WRMarketplace
An AALU Washington Report

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TOPIC: Part II -- Synthetic Equity Plans: Important Design Considerations.

MARKET TREND: In attempting to attract, retain, and motivate executive talent, employers are, in increasing numbers, using synthetic equity plans. These arrangements offer many of the benefits of traditional equity programs without some of the complications related to giving employees actual equity.

SYNOPSIS: In establishing an effective synthetic equity program, employers must ensure that the benefits are provided at a time that meets employees' expectations and the employer's needs. From a tax perspective, however, the timing of payments must be considered in light of the requirements of Internal Revenue Code ("Code") §409A. Valuation is also crucial, and relevant plan documents must clearly specify the valuation methodologies used.

TAKE AWAYS: Synthetic equity plans can be a valuable compensation device for an employer to use in attracting and retaining executive talent. While these arrangements typically provide for payments upon the occurrence of a liquidity event, employers may wish to consider other times of payout, taking into account restrictions imposed by Code §409A. Also, in the absence of a liquid market for the company's equity, it is crucial that synthetic equity plans clearly establish how the value of the company's equity is to be determined, taking care not to provide greater value for plan participants than would be received by real equity holders in a sales transaction.

PRIOR REPORTS: 16-41.

Part I of this topic, in *WRMarketplace* No. 16-41, discussed the basic elements of equity-based incentive compensation plans that deliver to participants either actual equity or use synthetic equity. Because synthetic equity arrangements require careful planning and consideration, this Part II addresses synthetic equity arrangements specifically and discusses the two most important considerations in designing the plan: (1) timing - when will payment be made and (2) valuation - how will the value of the payment be determined.

TIMING: WHEN DOES THE PARTICIPANT RECEIVE PAYMENT?

<u>Generally</u>

Employers prefer to target liquidity events, such as a sale of the company or an initial public offering ("IPO"), as the time for payment under a synthetic equity ("SE") arrangement. There may be circumstances, however, under which the employer's incentive and retention goals are achieved by paying a participant after that participant has worked for the employer for a given term. Depending on the SE plan structure, however, tax considerations may require the employer to make an irrevocable decision about the timing of the plan payment before the participant enters the plan, putting the employer at a significant disadvantage.

<u>The Tax Tail Wags the Dog – Code §409A</u>

<u>SE as Deferred Compensation</u>. If a SE plan qualifies as "deferred compensation," Code §409A will apply. This Code section significantly restricts flexibility in the payment of deferred compensation, which is generally defined as compensation paid in a year later than the year in which the participant's legally binding right to receive the payment arises. Typically, a plan that provides payment in a year after the participant begins his or her participation will give rise to deferred compensation.

<u>Timing of Payment Requirements</u>. Code §409A permits payments of deferred compensation to occur only upon the following events:

(1) A separation from service with the employer,
(2) A change in control of the employer (which generally requires a sale of at least 30% of the employer's stock or 40% of the employer's assets),
(3) The death or disability of the participant,
(4) An unforeseeable financial emergency, or
(5) An objectively determinable predetermined specified date.

Further, under Code §409A, the timing of payment of deferred compensation must be specified at the time the legally binding right to the payment arises and generally cannot be changed.

<u>Failure to Comply</u>. Failure to comply with the above timing restrictions will subject plan participants to severe tax penalties – current taxation on deferred amounts, with an interest component, plus an additional 20% penalty tax.

Short-Term Deferral Exception. Code §409A provides an important exception to the definition of "deferred compensation." Specifically, if an amount is paid no later than 2½ months after the end of the year in which the participant's right to payment ceases to be subject to a substantial risk of forfeiture (e.g., such as a requirement to work for a specified period to become vested in a right to payment), the payment is considered a "short-term deferral" and not deferred compensation (the "short-term deferral exception").

> Example: John is a participant in a deferred compensation plan sponsored by his employer, X Co. The grant date of the award of John's deferred compensation is January 1, 2014. Under the plan, John must work for five years from this date to become vested in his right to payment. If John is employed on January 1, 2019 and payment is made by March 15, 2020, the payment will qualify for the short-term deferral exception and will not be considered deferred compensation subject to Code §409A.

Structuring Plan Payments – Qualifying for Short-Term Deferral

Payments Triggered by Change in Control. Employers commonly select a change in control as a trigger for plan payments, since (1) that is when the employer will have the cash to satisfy the payment obligation and (2) it helps the employer retain its top talent until a sale of the company is about to occur. The next question that usually arises is whether the employer wants to limit payment to only those participants who are employed by the company at the time of the change in control or whether the employer also wants to reward people who have put in a specified period of employment with the company even if they are not actively employed at the time of the change.

Most employers limit payment to those employees who are employed at the time of a change. Further, many employers structure the payment so that only half of the benefit is paid out as of the time of the change ("control change date"), with the other half paid on the one-year anniversary of the control change date, as long as the participant is still employed ("1st anniversary date"). Prospective purchasers often look favorably upon this type of payment structure because it gives them a tool to retain the target's employees, helping them ensure a successful transaction.

If the employer requires employment at the control change date (and possibly the 1st anniversary date) and payment is made within 2½ months following the end of the year in which the control change date occurred (and the 1st anniversary date, if applicable), the promised payments will qualify for the short-term deferral exception.

> Example: Assume that the X Co.-sponsored plan from the above example uses a change of control as the payment trigger. The plan will pay half of the benefit upon the control change date to all participants employed as of that date and the remaining half on the 1st anniversary date to participants who remained employed as of that date. Assume that the control change date is January 1, 2017, the 1st anniversary date is January 1, 2018, and John, a plan participant, is employed on both dates.

> If the plan pays John the first half of benefits by March 15, 2018 and the second half of benefits by March 15, 2019, both payments will qualify for the short-term deferral exception and will not be considered deferred compensation subject to Code §409A.

Thus, with this structure, the employer retains some flexibility to pay early by cashing people out of their plan benefits sooner, if desired.

If, however, the employer does not require continued employment, and the plan payment is made to all participants or to those who satisfy some vesting requirement, the plan will be a deferred compensation plan subject to Code §409A. Accordingly, the plan will only be allowed to make payment if the transaction constitutes a technical "change in control" under Code §409A, which, as noted above, generally requires a sale of at least 30% of the company's stock or 40% of the company's assets.

Other Payment Triggers. In certain circumstances, the employer may wish to specify a combination or series of payment triggers, such as the earlier to occur of a change in control or the occurrence of a specified date, such as after the completion of 10 years of employment, a separation from service with the employer after a certain date, or similar triggers. Whatever the trigger selected, the timing of payment should be structured so that the employer will have sufficient liquidity to meet the payment obligations when due.

Note that, generally, so long as the plan payment is made within the required timeframe for the short-term deferral exception (i.e., within 2½ months after the end of the year in which the payment trigger occurred), it can be accelerated to an earlier date than originally scheduled and still remain exempt from Code §409A. However, vesting requirements cannot be extended without losing short-term deferral status under Code §409A unless the individual is paid an amount materially greater than what he or she would have received following the attainment of the initially-established requirements. For example, an employer could not extend a vesting requirement of five years of service to 10 years unless the payment received by the participant after completing 10 years of service was materially greater than promised at the end of five years.

Also, if the payment trigger is a separation from service following the completion of a stated period of employment, and not a specified payment date that falls within 2½ months after the end of the year in which the vesting period was completed, there will be deferred compensation subject to Code §409A. This is true even if the separation from service occurs within the relevant timeframe for the short-term deferral exception, because payment could have been made after the end of the short-term deferral period.

> Example: X Co.'s plan has a five-year vesting requirement, but a plan payment will not be made until the participant separates from service. John, the participant, meets his five-year vesting requirement on January 1, 2017 and separates from service on January 1, 2018.

> Even though John's separation occurred before March 15, 2018 (i.e., within 2½ months after the end of the year in which he vested), the plan payment will not qualify for the short-term deferral exception because John could have separated from service, and the payment could have been made, after March 15, 2018.

Payment upon an IPO. Some companies envision that their liquidity event will involve an IPO, rather than an acquisition by another company. Under applicable regulations, an IPO is not a change in control for purposes of Code §409A. Thus, to structure a plan with the IPO as the payment trigger, the plan must satisfy the short-term deferral exception by requiring that payment be made to participants within 2½ months after the end of the year in which the IPO occurs.

VALUATION: HOW IS THE VALUE OF A PARTICIPANT'S INTEREST DETERMINED?

Generally, a SE plan delivers a benefit that is based on the fair market value ("FMV") of the company's common equity. A unit of interest under the plan can provide for payment equal to the full FMV of a unit of the company's common equity or the amount by which that FMV exceeds a specified "base value." The former approach would be analogous to the benefit afforded by an award of restricted stock; the latter would be analogous to a stock option or a stock appreciation right.

There is, however, no single definition of FMV for purposes of a SE plan. Instead, the FMV is whatever amount is determined in accordance with the terms of the governing plan document.

When the plan payment trigger is a change in control, the FMV of the company's equity is usually defined by reference to the amount received by the company's "real" equity holders in the change in control transaction. But using the gross purchase price for determining the FMV for purposes of a SE plan may provide plan participants with more value than the real equity holders received, when all is said and done. For example, employers establishing SE plans may want to draft the plan's definition of FMV to account for, or carve out, the following when determining the amount payable to plan participants:

- The costs associated with an acquisition transaction, such as fees and expenses of legal counsel, accountants, investment bankers, and brokers. The real equity holders will bear these expenses, which can be significant.
- Potential liabilities for certain indemnities that real equity holders must provide in the sales agreement. SE owners will not bear that risk. The plan can provide that these values are to be determined by the Board of the company maintaining the plan, which eliminates the need to bring an outside appraiser to value these risks.

If payment is to be made upon the occurrence of an event other than a change in control, such as a separation from service or the completion of a number of years of service, there will be no proceeds from an acquisition on which to base the FMV for purposes of the SE plan. There are, however, multiple ways to address this issue. For example, the plan can state that FMV will be based (1) on a formula (such as a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA)), (2) the valuation established by an independent appraiser, (3) the valuation established in connection with the auditing of the company's annual financial statements (if such an audit is done), or (4) a value determined by the company's Board acting in good faith. There is a great deal of flexibility available to the company in this regard; the key is to clearly incorporate the valuation methodology in the plan document.

TAKE AWAYS

SE plans can be a valuable compensation device for an employer to use in attracting and retaining executive talent. While these arrangements typically provide for payments upon the occurrence of a liquidity event, employers may wish to consider other times of payout, taking into account restrictions imposed by Code §409A. Also, in the absence of a liquid market for the company's equity, it is crucial that SE plans clearly establish how the value of the company's equity is to be determined, taking care not to provide greater value for plan participants than would be received by real equity holders in a sales transaction.

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