Podcast

Granting Equity the Right Way

By Craig A. Day, Kellie M. Thomas & Douglas J. Klein

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Details

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Tech startup companies often choose to compensate or incentive employees with some form of equity to conserve precious cash. Compensating employees with equity acts as an incentive for employees to work hard to get the company's product ready for market, with a potential big payoff down the road. But determining what kind of equity compensation is right for a particular business can be difficult and the rules are complicated.

Jackson Lewis P.C. · Granting Equity the Right Way

Transcript

Alitia Faccone (00:06):

Welcome to Jackson Lewis's podcast, We Get Work, focused solely on workplace issues. It is our job to help employers develop proactive strategies, strong policies, and business oriented solutions to cultivate an engaged, stable and inclusive workforce. Our podcast identifies issues that influence and impact the workplace, and its continuing evolution, and helps answer the question on every employer's mind. How will my business be impacted? Tech startup companies often compensate or incentivize employees with some form of equity, like stock options, to conserve precious cash and motivate employees to work hard to get the company's product ready for market, with the potential for a big payoff down the road. But determining what kind of equity compensation is right for our particular business can be difficult, and the rules are complicated. On this episode of We Get Work, we share practical advice about what kind of equity compensation employers should consider and how to avoid some of the most common pitfalls.

Alitia Faccone (01:11):

Our hosts today are Craig Day, Doug Klein, and Kellie Thomas. Principles respectively in the Seattle, New York City, and Baltimore offices of Jackson Lewis. Greg's combined background is in-house counsel, in private practice and consulting, has shaped his practical approach to helping clients find solutions to complex

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employee benefits issues. Doug helps employers face multifaceted workforce challenges amid rapid growth, and provides labor and employment advice to private equity investors engaged in due diligence and M&A transactions. Kellie's goal with every client is to provide practical and straightforward advice, that breaks down and makes accessible the myriad issues and considerations arising under the various federal and state laws and regulations affecting benefit plans. Craig, Doug, and Kellie, the question on everyone's mind today is what kind of equity compensation tech employers should consider, and how does that impact my business?

Doug Klein (02:14):

Craig and Kellie, I'm going to do today what I do pretty much every day, working here at Jackson Lewis, which is to rely on the experts, which I am not. I know enough to be dangerous, but to rely on the experts when it comes to issues of comp and equity. And I think, something I see regularly is just a basic framework, misunderstanding, even from experienced business persons. So Craig, first question for you, getting to the nuts and bolts of it. With respect to the corporate form, are there different consequences for equity and what do founders need to be thinking?

Craig Day (02:50):

A good question, Doug. I think that the most important thing for founders to think about it when they're trying to set up an equity plan, the whole goal here is to make sure that your employees interests are aligned with the company's interests and that they can profit when the company hits it big. And I think it's really important to think about your form, because only certain types of equity are available to corporations. They're not available to partnerships, for example. And there are so many different ways to give your employees a piece of the pie, some skin in the game, and it's really important to consider all the various types and then only to think about the options that are available to you. So partnerships don't need to worry about stock options, for example.

Doug Klein (03:36):

Got it.

Kellie Thomas (03:36):

And I'll chime in there, because I've had that experience with clients where everyone reads articles or sees what other companies are doing and comes in and says, "Hey, we want to grant everybody options." And then to Craig's point, "Well, you're a partnership so you can't really do that." So that's a place where it's helpful to partner with the right team. We are here and can help with different options for equity, but corporate council's important too, because they can help sort out that corporate form. Because, I have seen startups come to us early enough that, that's even at play in terms of how they end up structuring. And obviously there are considerations beyond just equity for employees that come into play when you're choosing your corporate form.

Doug Klein (04:18):

And turning to the menu of options, Kellie. What are the different types of incentive arrangements that founders can be thinking of once we get the corporate form sorted out?

Kellie Thomas (04:31):

Sure. So there's, as Craig said, lots of options out there. One of them being options, stock options. So that's basically, granting employees the right, at some future date, to purchase options in a corporation. That's probably the most common that you see when you do have a corporation. There's restricted stock, there's restricted stock units, there's stock appreciation rights, there's even phantom equity, which would be like equity, sometimes called synthetic equity where it's based on, for example, growth of the company, but you're not actually granting pieces of the company. So there's a lot of room for creativity.

Kellie Thomas (05:06):

And then, each one has its own best practices, pitfalls, things to be aware of. And that's where I think it can get a little bit tricky. So we like to get in early when we can with clients, so we can really talk through each one of those and make sure... The scenario we don't love to see is, employees have been promised some form of equity and they think that they have it, but it's not yet really been run through with corporate council, with us, papered up all of those legal pieces that are important on the backend to make sure everything's compliant.

Craig Day (05:39):

I think that's an important point, Kellie. And I think that one thing every owner should think about before they head down the path of handing out equity to their employees, is whether they really want to give employees an ownership interest in the company. And if so, how much? 10% of the company, 15% of the company? That's an important decision point up front. And if they don't want to give their employees actual ownership interest, they can give them the same economic benefit through a phantom stock planner, synthetic equity plan, or even a bonus plan of some sort that's tied to the value of the company and the profitability of the company.

Kellie Thomas (06:13):

Yeah, that's right. Sometimes cash is just easiest when you're first starting out, because there's a lot of balls in the air for a new company. And so, that is a place that you can start and you can always do it later there. That's always okay too. So I think, proactively thinking about these things. And then again, working with the right team to put them in place, is going to get everybody to a better result.

Doug Klein (06:36):

This concept of phantom equity I'm interested in, mostly because of the word phantom and it just sounds intriguing to me. Can you, Craig, pull the curtain back on the phantom a little bit for us and dive a little deeper on what a phantom equity plan is and how it functions and how it may be beneficial to a founder or founders of a startup?

Craig Day (06:57):

Sure. Phantom equity includes a lot of different types of plans, but basically what you do with the Phantom equity plan is, you try to design a benefit for your employees. You say, "We're going to give you x dollars worth of an award, based on the company's value today. And as the company's value increases, the value of that award increases. And when you ultimately get paid out, it's going to be as if you were an owner in the company. So you're going to have the same economic benefit." And there's a lot of interesting legal language that goes into them. Interesting only to those of us who draft them probably. And I won't get into that detail, but you certainly can, regardless of the form of the company and regardless of even if you are a corporation and you are deciding that you don't want to give employees an actual ownership interest, phantom equity works just perfectly and the design options are basically unlimited. So you can design it to work exactly like a stock option. You can design it to work exactly like restricted stock or anything else in between.

Kellie Thomas (08:06):

And the other thing to add to that is that, you can do both. So sometimes we'll see startups particularly bigger than a few people, but not quite up to your 20, 30 folks where they want, say, their C-suite employees to have real equity in the company or options to buy real equity in the company. And then for everyone else, they want to incentivize in that same manner. They want people to feel personally invested in the growth of the company, but don't want to... There's only so much of a company that you can give away at any given point. And so, you can use the phantom option for everyone else.

Doug Klein (08:38):

Interesting. Okay. Well along those lines, Kellie, because it seems like you do have good tips, could you share with us some of the common pitfalls that you've encountered in working with startups as they think through how to make equity part of the offering to incentivize existing employees, to attract talent? What are some common pitfalls that you've encountered?

Kellie Thomas (09:01):

Sure. I have one that really springs to mind, because it was a company that I worked with in really early stages and they had heard about the idea of phantom equity. And so, they came to us to put the plan together. But the way that phantom equity generally works is, there's some kind of valuation at that point in time when you're granting the awards, because you need to see what the delta is. So if you are awarding it and these awards are going to vest over a certain amount of time, and then you're going to get a cash bonus based on the increase in that value. Well you have to have a value to start with. And so, they came to us to put a plan in place, but before they even could do that, they needed to go through a valuation process, which they hadn't done yet.

Kellie Thomas (09:43):

And that's something that you engage a consultant to do for you. There are certain, if you're looking at it to make sure we're 4098 compliant for options and other reasons, you want all of those ducks in a row. And so, I think that was a bit of a surprise for them and a bit of a stumbling block to start, which was to find out they had this heavy lift that they needed, before they could actually move forward with putting this phantom equity plan into place. Craig, I know you've had some experience with options that are granted with no option plans, so I'm sure people would be interested in hearing about that.

Craig Day (10:17):

That seems to be a common problem for a startup company. Sometimes they get really excited about their idea and they start making offers to highly competent people that can help them drive the success of the company. And in the offer letters, they'll promise them a certain number of stock options. Which is fine if you have stock options to grant, but if you forget about it and you don't get the plan in place and suddenly one or two years down the road, the employee comes along and says, "Hey, remember those 10,000 options that you promised me? I haven't seen those yet."

Craig Day (10:48):

You can set up your plan at that point in time and you can grant options, but the price of the option might be different than, what it would've been at the time of the offer letter. If the company has increased in value, you have to grant the options at the fair market value on the date of grant, so you can't go back and give them the price they would've received when you first promised them the option. And I've had that happen a number of times and employees are not really happy and there's really no good way to fix that either.

Doug Klein (11:16):

And what about issues, which I've come across where you have a foreign entity, perhaps for the first time employing individuals in the United States, and trying to transfer over an equity arrangement to the US. What considerations must the US operating entity take into account when bringing an equity plan or the concept of equity from abroad, into the United States?

Kellie Thomas (11:41):

So that's, I think always a tricky one because it depends on where that equity's sitting. And the fact is that, different laws and different tax considerations apply in different scenarios. So I've seen it where, as Craig just described, you need for section 409A purposes, options in the US to be granted with a fair market value price on the grant date. That's not necessarily the case in other countries. And so, if you have someone sitting in the US who's getting options from a foreign parent, that may not have applied, but they're still taxed on their worldwide income. And so, there can be somewhat of a tension between what's being granted under the foreign parents plan and what is going to cause troubles from a tax perspective, here in the US. Because again, if the goal is to incentivize employees, what you don't want to do is to cause a big tax headache for them.

Kellie Thomas (12:34):

And that's one where, I don't feel like there's always a perfect solution to that. So it's more just issue spotting and maybe saying, "Well, is there a way to do some kind of equity setup, here in the US, that mirrors what's being done through the foreign parent if the tax issues are insurmountable?" But again, it's just something that it's so fact specific and case by case when we see them. It's just important to flag and work with your council to, hopefully design around if that's the ideal scenario, is that you're aware of it and then you can design around it.

Doug Klein (13:06):

Just for some baseline understanding. We've mentioned 409A, which is reference to the US tax code. Correct? Did I get that right?

Craig Day (13:14):

Mm-hmm.

Doug Klein (13:15):

Okay. See, good. I said I know enough to be dangerous here, but with respect to fair market value and valuation, could you just give a layperson's take on what the valuation prospect looks like and how that dovetails with these concepts of equity that we've been talking about today?

Craig Day (13:33):

Yeah. Code section 409A is a broad statutory provision that applies to deferred compensation, and it has a carve-out for equity. So stock options, for example, are not subject to 409A, as long as they're granted at an exercise price that's equal to the fair market value on the date of grant. So that's what drives the 409A evaluation. We need to make sure that you've granted it at the fair market value on the date of grant, there's no discount that the employee's going to receive. And there are a number of different ways under code section 409A that you can do evaluation of the company.

Craig Day (14:10):

Most of them involve an outside person that's independent, doing some kind of appraisal of the company or creating a formula that you can use to value the company. But it's critical to do it. And if you're granting options on an ongoing basis, for example, you'd want to do one every year, because you can use the valuation for about 12 months generally, and then you have to do another valuation. And so if you don't do that, then it becomes deferred compensation and it creates a mess for the recipients. It creates immediate taxation upon vesting, and then there's a 20% penalty that applies to employees as well.

Kellie Thomas (14:46):

And I'll just add, this is the kind of thing that comes up in deals. So I know a lot of startups are thinking about exit events eventually. And I will say, having worked at my old firm almost exclusively on deals doing diligence, which was very exciting, that's one of the first things that you look for. So if you see a stock option plan, you want to know, were these options granted with a fair market value on the grant date? And that's probably a rep in the purchase agreement. So it flows through and it's not only an issue to your own employees and to your own business, but also when you're looking to sell. It's absolutely the kind of thing that can get picked up in the diligence process.

Doug Klein (15:24):

So putting my wage and our attorney hat on, because I do know a fair amount in that space. Do you encounter situations where probably, more likely a former employee or former executive associated with a startup comes back with a wage and hour claim that's driven by a grant of equity, so that they were not compensated properly and they received equity in lieu of pay. Have you encountered any situations like that?

Craig Day (15:52):

So I've had a lot of clients come to me and say, "Look, I've only got one person here. He or she is absolutely critical to the mission of the company. I don't have any cash to pay them, so I'm going to pay them entirely with equity." And as you're pointing out, Doug, that can create a problem with minimum wage, all kinds of wage laws in various states. You can't really give somebody illiquid stock that they can't sell, in lieu of wages. So you need to give them some kind of a minimum wage and give them equity in addition to that. But I have had that come back for some of my clients.

Doug Klein (16:30):

Any other considerations that our startup founders listening, should be thinking about when it comes to equity, other than partnering with competent council to evaluate how they're offering it? But even to the extent that founders have plans are or they've made promises and perhaps the underlying documentation is not perfect, I assume it's better to address those issues now and try to come into compliance as opposed to, Kellie, to your point, trying to figure it out at an exit event or the like.

Kellie Thomas (17:04):

Absolutely. Yeah, it's never too late. I would say that across my practice area, where it's always better if we catch it ahead of time, but better to find it when you do and then address it. Because I think there are certain ways to minimize the problems, and better earlier than later. And to dovetail on that, talking about council and securities council, because that's another thing I think that sometimes can fly under the radar, is sometimes there are requirements to register certain securities under various state laws. That's a little outside of my wheelhouse, I'll be honest. But it is something that we always want to make sure, it goes into that larger overview of what you're thinking about when you're talking about putting a plan like this in place. So I think to me, the takeaway when I'm talking, it's not always so simple as it sounds or as you might see it on succession or something like that. We're just throwing out equity for anybody who wants it. There's a lot of considerations in place.

Craig Day (17:59):

Yeah, that's an important consideration, Kellie. And I've seen situations where people assumed they had employees in California and they wanted to grant them options, and they assumed that it was fine to just do that without registering the plan. You need to find an exception to the state registration rules or you need to register it in that state. So even if you are granting equity and all of your employees are currently in one state, you have to be careful if you have employees in other states, especially in the environment we're living in now, where a lot of employees are working remotely. You could have employees in a number of states and you may have to register in all of those states or find an exception that applies. That's a good point.

Doug Klein (18:40):

Greg, on that point, just with respect to COVID and the way in which employees have spread out across the United States, working in remote arrangements. Have you seen issues creep up that businesses didn't anticipate, with respect to equity or options? Or is it a federal law consideration across the board, so not really?

Craig Day (19:03):

No. We don't have federal law preemption like we do for ERISA Plans, with equity plans and state rules are definitely applicable. There are some federal exemptions on registration, and again, I'm not a securities lawyer either. I just happen to have worked next door to one for many, many years. So they drilled this into my head. But yes, it is a problem if you have employees to whom you were making regular grants of equity and they're in a state that you didn't contemplate when you granted the equity. You need to talk to your securities lawyer, make sure that you're covered in that state. It's a problem overall for employers, but definitely it's also an equity problem.

Doug Klein (19:44):

We're up against the clock here, so I will give Craig and Kellie just a quick moment to give any closing thoughts that we haven't been able to cover here, before signing off for the day. So Kellie, I'll put you on the spot first. Any closing thoughts on this very important topic?

Kellie Thomas (20:01):

Sure. I think that equity can be a great tool for a startup. Thinking about parameters you can put around grants that can be time vested, so you're encouraging people to stay for a period of time. They can be performance based, so that you're setting specific goals for people or for the company to hit before these things pay out. So they really do, going back to what Craig said at the beginning, they really tie into that ultimate goal of everyone feeling solidly invested in the success of the company. As the company rises, so does everyone else. So they're a great tool. Equity is a great tool. It's just a matter of implementing it in the right way.

Craig Day (20:40):

Yep. I agree. And to dovetail on that, I would say that every company that's deciding to go down the path of granting equity, even phantom equity, but certainly equity, think about the costs upfront. It seems like it's free, because it's not cash, it's not coming out of your pocket, but there are implementation costs. You've got to get yourself a document. You probably need to come up with software to administer the equity grants that you have. You're certainly going to need that if you're ever acquired by another company or if you go public. Or in certain rounds of financing, they want to know how many options you're outstanding. They always want to know that. So get a good record keeper, get your plan in place, get a solid team in place, and make sure you're doing your valuations on a regular basis. But do understand that, it's not as simple as it may seem and understand what those costs are upfront and plan for them.

Doug Klein (21:33):

Right. Well thank you. This has been extremely helpful for me and I hope for those who are listening, and we'll look forward to hopefully, not having too many pitfalls for our startup clients, but definitely if you're listening and need some direction, you know who to reach out to. So thank you to Craig and to Kellie, it's very helpful.

Kellie Thomas (21:53):

Thank you, Doug.

Craig Day (21:54):

Thank you.

Alitia Faccone (21:58):

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