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Equity-Based Compensation

What Issues Do We Need to Consider?

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Dain's practice focuses on providing practical legal advice to help entrepreneurs decide how to structure and finance their start-up, assist with the purchase and sale of businesses, provide outside general counsel services, prepare shareholder and operating agreements, and implement employee option and bonus plans.

While he assists all types of businesses, Dain has a particular focus on advising high growth entrepreneurs on how to structure their company for angel, venture or private equity funding, as well as growing toward and executing a successful exit.

AREAS OF PRACTICE

Mergers and Acquisitions
Employment Issues and Compensation
Business Formation and Financing
General Business and Corporate Governance
Angel, Venture and Debt Financing
Intellectual Property Licensing and Protection

Why Employers Want Equity Compensation Plans

Grow Value

Provide additional incentives to employees or other stakeholders to grow the value of the Company

Incentivize

Use in place of cash to incentivize employees

Advantage

Provide competitive market advantages as an employer

Ownership

Give employees a sense of ownership in the company

Why Investors Want Equity Based Incentive Plans

Align

Align employees, contractors, advisors and shareholder/investor goals

Metrics

Motivate leadership to focus on specific performance metrics

Ownership

Create a vehicle for ownership

Keeps Best

Creates “handcuffs” to keep your brightest and best

Compensation

Important part of compensation package to attract the best talent

HOW to determine the Type of Equity Compensation Plan is best for Your Company

Align Outcome

Align desired outcome with type and structure of the Plan

Different Plans

Perhaps have different Plans for different employee constituencies

Manage Performance

Use the Plan as a vehicle to manage performance

Equity Compensation Can Be Complex

- ✓ **Structure needs to meet <u>management goals</u> (like a commission plan)**
- ✓ Legal issues run across multiple areas
  - ✓ State and Federal Tax Regulations
  - ✓ State Corporate Law
  - ✓ Federal and State Securities Law
- ✓ Available equity compensation plans for different entities
  - ✓ LLC-Taxed as a Partnership
  - ✓ S-Corporation
  - ✓ C-Corporation

Types of Equity Compensation Plans

- ✓ Buy-In Structures
- ✓ Direct Ownership Grants
- ✓ Option Plans
    - ✓ Options to purchase ownership at a later time
- ✓ Quasi Equity Plans
    - ✓ "Change of Control"
    - ✓ Phantom Stock
    - ✓ Profit Sharing
- ✓ <u>LLC Only</u> - Profits Interest
    - ✓ Participant shares in the profits of the business

Buy-In Scenarios
Multiple Structures

- ✓ **Used to give employees path to ownership (especially in a business that generates revenue that is distributed to owners each year)**
- ✓ **Whether buying from owner directly or from company**
  - ✓ If Owner, Owner needs to remember Owner will be taxed on sale
- ✓ **How will employee pay for the Ownership?**
  - ✓ Use year end bonus to pay on a going forward basis
  - ✓ Loan to employee to pay for it that is then paid back.
  - ✓ Pledge of purchased ownership to secure loan

Equity Incentive Plan

- ✓ Plan for all employees, advisors and contractors
- ✓ The overall Plan addresses general issues regarding administration of the Plan
- ✓ Number of shares (or units) reserved for issuance
  - ✓ 15% rule of thumb in high growth companies but I have seen as high as 25% and as low as 5%
- ✓ Who administers Plan (usually board given wide discretion in how to administer)
- ✓ Repurchase rights
- ✓ Change of control issues
- ✓ Must be approved by stock or unit holders
- ✓ Covers Direct Grants, Options or other grants

Direct Ownership Grant

Why Not Just give Employee The Same Ownership I Have?

- ✓ Can be done Under a Plan or Outside of a Plan
- ✓ Tax Issues
    - ✓ The IRS sees a direct grant of ownership as another form of compensation (equity instead of cash)
    - ✓ It is taxed as though it is compensation on the **current fair market value** at the time of grant as though it is compensation
    - ✓ ALSO, **the company** will have to pay the same taxes as if paying the employee in cash
    - ✓ ***HOWEVER*** there are ways to address this by giving employees bonuses or loans to pay the taxes
- ✓ Vesting
    - ✓ Forward "Vesting" so that it vests a little each year or quarter going forward
    - ✓ "Reverse Vesting" granted up front with repurchase rights if certain events occur like termination of employment
    - ✓ Must file an 83(b) election - This allows employee to pay tax on value at time of **grant** rather than higher value at later vesting date (which you hope will be higher)
- ✓ S-Corp - no direct grant with vesting is allowed

How Much Should I Give?

- ✓ Rule of thumb: each tier gets half the shares of the tier above it, for example:
  - ✓ VP of Sales 5%
  - ✓ Sales Manager 2.5%
- ✓ Remember – the total amount is spread out over time because of vesting

Options
(An Option to Purchase Equity Later)

- ✓Must be granted to **individuals** (per Rule 701 of the securities act)
- ✓Taxed at time ***exercised not at time issued***
- ✓Corporations can grant two types of options that have different attributes, as explained later slides
  - ✓ Incentive Stock Option (ISO) or
  - ✓ Non-Statutory Stock Option (NSO)

Option Award Agreements

- ✓ Defines number of shares or units granted
- ✓ Exercise price must be at fair market value (FMV) of the company at time of grant
  - ✓ May need company valuation (if an existing company and not recent funding round) per Rule 409
  - ✓ If in conjunction with a funding round can be done at the price of the round
- ✓ Vesting schedule (time based or event based)
  - ✓ Often see “cliff” vesting – does not start until grantee has been there one year
  - ✓ Annually, quarterly or monthly
  - ✓ Acceleration on "Change of Control"? But <u>beware of issues that buyers of the business may have</u>
- ✓ What happens on death, disability and employment termination?

Corporations and S-corporations
Incentive Stock Options (ISO)

Potentially Favorable Tax Treatment

- ✓ Possible to have gain on sale taxed at capital gains rates (estimate 25%)

Restrictions

- ✓ May only grant to **employees**
- ✓ Less than **$100K** worth of grants in any year
- ✓ 110% of exercise price if a large shareholder (>10%)
- ✓ Can only last for 10 years

Corporations and LLC's
Non-Statutory Stock Options (NSO)

- ✓Less favorable tax treatment than ISO
  - ✓ Gain taxed as ordinary income (40%) at exercise
- ✓BUT fewer restrictions than ISO
  - ✓ Can be granted to <u>anyone</u> providing bona fide services to company (Board of Advisors, Consultants, others)
  - ✓ Cannot be granted in exchange for services in raising capital
  - ✓ No restriction on amount granted in a year
  - ✓ No restriction on length
  - ✓ Can take advantage of "Cashless Exercise" provisions

LLC Profits Interest

- ✓ Not taxable at grant if:
  - ✓ No sharing of profits until a FMV of company at time of grant is met; and
  - ✓ Profits interest is not sold within two years of receipt
- ✓ Can have vesting schedules
- ✓ 83(b) Elections
- ✓ Capital gains treatment after FMV hurdle met
- ✓ Potential negative results for W-2 employees because they are treated like partners for tax treatment
  - ✓ Could effect availability of benefit plans and they have to pay their own taxes (K-1)

Quasi -Equity Compensation Plans

There are alternatives plans that allow a company to not have to give actual equity ownership (which includes voting and other rights) but that have some of the same **economic** attributes as giving actual ownership. Three types of these Quasi-Equity Compensation Plans are listed below and explained in the following slides.

1

Change of Control Plans

2

Annual Profit Sharing Plan

3

Phantom Stock and Phantom Appreciation Plans

Change of Control Plans

- ✓ Based on percentage of proceeds on sale of the company (like equity)
- ✓ Greater flexibility in design
  - ✓ Can assign points to a variety of behavior, employment levels, seniority, meeting goals
- ✓ Avoids undesirable aspects of employee stock ownership (no voting, taxation on grant, etc.)
- ✓ BUT not taxable at ordinary tax rates (est. 40%)

Annual Profit Sharing Plan

- ✓ Useful for lower level employees
  - ✓ If person would not value importance of ownership of the company but would rather see a larger paycheck at the end of the year
- ✓ Commission Plans and other bonus structures are also a way to reach the same goals

Phantom Ownership Plans

- ✓Phantom Ownership Plans
  - ✓Based on the value of the company at the time of event (termination, etc.)
  - ✓However cost of valuation to determine value can be costly
  - ✓Great flexibility in design\avoids undesirable aspects of employee stock ownership (no voting, taxation, etc.)
  - ✓BUT not taxable at capital gains rates

Summary

- **Determining** the correct Equity or Quasi-Equity Plan to put in place for certain individuals or the company as a whole is one of the most important decisions you will face as a business owner.
- An analysis of your **goals** and **desired outcomes** is critical because, once put into place, these Plans may be hard to alter.
- **Talk about** the different structures with someone who is knowledgeable with these Plans and decide which Plan best suits the needs of your business and will propel your business to new levels by having more engaged and incentivized workers and advisors!