Current Issues in Equity Compensation

By J. David Moran, Esq.

Gesmer Updegrove, LLP

GESMER UPDEGROVE LLP
Attorneys at Law

I. Overview – Basic Quandary

A. Newco has all kinds of potential / possibly some operational reality but tight cash

B. Needs creative individuals / experienced management

C. May already have some investment restrictions in place or high probability of future restrictions from outside investors

GESMER UPDEGROVE LLP
Attorneys at Law

Basic Quandary con't…

D. Temptation to be a "good guy" and indiscriminately let all the early stage employees become an owner of the company. Dispense equity to all employees regardless of age or position in the company.

1. Resist the temptation – age / position / understanding / appreciation by recipient of value is not seamless. Team building at certain levels may be an illusion.

Basic Quandary con't…

ABC Co. illustration ineffective use of stock awards

2. No liquidity / valuation is and always will be an issue / could be immediate tax consequences (w/h - FICA issues) etc,... Better dealt with at certain levels by way of a qualified profit sharing plan (although can be expensive and somewhat cumbersome), insurance premium assistance, 401(k) or by way of health benefit cards, regular year end discretionary bonus (without tax deferral), etc,…

POINT – for staff and admin. employees be careful about equity awards in whatever form.

MYTH – broad based participation reward of all employees will be equally appreciated and understood. Also, potential for unwanted intrusion into corporate operations if actual stock is granted to any individual. Legal rights attach to shareholder status and complexities of corporate administration are also increased.

II. Who Gets Equity Compensation / How is it Designed

A. Management and Key Personnel

(IP / Sales or similarly situated individuals)

1. Equity type compensation is used for the entrepreneurial type of individual. Need to identify that group capable of making a valid cost / benefit analysis.. It won't work on the "bean counter" who checks his / her bank account balance twice a day.

GESMER UPDEGROVE LLP
Attorneys at Law

2. It can be applied in a completely discriminatory manner (unlike IRC Sec. “401(a) plans.”

(a) Equity compensation can be granted in a discriminatory manner and also each individual award tailored to the particular individual – vesting, etc,…

3. Stock Option Plans

(a) Historically, this has been the most popular, and in some ways, most efficient method of awarding / allocating equity to defined group.

(b) ISO and Non-Qualified SOP – care with regard to vesting events (unintended consequences – merger / change in control).

(c) Tax and administrative distinctions

formalities of plan and shareholder approval / application to employees only and / or independent contractors / deduction or no deduction by issuing company / possible / probable long term capital gain treatment / AMT issues and valuation concerns/ accounting considerations

(d) Current and Potential Dilution Concerns

GESMER UPDEGROVE LLP
Attorneys at Law

4. Alternative Methods of Equity Compensation

(a) SAR’s / Phantom Stock Plans

(b) Restricted Stock / IRC Sec. 83(b) Election – possible capital gain characterization

GESMER UPDEGROVE LLP
Attorneys at Law

5. IRC Sec. 409A – The Fly in the Ointment of Equity Compensation

(a) (effective January 1, 2005) – transition issues

(b) Option plans exempt – IF – new fair market valuation rules are met.

(c) Restricted Stock exempt (most of the time).

(d) Lack of clarity with regard to 409A impact