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Clients Update - Participation Rights Agreement

Dear clients,

It is common practice for employees in various sectors to be granted, as part of their compensation package, the option to purchase shares of the company they work for (the "**Company**"). These options are typically granted under Tax Route 102 of the Israeli Tax Ordinance for Israeli employees, or under other applicable tax laws (the "**Options**").

While the grant of Options is a significant benefit, many employees face a common challenge: they are not permitted to sell their Options, even after they have vested, until the Company grants such permission. This permission is typically given in special circumstances, such as secondary transaction, where a substantial number of the Company's securities are purchased from several employees, or following the Company's initial public offering.

A potential solution to this issue is to enter into a participation rights agreement. In such an agreement, a purchaser acquires from the employee the right to receive all or part of the future income generated from their Options once they are sold in a Company-permitted transaction, without actually purchasing the Options from the employee (the "**Purchaser**").

Prior to any negotiation, it is important to verify that the participation rights agreement does not contradict applicable law or the Company's constitutional documents. As long as there is no contradiction, a participation rights agreement can be structured in various ways. However, it typically includes the following key provisions:

- Monetary valuation of the Options, to determine the amount the employee is entitled to for the sale of his/her participation rights in the Options;
- Method of transferring funds between the Purchaser and the employee, and vice-versa after the Options are sold;
- The tax liability of each party; and
- Formula for calculating the amount to be received by the Purchaser after the sale of the Options. In certain cases, the parties may agree that the Purchaser will receive all income generated from the sale of the Options, while in others, the employee may retain a portion of that income, usually if the Options are sold above a certain price.

As noted, determining the method of fund transfer between the parties and addressing tax liabilities are critical issues that may hinder and even prevent the transaction's execution. A potential solution is for the employee and the Purchaser to enter into a trust agreement with a third-party trustee. This agreement will allow the parties to transfer funds to and from a designated trust account, enabling the trustee to allocate such funds as a paying agent, in accordance with the provisions of the trust agreement. Additionally, in certain instances, the trustee can withhold the applicable tax imposed on the parties, thereby mitigating associated risks.

Our team is experienced in negotiating and drafting participation rights agreements, and will be happy to answer any questions you may have regarding this matter.

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