

USING STOCK OR OPTIONS AS COMPENSATION FOR KEY EMPLOYEES

By Marilyn J. Holt, CMC

Options are best opportunity to recruit the people you want in your industry, but there are some huge pitfalls.

All employees can receive compensation in stock. Senior employees — the “C-somethings” and those at or above the VP level, usually demand it during contract negotiations. Other employees usually will accept it as part of a general benefits package to offset salaries at the low-end of the going market rates.

To do this properly, a company must set up a stock vesting program that encompasses key employees and all other employees. These should be separate plans.

Regular employees should have a stock option plan in place that is part of their compensation and benefits package. It is usually an Employee Stock Option Plan (ESOP), Employee Retirement Income Security Act (ERISA) plan, or other qualified stock option plan. It is best to use a plan with which employees are familiar and comfortable.

Key employees usually have their stock compensation plans embedded in their employment contracts, although a company

can establish policies on key employee stock compensation.

PLAN BEFORE YOU GRANT STOCK OR OPTIONS

Separate types of stock should be established. For example, it could be a specific type preferred stock, although most key employees want common stock. Management, in conjunction with an attorney and an accountant, establishes the plan. The employee stock pool can be protected from dilution, and, if more shares are authorized, the pool must specifically have more shares added, in most cases. Just as with any other type of stock, there will be well-defined rules for all aspects of it. There may be voting restrictions on these shares.

The amount of stock set aside for employees used to be 15%. However, in the past two years, key employee portions have grown to 15%, causing larger pools that are up to 25% of all stock being held for employees. Investors tend to view this favorably.

These agreements have to be written, and are usually embedded in or referenced by the employment agreement. Because these agreements are rarely renegotiated, the stock compensation portion of the employment agreement is usually one of the first parts negotiated with the prospective key employee.

This is not haphazard. It must be planned, and a written plan developed and approved by management, legal, and accounting.

The plans really should be done before you start hiring at this level, although the first key employees into a company often establish the plan, and write an addendum to their employment agreements to cover what has been done informally.

Since this is often done about the same time as the first rounds of funding, some angel investors and West Coast VC firms will accept a general description of the stock pool and plan, such as "20% of all stock will be set aside for employees." For later funding, large and East Coast VC firms prefer substantial plans and signed agreements.

Stock compensation plans for key employees are usually set to milestones for key employees, and for everyone else based on wages. A company may peg stock option bonuses on company milestones, such as reaching \$1 million in sales per month.

Key employee stock plans should be specific about: vesting; expiration;

conformity of plan; withholding taxes; payments; adjustments; transferability; and registration. Your legal counsel may add to this.

STOCK OR OPTIONS A TAX DECISION

Employees can receive either payment of wages in stock or they can receive stock options.

Payment in stock triggers a taxable event; you must pay your income taxes on the value received for your labors. The taxes are due as part of your income taxes. One way to handle this is to have payroll pay the federal and state taxes and other fees on the wages, then the remainder is converted to stock at a pre-set price.

Payment of stock options is in addition to a salary, and does not usually trigger a taxable event. Depending on how the stock transfer is structured, there may be no taxable event until the stock received from these options is sold.

Receipt of stock options is usually keyed to milestones. For example, the stock option section of the employment agreement could specify:

"Upon signing [Key Employee] will receive options [in accordance with the Key Employee Stock Option Plan] for 500,000 shares of stock in the company at time of signing, using the following vesting schedule:

100,000 upon signing.

- 100,000 when outside investment in the company exceeds \$4 million.
 - 100,000 when outside investment exceeds a total of \$16 million.
 - 50,000 as of the first day of the second month following the month where The Company's gross revenue exceeds \$20,000 per month.
 - 50,000 as of the first day of the second month following the month where The Company's gross revenue exceeds \$100,000 per month.
 - 100,000 as of the first day of the second month following the month where The Company's gross revenue exceeds \$1 million per month.
- Other stock options and bonuses may be granted by the board of directors."

of securities fraud because some companies have back-dated the options, which defrauds other shareholders. It is best to grant options in an organized and legal fashion. This is one area you need an attorney experience in early-stage stock options.

Stock options allow start-up companies to afford the high-priced talent they need while delaying or offsetting full compensation. They have the effect of rewarding exceptional performance with exceptional rewards. Most significantly, for both employer and key employee, stock options have become a standard part of the employment package.

STOCK SIMPLY PART OF THE DEAL

Stock compensation has always been around; however, it became very popular in the 1970's with the high-tech firms in Silicon Valley. When the firms became successful, everyone associated with the firms benefited. There are several reasons that stock compensation, particularly options, has become so prevalent. Options can a source

Copyright © 2000, 2007 Marilyn J. Holt

All rights reserved. No part of this work may be reproduced or distributed in any form or by any means, or stored in any database or retrieval system without prior and express written permission of the author and publisher. Contact Holt Capital for reprint permission.