynch, Neuberger Berman, Daiwa, Salomon Brothers, Pitney Bowes and Estee Lauder Company.

11. In the late 1980's, I served as an expert advisor to the Financial Accounting Standards Board as it developed its standards relating to ESOPs and related compensation issues.

12. I have testified before the U. S. House of Representatives Committee on Education and Labor with respect to the impact of equity-based compensation on overtime pay requirements for nonexempt employees. I am a frequent speaker for various professional and industry groups worldwide (including the American Bar Association), have been quoted in business publications and newspapers, and have appeared on nationally televised business programs.

III. Analysis

A. The Grants Of Stock Under The PIP Provided Incentives To Employees.

13. The PIP is within the norm of employee incentive compensation plans. It served an important and valuable business purpose for CEOC when it was created in 2014. The use of CEOC shares as the "currency" for the PIP focused the attention of participants on the fortunes of their company. The PIP provided a motivation for the participating employees to improve the financial condition of CEOC in order to increase the value of the PIP shares they had been awarded. By doing so, they (1) would enhance the value of CEOC shares for all owners (not just PIP participants), and (2) would improve the financial capability of CEOC to, among other things, repay its noteholders.

14. The PIP is an equity-based performance incentive plan intended solely for employees. The PIP Plan Document is a typical equity plan that often is referred to as an "omnibus plan" because it allows CEOC to grant all types of equity awards. Rather than be limited to a specific type of equity award, the PIP allows CEOC to grant stock options (both nonqualified stock options and incentive stock options), stock appreciation rights, stock grants, and other awards such as stock bonuses, restricted stock, performance stock, restricted stock units, phantom stock, dividend equivalents, and similar rights to purchase or acquire shares, either at a fixed or variable price or ratio relative to the common stock. The other awards may vest based on the passage of time, the occurrence of one or more specified events, the satisfaction of performance criteria or any combination thereof. The PIP also may issue similar securities with the value derived from the CEOC stock value or cash awards. Furthermore, the PIP contains special rules in connection with Section 162(m) performance awards. Section 162(m) of the Internal Revenue Code relates to IRS guidelines affecting corporate tax deductions for compensation paid to the senior executive officers of the consolidated group, including the CEO.

15. The PIP provides CEOC with total flexibility with respect to the number of shares to be granted, the type of award(s) issued, if and how participants should pay for their awards, how to value the awards (unless the shares are publicly traded), and what vesting requirements, if any, should be imposed. The plan also contains typical miscellaneous provisions, such as employees having no rights to awards unless specifically granted, no assurance of ongoing employment, the plan being deemed to be unfunded, tax withholding, and limitations on amendments to the PIP plan and awards.

16. Section 8.14(d) of the PIP Plan Document further allows the board-approved plan administrator to impose a requirement that employees who voluntarily terminate their employment prior to CEOC being listed on a nationally recognized securities exchange must forfeit their shares unless the termination is for "Good Reason," defined in Section 6.6 as a material reduction by CEOC in an individual participant's base salary or relocation by CEOC of the participant's place of employment by more than 50 miles.

17. The valuation of the CEOC shares is based on its fair market value. The PIP Plan Document (Section 5.6) defines "fair market value" as the closing price of a CEOC share as determined on NASDAQ. The plan goes on to state that, if CEOC shares are not listed or actively traded, the value will be reasonably determined by the plan administrator in its sole discretion. Also, a different valuation methodology may be used if "necessary or advisable" in order to obtain favorable tax, legal or other treatment for the PIP awards.

18. In May 2014, CEOC shares were not listed or traded on any securities exchange. For income tax purposes, the Internal Revenue Service usually defines fair market value as being the price agreed upon by a willing buyer and a willing seller who are unrelated to each other. This definition seems apt in view of the transaction that occurred in early May 2014 where institutional investors purchased a 5% interest in CEOC. Consequently, the $90.30 valuation for a CEOC share appears to be appropriate for tax purposes as well as under the terms of the approved PIP Plan Document.

19. The Stock Award Agreement that was used for these 2014 grants under the PIP contains additional requirements and provisions. While these 2014 grants consist of stock awards that are fully vested and nonforfeitable at the date of grant, Section 7 of the Stock Award Agreement contains a provision entitled "Clawback" which states that the plan

administrator "may require" the participant to return all PIP shares in the event the participant leaves employment of his or her own accord within three years of the grant date without Good Reason and while CEOC shares are not listed on a nationally recognized securities exchange. In connection with the income tax impact of the PIP grants, CEOC agreed to make an additional gross-up payment to cover the participants' income tax obligations.

B. <u>The Incentives</u>

1. Incentive to Perform

20. The PIP incentivized employees to work hard and not look for employment elsewhere by giving them an opportunity to participate in the fortunes of CEOC. Because of CEOC's financial situation, there was a risk of losing valuable employees. Providing employees with an opportunity to participate in shares that may become publicly traded would be an appropriate incentive for those individuals to remain at the company and work to improve its financial condition. This is a common practice among companies prior to an initial public offering (IPO), including situations where an IPO is not anticipated in the near future. Granting equity awards to employees prior to the IPO allows them to continue growing the company to enhance its value and also participate in the increase in share price that occurs with many IPOs. Similarly, PIP awards provided the same opportunities for PIP participants with respect to CEOC future growth.

21. The PIP was an incentive program correlated to the stock of CEOC. This was a primary motivating factor with the 2014 grants because the PIP awards were based on the stock of a company for which participants worked. Their efforts, good or bad, would directly impact CEOC. Improvements in the financial condition of the company would likely enhance the value of its shares. Had the employees received shares of CEC instead of CEOC, their efforts would not be fully reflected in CEC's share price because CEC also owns other

subsidiaries and affiliates. Even if CEOC was successful, the value of CEC's shares also would reflect the successes or failures of its other affiliates, thereby diluting the impact of CEOC's performance. Consequently, granting shares of CEOC gave a greater motivation for employees than if they had received equity in the parent company.

22. PIP participants all received their awards effective immediately, with no vesting or waiting period. This means that they had a full interest in their shares right away, thus providing them with a sense of ownership immediately, rather than waiting for their ownership rights to vest over time.

23. I understand that certain plaintiffs have argued that I have referred to the immediate vesting of the awards under the PIP as "atypical." This mischaracterizes my testimony. Rather, as I testified, not all compensation plans are designed the same. When designing such a plan, a company has multiple options that it may employ to tailor the plan to the incentives the company wishes to create including, among other things, an incentive for employees to perform and, as discussed below, an incentive for the employees to remain at the company during a difficult period. Here, the use of immediate vesting was entirely appropriate and consistent with the incentives that CEOC sought to create. In other words, the immediate vesting, which is a feature I have seen other companies use, provided each participant in the PIP with "skin in the game" and an immediate sense of ownership in the company, each of which is designed to incentivize the employee to perform for, and remain with, the company.

24. I further understand it is plaintiffs' position that the PIP awards did not have much value at the time of grant. I take that as an additional incentive. Receiving shares at a low value means that there is greater upside potential if CEOC's fortunes improve. The adage,

"Buy low, sell high" goes exactly to this point. A grant of low-value shares, the value of which participants themselves can impact, would only add to the incentive for employees to succeed.

25. Another advantage to CEOC's share value at grant date is the possibility that the shares might become tradable in the foreseeable future. The May 5, 2014 announcement opened the door to that possibility. Whatever the likelihood of a public offering, the announcement by CEC raised the motivational value of the PIP shares as an incentive.

26. Also, the 377 participants all received the same type of equity. This encourages people to work together instead of pulling in different directions. As a group, they all "sink or swim" together, which fosters teamwork, thereby improving their chances of success. This also puts greater peer pressure on each person to succeed, because underperformers can adversely impact the entire team, not just themselves. Having upside potential and motivation to pull together as a team are strong elements of a successful incentive plan. These incentives may help to explain why none of the 377 employees who were offered the opportunity to participate in the PIP declined the offer.

27. I have frequently observed that when companies make equity grants, employees do not recognize or appreciate the inherent value of those grants. Employee equity awards have value for economic, accounting and reporting purposes, but they cannot yet be monetized. The inherent value in a stock option is the future opportunity of what may occur as the underlying share price increases over the term of the option. Accountants require companies to incur an expense for the option grant (using economic formulas) and the SEC requires companies to disclose that economic value in their annual proxy statements sent to shareholders. Based on those disclosures, the Wall Street Journal and other newspapers report those amounts as "compensation" paid to the employees in the year of grant. Yet, at the same time, the

employees holding those stock options are unable to monetize until if and when the stock price rises and the options become exercisable.

2. Incentive to Remain at CEOC

28. The PIP created an incentive for employees to not look for other work. Even though the PIP shares were fully vested immediately upon grant, the shares were subject to the following clawback provision:

> "If at any time during the three years following the Date of Grant and during which the Shares are not listed on a nationally recognized securities exchange, Participant terminates Participant's own employment without Good Reason, then the Administrator may require Participant…. . to deliver to the Corporation on demand all of the Awarded Shares. "

(Stock Award Agreement, Section 7).

29. This means that participants who chose to leave voluntarily during the three-year period following the grant date could forfeit their PIP shares unless CEOC shares had been listed on a national securities exchange. Put another way, PIP shares may be forfeitable during the three-year period. One exception is if an employee is terminated for "Good Reason" during this period, where Good Reason is defined as,

> a material diminution…in the participant's annual base salary,…other than a reduction in base salary that applies to a similarly situated class of employees…or relocation…of the participant's principal place of employment to a location that is more than 50 miles from the participant's principal place of employment upon the date of grant of an award…"

(PIP Plan Document, Section 6. 6)

30. A second exception is if during this period the CEOC shares became listed on a nationally recognized securities exchange. In order for this to occur, it would be necessary for CEC to arrange for a public offering of CEOC shares reasonably soon, and it also would be

necessary to avoid a scenario where, for example, CEOC was broken up and the pieces sold off to others.

31. The purpose of a retention plan is to ensure that key employees remain with the company, including during difficult periods, by providing them with a financial inducement to stay. Experience has shown that a retention plan can slow the loss of key employees (but usually does not stop it altogether).

32. In the case of CEOC and the PIP participants, the share awards granted in May 2014 provided a meaningful retention incentive. Participants received equity that could increase in value based on CEOC performance over the next three years, provided they remained employed for what might turn out to be that entire time. The PIP participants had no assurance that, during these three years, they would not leave the company under circumstances not involving termination for Good Reason, or that CEOC would remain an integral company that would go public. If they voluntarily resigned in order to take a job elsewhere, that would mean the loss of their shares.

33. Based on the foregoing, I believe that the PIP awards contained a meaningful retention element because employees who chose to leave would forfeit their shares.

3. Value of the PIP Grant

34. I understand plaintiffs' position may be that the shares of CEOC, when awarded, provided limited or no incentives to employees because of CEOC's economic condition, and because there was no public market for the shares and no assurance there ever would be. I would disagree. As discussed in Sections III. B. 1 and III. B. 2 above, there was meaningful incentive value in the PIP awards. The awards provided a motivation to both step up performance and to remain with the company. In multiple depositions I reviewed, employees explained that they viewed the awards as having option value.

35. What is determined to be the value of an equity award for economic or income tax purposes is not necessarily how an individual recipient may value it. For example, a stock option typically has an exercise price equal to the value of the share on the date of grant of the option. If the option is exercised immediately, there would be no resulting gain. Assuming the share price increased over time from its grant date value of $100 to $300, the employee could exercise the option for $100 and receive a share worth $300 in return, thereby resulting in a $200 gain. The economic value of the option lies in its potential for profit over the term of the option, and not just the intrinsic value that could be recognized from an immediate exercise on the date of grant. Similarly, a share of stock that an employee purchases and immediately sells would produce no gain. The share must be held for a period of time to allow for an increase in share price in order to recognize a gain on the sale.

36. In the case of PIP participants, they effectively "paid" for their shares by virtue of their share values being taxable to them at the date of grant. If they were permitted to sell those shares immediately, there would be no gain because there was insufficient time for the share price to increase in value. Only by holding the shares for a period of time (until the earlier of three years subject to the clawback provisions, or the sale restrictions being lifted) could a participant enjoy a profitable gain in the PIP shares.

37. Even as of May 2014, there was economic value to CEOC's stock, as evidenced by the purchase of 5% of the shares by institutional investors. Moreover, other investors (including so-called "vultures"), which purchase shares that have fallen out of favor because of investor perceptions, and hold those shares until they recover in value, might have found CEOC stock to be attractive.

4. The Tax Gross-Up Payment that was Made to PIP Participants

38. CEOC concluded that the value of the share awards that PIP participants received in May 2014 was immediately taxable. One impact of immediate taxability, combined with CEOC not being a publicly traded company, was that participants would owe income taxes at a time when they would be unable to liquidate any of their PIP shares in order to raise cash to finance the required tax payments. In order to alleviate this burden, CEOC decided that each participant would receive a tax gross-up payment that would provide the necessary funds to pay his or her tax obligations.

39. As an example, an individual who became entitled to a $10,000 PIP award would be subject to income tax on the value of that award. Assuming a 25% effective tax rate, the individual had a $2,500 tax obligation on the value of the award. Because the PIP award was in the form of equity rather than cash, it would have been necessary for the employee to draw on other personal resources in order to pay that amount. Depending on the size of the award and the individual's resources, this would have been a financial burden. Not until such time as the PIP shares were sold could the employee enjoy the proceeds of the shares. Providing the individual with a tax gross-up payment addressed two issues. First, CEOC ensured that the employee had sufficient cash to pay the income taxes associated with the PIP grant. This obviated the necessity of the employee using his or her other financial resources. Additionally, the gross-up payment protected the motivational value of the PIP award. By making the award cost-neutral, CEOC ensured that the employee incurred no out-of-pocket cost at the time of the grant, thereby allowing the PIP award to serve as a motivating incentive. Absent a gross-up, the PIP award would not only fail to serve as an incentive, but instead would be viewed negatively. This was CEOC's objective for paying the gross-up.

40. Tax gross-up payments have been used in a variety of circumstances for many years. For example, employees who are requested by their employer to transfer to a different location will almost always be reimbursed for the associated moving costs. Internal Revenue Service guidelines require that this reimbursement be included in the individual's taxable income, as reflected in a Form W-2. It is common practice for companies to gross up this reimbursement in order to keep the employee neutral with respect to his or her tax costs. Similarly, expatriate employees who transfer overseas receive grossed-up reimbursements intended to cover moving costs and many incremental living expenses as well as the related U. S. and foreign income tax costs. For senior employees in the U. S. some companies have provided tax gross-ups on certain executive perquisites and fringe benefits, including golden parachute payments, although that has become less common in the past few years.

41. I believe that it was reasonable to provide tax gross-ups to PIP participants in this particular situation. CEOC had decided that participants should be receiving PIP share awards as an incentive. Because these awards were denominated in shares of a privately-held company, there effectively was no liquidity available that would enable participants to pay their income taxes. Had CEOC not provided the tax gross-ups, the incentive value of the PIP share awards would have been significantly diminished or completely lost.

42. I understand that certain plaintiffs have argued that I have referred to the tax-gross up as "atypical." This, too, mischaracterizes my testimony. Rather, I have seen numerous uses of tax gross-ups over time and nothing suggests that CEOC's use of a tax-gross as to the PIP was unreasonable. To the contrary, as I have concluded, the tax gross-up here ensured that the stock awarded to employees, which could not be immediately traded (which, as discussed, is not uncommon), did not cause employees to incur a tax cost that they could not

immediately finance by the sale of a portion of their award or form a negative perception of the award because of the immediate cost to the employee of taxes related to the award.

5. *Multiple Objectives for the PIP*

43. I understand plaintiffs allege that the PIP was created to allow CEC to release itself from certain guarantees of CEOC's debt. It is beyond the scope of this report to address the guarantee, the release thereof, or the PIP's effectiveness as an event which releases the guarantee. My opinion is that irrespective of whether the PIP served another function (e. g., releasing the guarantee), the PIP in fact incentivized employees as described herein.

44. Similarly, in many situations, companies address more than one business objective through the issuance of an equity incentive plan for employees, including the following:

a. The grant of restricted shares or stock options that are subject to vesting requirements provide (1) an incentive for participants to work towards the enhancement of share value, (2) a "handcuff" feature that induces employee retention during the vesting period, and (3) a way of compensating employees while conserving cash. In fact, many corporate proxies contain statements such as,

> *The Company depends on the performance and commitment of its employees to succeed.*
>
> *The use of equity-based long-term incentives assists the Company in attracting, retaining, motivating and rewarding talented employees.*
>
> *Providing equity grants creates long-term participation in the Company and aligns the interests of its employees with the interests of its shareholders.*

b. The proliferation of ESOPs since 1975 has allowed participating companies to (1) facilitate broad-based employee share ownership in lieu of a portion of cash compensation, (2) provide a sense of ownership to employees across the board, thus providing a significant incentive, (3) obtain a tax credit, in some cases, (4) use their shares as a corporate financing tool, (5) obtain below market financing rates, in some cases, (6) use the ESOP as a defense measure against a hostile takeover, (7) provide employees with more favorable tax rates on retirement benefits, and (8) receive a tax deduction for a capital transaction, something they would not otherwise be allowed to do.

c. The growth in restricted stock units and other phantom arrangements has allowed companies to (1) provide equity-based pay to employees and enjoy the advantages of equity programs, (2) incur no ownership dilution because awards are settled in cash, and (3) provide a form of deferred compensation that may avoid the onerous tax restrictions that otherwise would be applicable.

45. Similarly, in many documented cases, companies state that equity compensation was being used as a means to pay employees while at the same time avoiding the expenditure of cash. Indeed, a search of public company proxy statements disclosed that many companies used exactly the following language with respect to their equity incentive plans in the last two years alone:

> 'The use of equity awards as compensation also allows the Company to conserve cash resources for other important purposes.'

46. In addition, in some instances, companies have used their incentive compensation programs for purposes entirely separate from employee compensation. These include:

a. In 2008, Yahoo! had become a takeover target. It instituted a broad-based employee retention plan which offered generous benefits because of its concern about employee defections. The retention plan also served as a defense mechanism against a hostile takeover attempt. (http://www. macworld. com/article/1133778/yahoo. html).

b. During the 1980s and 1990s, many large publicly-traded companies began to offer a "company stock" investment alternative within their 401(k) plans, which allowed employees to invest a portion of their 401(k) balances in company shares. Besides permitting employees to use their retirement money to invest in company shares, this also served as a defense measure against unfriendly takeover offers. The companies realized that shares held by their employees or by a company-appointed trustee were in "friendly hands", thereby reducing the risk of a hostile takeover. (The Journal of M&A Analysis, Vol. 1, No. 1, 1990, The Leveraged ESOP as a Takeover Defense, (http://faculty. darden.virginia. edu/brunerb/Bruner_PDF/Leverage%20ESOP%20Poloroid pdf))

c. In 1990, Salomon Brothers Inc revised its deferred compensation plan so that employee deferrals would be invested in company shares that would be held in a trust. The arrangement (referred to as a rabbi trust) ensured that the shares would remain outstanding and not be withdrawn by the company, thereby allowing employees to participate in the share performance. At the same time, the trust provided the company with a measure of security based on an 85% shareholder approval requirement for hostile takeovers.

47. Finally, I am aware that within the Caesars organization, other incentive compensation plans existed contemporaneously with the PIP. Based on the plan documents I reviewed, these plans did not share certain interrelated features of the PIP discussed above, such as immediate vesting, the use of stock as the award currency and a gross-up. This is irrelevant to and does not affect my opinion that the PIP's features were within the norm for such incentive plans and its design was to incentivize employees in a typical manner.

Executed this 27th day of May, 2016

Alan Nadel