

Morgan Lewis

STARTUP & ACCELERATE

**YOUR TEAM IS YOUR FOUNDATION:
DISCUSSING YOUR COMPANY'S EQUITY COMPENSATION**

March 9, 2023

Erin Randolph-Williams, Brian Slough, Claire Rowland

Why Equity Compensation?

Morgan Lewis

Most employees being hired into emerging growth companies expect to receive some form of equity compensation.

- Most emerging growth companies do not have enough cash to pay competitive salaries.
- Employees want to get in at an early stage when the equity has a low value and work to help increase the equity value over time.
- Goal is to hold equity on a liquidation event/sale of the company.

Expect to negotiate with employees over the amount, type and terms of equity compensation.

The following slides will highlight certain considerations as to the amount, type and terms of equity compensation commonly used in emerging growth companies.

Governing Law/Rules



Internal Revenue Code

Securities Act of 1933

State corporate laws and securities laws

Financial accounting rules

Equity Compensation In Corporations

Morgan Lewis

Equity Compensation (Corporate)



Equity Compensation (Corporate)

What is a Stock Option?

Right to purchase a fixed number of shares at a fixed price

Types of Stock Options

Nonqualified Stock Options & Incentive Stock Options

Nonqualified Stock Options

Must have exercise price not less than fair market value to avoid tax issues under section 409A of the Internal Revenue Code

May be granted to any type of service provider (employee, director, consultant)

No tax at grant

Taxable at exercise on the spread (fair market value of the purchased shares at the time of exercise, less the exercise price of the purchased shares) at ordinary income rates

Incentive Stock Options



May only be granted to employees



Must have exercise price not less than fair market value



Corporations Only



Other Internal Revenue Code requirements (e.g., hold shares for two years from grant and one year from exercise)



No tax at grant



No income tax at exercise (alternative minimum tax applies on the spread at date of exercise)



Taxable at sale of stock at capital gain rates if holding period requirements are met



If shares are sold before expiration of holding period, a portion of the gain is taxed as ordinary income

Equity Compensation (Corporations)

Example: NQSO Exercise

Stock value per share on exercise date	\$15
Minus exercise price per share	<u>-10</u>
Equals ordinary income per share	\$5
Times number of options exercised	X <u>10,000</u>
Equals ordinary income ("spread")	\$50,000
Less: income tax at exercise (45%)	<u>(20,000)</u>
Net value	\$30,000

Equity Compensation (Corporations)

Example: ISO Exercise

Sales price per share	\$15
Minus exercise price per share (basis in the shares)	<u>-10</u>
Equals gain per share	\$5
Times number of shares exercised	X <u>10,000</u>
Equals total gain ("spread")	\$50,000
Less: capital gain tax when shares sold (27%)	<u>(13,500)</u>
Net value	\$36,500

Equity Compensation (Corporate)

Potential advantages of ISO compared to NQSO:

- Lower tax rate (capital gain)
- Delayed tax (tax at sale of shares)

Disadvantages of ISO compared to NQSO:

- Company has no tax deduction if employee recognizes capital gain
- Alternative minimum tax

Stock Appreciation Rights

Employee receives the spread between the value of the stock at exercise and the exercise price

Must have exercise price not less than fair market value to avoid tax issues under section 409A

Taxable at ordinary income rates on the fair market value of net shares or cash issued on exercise

The spread can be paid in stock or cash

No tax at grant

Deduction for company at time of exercise

Restricted Stock

Morgan Lewis

Generally taxed at time of vesting at ordinary income rates

83(b) Election

- Freezes ordinary income at date of grant
- Must be made within 30 days of grant/irrevocable
- Especially important where employee has paid purchase price for unvested shares
- No further taxation until shares are sold

Deduction for company at time of vesting or, if 83(b) election is made, at time of grant

Restricted Stock Units (RSUs)/Phantom Shares

Generally not taxed
until distribution

Ordinary income; no
83(b) election available
because no property
transferred until
distribution

Deduction for company at
distribution

Can be paid in cash or
stock

Performance-based
RSUs have vesting
based on achievement
of performance goals

Distribution can be
deferred beyond vesting,
must comply with section
409A

Equity Compensation In Limited Liability Companies

Morgan Lewis

Equity Compensation (LLCs)

Appreciation In Value

- Profits Interests
- Options (Nonqualified only)
- Phantom Appreciation Rights (More common than full-value phantom awards)

Full Value

- Capital Interests
- Phantom Award

Equity Compensation (LLCs)

Profits Interests

- Provide appreciation in value
- Can be transferred to an employee of the LLC without current tax
- Generally should make 83(b) election at grant
- On liquidation of the LLC immediately after the grant of the profits interest, the profits interest would NOT allow the recipient to participate in liquidating distributions – the recipient only has a share in the future profits and appreciation in value of the LLC following the date of grant

Capital Interests

- Provide full value of membership interest
- Taxed at grant or vesting (similar to restricted stock)
- The recipient has a grant date economic right in the underlying capital of the LLC, as well as its profits and losses on a going forward basis
- Entitles the holder to share in the proceeds if the LLC's assets are sold at fair market value and the proceeds are then distributed in a complete liquidation of the LLC immediately after the interest is granted

Equity Compensation (LLCs)

- Ownership of profits interests or capital interests generally makes the holder a “member” instead of an “employee” of the LLC, so income is reported on Form K-1 instead of Form W-2

Equity Compensation (LLC)

Options (Nonqualified Only)

- Entitles a recipient to purchase LLC interests at a later date for a purchase price that is at least equal to the fair market value of the LLC interests on the date the option is granted
- Option holder is generally not an equity holder for tax and state law purposes with respect to the underlying option equity until the date of exercise
- No income tax upon grant
- Under Section 409A of the Code, options cannot be granted with an exercise price below fair market value
- Profits interests and options on LLC interests are economically similar, but there are tax advantages for holders of profits interests

Equity Compensation (LLC)

Phantom Equity

- Can be an appreciation award or full value award
- Bonus awards that mimic equity
- Not really treated as equity for state law or tax purposes
- Employee can participate in the financial rewards of ownership without voting and other rights associated with equity ownership
- Generally subject to vesting, whether time-based or performance-based
- Taxed like a nonqualified deferred compensation plan

Key Considerations

Options/SARs

Advantages

- Gives employee appreciation in value without employee having to make an investment or pay tax currently
 - No tax at grant or vesting
- Employee can choose when to exercise the option/SAR
 - Employee can control date of taxation
 - Most employees wait until a liquidity event to exercise options/SARs because they don't want to pay for stock that may never be liquid
- ISO can result in capital gain if shares are held for holding period
- Often used for private companies

Disadvantages

- Options/SARs can go underwater (if fair market value is less than exercise price)
- Financial accounting charges are based on Black-Scholes value

Full Value Awards

Advantages

- Employee receives existing value of the shares/units, not just the appreciation
- Full value awards do not go underwater
- Financial accounting charge correlates to value delivered
- Restricted stock/Capital interests:
 - Can lock in tax event at grant or vesting, so future appreciation is capital gain
 - Often used for founders shares
- RSUs/Phantom equity
 - Postpone tax until distribution date
 - Often vest based on performance goals

Disadvantages

- Employee receives existing value of the shares/units; reward for breathing
- Employee has little control over when the shares/units are taxed
- Employee may have to pay tax before a liquidity event

Terms of Equity Grants



Vesting



Fair Market Value



**Repurchase rights by
the corporation/right of
first refusal**



**Non-competition
covenants/
clawbacks**



Change of control

Single trigger/ Double trigger
Need flexibility to cash out
equity grants



**Levels of equity
grants**



**Hiring a new
executive**

What form of equity?
How much equity? Terms?



No backdating!

Importance of
contemporaneous
documentation

Accounting Consequences of Equity Compensation

FASB ASC Topic 718

Compensation cost for full-value awards is based on the market value of the stock on the date of grant, and amortized over the service period

- Restricted stock
- RSUs settled in stock

For securities issued on the vesting of restricted interests, a company is generally required to amortize over the vesting period a compensation cost equal to the fair market value of the underlying securities on the date of the award

Compensation cost for options and stock-settled SARs is estimated at grant date using an option-pricing model (usually Black-Scholes) and amortized over the service period

- Stock options
- SARs

Compensation cost for liability awards has to be remeasured at the end of each reporting period until exercise or settlement (variable accounting)

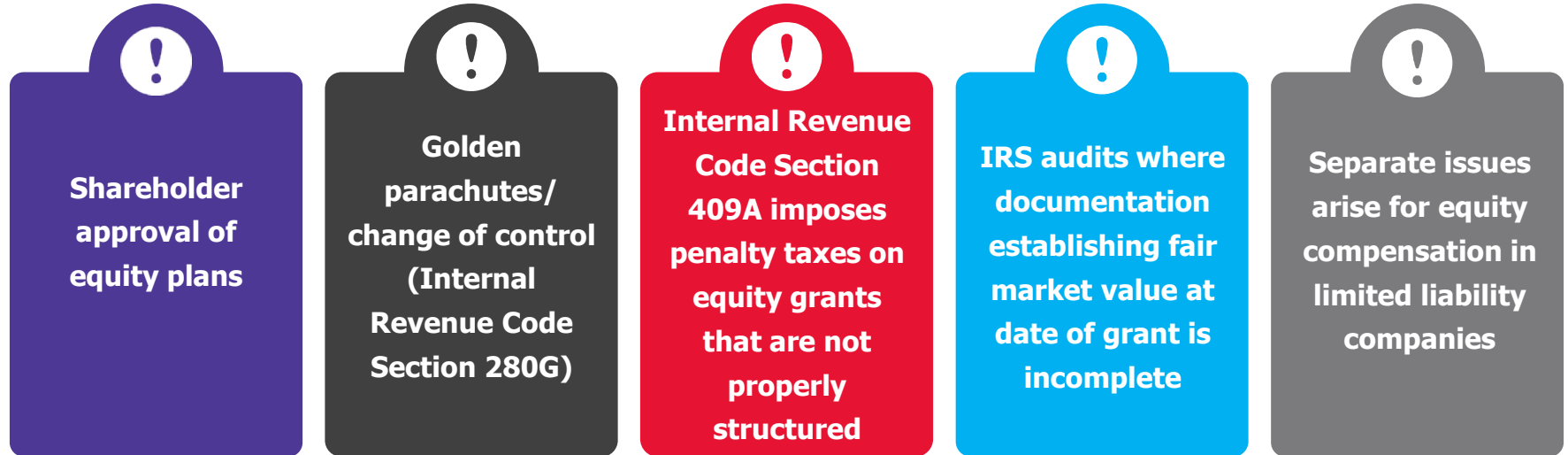
- Cash-based SARs
- RSUs settled in cash

Securities Law Requirements



State securities laws (“blue sky laws”)

Executive Compensation Issues



Key Takeaways

Morgan Lewis

Restricted stock may be best for founders shares

- Do not forget 83(b) election; very short time frame

Options usually best for private company after stock starts to appreciate

It is worth the investment to have the equity plan and procedures set up correctly

IRS is auditing equity compensation, so it is important to keep accurate, contemporaneous board of directors minutes documenting equity grants

Expect to negotiate with the employee regarding the amount, type and terms of equity compensation

P.S. Other Employee Benefit Plan Issues Grab Bag



Retirement Plans



Health Plans



Cafeteria Plans



**Professional
employer
organizations
(PEOs)**



**Do not set it and
forget it**



Questions?

Morgan Lewis

Biography



Erin Randolph-Williams

Partner

Philadelphia, PA

+1.215.963.5982

erin.randolph-
williams@morganlewis.com

Erin Randolph-Williams is part of a team that helps clients find solutions to their employee benefits–related problems. She counsels clients on employee benefits matters, including design, implementation, and administration of cash or deferred compensation arrangements, nonqualified deferred compensation plans, and executive and equity compensation arrangements. Erin negotiates employment agreements and severance arrangements for senior executives, and advises clients on all employee benefits and compensation-related aspects of mergers, acquisitions, sales and spin-offs.

Biography



Brian P. Slough

Of Counsel

Philadelphia, PA

+1.215.963.5256

brian.slough@morganlewis.com

Brian P. Slough is a seasoned practitioner who counsels clients on a range of business and legal matters. His diverse legal practice and business background enable him to holistically service clients. While he often acts as general counsel to assist clients on a variety of governance and operational issues, Brian also advises venture capital, private equity, institutional, and strategic investors on financing, mergers and acquisitions (M&A), and portfolio transactions. Additionally, Brian counsels founders, emerging businesses, and other innovative companies at every stage of the lifecycle, from inception through exit.

Biography



Claire P. Rowland

Associate

Seattle, WA

+1.206.274.6405

claire.rowland@morganlewis.com

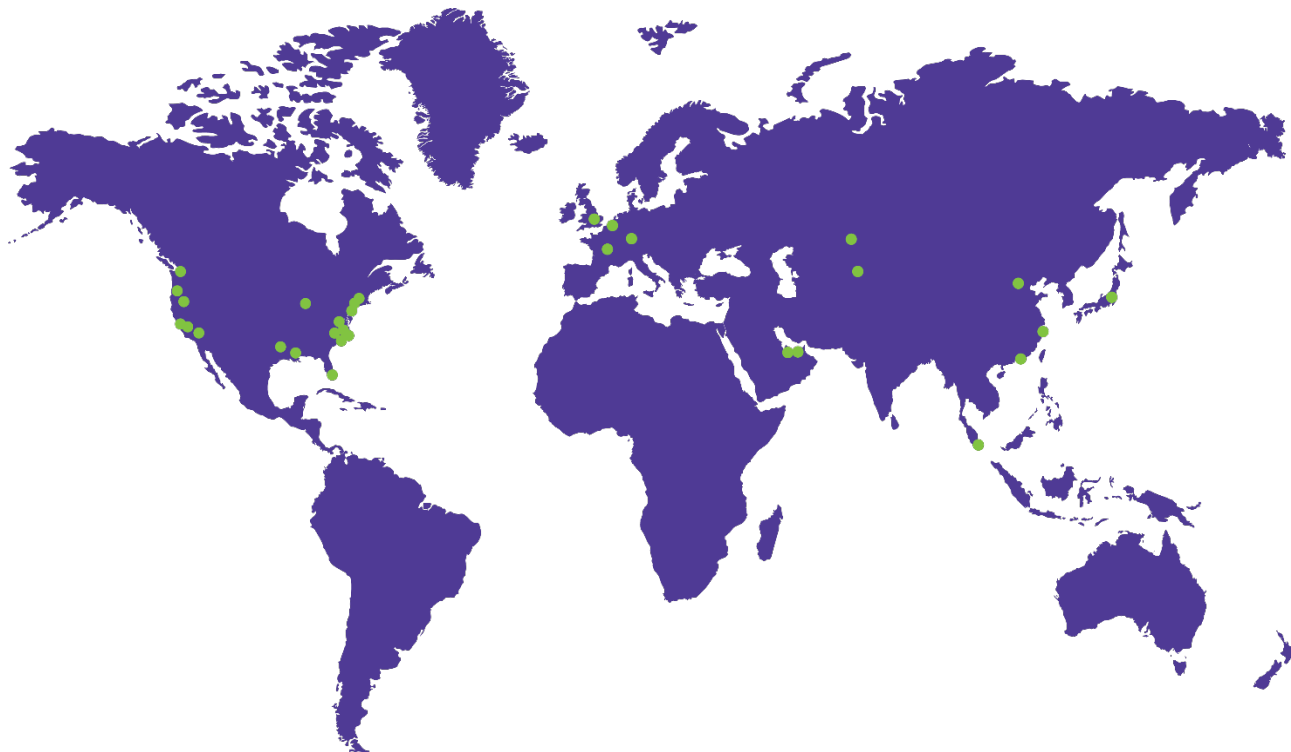
Claire Powell Rowland is an associate with the employee benefit and executive compensation practice. Her practice focuses on providing real world, business-minded advice to employee benefit plan sponsors in all industries, including public and private companies, startups, professional employer organizations (PEOs), governmental entities, higher education institutions, and non-profit organizations. Claire counsels clients in plan design, regulatory compliance and corrections, defense of governmental audits by the Internal Revenue Service (IRS), US Department of Labor (DOL), and Pension Benefit Guaranty Corporation (PBGC), mergers and acquisitions, and ERISA class action litigation defense.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
Shanghai*
Silicon Valley
Singapore*
Tokyo
Washington, DC
Wilmington



Morgan Lewis

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU

© 2023 Morgan, Lewis & Bockius LLP
© 2023 Morgan Lewis Stamford LLC
© 2023 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.