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EMPLOYEE EQUITY: A POWERFUL AND RISKY TOOL

Those considering providing equity participation to employees need to consider whether and how it makes sense to do so. There are a number of business, accounting, tax, legal, and timing considerations associated with this decision, all of which may have major implications for the organization and participating employees. This discussion can only scratch the surface and highlight the need to have a well-defined rationale for proceeding in this manner and in all cases to obtain the input of professionals with pertinent experience. Simply issuing shares or LLC interests without appropriate deliberation is NEVER a good idea.

Q. Why would someone consider an equity plan?

A. Two main reasons: (i) to augment the company's compensation and benefits offerings without current cash expenditure; and (ii) to enhance employee motivation, owner orientation, and retainage by giving them a stake in the financial success of the company.

Q. What paperwork is required?

A. In most cases, you will need: a) a formal plan document indicating what interests are to be issued, to whom, when, and for what consideration; b) board and shareholder resolutions formally adopting the plan; and c) written agreements with participants setting forth the details of the specific grant and the related terms and conditions. In some, but not all, cases, securities law requirements will also mandate a separate disclosure document and/or governmental filing.

Q. Are the equity interests offered to employees equivalent to those of the company founders?

A. No. Generally the equity interests offered to employees are subject to an agreement governing vesting, restrictions on transfer, forfeiture under certain circumstances, lack of marketability, and may not have voting rights. These restrictions vary widely based upon the type of plan being offered.

Q. I greatly value my team and want to keep them with me, but don't want them looking over my shoulder in running the company. Is this a problem?

A. Possibly. Issuing interests to employees or anyone else may trigger a fiduciary duty of a majority shareholder – for example limiting opportunities for self-dealing -- to them as minority shareholders and entitle them to share corporate records and financial information. This consideration may be mitigated by the choice of plan – for example by providing for options instead of restricted stock -- and by the terms of participant agreements. It should be noted that no equity issuance in and of itself will alter an individual's status as an at-will employee.

Q. What about taxes?

A. The employee equity plans discussed here are in the nature of compensation, and compensation is always subject to tax in some manner at some time. The differences among the plans have to do with the timing of the tax recognition to the employee, basis of the interests, the type of income (ordinary or capital gain), and the timing of any corresponding compensation expense deduction to the company for both book and tax purposes. Depending on the type of plan and whether a participant decides to utilize tax elections that may be available, a taxable event for both parties may occur upon issuance, vesting, exercise or disposition. It is essential for both to consider optimal treatment for their specific actual and anticipated circumstances.

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Q. What sort of plans are there?

A. There are many 'flavors', but the most often used types are:

- Stock options, both Incentive Stock Option and Non-Qualified;
- Restricted stock;
- Stock appreciation rights; and
- Phantom stock.

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