



Long-Term Incentive Compensation Alternatives: Finding the Right Fit for Your Company

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Why long-term incentive (LTI) compensation?

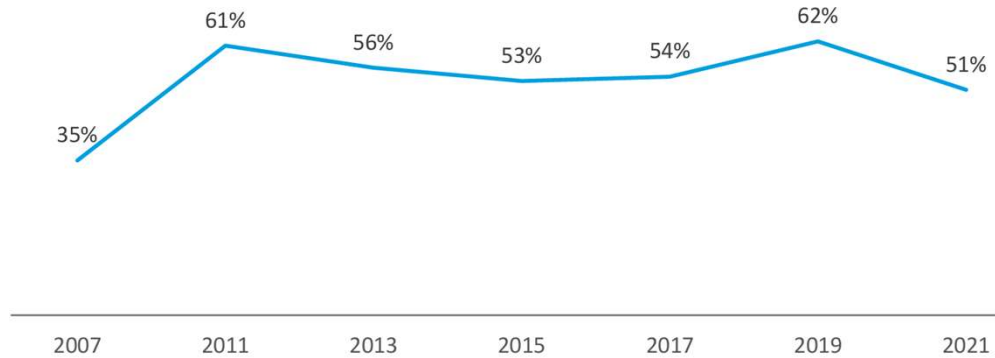
- Four R's: Recruit, Retain, Reward, Retire
- Align management's interests with those of shareholders
- Motivate performance to achieve targeted financial and other company goals

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Prevalence of LTI at privately-held companies (from 2021 WorldatWork survey)



Know How You Compare

$$\underbrace{\text{Base} + \text{Bonus} + \text{LTI}}_{\text{TCC}} = \text{Total Direct Compensation} \quad \downarrow \quad \text{TDC}$$

- Consider the mix of pay and the importance of LTI in combination with Total Cash Compensation (TCC) to TDC
- Perform compensation benchmarking

Setting the Compensation Bar

Balance

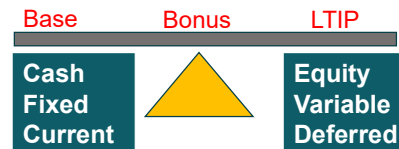
- Among components

Alignment

- With owner and company goals

Results

- Program should drive results for the company, owners and executives



Some threshold questions:

- Reward based on value of company or financial performance?
- If value, real equity or “synthetic” (aka phantom) equity?
- If value, appreciation only or full value?

Corporations Real and Synthetic Equity Alternatives

	Appreciation Only	Full Value
Real Equity	Stock Options	Restricted Stock and Restricted Stock Units (RSUs)
Synthetic Equity (aka Phantom Equity)	Stock Appreciation Rights (SARs)	Cash-Settled RSUs (aka Phantom Stock)

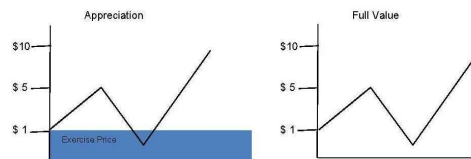
Real equity or synthetic equity?

- Considerations:
 - Ownership dilution (economic is inherent either way)
 - Corporate form (S corp or C corp)
 - Statutory rights (e.g., dividends, voting)
 - Tax treatment
 - Perceived value
 - Accounting treatment (equity vs. liability)

Appreciation only or full value?

- Considerations

- Growth versus value company?
- Relative value (1:3 or 1:4)
- Underwater awards



Corporations Stock Options

- The right to purchase a share of stock at a fixed price (the “exercise” or “strike” price) over a set period of time.
- May be incentive stock options (ISOs) or nonqualified stock options (NSOs).
- Exercise price generally equals FMV on date of grant.

Corporations Restricted Stock (RS) and Restricted Stock Units (RSUs)

- RS is the grant of a share of stock subject to time- and/or performance-based vesting or other restrictions.
- RSUs represent the right to receive the value of a share of stock in the future. RSUs may be settled in stock or cash.

Corporations Stock Appreciation Rights (SARs)

- SARs represent the right to receive the difference in value between the strike price and the then-FMV of a share of stock in the future usually in cash.
- Like a stock option except no need to come out of pocket to pay exercise price.

Corporations Cash-Settled RSUs (aka “Phantom Stock”)

- “Phantom stock” can mean different things to different people
- Cash-settled RSUs are a classic phantom stock award as they represent the right to receive the value of a share of stock in cash in the future.

The bottom line on taxation:

Only real equity held for the requisite holding period will qualify for long-term capital gains treatment. Otherwise payouts will be ordinary income or taxed at the same rate as if they were.

Other Value-Based Alternatives

- Instead of value tied directly to FMV of underlying shares, value can be based on the overall value of the company.

	Appreciation Only	Full Value
Aggregate Value of Company	Percentage of increase in overall value (either above value on date of grant or fixed amount)	Percentage of overall value

Evaluating other value-based alternatives

- Considerations
 - Eliminates need to adjust for changes to shares (e.g., stock splits)
 - Solves for dilution resulting from later-in time grants
 - Could eliminate need for regular valuations if pays only on change in control

Performance-Based Alternatives

	Allocation	Objectives-Based
Profit/Cash Flow	Cash plan allocating a % of a pool	
Other Metrics (e.g., EBITDA)		Cash plan paying an objectively determinable amount (often a % (or multiple of a %) of base salary)

Evaluating performance-based alternatives

- Considerations
 - Focuses attention on particular metrics
 - Allows for a bottom-up approach that starts with the individual and aligns to market compensation data

LLCs/Partnerships Real and Synthetic Equity Alternatives

	Appreciation Only	Full Value
Real Equity	Profits Interests Options	Capital Interests
Synthetic Equity	Equity Appreciation Rights	Phantom Equity

LLCs/Partnerships Profits Interests

- The right to share in distributions representing post-issuance value accretion and/or income.
- Cannot be “in the money” under a hypothetical liquidation at FMV scenario at time of issuance. Typically achieved by setting a “Distribution Threshold” that must be met before recipient shares in distributions.
- May include “catch up” to potentially put recipient in same position as full value award (assuming sufficient value accretion).

LLCs/Partnerships Profits Interest

- Neither grant nor vesting is a taxable event if certain requirements are satisfied.
- Recipient may have pass-through income.
- Greater potential for long-term capital gain relative to options.

LLCs/Partnerships Options

- Less common than profits interests, due to less favorable tax treatment.
- Recipient does not own equity (or become a partner for tax purposes) until option is exercised.
- Sometimes used to make appreciation-only awards without immediately triggering additional tax compliance burden.

LLCs/Partnerships Capital Interest

- Equity award that is “in the money” on a hypothetical liquidation at FMV at time of issuance.
- Can be purchased at full value, purchased at a discount or issued for no consideration other than services.
- Common scenario is “buy-in” for professional services firms.

LLCs/Partnerships Real Equity - Tax Reporting Complexity

- Recipient becomes “partner” for income and payroll tax purposes and ceases to be an employee.
- Pass-through taxation/phantom income.
- Self-employment tax vs. FICA
- Estimated tax payments.
- State income tax implications.

LLCs/Partnerships Synthetic Equity

- Appreciation-Only
 - Equity appreciation rights: Similar to options but no exercise required.
- Full Value
 - Phantom equity: Cash payments equivalent to distributions made to equity holders.

Design Decisions

- Who is eligible?
 - If payout will be delayed to termination or beyond, may need to limit to “select” group
- Authority to make awards
- Vesting and/or performance periods
- Forfeiture

Questions?



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