Cash Awards

A Solution to Equity Award Challenges?

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Baker & McKenzie's Global Equity Services Practice

The Global Equity Services practice works with multinational companies to design, implement, and maintain equity-based and other incentive programs for their global employees, consultants and directors.

We help design programs to maximize tax benefits for both the company and the award recipient, anticipate and minimize adverse accounting effects, satisfy securities, exchange control, and data privacy legislation and minimize labor law risks in each jurisdiction.

Introduction

We are often asked whether some of the difficult tax and legal issues associated with granting equity awards could be avoided by granting cash awards instead. The answer to this question is not straightforward - it depends on which particular issues are under consideration and the applicable company's priorities.

In some cases, a cash award may avoid some of the complicated issues that are associated with equity awards, but in other cases a cash award may not avoid such issues and may in fact trigger different issues.

This paper summarizes the considerations for granting cash awards and explains how such awards may or may not address the challenges associated with equity awards.

What is a Cash Award?

To begin, we should clarify what we are talking about when we refer to a "cash award." Simply put, a cash award is an award paid in cash. This can take the form of a lump sum of cash paid immediately, an award paid in cash if certain vesting conditions are met, an award where the amount of the cash payment is dependent on the company's share price or the achievement of other performance metrics or another form.

Cash-settled Equity Awards

What we are mainly focused on in this paper are cash awards that are used in place of long-term equity incentive awards. Therefore, what we are typically referring to with a cash award is an equity award that is settled in cash. The most common types of cash-settled awards are restricted stock units ("RSUs") and stock appreciation rights ("SARs").

› A cash-settled RSU constitutes an unsecured, unfunded promise to make a cash payment to the grantee in an amount that is equal to the fair market value of the company's share price on the vesting date, provided and to the extent the applicable vesting conditions are met. These awards may also be referred to as phantom stock units, phantom awards or phantom shares.

With these awards, the cash payment is automatically issued to the grantee when and to the extent the vesting conditions are met. However, some companies also couple these awards with a deferral feature allowing the grantee to defer receipt of the cash payment until a later date.

Like share-settled awards with a deferral feature, special attention must be paid to the structure of the deferral to avoid adverse tax consequences in certain countries. Many companies that offer cash awards with a deferral feature limit the availability of the deferral feature to executives and directors.

- A cash-settled SAR constitutes an unsecured, unfunded promise to make a cash payment to the grantee in an amount that is equal to the appreciation in the fair market value of the company's share price between the date of grant and the date of exercise, provided and to the extent the applicable vesting and exercisability conditions are met. With SARs, the employee typically must take action to exercise the award and receive the cash payment.

Companies may grant cash-settled awards that include the discretion for the company to settle the award in shares instead (or, vice versa, the company may grant share-settled awards that include the discretion for the company settle the award in cash).

In some cases, certain regulatory or tax issues associated with equity awards may be avoided, provided the award is ultimately settled in cash, even if the award included some discretion to be settled in shares. In other cases, there must be no discretion to settle in shares to avoid the applicable requirement.

Other Cash Awards

There are other kinds of cash awards that are useful to mention as it may be desirable to consider something other than a cash-settled equity award when seeking to address certain of the issues associated with equity awards.

- A cash bonus where the amount is set at the time of grant, but the payment is subject to service-based vesting conditions. In this case, the amount may depend on the company's share price at the time of grant or some other metric, but it does not change throughout the vesting period (although some companies may provide for interest to accrue over the vesting period).

  This award does not fully replicate an equity award since the ultimate payment does not reflect changes in the share price over the vesting period; however, it has retentive value since the grantee will only receive the payment if he or she provides the requisite services.

- A cash bonus where the amount of the cash payment depends on the achievement of certain performance metrics that are not directly or solely tied to the company's share price (e.g., revenue, profits).

  Again, this award does not replicate an equity award since the payment is not dependent upon the company's share price and is often used to motivate more specific short-term efforts. These awards often have annual performance periods and, therefore, these awards are not necessarily aimed at the long-term behavior and loyalty that companies hope to motivate with equity awards.

The distinguishing factor for these types of cash awards versus cash-settled equity awards is that the payment is not dependent on the development of the price of the company's shares, which may be a relevant factor when considering the regulatory issues for equity awards (including cash-settled equity awards).

Equity Awards With Immediate Sale Feature

It is also useful to mention share-settled equity awards with an immediate sale feature whereby grantees end up with only cash and not shares when the award is paid. These awards are generally seen in the form of a stock option with a mandatory "cashless exercise" or "same day sale" feature or in the form of a share-settled RSU with a forced sale requirement.

We do not consider these to be "cash awards" because shares are issued pursuant to these awards even if they are held by the grantee for only a moment in time, but they can address some of the issues associated with equity awards without triggering some of the downsides of cash awards.

Additional Features of Cash Awards

Cash awards do not need to be granted under the company's equity award plan. However, if the company wants to retain any ability to settle an award in shares, then such award must generally be granted under an equity plan.

Further, even if it is not necessary to grant cash awards under an equity plan, it may be useful to do so because the plan includes terms and conditions that the company may wish to apply to the cash awards (e.g., related to the administration of the award or treatment upon change in control). It is usually desirable to document the terms and conditions of a cash award in an award agreement similar to what is done for equity awards and to have grantees accept the terms and conditions of a cash award.

Cash awards that are intended to replace equity awards are typically granted by the parent company rather than the grantee's employer and, like equity awards, the cost of a cash award may be borne by the parent company or by the grantee's employer.

However, there is more flexibility in terms of how a cash award will be paid as a cash payment may be delivered to a grantee through local payroll or through a brokerage account. As further described below, the entity that bears the cost of the award and the method of payment of the cash award may depend on the issue(s) the company is seeking to address with the use of cash awards versus equity awards.

Benefits of Cash Awards

Avoiding Securities Law Requirements

One of the primary reasons that companies turn to cash awards is that they are not subject to as many securities filing requirements as equity awards. The list of countries where cash awards may avoid such requirements is constantly shifting so these issues should be reviewed on a regular basis.

Currently, securities filings in the Philippines, Malaysia and Thailand (among others) may be avoided if cash awards are used. However, in Malaysia, if a cash-settled equity award is granted, a tax filing (which is arguably more burdensome than the securities filing) still needs to be completed. Also, note the later comments in this paper regarding the imposition of social insurance contributions on cash awards versus equity awards in Malaysia. In the United States, if an award can only be settled in cash, the federal securities registration and reporting requirements generally do not apply, although state securities requirements still need to be considered.

In some countries, if the cash award is a cash-settled equity award, the same considerations that apply to equity awards will apply. For example, this is currently the case in Australia, Canada and South Africa. In these countries, a different kind of cash award (e.g., where the payment is not dependent on the development of the share price) would be necessary to completely avoid the securities law requirements.

Lastly, we should note that in a small handful of countries, a cash-settled award could trigger securities law issues where share-settled awards do not. In the United Kingdom, there are exemptions from financial services regulations for share-settled awards but these do not necessarily apply to cash-settled awards. There is often a way for companies to get comfortable that a cash-settled award can be made without running afoul of the financial services regulations. However, the ability for a company to get comfortable with this conclusion will depend on the specific facts and circumstances and should be examined before granting cash-settled awards.

Easing Exchange Control Difficulties

Another significant reason that companies have turned to cash awards is to avoid certain exchange control requirements. Often if cash awards are paid locally without the cross-border transfer of funds, they are not subject to exchange control requirements. The most common example of this is in China where, since 2007, a somewhat costly and burdensome exchange control registration and ongoing filing requirements have been required in order to offer any kind of equity award.

For some companies, it is not feasible to complete such a registration - this may be because the headcount in China does not merit the effort or expense or because it is not possible for the company to register its plan/awards (e.g., the company is private or does not have the right corporate structure to be able to register). Similarly, a somewhat costly and increasingly burdensome exchange control filing is required to operate an equity plan in Vietnam and some companies cannot undertake this filing. In both of these cases, if a cash-settled equity award can be paid locally, the filing requirements should not apply.

However, to avoid such filings, the awards should also be funded locally such that there is no cross-border transfer of funds related to the cash-settled awards. This can be problematic if the local entities do not have the funds to pay such awards and there is no way for the funds to be transferred into China.

Addressing Tax Issues

There are a few countries where a cash award may have certain tax benefits. For example, for foreign companies offering share plans in India, to correctly fulfill tax withholding and reporting requirements, it is necessary to engage a Category 1 Merchant Banker registered with the Securities and Exchange Board of India to determine the fair market value of the company's shares.

If the company grants cash awards in India instead of equity awards, a Category 1 Merchant Banker valuation is not required and tax is simply due on the cash payment received (even if it is based on the value of the company's shares). In addition, in some countries, for equity awards, tax may be due prior to the time the shares are actually issued to the employee (e.g., in cases where the risk of forfeiture lapses before the shares have been issued) whereas for cash awards, tax is generally due once the cash payment is actually received.

Even more basic than this, tax withholding is much simpler on a cash award as there is a readily-available source for withholding and the company does not need to worry about whether it will fulfill its withholding obligations by net share settlement, selling shares to cover taxes, deducting amounts from payroll or requiring a payment from the employee.

Lastly, in a few countries, it is still not possible for the local entity to take a local tax deduction for an equity award (even if it reimburses the parent company for the cost of the award) whereas in almost every country, if the local entity bears the cost of the cash-settled award, it will be able to take a local tax deduction with respect to that amount.

Preservation of Shares

Cash awards do not deplete the company's share reserve. Recently, companies have faced difficulties in obtaining approval for new share plans and increased share pools due to concerns about shareholder dilution and burn rates. By granting cash awards, companies can preserve shares for strategic grants where a share-settled award is needed or desired.

For example, some companies with broad-based grants may grant cash awards to rank-and-file employees so that they can save shares and grant share-settled awards to targeted groups such as executives who may tend to hold on to shares longer than the general population or who may be required by share ownership guidelines / requirements to hold a certain number of company shares.

Easily Understood and Simple to Administer

Everyone understands a $100 bill. You can hold it in your hand, use it to buy groceries or put it in the bank. On the other hand, equity awards are a "little bit like paying your employees…in lottery tickets" says Dirk Jenter, an associate professor of finance at the London School of Economics and the Stanford Graduate School of Business who studies employee attitudes towards equity compensation.[1] Employees may have trouble grasping the potential upside of equity awards and may not be confident as to the future value of the equity awards. As a result, equity awards require more employee education than cash awards.

Not only do cash awards require less employee communication, they require less action on the part of the employee. Cash awards are automatically delivered to the employees through their brokerage account or through local payroll. Employees do not have to track the company's share price to determine the best time to exercise options and they don't have to worry about the best time to sell the shares they have acquired with share-settled awards.

In addition, cash awards are simpler because there is no need to worry about plan or regulatory restrictions. For example, generally, share-settled awards cannot be made to someone who is not a service provider to the issuing company or one of its related entities. On the other hand, if the company needs to grant an award to someone who is not an employee or other service provider for any reason, a cash award can be made without any concern. (In this case, the award could not be granted under the plan because the plan likely restricts grants to service providers.)

Downsides of Cash Awards / Benefits of Equity Awards

Impact on Share Ownership

One of the reasons for offering equity awards is to align the interests of employees, and especially executives, with the interests of shareholders, to motivate employees to work toward the good of the shareholders. In the case of a cash-settled award, this alignment only lasts for the life of the award and does not continue past the settlement date as the employee does not end up holding any shares. Share ownership can also provide employees with a pride of ownership and, therefore, greater engagement which is lacking or at least limited with a cash award. It should be noted that even share-settled awards

[1] Feintzeig, R. (2015, October 27). Do Workers Want Shares or Cash? *The Wall Street Journal*.

may not serve these purposes if employees "flip" (sell) the shares immediately upon receipt.

It should be noted there is at least some hope of this alignment of interest / pride of ownership with share-settled awards and there will almost always be some segment of employees that will hold shares.

On this note, many companies are implementing share ownership guidelines or requirements for employees, at least at the executive level, and cash awards do not help executives achieve these requirements. Instead, these individuals would need to purchase shares on the open market to achieve the required thresholds which is less convenient and creates additional considerations for Section 16 individuals as the open market purchase will be a matchable event for purposes of the short-swing profit rules / restrictions whereas an equity award vesting/settlement will not.

Cash Flow Considerations

One obvious downside of cash awards is that cash awards require that a company have sufficient cash flow to be able to deliver adequate value to employees in cash. Equity awards can be a great way to compensate or reward employees even when cash is limited, e.g., in a start-up scenario or when cash flows are otherwise low. And, in the case of a cash-settled award, the hit to cash flow can be major when the company's share price rises significantly. This volatility raises another point about the downsides of cash awards.

Accounting Treatment

Equity awards have more favorable accounting treatment than cash awards. To put it simply, an equity award appears as equity on the balance sheet, not a liability, and the fair value of the award is measured once at the date of grant (unless the award is modified) and the fixed amount is recognized over the vesting period.

On the other hand, a cash award based on share price or a cash-settled award appears as a liability on the balance sheet, not equity, and the fair value must be re-measured each reporting period until the date of settlement (even if the award is fully vested before then), which creates greater volatility in the income statement. (Note: We are not accountants. Pease speak to your accountant about the accounting implications of cash awards versus equity awards.)

Lack of Favorable Tax Treatment

Equity awards are able to benefit from favorable tax treatment in several countries where cash awards cannot. The formal tax-qualified regimes in France, Israel and the United Kingdom are only applicable to share-settled awards. In addition, there are beneficial tax regimes in Belgium, Canada, Italy and Spain that do not apply to cash awards.

Further, in Canada, cash awards can have a negative tax consequence depending on the vesting schedule as they can fall under the salary deferral rules whereas share-settled awards will not. Companies should consider whether any of the beneficial tax regimes warrant the grant of share-settled awards rather than cash awards. In certain cases, the benefits to the employer and employee of share-settled awards may outweigh some of the obstacles, such as complying with local securities law requirements.

Impact on Tax Withholding Requirements / Social Insurance Contributions

In many countries, cash awards are more likely to be subject to income tax withholding and social insurance contributions than share-settled awards. This is particularly so if the cash awards are paid through local payroll, but even cash awards paid into an offshore brokerage account are more likely to be subject to income tax withholding and social insurance contributions than share-settled equity awards.

In Australia, withholding is typically not required for share-settled awards but will be required for cash awards, regardless of whether the cash is paid through local payroll or into a brokerage account. On the other hand, in Japan - where withholding is generally not required for share-settled awards (assuming the local entity is not substantially involved in the administration of the equity plan) - if a cash award is paid into an offshore brokerage account, the treatment is likely the same as a share-settled award whereas if the cash award is paid through local payroll, withholding will be triggered.

In Ireland, cash awards will be subject to (uncapped) employer social insurance contributions while share-settled awards are not subject to employer contributions. Similarly, in Malaysia, cash awards may be subject to employee and employer contributions, depending on certain factors, while share-settled awards are not subject to social insurance contributions. In practice, these contributions in Malaysia are capped and at least some employees will meet the threshold for such contributions based on regular salary. However, the imposition of social contributions is something to consider, especially if the company is considering granting cash awards in Malaysia as a way to save money by avoiding the securities filing.

The list of countries where cash awards are subject to withholding or social insurance requirements whereas equity awards are not is constantly shifting so these issues should be reviewed regularly.

Labor Law Implications

When a foreign parent company is offering any kind of award to employees in another country, there is a concern that the award may be considered part of the local employment terms. In many countries, a significant risk is that the award and the related award income may become an "acquired right" or entitlement which, in turn, means that the company cannot cease offering the award or must seek consent before changing the terms of future awards. In addition, the award income may need to be included for purposes of calculating local mandatory payments (e.g., severance payments).

For cash awards, these labor law risks are increased because the cash payment "looks and feels" more like other aspects of local compensation, especially if the award is paid through local payroll. Conversely, shares of a foreign company do not have the same look and feel as the rest of local compensation.

Because of these risks, we caution companies to be careful to keep any parent company award - whether share-settled or cash-settled - separate from the local employment arrangement. To accomplish this, the award should not be mentioned in the local employment offer letter or agreement and all inquiries about the award should be handled by the parent company. Further, cash awards should be paid into an offshore brokerage account. This may not be possible in countries like China and Vietnam where the payment of the cash must be paid through local payroll in order to address the relevant regulatory issues. And, in countries where cash awards can be paid into an offshore account, this means that these awards still have some of the same operational burdens as share awards.

Implementation of Cash Awards

If your company decides to offer cash awards, there are a few decision points as well as administrative considerations. As discussed above, cash awards do not necessarily need to be granted under the company's equity plan, but it may be desirable to do so to benefit from the terminology and provisions in the plan.

To the extent it is not possible or desirable to grant cash awards under the company's equity plan, the company should be sure to incorporate any necessary terms into the cash award. Whether the award is granted under the equity plan or not, an award agreement should be used to document the grant and communicate important information about the award to the grant recipient.

For example, such award agreement should include provisions on award structure (e.g., is the award a cash-settled equity award that mirrors the company's share-settled award, or is the cash amount set at grant or pegged to something other than the company's share price), vesting and settlement conditions (e.g., when and how will the award be paid), tax withholding, entitlement and other labor law issues, data privacy, clawback (if applicable) and other standard contract terms that are normally included in share-settled award agreements.

Similar to equity awards, it is advisable to provide employees with a brief description of the tax consequences of the award and any local law considerations of which they should be aware in connection with the award (e.g., if the award will be paid into an offshore brokerage account, inform the employee of any exchange control or foreign account reporting requirements that may apply to him or her in connection with the funds or the account).

Bottom Line

Companies considering granting cash awards in place of equity awards should conduct a cost-benefit analysis that takes into consideration their own priorities and areas of concern. Cash awards can help to address some of the issues associated with equity awards, but should be treated more as a tool in the company's long-term incentive program toolkit rather than a panacea.

Lastly, cash awards should be treated with similar cautions as equity awards - due diligence must be done to determine the relevant regulatory and tax issues associated with such awards and proper grant documentation should be used to protect the company and communicate necessary information about the awards to the employee.

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