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DOUBLE-TRIGGER RSUS AND THE QUESTION OF THE SEVEN-YEAR TERM

Double-Trigger RSUs and the Question of the Seven-Year Term.

A privately-held company recently asked for confirmation that it could grant "double-trigger" restricted stock units ("RSUs") with a 10-year term without running afoul of the deferred compensation rules of Section 409A.[1] The company was referring to a now well-known RSU award design, frequently used by private companies, where the vesting of RSUs is conditioned on both the award holder's continued employment (or service) and the occurrence of the granting company's initial public offering ("IPO") within a specified award term; hence the "double-trigger" nomenclature. A key feature of the preferred double-trigger design is that, to the extent that award holders have met the service-based vesting requirement, they can terminate employment and remain eligible to vest in the service-vested RSUs upon the occurrence of an IPO. Because an IPO is not a permissible payment event for deferred compensation under Section 409A, this design is feasible from a tax perspective only if the occurrence of an IPO is sufficiently unlikely that the RSUs can be considered subject to a substantial risk of forfeiture. If not, then the RSUs would be considered vested, for tax purposes, as soon as the employee (or other service provider) is no longer required to perform services, and if not then paid within 409A's short-term deferral period, the RSUs would typically be considered to violate Section 409A, resulting in immediate income inclusion at vesting, plus a 20% federal penalty[2] and premium interest, potentially on an aggregated plan basis.

For several years, industry lore in the executive compensation world has held that to avoid a 409A violation (and the ensuing parade of horribles), double-trigger RSUs must have a term of no more than seven years from the date the RSU is granted in which the IPO must occur. And out of that arose a company's somewhat fraught question as to whether a 10-year term (or indeed any term in excess of seven years) is permitted.

To answer this question, we will review the thinking behind the double-trigger RSU design and the legal underpinnings under the substantial risk of forfeiture rules of Section 409A.

Rationale for the Double-Trigger RSU Design

Historically, private companies granted stock options, and in some cases, restricted stock, to their employees and other service providers. Even when RSUs became an equity vehicle of choice for public companies, options remained the norm in the pre-IPO sector. With the lack of liquidity in private company shares, the principal reason stemmed from the fact that an option holder may select the timing of taxation by deciding when to exercise a vested option and can therefore plan for the payment of the withholding taxes due to the employer on exercise (as well as the option exercise price) or may wait until the occurrence of a liquidity event to exercise.[3] In contrast, an RSU holder is automatically subject to FICA taxes when the RSUs vest[4] and to income tax when shares are issued in settlement of the RSUs, which issuance generally occurs at or shortly following the scheduled RSU vesting date[5], when the RSU holder may or may not be in a position to pay the withholding taxes.

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1 Unless otherwise stated, section references herein refer to sections of the Internal Revenue Code of 1986, as amended.

2 In addition, for state income tax purposes, California imposes a 5% penalty for a Section 409A violation.

3 This assumes that the options meet the requirements to be exempt from Section 409A under Treas. Reg. § 1.409A-1(b)(5)(i)(A).

4 RSUs are subject to the "special timing rule" in Section 3121(v)(2)(A), under which Federal Insurance Contribution Act ("FICA") tax applies at the later of (i) when the services to earn the RSUs are performed, or (ii) when there is no substantial risk of forfeiture of the RSUs, i.e., generally, the RSU vesting date.

5 See Treas. Reg. § 1.83-1(a) under which income inclusion occurs when the vested RSU shares are transferred to the service provider, as well as Treas. Reg. § 31.3402(a)-1(b) which requires an employer to withhold federal income taxes from an employee's wages "as and when paid, either actually or constructively." Further, the IRS has recently expressed the view that RSUs are subject to income tax when the issuer company "initiates payment" of the RSUs by requesting its transfer agent to transfer shares to the RSU holder's broker account. See GLAM 2020-004 dated May 18, 2020

Therefore, when there is no market on which to sell the shares, it can be difficult, or even impossible, for the employer to meet its tax withholding obligations with respect to RSUs, given that private companies often don't have the cash reserves to withhold shares for taxes and pay over the cash equivalent to the tax authorities, as well as that the taxes due on an RSU vesting date may dwarf an employee's paycheck, making payroll withholding infeasible.

The double-trigger RSU design emerged to solve the majority of this problem by delaying the issuance of shares, and with it, the federal income tax liability, until there is liquidity in the shares.

The design therefore layers a liquidity-based vesting condition on top of the service-based vesting condition that typically applies to RSUs and other equity awards.

Features of Double-Trigger RSU Design

Typically, double-trigger RSUs will provide for service-based vesting over a period of three to four years, coupled with a requirement that a liquidity event occur within a specified term. The liquidity-based vesting condition will include an IPO, but may also include a change in control or similar company sale event so as to avoid the situation where the company is merged out of existence, causing the RSUs to become incapable of vesting.

If no liquidity event occurs within the specified award term, the RSUs are forfeited in their entirety, regardless of whether the service requirement has been met.

If a liquidity event *does* occur before the expiration of the RSUs, the RSUs vest to the extent the service condition has been met, even if the RSU holder is no longer employed at that time. Most double-trigger RSUs are designed to be exempt from Section 409A as short-term deferrals, and therefore are settled through issuance of shares either on vesting, or in the case of an IPO liquidity event, at the *earlier* of (i) the expiration of any post-IPO lock-up period during which the RSU shares cannot be sold and (ii) the end of the applicable period required for the short-term deferral exemption to apply (*i.e.*, March 15th of the year following the year of the IPO for calendar year taxpayers).[6]

Depending on the date of the IPO and the length of any post-IPO lock-up period, this short-term deferral design could result in shares having to be issued before the end of the lock-up in order to make the March 15th or other applicable deadline (*i.e.*, when shares still can't be sold to cover taxes). To avoid this, double-trigger RSUs will occasionally provide for settlement of the shares on a fixed date that is at least six months following the IPO when any lock-up period should be over.[7] However, this fixed payment date design is generally less favored because it means that the RSUs are *not* exempt from Section 409A and eliminates flexibility in payment timing at a time when the IPO market is changing and companies are going public through means such as direct listings, after which there may be no lock-up period or a lock-up period significantly shorter than the historical six months. Also, the variety of IPO methods - including the proliferation of SPACs[8] during the 2020-2021 period - has increased competition in the IPO market, giving companies greater leverage to negotiate a shorter lock-up period with their underwriters, or an exception to the lock-up period that would allow for the sale of shares to cover withholding taxes on vesting of double-trigger RSUs within the short-term deferral period.

6 Under the short-term deferral exemption, a deferred compensation arrangement will be exempt from Section 409A if payment of the compensation must under the terms of the plan be made (and actually is paid) by no later than the 15th day of the third month following the later of the end of the service provider's taxable year or the end of the service recipient's taxable year in which the compensation first ceases to be subject to a substantial risk of forfeiture. See Treas. Reg. § 1.409A-1(b)(4)(i)..

7 This form of double-trigger design appears to be permitted by the fixed schedule payment regulations under Section 409A, under which a plan may provide for a payment due upon the lapse of a substantial risk of forfeiture (e.g., upon vesting of RSUs on an IPO or other event) to be made in accordance with a fixed schedule that is objectively determinable based on the date the substantial risk of forfeiture lapses (disregarding any discretionary acceleration of such vesting). See Treas. Reg. § 1.409A-3(i)(1)(i).

8 A "SPAC" is a special purpose acquisition company formed to raise investment capital through an IPO, which goes public (relatively quickly) as a shell company and then acquires one or more unspecified target companies to be identified after the IPO, with the result that the target company becomes public while avoiding the cost, time and risk associated with the traditional IPO process.

Liquidity Event as a Vesting Condition

In any case, because an IPO is not a permissible payment event for deferred compensation under Section 409A,[9] double-trigger RSUs can work from a Section 409A perspective only if the liquidity event vesting condition constitutes a "substantial risk of forfeiture" under Section 409A, such that the RSUs may be treated as unvested until the liquidity event occurs. In this regard, Treas. Reg. Section 1.409A-1(d) states that:

"Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial."

Therefore, if an RSU holder will not be required to remain employed or providing services until an IPO in order to vest in double-trigger awards, the IPO must constitute a "condition related to a purpose of the compensation." In this regard, the regulation is clear that an IPO may constitute such a condition, stating (emphasis added):

"*For purposes of this paragraph (d), a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering).*"[10]

However, the key point is that the possibility of forfeiture must be *substantial*. In other words, there must be a *substantial* risk that the IPO will not occur. This brings us to the question of the term required for double-trigger RSUs. The regulation itself does not specify that an IPO must occur within any particular period, much less a seven-year period, in order for an IPO to constitute a substantial risk of forfeiture.

However, it is obvious that a vesting condition that requires a private company to consummate an IPO at any point in its unlimited future existence is a lot less likely to create a risk of forfeiture that is substantial than one that requires this goal to be achieved within a specified period. And, all other things being equal, it follows that the shorter the period, the greater the risk of forfeiture. So at a minimum, it is prudent to impose a deadline by which the IPO must occur. Where the RSUs have a second liquidity-based vesting event, such as a change in control, there is a heightened need for such a deadline given the additional opportunity for the RSUs to vest even if an IPO does not occur. But, nonetheless, there is nothing magical about a seven-year term and it provides neither a safe harbor nor an outer limit on the period in which a liquidity event must occur. Instead, the appropriate RSU term for a particular granting company will be dictated by the facts and circumstances relevant to that company and whether an IPO, or, if applicable, a change in control, of that company is substantially unlikely to occur within the specified period.[11]

Indeed, in these recent years of business uncertainty created by the COVID-19 pandemic, combined with the ready availability of private capital and low interest rates on borrowing, the likelihood of an IPO may be not at all clear for a private company, in which case, depending on the facts, an RSU term in excess of seven years during which an IPO must occur might reasonably be viewed as subjecting the RSUs to a substantial risk of forfeiture.

On the other hand, once a company has begun taking definitive steps towards an IPO, there is significantly more risk with using an IPO as a vesting condition in this manner. In this situation, it may be appropriate to require that, in order for the RSUs to vest, an IPO must happen within a relatively condensed period, or to require RSU holders to remain employed through the IPO in order to vest, thereby relying on the service condition to create a substantial risk of forfeiture and ensure that the RSUs will be exempt from Section 409A (assuming the post-vesting payment terms are drafted accordingly).

9 See Treas. Reg. § 1.409A-3(a) which provides the following six permissible payment events for deferred compensation that is not exempt from Section 409A: (i) separation from service (per Treas. Reg. § 1.409A-1(h)); (ii) disability (per Treas. Reg. § 1.409A-3(i)(4)); (iii) death; (iv) a time or a fixed schedule specified under the plan; (v) change in control (per Treas. Reg. § 1.409A-3(i)(5)); or (vi) unforeseeable emergency (per Treas. Reg. § 1.409A-3(i)(3)).

10 See Treas. Reg. § 1.409A-1(d).

11 It is notable that Section 409A's substantial risk of forfeiture regulations do not expressly state that a change in control can be used as a vesting condition, as they do for an IPO. However, it is difficult to see any policy reason for a distinction between an IPO and a change in control in this context as these are both exceptional, objectively determinable and transformative company events. Nonetheless, given that the list of conditions that can constitute a substantial risk of forfeiture under the regulations is not exhaustive and the occurrence of a change in control is related to the service recipient's business activities and may well be one of its organizational goals, practitioners often conclude that a change in control is a condition related to a purpose of the compensation, as required by Treas. Reg. § 1.409A-1(d), and therefore may be used as a vesting condition. ...

Similarly, if a company is using a change in control or similar company sale event as a liquidity-based vesting condition for RSUs, it needs to consider all relevant facts and circumstances to determine the likelihood of whether a change in control will occur and the period in which it might happen. In particular, if the company has already been the subject of takeover bids or has received legitimate purchase offers in the past, it will need to carefully consider the circumstances around those bids or offers and whether it remains sufficiently unlikely that a change in control or similar event will occur in its future that it can use such an event as an RSU vesting condition. And if the company concludes that such a transaction does remain sufficiently unlikely, it will then need to determine whether the period during which the transaction must occur should be less (even significantly less) than the seven years that has become an industry standard.

We also note that whether the RSUs are subject to a substantial risk of forfeiture should be determined at the time the RSUs are granted, when the legally binding right to the compensation arises, based on the facts and circumstances in play at that time. This forfeiture risk should not need to be re-evaluated over the vesting period of the RSUs, when it invariably will decrease (as it does with any vesting condition, even one requiring a several-year service period as that period reaches its final stretches). The Section 409A regulations are silent on this particular point and the preamble to the regulations is not crystal clear, stating (emphasis added):

"A right to an amount deferred may be subject to the satisfaction of two or more different conditions that each independently would be a substantial risk of forfeiture. In that case, the substantial risk of forfeiture generally would continue until all of such conditions had been met."[12]

Nonetheless, in view of Section 409A's overarching philosophy that its application should be determined at the time the legally binding right to compensation is created, as well as its written plan document rules requiring deferred compensation arrangements to specify at the outset of any deferral the amount of compensation to be paid and the payment schedule or payment triggering events, it would be inconsistent with the overall regulatory framework of Section 409A to require the substantial risk of forfeiture test to be applied on an ongoing basis after the grant date of an RSU when the legally binding terms of the award are entered into with the award holder. Further, any such ongoing testing of the forfeitability of the RSUs would be entirely unworkable from both a contractual and administrative standpoint.

Therefore, in order to grant RSUs that vest on an IPO or other liquidity event (irrespective of employment), a company needs to be comfortable that the IPO and such other event are sufficiently unlikely to occur at the time of grant and that they each present a substantial risk of forfeiture based only on the facts and circumstances when the RSUs are granted. The same type of analysis applies when addressing the question as to whether such RSUs should have a term of seven years or such other period - with the answer being (as it so often is), it depends!

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11 That said, some companies with double-trigger RSUs opt to use the Section 409A definition of change in control in Treas. Reg. § 1.409A-3(i)(5) for their liquidity-based vesting condition (even where the RSUs are intended to be exempt from Section 409A as short-term deferrals), on the theory that its strict standard is more likely to create a substantial risk of forfeiture.

12 Preamble § V(A) (second paragraph), 72 Fed. Reg. 19,234, 19,251.

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