Outline: Equity Compensation Alternatives

Key Decisions in Equity Sharing
- Deciding how much equity to share
- Deciding who will get how much with what terms
  - Allocation
  - Vesting
  - Sale of stock rules
- Deciding how to make shares liquid
- Choosing a form or forms of equity

Models for Deciding How Much Equity to Share
Approaches
- Fixed percentage of the company (such as 10%)
  + Simple and intuitive
  - 10% of one company is not 10% of another
  - Doesn’t accommodate growth easily
- Individual percentage of the company based on surveys
  + May be what people expect
  + Seems market based
  - Doesn’t accommodate growth easily
  - Hard to equate value across companies
- Dynamic model based on sharing a percentage of growth targets
  - Less certain about how much will be shared
  + Focuses on sharing value, not percentages
  + Changes entitlements to incentives

Deciding Who Gets How Much
Approaches
- Using surveys
  + Market-based (in theory)
  - Hard to find truly comparable companies
  - Your other compensation and your corporate philosophy may be very different
- Percentage of Compensation
  + Consistent with your assessment of employee’s overall contribution
  + May seem more equitable to broad employee population
  - Doesn’t recognize special roles or abilities
- Merit assessment
  + Based on actual contributions
  - Can be difficult and controversial to implement
- Egalitarian
  - Can be difficult and controversial to implement
  + “All in this together”

Vesting, Exercise, and Share Sale Rules
- Vesting can be gradual, “cliff,” or only on a liquidity event
  → If only at a liquidity event, will employees over-discount the value of the reward?
- Will employees be able to exercise before a liquidity event?
  → If they can, and have to pay taxes, will they resent this?
- Can employees sell the shares to anyone or will the company have a right of first refusal?
Liquidity

- Value for the shares must be established. If the company is public, a rule must be set as to what price (such as average price for the day) governs. If private, some form of reasonable valuation method must be employed.
- Company can be sold or go public, but this may be impractical or too far off in the future. Company can also buy back shares and/or arrange informal markets between employees.

Choosing an Instrument

- Stock options
- Restricted stock
- Phantom stock
- Stock appreciation rights
- Other approaches

Stock Options

- Rapid growth of plans giving stock to most or all employees from 1 million employees in 1992 to 12 million in 2001. This number has now dropped to about 9 million due to accounting rules changes and shareholder pressure for reduced dilution.
- Most common in technology companies, but most people getting them actually work for non-technology companies.
- Most common in pre-IPO, pre-sale, and public companies or as a tool to compensate key employees

What is a Stock Option?

- Right to buy shares at a price fixed today for a defined number of years into the future
- Can be granted on a discretionary basis
- Different kinds of options have different kinds of tax treatment
- ISOs and NSOs
- Spread on nonqualified options (NSOs) is taxed at exercise as ordinary income and is deductible to the employee.
- Employee who gets an incentive option (ISO) is not taxed on exercise, but rather at sale, and then the spread is taxed as a capital gain.
- ISO must be held one year from exercise and two years from grant. Spread is not deductible to company.

More ISO Rules

- Grant at fair market value; 10% shareholders must receive grant at 110% of FMV
- Not more than $100,000 can first become exercisable in any one year
- Not more than 10-year term
- Only employees can hold ISOs (automatically convert to nonqualified options if not exercised within 90 days of termination)

The Dreaded AMT

- The spread on the exercise of an incentive stock option is subject to Alternative Minimum Tax.
- Many, if not most, ISO recipients will be subject to the AMT, meaning they will have to pay tax in the spread with their next return even though they have not sold their shares.

Nonqualified Options Rules

- Can be granted to anyone
- Can have any terms the company chooses
- Can be transferred, but the tax obligation rests with optionee

Restricted Stock

- Right to buy or be granted stock
- Stock only transfers when restrictions lapse, such as meeting performance or vesting targets.
- Taxed as ordinary income when restrictions lapse unless 83(b) election made

83(b) election
• Election to be taxed on value of benefit at time of grant (may be zero if stock purchased for FMV)
• If stock never transferred, taxes cannot be recovered.
• If stock is transferred, gain from FMV at time of grant to FMV at time of sale is taxed as capital gain.
• When employee realizes ordinary income, employer gets a corresponding tax deduction.

Phantom Stock and SARs
• Phantom stock is the right to the value of a set number of shares, subject to some restriction lapsing (vesting, performance, etc.) Usually paid in cash, not shares.
• Stock appreciation rights (SARs) are the right to the increase in the value of a number of shares.
• Both are taxed as ordinary income when paid.

Stock Settled SARs
• Essentially the same as a stock option, except that, typically, when they vest the employee would exercise the SAR rather than wait for some additional term
• Less dilutive than options
• Accounting Issues
• Companies must record the estimated present value of all equity awards at the time of grant.
• Formula considers volatility, dividends, risk-free interest rates, exercise and current price, and expected life of award
• Amounts can be adjusted to forfeitures.

Deferred Compensation Rules
• If an employee chooses to defer receipt of an exercised award, taxation can be deferred if certain rules are met.
• For time-vested awards, deferral election to a specific date must be made in the year prior to the year the award vests.
• For performance-vested awards, election can be six months before
• For equity awards discussed here, applies only to cash-settled SARs and phantom stock and discounted stock options.

Other Forms of Equity Compensation
• 401(k) Plans
  → Company matches
  → Employee contributions
• Employee Stock Purchase plans
  → Employee set aside after tax wages for an offering period, usually 6 months to two years
  → Can buy stock at lower of 15% off share price at beginning or end of offering period
• ESOPs

Direct Stock Purchases or Awards
• Simplest of plans
• Can be financed as a bonus, with a loan, or with employee after-tax money
• Securities Law Issues
• If there is an offer to sell, this triggers securities law issues.
• Exercise of an option comes under this definition.
• Closely held companies can be exempted from registration under federal and most state laws if they meet certain rules.
• Anti-fraud disclosure statements are required.