Synthetic Equity Plans for ESOP Sponsor Companies

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Synthetic equity compensation practices—such as phantom stock plans and stock appreciation rights ("SARs") plans—are often used by employee stock ownership plan ("ESOP") sponsor companies to help retain and incentivize the sponsor company's key employees. These plans have become popular compliments to the ESOP sponsor company, and they offer additional compensation flexibility for the ESOP sponsor company. This discussion addresses (1) the definition of both phantom stock and SARs, (2) the development of an executive compensation plan, (3) the implementation of an executive compensation plan, and (4) the procedure for how phantom stock plans and SARs may be considered when valuing an ESOP sponsor company.

Introduction

Stock appreciation rights ("SARs") and phantom stock plans are often set up in conjunction with an employee stock ownership plan ("ESOP"). These compensation plans are usually promoted to both prospective and current employees—as part of a total benefits package to attract and retain talent. After their implementation, these compensation plans align the incentives of key employees and executives with the objectives of the ESOP shareholders (i.e., through the appreciation of the sponsor company stock).

Generally, SARs and phantom stock awards are designed to provide for the cash payment of a benefit—rather than for a payment in the form of shares of company stock. Phantom stock plans and SARs share certain pros and cons.

A major advantage of these compensation plans is flexibility in deciding who gets how much and under what rules. Additionally, these compensation plans do not dilute existing ownership interests and do not require existing shareholders to give up any control.

In order for SARs and phantom stock plans to be implemented appropriately, the private company should develop an executive compensation plan that suits the goals of the company. Once implemented, these compensation plans may have an impact on the value, or perceived value, of the sponsor company.

Valuation analysts ("analysts") should consider the value impact that these compensation plans have on an ESOP sponsor company when conducting a valuation analysis for ESOP administration or other purposes.

Definition of Phantom Stock

A phantom stock plan is defined as an employee benefit plan that gives selected employees many

of the benefits of stock ownership without actually giving them any company stock. Phantom stock is a reward paid to an individual for the value of a defined number of shares.

The award is not actually made in shares, but rather in a promise to pay the employee the value of the shares at some point in the future. The award is typically paid in cash.

These awards are subject to the requirements of the deferred compensation rules under Internal Revenue Code Section 409A.

Participants in a phantom stock program benefit from the underlying stock value, as well as the appreciation in the stock. The participants receive an award of hypothetical or "phantom" shares of company stock and are entitled to payment at a specified date in the future for the full value of the underlying shares.

There is typically no exercise price associated with phantom stock—except in the case of a deferred compensation plan investing in the phantom shares.

Definition of SARs

A SAR is a form of bonus compensation given to employees that is equal to the amount of appreciation in company stock over a previously agreed upon period of time. Due to this fact, SARs only provide value if the stock price rises.

This arrangement can be a benefit for the company as employees will benefit only if the company stock appreciates, which will entice employees to ensure that the company performs well.

As with phantom stock, benefits are normally paid out in cash, but could also be paid in shares. SARs may also be paid in a combination of cash and stock.

Participants generally have the right to exercise and realize the value of their SARs at their election or upon the occurrence of a payout event. This payout event can include the following:

1. A specified date in the future
2. Termination of employment
3. A change in control
4. A public offering[1]

Most agreements are structured so that SARs can be exercised any time after they vest.

SARs are different from stock options due to the fact that when the option is exercised, an employee does not have to pay to acquire the underlying security. It is a straight cash expense for the company. Payments are typically made in cash by the company and reported as compensation expense.

Compensation expense related to a SARs plan is reported on the sponsor company income statement based on:

1. the change in the fair value of the underlying stock and
2. the anticipated vesting schedule of the SARs.

Arguments for and against Phantom Stock Plans and SARs

Both phantom stock plans and SARs are considered synthetic equity. These types of equity plans are often favorable for S corporation ESOPs due to the fact that if the benefits are settled in cash, the ESOP's equity interest in the sponsor company is not diluted for income tax purposes.

Some other typical arguments for synthetic equity, and specifically for phantom stock plans and SARs, include the following:

1. Some private companies do not want employees to actually own shares or, in some cases, have no shares to make available. For instance, limited liability companies, partnerships, and sole proprietorships may not have stock, but they could give employees a right to a capital interest in the company.

   These private companies have equity value, and owners may want to share this in some way with employees without actually making them partners in the firm.

2. In companies that do have stock, owners may be concerned about employees owning actual shares. In some cases, this may be for fear of losing control, although, in practice, other kinds of stock plans (such as creating different classes of voting and nonvoting shares) can usually handle the control issue with little or no difficulty.
3. Private company owners may be concerned that there is no foreseeable market for actual shares given to employees. It may be simpler in these cases to give employees cash rather than to buy shares back from them or try to find other buyers. Such sales may also raise securities law compliance issues.

   Even the issuance of shares can trigger securities law compliance issues, although

it is usually a fairly simple process to obtain an exemption from these rules.[2]

4. When a company first implements an ESOP, before the sponsor company shares are released, these plans can help to incentivize and retain key executives (who are sometimes also the sellers to the ESOP) until the employee ownership interests are significant enough to promote retention and performance.

5. Phantom stock plans and SARs are flexible, and the issuing company can assign them to specific employees that they determine will have the greatest impact on company performance.

Some of the arguments against the use of the above-mentioned plans include the following:

1. They provide no significant income tax benefits to employers or employees, especially relative to such tax-qualified employee ownership plans as ESOPs, 401(k) plans, and incentive stock options.

2. They may be difficult to communicate to employees who are skeptical about whether the plans will deliver significant value.

   Whereas stock comes with specific contractual and general corporate law rights, and carries the same value as shares of the same class held by other owners of the private company, phantom stock or SARs are based only on a contractual agreement to pay out based on management's determination of what the private company is worth.

3. For ESOP sponsor companies, employee owners are already rewarded for appreciation in the value of the sponsor company stock through the ESOP shares that they own. Further, awarding additional synthetic equity to certain employees will create haves and have nots.

4. The value of SARs can fall to zero if the stock price of the issuing company is declining, thereby no longer providing a strong incentive to management when the current share price is significantly below the strike price.

5. When issuing phantom stock or SARs, the private company will need to determine the value of the shares on a regular basis. This could increase the administrative burden and cost, and lead to disputes regarding the determined value of the shares. However, this may be less of an issue for an ESOP sponsor company that already receives annual valuations for ESOP administration purposes.

Equity-Based Compensation Plans

The first procedure to figuring out which plan works best for the sponsor company looking to build an executive compensation plan is to figure out what the company intends to accomplish with this plan.

A philosophy statement is something that should be a part of all businesses that are looking to formulate an executive compensation plan.

A philosophy statement generally lays out:

1. how the company intends to recruit and retain employees,
2. how the company will pay employees, and
3. what the company will pay employees.

The philosophies will vary company to company based on how base pay compares to market-based compensation. Companies that set base pay below market price often will rely on benefits beyond base pay such as phantom stock plans or SARs plans to remain competitive.

One piece of information that many executive compensation programs rely on when planning is compensation survey data. This data is relied on for monitoring trends and to help formulate an equity compensation plan that works best for the specific company in question.

Keeping up with trends in order to offer competitive compensation packages is very important for attracting and retaining not only high-level executives, but employees at all levels of the company. Surveys are a great way to set a benchmark or provide a basis for formulating an ESOP company's executive compensation program.

Executive Compensation Surveys

Some executive compensation surveys gather a diverse sample of ESOP companies. One survey that is useful for ESOP companies is the National Center for Employee Ownership ("NCEO") *Survey of ESOP Company Executive Compensation*. The NCEO's most recent survey compiled 419 responses from various ESOP companies.[3]

The survey gathered compensation data for eight different executive positions. The survey goes into extreme detail in various tables detailing what different kinds of ESOP sponsor companies are doing for their executive compensation plans.

ESOP-specific compensation surveys are especially useful tools because such survey data from non-ESOP companies may not take into account the ownership benefits associated with being part of an ESOP.

Generally, executive compensation surveys are more useful for private companies, as public companies have a plethora of data at their disposal between publicly available SEC filings and discussions on executive pay philosophy among public companies.

Of course, executive compensation surveys may not take everything into account regarding a company's specific situation, but these surveys can be used as a good starting point for compensation discussions.

Implementing Executive Compensation Programs

Reasons for Implementing Executive Compensation Programs

Determining executive compensation is generally the responsibility of a company's board of directors or a compensation committee that is selected by the board of directors.

The objectives associated with an ESOP sponsor company implementing plans such as a phantom stock plan or SARs plan are to:

1. retain their key executives,
2. incentivize the growth of shareholder value, and
3. generally entice their executives to act and think like shareholders.

Newly hired executives may not have significant ownership in the ESOP early in their tenures. Likewise, newly created ESOPs may not have shares released yet.

Much like ownership through an ESOP, these synthetic equity plans are more of a benefit to executives if the share price of the company grows. By thinking and acting like shareholders, executives will most likely put the company in the best position to increase in value, which in turn will increase the compensation received by the executive.

The two most popular plans for ESOP companies to supplement the equity executives receive through an ESOP are:

1. phantom stock plans and
2. SARs.[4]

Phantom stock is often utilized to encourage employee retention. This is because phantom stock has value as long as the share price is greater than zero, regardless of the increase in share value. In order for phantom stock to be a useful retention tool, it is often granted with a multiyear vesting schedule.

If new phantom stock is continually granted with a multiyear vesting schedule, the recipient will continue to realize value from staying with the company as more shares will vest the longer they stay with the company.

If the primary goal of an executive compensation plan is to encourage growth in the value of the company, SARs can be an effective tool. Much like an at-the-money stock option, the recipient of a SAR will only realize value if the shareholder value of the company increases.

Scrutinizing Executive Compensation Programs

When implementing executive compensation plans, it is important for those in charge of the decision to consider potential conflicts of interest, particularly members of management who serve on the board.

This is why it is usually a best practice to have independent members who are not part of management be in charge of selecting the levels of executive compensation for the ESOP sponsor company.

It is important to be diligent in the selection of compensation as both the Internal Revenue Service ("Service") and the Department of Labor will be responsible for enforcing any rules that the ESOP is required to follow. Some of those requirements that the sponsor company will be subject to are laid out in the Employee Retirement Income Securities Act ("ERISA").

There are two types of analyses that are often used to assess the reasonableness of executive compensation:

1. A multifactor analysis
2. The independent investor test.

As mentioned previously, the Service will be scrutinizing any compensation plan that an ESOP sponsor company decides to implement.

According to the Service's *Job Aid for IRS Valuation Professionals*,[5] reasonable compensation is defined by Treasury Regulation § 1.162-7(b)(3) as the "[a]mount that would ordinarily be paid for like services by like organizations in like circumstances, and this standard is adopted in Treas. Reg. § 53.4958-4(b)(1)(ii)(A)."

The reasonableness of compensation concept has two prongs: (1) the amount test and (2) the purpose test. Generally, courts only need to examine the first reasonableness of compensation prong.

When analyzing the amount test, the courts are focusing on the reasonableness of the total amount paid. In order to satisfy the requirements of Section 162, there are 12 factors considered when assessing the reasonableness of any executive compensation.

The 12 reasonableness of compensation factors typically considered are as follows:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's duties
3. The employee's background and experience
4. The employee's knowledge of the business;
5. The size and complexity of the business
6. The time devoted by the employee to the business
7. The economic conditions generally and locally
8. The character and amount of responsibility of the employee
9. Whether or not the compensation is predetermined based on activities to be performed or not determined until the end of the tax year
10. Amounts paid to the employee in prior years
11. The salary policy of the taxpayer as to all employees
12. The amounts paid by similar size businesses in the same area to equally qualified employees for similar services

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Different Ways SARs Are Utilized

For an ESOP sponsor company, SARs can be utilized to:

1. help retain management after an initial ESOP transaction and
2. incentivize management on an ongoing basis.

When an initial ESOP installation occurs, or when there is a large sale of equity to an ESOP, the selling shareholder(s) are often key members of management. To incentivize these selling shareholders (and other members of management) to continue their employment with the sponsor company, they are often granted SARs that vest over a defined period of time.

If the ESOP purchase was financed through debt (i.e., a leveraged ESOP), the equity value of the ESOP sponsor company may be depressed due to the significant debt burden. This situation presents issues with setting the strike price of the SARs at the current share value, which could be significantly below the pretransaction share value depending on the debt burden incurred by the sponsor company.

The assumption is that as the ESOP sponsor company pays down the debt, and the sponsor company continues to perform, the equity value and corresponding share price will increase significantly over time.

When SARs are used to incentivize key employees after a sponsor company is 100 percent owned by the ESOP, and all ESOP stock acquisition debt has been paid off, SARs are typically set at the current share price. This is typically the share price determined by an independent valuation adviser on an annual, semiannual, or quarterly basis for ESOP administration purposes.

In this scenario, the initial exercise value of the SARs will be zero but will become in the money after any increase in the value of the company shares. These SARs will often vest over a number of years, such as 20 percent annual vesting. The SARs plan may have special rules for employees at or nearing retirement age that allow for immediate vesting of the shares.

Valuation Considerations

Synthetic equity plans are typical in ESOP sponsor companies and are often adopted contemporaneously with the formation of an ESOP. SARs plans are one of the typical forms of incentive compensation implemented alongside an ESOP.

Assuming the value of a sponsor company is increasing, SARs create a real liability that analysts should consider when estimating the value of an ESOP sponsor company.

Knowing the Plan Documents and Plan Attributes

When determining the value impact of a synthetic equity plan such as SARs, the rights and characteristics of the plan, as outlined in the plan documents, may have a significant impact.

Therefore, the analyst should make sure he or she understands the attributes of the SARs plan including but not limited to the following:

1. What is the vesting schedule of the SARs?
2. Is the vesting schedule based on time of employment or company performance?
3. Is there a mandatory exercise of the SARs based on a date or event?
4. Is there an expiry date for the SARs plan?
5. How are the SARs treated in a change of control transaction or liquidity event?
6. How will the share value on which the SARs are based be determined?
7. Are the SARs settled in cash, stock, or both?
8. How many SARs are outstanding and how is this number expected to change over time?
9. What is the age of the employees that hold SARs and when will the payments associated with the SARs likely occur?
10. What are the strike price(s) of the various SARs outstanding?

Consideration of these attributes will help the analyst understand and, therefore, more accurately value, the SARs liability and associated valuation impact. Not knowing how these attributes will impact the value of the SARs and the associated liability may cause the analyst to overvalue or undervalue the ESOP shares.

Additionally, not understanding the liability associated with the SARs plan could create an unexpected liquidity problem for the sponsor company when the SARs come due.

Income Statement Impact of SARs

The accounting expense associated with a SARs plan is required to be measured on a fair value basis for financial statement reporting purposes at each reporting date. After the fair values of the grants are determined, the associated expense is recognized as a charge to the income statement.

The expense can be volatile, and it is affected by both the change in the fair value of the underlying shares and the change in the private company's expectation of the number of SARs expected to vest.

Given that SARs expense can be volatile, and not necessarily representative of the normalized cash flow impact of the SARs plan, it is typical for analysts to add back any SARs expense reported in the income statement and account for the SARs liability in other ways.

The analyst should interview members of the subject company accounting department to ensure that the analyst recognize how the SARs expense affects the income statement so that he or she can correctly adjust for the expense.

This procedure applies to adjusting both historical financial statement information, and projected financial statements that include management's expectations of future SARs-related accounting expense.

If the analyst excludes the SARs expense when determining normalized earnings, the value impact of the SARs liability should be addressed in another way. Assuming that the SARs liability will be settled in cash, it can be accounted for by one of the following procedures:

1. Estimating the actual cash flow impact in future years (for a discounted cash flow method analysis) and the normalized cash flow impact in historical years (for a market approach or direct capitalization method analysis)
2. Excluding the cash flow impact of the SARs plan for purposes of determining the unadjusted equity value of the private company and then subtracting the total SARs liability from the estimated equity value of the private company

Accurately estimating the timing of future cash flow payments as SARs are exercised can be difficult, so it is typical for analysts to account for the value impact of a SARs plan by subtracting the estimated SARs liability from the estimated equity value of the private company.

Determining the SARs Liability

The attributes of a SAR are similar to those of a stock option and may be treated in a similar manner for valuation purposes. Two ways to value the SARs liability are the intrinsic method and an option pricing model such as Black-Scholes.

The application of both models have advantages and disadvantages.

The Black-Scholes formula for pricing options or SARs is complex, the details of which are beyond the scope of this discussion. The Black-Scholes formula estimates the potential future value of a SAR based on inputs including the grant or strike price, a risk-free rate, the time to expiration, and the volatility factor.

One argument for applying the Black-Scholes formula to value a SAR is that even an out-of-the-money SAR has some level of value due to its potential to have value in the future. The Black-Scholes formula quantifies this future value potential.

However, the Black-Scholes model can be complicated to understand, and it relies heavily on one subjective input, the volatility factor of the share price. The higher the volatility factor in the Black-Scholes formula, the higher the estimated value of the SARs liability will be.

Volatility factors are typically estimated based on the price volatility in guideline publicly traded companies. However, the value of the ESOP shares, typically based on an annual valuation, may not have the same level of volatility as public company shares subject to dramatic swings from market duress or optimism.

The intrinsic method is a simpler and more intuitive way to estimate the value of the SARs liability. The intrinsic method calculates the value of a SAR based on the difference between the current value of the private company stock and the strike price of the SAR.

This method calculates what the cash outflow would be if each vested (or the vested portion) and exercisable SAR was exercised as of the valuation date. However, unlike the Black-Scholes model formula, the intrinsic method does not account for the time value of the option to hold onto the SAR, and any SAR not in the money as of the valuation date is assigned a value of zero.

Summary and Conclusion

When implemented correctly, executive compensation plans that utilize synthetic equity are a useful tool to attract, retain, and incentivize employees. Synthetic equity plans such as phantom stock and SARs have become popular tools for ESOP sponsor companies, both at the implementation of the ESOP and on an ongoing basis.

"[I]t is important for ESOP trustees to understand their fiduciary duties when it comes to executive compensation plans."

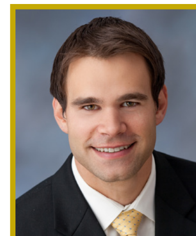
However, it is important that ESOP sponsor companies understand how and when to effectively utilize these plans. Further, it is important for ESOP trustees to understand their fiduciary duties when it comes to executive compensation plans.

Given the prevalence of SARs plans and other executive compensation plans in ESOP sponsor companies, analysts need to understand the impact that these plans have on the value of the sponsor company and the underlying ESOP shares.

Analysts should take care to understand the specific attributes of subject company synthetic equity plans and be comfortable with the valuation methods used to quantify them.

Notes:

1. *Beyond Stock Options* (Oakland: National Center for Employee Ownership, 2006).
2. Ibid., 13–14.
3. "2019 ESOP Executive and Board Director Compensation Survey Report," NCEO.org, 2019.
4. Aziz El-Tahch and Michael Ricaurte, "Executive Compensation Programs in ESOP Companies and Their Impact on Value," *The Journal of Employee Ownership Law and Finance* 21, no. 1 (Winter 2009).
5. "Reasonable Compensation: Job Aid for IRS Valuation Professionals," Internal Revenue Service (October 29, 2014).



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