KEY CONSIDERATIONS FOR EQUITY INCENTIVES

When is the right time to offer equity incentives to my employees?

As a general rule of thumb, the earlier you make grants/awards to employees, the better for two primary reasons: first, any potential tax advantages will usually be maximized if awards are made at the earlier stages of the company's growth, and second, employees will be further incentivized to reach desired performance goals with a grant/award actually in place. This is still the case even in light of the current economic environment and any new tax changes on the horizon. However, before you can implement any incentive compensation arrangements, you should consider some of the following factors:

- what group of employees you would like to reward;
- how closely should the reward be tied to specific measurable performance goals;
- what type of employment goals do you want to implement;
- will equity incentives be used as a balance instead of cash or other bonus arrangements, or will they make up more of the overall compensation program in light of expected salary reductions; and
- how can the equity incentive plan be used with the work incentives you currently have in place.

What forms of awards can I make?

A variety of equity incentive plans exist for companies to create employee incentives through pay-for-performance compensation systems. Stock options, stock bonuses, and stock purchase plans are frequently used to provide incentive compensation at all organizational levels in order to merge the interests of employees, managers, and investors. Stock options are fairly easy to administer, primarily because they do not require that the company establish any financial targets and due to their widespread use over the last couple of decades, a fairly well-developed industry practice has been accepted as to general terms, which can be modified on a case-by-case basis as the need arises.

In addition, there are also "simulated" equity arrangements, which may be more appropriate under certain circumstances. Although these would not involve actual equity of the company, they operate in similar fashion economically (i.e. tied to the net worth or an increase in value of the company) but avoid employees becoming shareholders or other equity owners. This may be important if you want to limit the number of shareholders or employees' ability to participate in voting matters, avoid complications of employees becoming members of a limited liability company, or restrict the timing of when the incentive compensation is paid. One drawback to these types of "simulated" plans, sometimes referred to as "phantom" equity plans or structured as "restricted stock units," is that they are primarily settled in cash, so anticipated cash-flow needs and other capital requirements will need to be well thought out for these plans to really work in achieving the intended consequences. Another potential issue may arise if these awards are offered to all (or most) employees rather than a select few management individuals.

How do I make offers to my employees; do I need to set up a formal equity ownership plan?

Although you are not required to adopt a specific plan in order to make equity awards to employees, there are a number of good reasons for a company to do so. Among these are (i) taking advantage of certain tax-qualified provisions relating to incentive stock options; (ii) qualifying for certain exemptions under federal and state securities laws relating to stock issued to employees; and (iii) presenting a more organized and favorable business profile from a diligence perspective, which may be helpful in negotiations with new investors or a possible acquirer of the company.

When a company does decide to implement a formal employee equity ownership program,

management will typically arrange for the preparation of an appropriate plan document. Typically, the plan's structure, as well as its specific terms and conditions, will be determined in consultation with the company's legal counsel, accountants, and outside compensation or benefits specialists. Generally, the company's legal counsel will prepare the plan documents. Factors taken into consideration in designing the plan will include the cost to the company and to proposed participants, the potential liquidity for participants, and the income tax and financial accounting consequences arising from the operation of the plan. Once you've given these factors some thought, it's a good idea to set up meetings with your legal counsel, accountants, and benefits specialists to get the process started.

What are the main structural components I should consider for employee option awards?

You should consider the following recommendations regarding terms and structure of stock option plans:

- Stock Option Reserve – generally, the overall amount of equity set aside for management and employees will range between 5 and 20%, depending upon industry factors and the percentage of overall compensation apportioned to equity.

- Types of Awards – for development-stage companies, usually just stock options are granted; founders and key executives may have direct stock issuances, but direct issuances raise additional tax, accounting, and corporate governance issues.

- Term of Plan/Option – the standard term is 10 years; in almost all instances the only modification would be a shorter term based on certain performance measures; however, if non-statutory options are granted, they can have a term greater than 10 years.

- Vesting/Exercise Features – most vesting is time based ranging in installments over anywhere from three to five years; more frequently now are options with some type of performance measure vesting based upon Board-approved metrics tied to targeted goals for the employee; usually, options may only be exercised if vested, and in some cases, options are being limited to exercise only in connection with a sale of the company or the final year of the term; in certain cases with executives, there may be some tax planning uses for an *early-exercise* feature.

- Acceleration of Vesting – should be reserved for uses with key management or executives demanding such as part of the initial employment offer; in structuring any acceleration in connection with a change of control, careful planning must be undertaken as the treatment of options usually have a significant impact upon such a transaction, sometimes with a negative impact to the company's shareholders.

- Post-Termination Exercise – this is usually limited to vested options only and for a period ranging from 30 days to 3 months; employees terminated for "cause" or "misconduct" usually forfeit options, including vested options; sometimes, the company has favorable buy-back rights for non-compliance with any post-termination restrictive covenants (such as competitive restrictions and trade secret protections).

- Repurchase Rights and Transfer Restriction – quite often, private companies have a buy-back right (generally at fair market value) upon termination of employment; in addition, the company (and perhaps other shareholders) will have a right of first refusal of any proposed third party transfers of shares; if the company has a shareholder agreement (or its equivalent), option holders will be required to adopt the terms as a condition to exercise; there are also some standard provisions in order to facilitate certain estate planning transactions, such as allowing shares to be transferred to family members or family trusts (subject to the transferee's adoption of the repurchase right and right of first refusal, etc.)

What happens to equity awards upon a Sale of the Company?

Depending upon the size of the transaction and the number of employees being retained, an acquirer may assume the outstanding options. Potential acquirers generally disfavor automatic acceleration of options in the event of a sale

because it impacts the level of incentives needed to retain key employees following the acquisition. If a target company cannot eliminate (or have employees waive) acceleration, the adverse impact will come at the expense of the target's shareholders, which can often lead to difficulties or a protracted level of negotiations during the period leading up to closing. Accordingly, it is best to leave maximum flexibility for the board to provided acceleration in specific awards to key employees, and quite often, that acceleration should be structured as so-called "double trigger" acceleration, which would occur only upon termination or under certain circumstances within a limited period (usually 12 months) following the acquisition. This approach provides a certain level of protection to the employee and still provides the necessary incentives an acquirer will need without a negative impact to the shareholder consideration received upon sale.

Options that are not assumed should terminate upon the closing of an acquisition. There are different approaches as to how to deal with options that are not assumed. These are usually left to the transaction negotiations (as to the portion of consideration to be allocated), and the plan or awards should provide for as much flexibility as possible in order to maximize shareholder return.

What are the tax ramifications related to incentive equity plans?

For stock options, there are two types, an incentive stock option ("ISO") or non-statutory stock option. ISO's must meet strict requirements under the Internal Revenue Code in order to receive preferential tax treatment. Listed below are some of the primary differences between ISO's and non-statutory options:

- ISO's are subject to a statutory holding period. This holding period is the later of two years after the granting of an option or one year from the date of exercise.

- The company obtains a deduction on exercise of a non-statutory option equal to the ordinary income recognized by the employee. The company receives no deduction with respect to ISO's unless there is a premature disposition by the employee, a so-called "disqualifying disposition."

- No *ordinary* income is recognized on the exercise of the ISO, but the "spread" is includible for purposes of the employee's AMT calculation.

- Non-statutory options provide the employer with flexibility in plan design, because of a lack of qualification rules. For example, non-statutory options may be granted to individuals who are not employees, such as valued outside contractors.

- Unlike ISO's, non-statutory options can be granted pursuant to a plan that is effective longer than ten years and the options can be outstanding for periods over ten years from date of grant.

For simulated equity awards, employees will generally be taxed at ordinary income rates for the year when payment is made. Because of certain recent changes in the tax laws concerning non-qualified deferred compensation, there is less flexibility for the timing of making payments to employees under these types of programs.

What additional issues should I be concerned with equity incentives if there is no established public trading market for my company's stock?

Lack of a public market for the underlying equity award often becomes an issue if there is a short-term need for liquidity. Sometimes, the company will serve a role in facilitating a buy-back either directly to the company or one or more of its shareholders. There are also smaller OTC markets becoming more popular for companies whose stock is not listed on an established exchange and who are not otherwise considered a reporting company under the Securities Exchange Act of 1934, as amended. This may also becomes applicable for those companies choosing to "*go private*" either through a reduction in the number of shareholders or through a private sale. The terms of outstanding options could impact the treatment or any exchange of options in a tender offer or other "going-private" transaction.

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