Epstein Rosenblum Maoz
Law Office

# Equity Incentive Awards

## Past decades have seen an increase in the role played by equity based awards in the various incentive packages offered by companies to their employees and service providers.

The summary below contains a general overview regarding the legal aspects relating to the granting of equity based awards ("**Awards**") to employees and service providers in Israel, as well as the main issues generally covered by equity incentive plans.

### A. LEGAL TERMS AND CONDITIONS FOR GRANTING AWARDS

Under Israeli tax law, equity based awards reside under one of several legal "tracks", with different conditions and tax implications included in each such track. The primary distinction in this regard is between Awards granted under section 3(i) of the Israeli Income Tax Ordinance [New Version] – 1961 (the "**Ordinance**") and those granted under section 102 of the Ordinance.

Section 3(i) of the Ordinance serves as a general or "default" track for granting options and is not designated for any particular sector. Under this section, the tax event for a recipient receiving an option shall occur upon its exercise (unless the company's shares are publicly traded). In general, the tax rate under this section is according to the general income tax that applies to the recipient (e.g. employees receiving such options will pay income tax at the marginal rate). Consultants (who are not officers or directors of the company) will typically be granted options under the 3(i) track.

Alternatively, section 102 of the Ordinance includes particular tracks designated for employees and officers of a company, excluding controlling shareholders (as such term is defined in the Ordinance). This track includes several sub-tracks: (i) a non-trustee track; (ii) trustee work-related income track; and (iii) trustee capital gains track. The most common among these sub-tracks is the "102 trustee capital gains track", which includes major tax benefits for recipients. First, as in both trustee tracks, the tax event is postponed until the selling of the shares or their release from the trustee to the recipient (whichever is earliest). Second, under this specific track, such income is treated as capital gains and taxed at 25 percent (which is the current capital gains tax rate in Israel for non-controlling shareholders and often considerably lower than the regular marginal income tax). However, it should be noted that this track may pose a disadvantage for companies, as they may not deduct the expenditures relating to grants thereunder.

Two main conditions must be met in order for an employee to enjoy 102 trustee capital gains track Awards. First, the Awards must reside with a trustee for a minimum 24 month holding period, commencing on the grant date. Second, the company must have in place an equity incentive plan (the "**Plan**") that was filed with the Israeli Tax Authority (the "**ITA**") at least 30 days prior to the grant[1]. Moreover, ITA regulations include additional timetables that must be met in order for the recipient to enjoy the tax benefits associated with this track.

### B. THE EQUITY INCENTIVE PLAN

The main purpose of the Plan is to set out the general conditions relating to the granting of Awards, as follows:

1. Those who may be eligible to receive Awards under the Plan (both in general and under each specific track) as well as what type of Awards may be granted (e.g. options, restricted shares, etc.).

2. The particular conditions relating to each

[1] If the plan is neither approved nor denied within 90 days then the plan is deemed to have been approved.

track, in accordance with applicable law. Please note that the Plan may also allow for grants to recipients who are not subject to Israeli tax regime.

3. The Plan may establish a default vesting schedule in case of options. Normally vesting shall extend over a several year period and occur in several installments, so as to incentivize employees to remain with the company.

4. The matters that may be regulated under specific Award agreements, as shall be determined by the company's board of directors and agreed to by the recipient. Such agreements normally contain primarily commercial matters (e.g. number of Awards, their exercise price, vesting period, terms of the options, etc.), while the main legal terms and conditions usually reside within the Plan.

5. The manner in which Awards may be exercised. It should be noted that, so long as the company is not publicly traded, and in the absence of any exceptional terms granted to the recipient, exercise will normally be via a cash payment. In addition, the Plan typically provides that upon exercise of options recipients will be required to sign an irrevocable voting proxy, with respect to their voting rights as shareholders.

6. Terms concerning the fate of the Awards, including expiration dates in the event of termination of relations between the company and the recipient.

7. Effects of certain changes in the structure or ownership of the company (e.g. mergers and acquisitions). The Plan typically grants the company's board of directors broad discretion in such events, including, *inter alia*, decisions regarding acceleration of outstanding options or the cancellation thereof.

8. Rules limiting the recipient's right to sell or otherwise transfer Awards.

Please note that the company's board of directors (or a committee to which it has delegated its powers) typically has the authority to determine all matters relating to the Awards that the company may grant as well as the administration of the Plan (e.g. who may be a recipient, exercise prices, vesting schedules, tracks and any other matter concerning the administration of the Plan).

## C. DECISIONS TO BE UNDERTAKEN BY THE BOARD

In view of the above, upon approving the Plan or granting Awards, the board of directors will normally be required to exercise its discretion regarding the following key matters (note that the list below is not exhaustive):

1. The type of shares and number of shares (if applicable) to be reserved for grants under the Plan and for each award. Alternatively, the board of directors may determine how many shares are to be granted on an ad-hoc basis upon each individual grant, without reserving an aggregate number of shares under the Plan.

2. The type of Awards to be granted to the recipient (typically options, but may include also shares, restricted shares, etc.).

3. The specific tracks under which Awards shall be granted. As stated above, market practice is for employees to be granted options under the 102 trustee capital gains track.

4. Engagement with a particular trustee (assuming a relevant track is chosen).

5. Terms and expiration of options (both as a default arrangement to be established in the Plan as well as for a specific grantee within a framework of the award agreement).

   In cases of termination of the engagement, vested options may be exercisable for a limited period which is usually 90 days (sometimes 30 days). Moreover,

termination due to "cause" (i.e. particular behavior deemed to be serious misconduct by the recipient, etc.) normally results in cancellation of all of the recipient's options (whether vested or not). In addition, termination due to death, disability or retirement typically leads to a one year exercise period of vested options.

6. The options' vesting schedule. From our experience, common market practice is for options to vest over a three or four-year period, in equal installments, at the end of each year, or alternatively with a one-year "cliff" before the first portion of options (often as much as 25 percent) becomes available. In case of the latter, options will usually then vest in a series of more frequent and smaller installments (usually quarterly and sometimes monthly).

   Companies sometime opt to establish a default vesting schedule under the Plan. Others prefer to leave this entirely to respective option agreements.

7. The price per Award for each recipient (in case of option called exercise price). Such price may vary greatly and depends, inter alia, on previous investments in the company as well as the recipient's applicable tax regime. Whereas early on companies may elect to provide a low or nominal exercise price, more mature companies will rely more heavily on previous investment rounds to determine exercise prices.

8. With regard to the irrevocable voting proxy: (i) the identity of the proxy holder (usually a person designated by the board of directors or its chairman); and (ii) whether the eligible board member shall vote the shares in the same proportion as the votes of the other shareholders of the company or, alternatively, be given discretion in such an event.

9. Other particular benefits to be provided to the recipient (e.g. acceleration of unvested options in case of a merger or acquisition of the company, cashless excercise, etc.). Note that in our experience these types of benefits are not standard and, if given, will normally be reserved for senior employees or management.

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This document contains only a general overview of the subject matter discussed herein and should not be regarded as legal advice or be relied upon. You should seek specific professional advice in applying the applicable law to any specific situation.

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For more informaton, please contact:

Simon Marks
Partner, Technology Practice
marks@erm-law.com
+972 (0) 3 6061605

Natalie Noy
Partner, Technology Practice
noy@erm-law.com
+972 (0) 3 6061626

Maya Schneider-Hecht
Partner, Head of Employment Practice
schneider@erm-law.com
+972 (0) 3 6061617

Shlomo Kaplan
Associate, Employment Practice
kaplan@erm-law.com
+972 (0) 3 6061640