These SARs are not contagious: A summary of stock appreciation rights

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By contrast to stock options, few employees are familiar with stock appreciation rights (SARs). As companies look for new ways to attract, retain and motivate their employees, equity-based incentives have emerged as a critical component of an employee's overall compensation opportunity. In order to effectively implement an equity-based incentive program, however, the employee population must have a meaningful understanding of the incentive being offered. As such, many companies adopt equity programs based on familiarity rather than designing a program specifically tailored to its goals and employee population. In this way, companies often dismiss SARs as a viable choice because the mechanics are unknown. While the name may seem scary, SARs operate in a similar way as stock options, and offer benefits not necessarily available with traditional stock options.

A SAR program generally entitles participating employees to a payment based upon the appreciation in the value of a share of company stock. The value of a SAR is typically based on the difference between a stated per share price, also called the "base price," over the value of the company's stock on the date of exercise. Similar to stock options, SARs gain value as a company's stock price increases. By contrast to stock options, however, employees are not required to pay the base price but are entitled to the amount of the increase in the company's stock. In other words, employees are not purchasing the underlying shares, as would be the case with stock options. Rather, when an employee exercises a SAR the employee is entitled to a determined value (not a set number of shares). Further, unlike stock options, SARs can be settled in cash or stock on exercise, which can provide companies with needed flexibility depending on cash flows issues and shareholder concerns (discussed below).

> **Example 1: Employee receives a SAR covering 100 shares of Company stock with a base price of $1. If the stock price goes up to $10, Employee can exercise the SAR and receive $900 of value ($1,000 value on the date of exercise minus $100 base price).**

In order to exercise the SAR in the example above, Employee will not have to pay Company the base price. Rather, Employee elects to exercise and Company settles the SAR with the appropriate payment. As a further illustration, if Employee had been granted a stock option, Employee would have had to pay $100 to exercise the option and receive stock worth $1,000. Although the net economic benefit to Employee ($900) is the same for SARs and stock options, Employee did not have to come out-of-pocket any money to exercise the SAR.

Moreover, as noted, SARs can be structured to be settled in either cash or stock.

> **Example 2: Employee receives a stock settled SAR covering 100 shares of Company stock with a base price of $1. If the stock price goes up to $10, Employee can exercise the SAR and receive $900 of value in the form of 90 shares of stock ($900 of value divided by $10 per share price on the date of exercise).**

> **Example 3: Employee receives a cash settled SAR covering 100 shares of Company stock with a base price of $1. If the stock price goes up to $10, Employee can exercise the SAR and receive $900 of cash.**

As illustrated by the foregoing examples, the ultimate value delivered under each form of SAR is the same ($900 of value is provided to Employee in each example). Notably, a SAR can be structured to be settled in cash or stock at the election of the company upon exercise. In other words, a company does not have to decide on the date of grant whether a SAR will be settled in cash or stock. Rather, a SAR grant can be structured so that upon exercise, the manner in which the SAR is settled is determined by the company in its discretion. In this way, a company can survey its financial situation and employee needs when the value is actually being delivered and the state of the company known. There are several important differences and considerations related to cash versus stock settled SARs.

For one, because taxes will generally be due upon exercise, the exercise of a SAR will trigger the company’s tax withholding obligation. With a cash settled SAR, the company typically withholds from the cash payable in settlement of the SAR in the same manner that it would for other forms of cash compensation (e.g., a bonus). By contrast, with a stock settled SAR, the company does not have cash against which to withhold, meaning that the employee will have to come up with out-of-pocket cash to pay the tax liability. In other words, while a SAR avoids the need for an employee to come up with out-of-pocket cash with respect to the base price (unlike with a stock option), the cash-based tax liability remains.

> **Example 4: Employee receives a cash settled SAR covering 100 shares of Company stock with a base price of $1. If the stock price goes up to $10, Employee can exercise the SAR for $900 of cash. Company will withhold $360 ($900 value multiplied by a 40 percent tax rate), and actually deliver $540 in cash to Employee.**

> **Example 5: Employee receives a stock settled SAR covering 100 shares of Company stock with a base price of $1. If the stock price goes up to $10, Employee can exercise the SAR and receive $900**

of value in the form of 90 shares of stock. Employee will have to pay Company $360 in cash in respect of Employee's tax withholding obligation. Employee has received a $540 net benefit from the exercise of the SAR (Employee holds $900 worth of stock, but had to pay $360 in cash for taxes ($900 minus $360)).

Further complicating matters, a company could also issue stock settled SARs that are "net settled." Under this mechanic, the appreciation value is delivered in the form of stock, but the number of shares delivered is reduced by the amount of the tax withholding obligation. The company will, however, have to pay the cash in respect of the tax withholding obligation, although it will be delivering fewer shares.

Example 6: Employee receives a stock settled SAR covering 100 shares of Company stock with a base price of $1. If the stock price goes up to $10, Employee can exercise the SAR and receive $900 of value in the form of 90 shares of stock. Employee will have to pay Company $360 in respect of Employee's tax withholding obligation. If the SAR is "net settled" Company will withhold 36 shares in respect of the tax withholding liability ($360 tax divided by $10 share price). Once the dust has settled, Employee will hold 54 shares of stock without any out-of-pocket cash outlays, and Company will remit $360 in cash to the IRS in satisfaction of its tax withholding obligation. Employee ultimately holds fewer shares, but did not have any cash outlays.

Another consideration relates to potential shareholder issues. Specifically, because a stock settled SAR delivers shares to the employee upon exercise, the employee becomes a shareholder in the company once settled. As a result, the employee will have the rights as any other shareholder in the company as provided under the company's organizational documents and applicable law.

Further, if the company is a pass-through entity, such as a partnership or an LLC (the grant is typically referred to as a unit appreciation right or UAR), the employee will become a partner or member in the company and be subject to additional obligations. For private companies, employee-shareholders can create administrative, financial and legal burdens that may undermine the effectiveness of the program. These issues, however, are not unique to SARs and companies should consider these issues irrespective of the form of equity program they choose to adopt. A cash settled SAR, however, avoids the employee-shareholder issues.

As may be obvious, a cash settled SAR requires the company to pay cash. Because many equity-based incentive awards are designed to compensate employees in forms other than cash, a cash settled SAR may undermine the purpose of the equity program due to the requirement to pay cash. A stock settled SAR avoids the cash outlay and permits the company to use its cash for operations, which can be particularly important for emerging growth companies.

An interesting alternative

SARs in any form present an interesting alternative, particularly for companies considering adopting a stock option program. Because SARs avoid the need for employees to pay to exercise, SARs can deliver the same value as stock options with less liquidity risk to employees. Moreover, due to the flexibility that can be built into a SAR program regarding the manner in which SARs are settled (e.g., cash or stock settled), companies can protect themselves against issues that are present at the time of exercise, rather than having to speculate about the state of the company at the time of grant. In this way, companies should evaluate SARs as a viable component of their equity-based compensation program. With the proper education, companies can teach employees that SARs are not contagious and do not need to be avoided

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Team member bio