

Sharing Equity in Private Companies
Consider Alternatives Before Promising Shares To Employees
Valerio Giannini

A common practice of small to medium size companies in recruiting or rewarding management is to proffer some form of equity, often without further specificity.

As investment bankers for privately held companies, we have been well down the road on a sale, acquisition or financing, when we discovered that there are current or former employees, early investors, consultants, or even relatives who have – or believe they are entitled to – shares or some form of ownership.

Typically, records are piecemeal or vague. Shares, if issued, may have since been gifted, sold, hypothecated, or given up in a settlement; or it's unclear just what the promised "5% of the company" meant ten years ago, let alone what it means today.

In smaller companies such situations generally get resolved, but not without costing more than it should, financially as well as in angst, time, energy and damage to relationships and trust.

But if it happens, don't feel badly; it happened to Bill Gates and Paul Allen as well as Mark Zuckerberg and Eduardo Saverin. To dodge such bullets next time, just be sure that promises and grants of equity are scrupulously memorialized and in the form that best meets the needs and expectations of all concerned.

Before committing to issuing actual shares, the company should consider alternatives of phantom equity or options, which may be to the advantage of both the company and the employee and provide the same economic outcome.

Although outright ownership of actual shares may be psychologically gratifying, there are drawbacks for both the company and the employee, and alternatives that may achieve the same or better results should be explored and understood.

The existence of an already-established equity participation plan or even outstanding shares or options should not preclude creating a new plan as either a replacement or alternate. In any case, one-off deals for just one person should be avoided in favor of a plan that can be used for others.

*This article addresses **equity participation** that may be offered to **selected employees** by a **privately-held company** (a corporation or LLC). It excludes non-selective ERISA regulated plans required to include all or most employees, such as an ESOP, a 401(k), a defined benefit pension plan or an employee stock purchase plan, to name a few..*

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Employee equity participation can take the form of

- A. Actual equity ownership.**
- B. Stock Appreciation Rights (SARs),** aka phantom equity
- C. Options to purchase equity**

Then there's *handshake or sweat equity*, which is equity promised to an employee, investor or anyone else, but which hasn't been memorialized in a definitive agreement. *Handshake equity* should be avoided at all costs.

A. Actual equity ownership:

Shares or membership interests are usually acquired from the company, but can also be sold or gifted by an existing shareholder¹.

A company may give grants of shares, so called "restricted stock grants", typically used by public companies as part of a compensation package. Such grants are taxable as compensation to the recipient when received, but sometimes companies will bonus cash to cover the tax due. They are the functional equivalent of granting a cash bonus to purchase shares.

Bona fide gifts of shares from an existing individual shareholder of up to \$13,000 (currently) per donor per recipient per year are not taxable to the recipient and do not count against the donor's unified gift/estate tax exclusion². This is commonly done as gifts to children, but can also be done for un-related adults provided it isn't a disguised form of compensation or payment.

The primary reason for a company to sell actual equity to anyone (including to employees) is that the company wants or needs the money to repay debt, invest in fixed assets, retire other shareholders' interests or just for working capital.

Payment for actual equity from the company can be:

- With the employee's personal funds or independently borrowed money; or
- Financed by the company or the selling shareholder over time (commonly on a non-recourse basis except to the shares); or
- With cash left over after taxes from a company-paid bonus.

¹ An employee buying shares from an existing shareholder is simply a transaction between individuals, but is subject to whatever restrictions may be incumbent on the selling shareholder, which usually include an obligation to offer the shares first to the company and then to other shareholders, and also a restriction on selling to any third party without the Company's consent.

² However, the gift recipient's tax basis remains the donor's tax basis, unlike inherited property, which gets a "stepped up" basis.

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A company may commit to sell an employee a certain number of shares at today's price, vesting and payable over several years, or alternately sell shares in increments over time at future prices.

The sale of equity in a private company, however it is structured and whether being sold by the company or a shareholder, is a **securities transaction** and it is incumbent upon the company or selling shareholder to provide the buyer with disclosure of all material information about the company.

In addition, the sale and purchase of shares require two basic documents:
A Stock Purchase Agreement and a Shareholder ("buy/sell") Agreement.

- ***A Stock Purchase Agreement*** between a seller and a buyer in which the buyer acknowledges his or her due diligence and a litany of risk factors. This is to reduce the risk to the company or selling shareholder if the buyer later claims he or she were misled or not informed. It is also customary that the employee's spouse waive any claims to such shares.
- ***A Shareholder ("buy/sell") Agreement*** between the employee and the company delineates restrictions on resale and the rights and obligations of both if the employee leaves the company³. Typically the employee must sell the shares back to the company, and the company must purchase them, at a price established by a formula or appraisal. In addition the company usually has the option of paying over time on an installment basis.

Some companies will only issue employees non-voting shares or require an irrevocable voting proxy from the employee, especially if the purchase money is bonused or lent without recourse. Such measures do not, however, take away the minority shareholders' other rights and the company's obligations to them.

The primary drawback of owning shares in a private company is that the shareholder probably won't see any cash (except distributions or dividends) until they leave or the company is sold or goes public.

From the company's standpoint, a major drawback of issuing new shares is that unless the company is sold or goes public, it will probably have to redeem those shares with after-tax dollars.⁴

³ Even gifted shares should be accompanied by a shareholder agreement stipulating restrictions on the disposition of the shares.

⁴ Redemption through an ESOP would be pretax for the company, but that's another conversation.

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The tax treatment of redemptions for both the company and the employees can become complicated. It may, for instance, be considered a dividend (vs. a purchase) depending, for instance, on what percentage of their holdings they sell or their relationship to the person(s) who control the company.

Advantages to the Employees of actually purchasing equity are:

- They feel as if they actually own a piece of the company, which they do.
- They usually get voting and minority shareholder rights.
- Appreciation actually realized will be taxed as capital gains after one year.
- They are entitled to dividends and distributions, if any.

Disadvantages to the Employees:

- They have to pay for it and are at risk, assuming it's their money.
- There's no market for their shares.
- Appreciation usually isn't realized until they leave or the company is sold.
- They have downside risk of diminished value or the company's inability to redeem, unless purchased with non-recourse financing.
- In an S Corp or LLC they may have tax liability without necessarily a firm commitment of a distribution to cover it.

Advantages to the Company

- The company receives non-taxable capital.
- The employee has *skin in the game*, a highly effective motivator.
- Redemption probably doesn't affect reported earnings.

Disadvantages to the Company as the seller

- The company now has shareholders with minority shareholder rights⁵.
- The company may need to add directors to its Board⁶
- Dilution to other shareholders (more shares outstanding).
- The company is obligated to pay them any dividends or distributions.

Shares gifted by an existing shareholder do not cause dilution nor increase an obligation for distributions, but may create additional minority shareholders and possibly create pressure for pre-emptive redemption from the recipient.

⁵ Even if control isn't an issue, a Company Board has fiduciary obligations to all shareholders, and majority shareholders to minority shareholders. Minority shareholders aren't evil per se, but can become high maintenance.

⁶ Most states require that a company with two shareholders have two directors and one with three or more shareholders have at least three directors.

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B. Stock Appreciation Rights (SARs)

Stock Appreciation Rights (SARs) are the economic equivalent of equity. Sometimes referred to as *Phantom Equity*, SARs are a deferred compensation plan that can be positioned and configured to have the look and feel of actual equity ownership with many of the same benefits, but without several of the disadvantages for the company and the employee.

SARs are most commonly used by public companies, but are just as useable in private ones. SARs are simply a commitment to pay cash bonuses which are the equivalent of the appreciation in the value of a certain number of shares. SARs, like options, typically “vest” over several years.

Payments of appreciation can take place annually or every few years⁷. In the event of a sale of the company or upon leaving, employees are paid an amount equal to what would have been the appreciation of “their shares”, the same as they might be for vested options. The good news for the shareholder is that there’s no waiting for retirement, a sale or an IPO to realize some cash. The bad news is that SARs payments are taxed as ordinary compensation, subject to federal and state withholding and payroll taxes.

Appreciation payouts can be designed to lag in arrears, perhaps longer for people who leave voluntarily or involuntarily for-cause. At the company’s option, a plan may provide for paying employees the equivalent of any C Corp dividends or S Corp or LLC distributions paid to the actual shareholders or members.

An important advantage of SARs to the company is that they are “redeemable” with pre-tax cash, whereas, shares are not. However, a major disadvantage to some companies is that certain SARs obligations should be accrued continuously as an expense, which reduces “earnings” and net worth, even if no cash is expended. If a company is sensitive to “financial statement earnings”, such as when being valued for an IPO, SARs can be detrimental.

In contrast, since there is no schedule for redemption of actual shares, depending on the magnitude of the obligation, there may be no expense accrual booked for future share redemption, although an auditor may require a reserve or an underwriter or investor may take the obligation into account.

⁷ Care should be taken, not to make the SARs payouts payable over a long term or to offer SARs too broadly lest the plan be deemed a regulated ERISA retirement plan.

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Advantage of SARS to the employee vs. buying outright equity ownership:

- They have paid nothing and have no capital at risk.
- They have upside but no downside.
- They get the same dividends or distributions, if the plan includes them.
- Appreciation can be realized periodically.

Disadvantages of SARs to the employee:

- Appreciation payouts are taxed to the employee as compensation.
- They don't get dividends or distributions if the plan doesn't include them.
- They have no voting or minority shareholder rights.

The advantages of SARs to the Company are:

- The company only needs to redeem the appreciation, not the full value of appreciated shares.
- The appreciation payout is pre-tax, i.e. it's tax deductible.
- SARS don't create minority shareholder rights or associated obligations.
- There are no Stock Purchase or Shareholder Agreements.
- There are no promissory notes (as with company-financed share purchases).
- The ongoing cost to the company may be lower than actual equity ownership if the SARs plan does not entitle the employees to dividends and distributions.
- A SARS plan can be converted to an actual equity purchase or option plan, and in fact can be settled with shares.
- There's no dilution of ownership.
- SARS aren't regulated (like options or shares) nor deemed to be **securities**.

Disadvantages of SARs to the Company:

- The company doesn't receive any capital.
- The company may need to periodically lay out cash for interim appreciation as well as phantom dividends, if the plan provides for them.
- Payout obligations reduce reported ongoing earnings, which may reduce the value of company, which actual equity redemption obligations may not.
- The employee doesn't have *skin in the game* (i.e. *capital at risk*).

If structured and positioned correctly, SARs can be made to feel like bona fide employee equity participation, notwithstanding the better tax treatment for shares actually bought and paid for and held long enough to qualify for capital gains.

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C. OPTIONS TO PURCHASE EQUITY.

Options to purchase shares are **phantom equity** until they are exercised and **actual equity** afterwards, but primarily the former because private company options are rarely exercised until the shares can be quickly converted to cash, such as in an acquisition or IPO or when the employee is leaving.

Options to purchase equity can be for the purchase of

- 1) An existing shareholder's equity or
 - 2) New equity issued by the company.
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- 1) An option for an employee to buy an existing shareholder's shares is just an agreement between individuals, but like the purchase of actual equity from a shareholder, is subject to whatever restrictions may already exist with respect to those shares.
 - 2) Options to buy new shares from the company fall into two categories:
 - a) **Qualified Stock Options/Incentive Stock Options (ISOs)**
 - b) **Non-qualified/Non-statutory Stock Options (NSOs)**

Incentive Stock Options (ISOs) require a registered plan, are limited to employees owning less than 10% of the company, may be granted for a maximum of \$100,000 in stock value per year, must be exercised within the sooner of ten years or 3 months of leaving the company; and must have an exercise price not less than Fair Market Value at the date of grant.

The big advantage of ISOs to the employee is that there is no tax due on the gain upon exercise⁸, which is due upon exercise for non-ISO options. However, in order for ISO's to qualify for capital gains, the sale must be at least one year from date of exercise and two years from the option grant date.

Non-Qualified/ non-statutory options (NSOs) have no such regulatory restrictions, but should be memorialized in a definitive plan approved by shareholders. The primary disadvantage to the employee of non-qualified options is that any gain upon exercise is taxable as ordinary income to the holder, even though no cash is received. On the company's side, however, the employee's gain on the exercise is deductible to the company.

⁸ The paper gain of an ISO upon exercise, however, is a preference add back for Alternative Minimum Tax (AMT), even when no cash is received.

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Shares acquired by exercising NSOs and held for one year qualify for capital gains on the gain above the exercise price, which means a confident option holder will exercise early vs. waiting and paying ordinary tax on the entire gain.

All options typically “vest” over three to five years and expire in the sooner of about ten years, or 60 to 90 days after the employee leaves. Options are generally not transferable except under limited circumstances, such as temporarily to a deceased employee’s estate.

Many option plans provide for “accelerated vesting” if the company is sold, whereby option holders are paid for all their vested and unvested options the difference between their exercise price and the realized value of actual shares.

A company may also “cash out” un-vested options at the difference between their exercise price and Fair Market Value when the employee leaves involuntarily, or retires, but this is usually at the company’s discretion on a case-by-case basis.

Advantage of options (vs. outright purchase) to employees

- They have paid nothing and have no capital at risk, like SARs.
- Upside but no downside (assuming shares aren’t held after exercise).

Disadvantage of options to employees

- The gain on the exercise of NSOs is taxed as ordinary income.
- The gain on the exercise of ISO’s is subject to AMT.
- Post-exercise appreciation is taxed as ordinary income unless shares are held for one year (and 2 years from grant for ISOs).
- Option holders don’t get dividends or distributions.
- Appreciation usually isn’t realized in cash until the employee leaves or the company is sold or goes public.
- Option holders have no voting or minority shareholder rights.

Advantages of options to the Company

- The company receives non-taxable capital when options are exercised.
- The employee gets no voting or minority shareholder rights.
- The company gets a tax deduction equal to the gain upon exercise of NSO’s.
- Options don’t cost the company anything in cash until redeemed, i.e. no dividends or distributions⁹.

⁹ However, even if the option’s exercise price is the Fair Market Value at issuance, Generally Accepted Accounting Practices (GAAP) postulate that even options “at par” have “value” and require that GAAP financials show a “charge” (expense) against earnings in the year of grant.

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Disdvantages of options to the Company

- Unexercised options dilute earnings per share on a “fully” diluted basis.
- After exercise, all the same disadvantages as issuing actual equity.
- When options are exercised, the company gets paid for the shares, but in private companies that often will be offset by having to redeem the shares immediately at their higher current value (with after-tax dollars) because the employee is leaving, which is the most common reason for exercising.¹⁰

WARRANTS

Warrants are a form of non-statutory option to purchase shares, but are usually not tied to employment. They are typically issued by public companies to investors in conjunction with a financing or to investment bankers as part of their fee, but can be used by private companies as well. Warrants typically have a 5 or 10 year life and are usually transferable.

DOCUMENTATION AND VALUATION

All of the alternatives – actual shares, SARS and options - require written plans and agreements. Plans for SARs are fairly straightforward, but stock purchase agreements, shareholder agreements and option plans (which typically incorporate the first two) tend to be more complex and require customizing.

All of the alternatives also require prior agreement on a protocol to establish a value of the company’s shares, both at the outset as well as at future dates.

One valuation option is a financial statement-based formula, but these can get complicated as well as challenged. Simplistic measures such as book value or a multiple of some definition of profit may or may not suffice. In any case, if a formula is used, there need to be detailed definitions and clarity as to what is included and what is excluded, as well as considerations such as discounts for lack of control and/or marketability.

A credible valuation source of is a firm that does ESOP valuations, which conform to a standardized protocol, have the authority of independence and are pretty well universally accepted. Care should be taken in selecting such a firm because for continuity it is desirable to keep the same one over years.

¹⁰ In fact in public companies many if not most option exercises are “cashless exercises”, in which the employee pays nothing and receives the net difference between market and exercise prices.

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CONCLUSION

The trade-offs among the alternatives are numerous and the right answer depends on the needs and objectives of the company and its owners, e.g. to reward loyalty and performance; to provide incentives, financial security and promote retention of employees; to transfer ownership; to raise capital; to prepare for a sale or IPO; to maintain maximum flexibility and minimize taxes....,

Before embarking on any plan, especially options or outright equity issuance, the company should evaluate alternatives with their accounting and tax advisors. Most important is not to get locked into a plan that has not been thought through thoroughly and may be difficult to unwind.

Unless the company needs capital or there are other compelling reasons to sell shares, SARs would appear to be the safest way to start. It achieves many of the objectives of all three alternatives and some that the others don't. Most important a SARs plan can easily be converted into a real equity plan (e.g. settled in shares), or even terminated.

The foregoing was prepared for general information and educational purposes only, does not constitute legal or tax advice and should not be relied upon without first seeking the advice of an attorney and/or a CPA.

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