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 outstanding 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..*

NewCap Partners, Inc. giannini@newcap.com **www.newcap.com**

Sharing Equity in Private Companies

Employee equity participation can take the form of

A. **Actual equity ownership.**
B. **Stock Appreciation Rights (SARs) / 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 shareholder[1].

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 employee when received and vested. Sometimes companies will bonus cash to cover the tax due, but the end result is the same as granting the employee 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 exclusion[2]. 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] The purchase of 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.

Sharing Equity in Private Companies

Some companies have a practice of offering shares to employees comcurrent with receiving annual bonuses. Employees making the decision to buy shares with bonus money they could otherwise keep have made a greater commitment than if the equity had just been given to them.

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 agreements: ***A Stock Purchase Agreement*** *and* ***a Shareholder ("buy/sell") Agreement,*** which can, however be combined in one document.

- ***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 often 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 company[3]. 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 other rights of minority shareholders and the company's obligations to them.

Before issuing or buying shares, both the company and the employee should be aware that the tax treatment of redemptions can become complicated. A repurchase, for instance, may be considered a dividend (vs. a purchase) depending on what % of the company they own, what % of their holdings they are selling or their relationship to person(s) who control the company.

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

Sharing Equity in Private Companies

Advantages to the Employees of actually purchasing shares are**:**

- They feel as if they actually own a piece of the company, which they do.
- They usually get voting rights and in any case, 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 the shares and are at risk, assuming it's their money.
- There's no market for the shares. They probably won't see any cash except distributions until they leave or the company is sold or goes public.
- 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 an annual 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 rights[4].
- The company may need to add directors to its Board[5]
- Dilution to other shareholders (more shares outstanding).
- The company is obligated to pay them any dividends or distributions.
- Unless the company is sold or goes public, it will be obligated to redeem those shares with after-tax dollars when the employee leaves.[6]

Shares sold or gifted by an existing shareholder do not cause dilution or increase distribution obligations, but may create additional minority shareholders and possibly create pressure for pre-emptive redemption from the recipient, such as from the next generation, who may value cash more than shares.

---

[4] 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.

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

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

B. Stock Appreciation Rights (SARs)

Stock Appreciation Rights (SARs) are the economic equivalent of equity. Sometimes referred to as ***Phantom Equity***[7]**,** 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 with quoted share prices, but can also be used 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 years[8], meaning that the SARs-holder doesn’t have to wait for retirement, a sale or an IPO to realize some cash, even though SARs payments are taxed as ordinary compensation, subject to federal and state withholding and payroll taxes.

SARs payouts can be designed to lag in arrears, perhaps longer for people who leave voluntarily or 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 [7].

An important advantage of SARs to the company vs. shares is that they are “redeemable” with pre-tax cash, whereas, actual shares are not. At the same time, however, obligations to redeem SAR’s, which are actually deferred compensation, are expensed (or accrued if not paid contemporaneously), which reduces “earnings” and net worth, even in years in which no cash is expended. (Actual shares are redeemed with after tax dollars, but accounting-wise don’t impact reported profits)

If a company is sensitive to “financial statement earnings”, such as when being valued for an IPO or by private investors, SARs can be detrimental, but less so in a sale, assuming the accrued liability will be paid off and not carry forward.

[7] Technically Phantom stock should be used to refer to SARs that have dividend and distribution rights, but in practice the terms Phantom Stock and SARs, with and without such rights, are loosely used interchangeably.

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

© Valerio Giannini

Advantage of SARS to the employee vs. buying actual shares:
- 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.
- They get a full payout when they leave, vs. deferred payment for shares.

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 vs. giving or selling shares:
- The company only needs to redeem the appreciation, not the full value of appreciated shares.
- The appreciation payout /redemption is pre-tax, i.e. it's 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 will need to periodically lay out cash for interim appreciation, vs. shares, which aren't usually redeemed until the employee leaves, and even then payments may be spread over several years.
- The company will pay phantom dividends, if the plan includes them.
- Payout obligations reduce reported ongoing earnings, which may reduce the total 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.

© Valerio Giannini

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 leaves.

Options to purchase equity can be for the purchase of
1) An existing shareholder's equity or
2) New equity issued by the company.

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 individual 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 *paper profit* realized when the ISO is exercised[9]. 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) don't have ISO restrictions, but should be memorialized in a definitive plan approved by shareholders. The disadvantage of NSOs to employees is that any *paper profit* on exercise is taxed as ordinary income at the time of exercise, even though no cash is received. The gain after exercise qualifies for capital gains if the shares are held for one year.

[9] *Paper profit* means the difference between the exercise price and the market value when exercised, which is only "on paper", i.e. not paid. The paper profit of an ISO upon exercise, however, is preference add- back for Alternative Minimum Tax (AMT), even when no cash is received.

© Valerio Giannini

On the company's side, the employee's taxed paper profit on the exercise of NSOs is tax deductible to the company, but does impact reported earnings.

NSOs 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. ISOs and NSOs are generally not transferable except under limited circumstances, such as temporarily to a deceased employee's estate.

Some option plans provide for "accelerated vesting", meaning that if the company is sold, option holders are paid for all their vested and unvested options the difference between their exercise price and the transaction value of the shares.

A company may also "cash out" un-vested options at the difference between their exercise price and Fair Market Value when an employee leaves 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 exercised and held).

Disadvantage of options to employees

- The "paper" gain on the exercise of NSOs is taxed as ordinary income.
- The "paper" 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.
- Option holders have no voting or minority shareholder rights.
- Since there is no market for the shares, appreciation usually isn't realized in cash until the employee leaves or the company is sold or goes public.

Advantages of options to the Company

- 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, usually well down the line, i.e. no dividends or distributions[10],
- The employee gets no voting or minority shareholder rights.
- The company receives non-taxable capital when options are exercised.

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

© Valerio Giannini

Disdvantages of options to the Company

- Unexercised options dilute earnings per share on a "fully diluted" basis.
- After exercise, the shares become equity (q.v.).
- The "paper" profit upon exercise of NSOs is deductible and thus impacts accrual earnings.
- Although the company is supposed to get paid for the shares on exercise, given that the most common reason for "exercising" is because the employee is leaving, the company instead ends up having to immediately buy back the shares, or cash out in-the-money vested options, with after-tax dollars.[11]

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, to some degree.

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 needs to be clarity as to what is included and what is excluded, as well as considerations such as discounts to value for lack of control and/or marketability.

A credible valuation source 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.

[11] In fact in public companies many if not most option exercises are "cashless exercises", in which the employee simultaneously exercises the option, sells the shares and receives the difference between the market and exercise price, which is taxable as ordinary income..

CONCLUSION

The trade-offs among the alternatives are numerous and the right answer depends on the needs and objectives of the company and it owners, e.g. to reward loyalty and performance; to serve as compensation when the company is low on cash, 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. They achieve 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.

Valerio Giannini, *is a principal in the Orange County office of NewCap Partners, Inc. a private investment banking firm headquartered in Los Angeles.*

He also held appointments as Director of White House Operations and as a Deputy Assistant Secretary of Commerce. He has been CEO or COO of 3 public and 3 private companies, and a principal or intermediary in over 40 M&A transactions.

Mr. Giannini currently serves on the Board of Directors of Dudek & Associates and previously was a Director of Pro-Dex, Inc. (NASDQ), Numex (OTC), Fraser Yachts California and the Lynx Educational Foundation and an adjunct professor of Entrepreneurial Finance at Chapman University's Argyos School of Business.

Mr. Giannini holds a BSE from Princeton University and is listed in Who's Who in America and Who's Who in Industry and Finance. .

NewCap Partners, Inc. - giannini@newcap.com www.newcap.com