

# Private Equity Update

An informational newsletter from Goodwin Procter's Private Equity Group

## Ten Thoughts About Equity Compensation for Investors and Entrepreneurs

Equity compensation is a subject that captures the attention of private equity and venture capital investors and company management teams alike. For many years, the rules and standard techniques used to grant equity compensation were relatively static. More recently, however, changes in the tax, accounting and securities laws and development of new techniques have led to new approaches. Some of the changes, such as the requirement to expense options, have been well publicized. Other changes are less obvious, and present both opportunities and pitfalls for the unwary.

The following is a summary of 10 thoughts about equity compensation in the current environment.

**1. Profits Interests.** The reduction of the federal long-term capital gains rate to 15% has led to renewed focus on equity compensation approaches that will generate long-term capital gains. Options usually will not. And while restricted stock will produce capital gain treatment, many executives are reluctant to risk the capital or incur the tax necessary to start a capital gains holding period for restricted stock, even when equity value is low. In this environment, sponsors increasingly consider holding the stock of their portfolio companies through an LLC and granting LLC "profits interests" to top management.

The grant of a profits interest will not result in tax to the grantee if properly structured. Gain above the "strike price" can be capital in nature, and the LLC interests are rolled into stock upon an IPO. However, LLC interests will not give rise to a tax deduction for the company, unlike the cash out of options in a liquidity event or the exercise of nonqualified stock options.

**2. Tax Deductions on Sale.** The cash out of options at the time of a sale of a company produces a tax deduction equal to the spread between the value of the stock and the strike price. Historically, buyers have obtained the benefit of this deduction, which remains on the tax books of the target company. Increasingly, financial sponsors and other sellers are demanding to be compensated for some or all of this benefit. Buyers may argue that the availability or timing of this tax benefit is uncertain, but in a hotly contested auction process a buyer's willingness to share these benefits with the seller can help win the deal.

**3. Options vs. Restricted Stock.** Under FAS 123R, the accounting treatment for options is generally less favorable than the accounting treatment for restricted stock. Generally, options need to be valued under a Black-Scholes or binomial formula, with the value taken as an expense over the vesting period, even if the grant is made at fair

market value (FMV). (Private companies may still use the intrinsic value method but must mark the options to market on a quarterly basis under so-called variable accounting.) The longer the option term and the higher the volatility of the stock, the greater the charge. Restricted stock, by contrast, will result in a P&L expense only to the extent the purchase price is less than FMV, as under the old APB 25 rules. The expense is taken over the “vesting” period (i.e., the period in which the restricted stock is subject to forfeiture).

Restricted stock granted to employees for no consideration, as is typically the case, has a greater value than FMV options on the same number of shares of stock, with both upside potential and downside protection. Accordingly, public and private issuers tend to grant fewer shares of restricted stock relative to a comparable option grant, resulting in lower dilution.

**4. FMV.** Determining the fair market value of equity awards has always been important, since grants below FMV result in earnings charges under GAAP and (in the case of stock options) cannot qualify as ISOs. However, the new deferred compensation tax rules have put increased pressure on FMV determinations. Under the new rules, if an option is granted with a strike price below FMV, the option will be taxed as it vests (resulting in “phantom income”) and a 20% additional tax will apply to the recipient. Accordingly, many private issuers are obtaining third party appraisals to support FMV determinations (which practice is also strongly recommended by accounting guidance from the AICPA), and board deliberations concerning strike/purchase prices for grants increasingly are documented with an extra level of care and detail. This is a particularly critical issue for issuers contemplating an initial public offering, as any cheap stock charges may provide ammunition to the Internal Revenue Service in arguing that option grants were not made at FMV. It is important to note that the new deferred compensation tax rules generally do not apply to grants of restricted stock or profits interests.

**5. Performance Vesting.** Historically, issuers have viewed performance-based vesting favorably due to its ability to align executive and corporate goals. But they have been frustrated by accounting rules that required quarterly mark-to-market accounting unless the performance-based award included a fixed date for vesting, which could result in vesting of the grant even if the performance hurdles were not met. FAS 123R changed this approach and mandated fixed accounting treatment for performance-based options and restricted stock, thus eliminating the need for a cliff vesting date. This has spurred broader use of performance-based vesting.

**6. Change in Control.** It is fair to say that no “market standard” has emerged for treatment of vesting on a change in control. For public companies, full acceleration is common, but for many new public companies, like private companies, so called “double trigger” vesting is often used. Under “double trigger” vesting, options assumed in a change in control vest if the optionee is terminated without cause (or resigns for good reason) within a specified period after a sale. Full vesting on an IPO is rare, although sometimes companies provide for partial acceleration on an IPO to incentivize management. If options are not assumed, mandatory or discretionary acceleration on a sale usually occurs, although acceleration of performance-based vesting terms varies widely – management will argue that a sale before the performance period has elapsed precludes attainment of the specified objective (unless it is based on exit price per share), whereas a board may be disinclined to vest an equity grant that has not been “earned.”

**7. Pool Size.** Issuers generally appear to be establishing pools that are comparable in size to pools established prior to the accounting changes, ranging from 5%-10% for more established companies and later stage recaps to 15%-20% for technology, life sciences and early stage companies. Also, since equity compensation has become more expensive from an accounting perspective, some companies have considered reducing or even eliminating equity awards to non-management employees. In any case, issuers need to be sure that equity granted before a public offering does not exceed applicable SEC (i.e., Rule 701) and state “blue sky” limits and that shareholders approve a sufficient number of equity grants prior to going public, as stock exchanges now essentially require that all equity awards be made from shareholder approved pools. Many will remember that the Google offering, while ultimately successful, faced SEC scrutiny and sanction because the company’s pre-public option issuances exceeded SEC limits.

**8. Amendments.** Not many years ago, options were repriced or otherwise amended frequently as circumstances changed. Now, under FAS 123R, charges resulting from amendments, including repricing, will be fixed rather than variable on a mark-to-market basis. For example, the repricing of an option from a \$10 per share exercise price to \$6 per share (assuming \$6 per share is then FMV) will result in a fixed charge equal to the increase in the option’s fair value (e.g., the difference between the Black-Scholes value of the option immediately before and immediately after the repricing) taken over the remaining vesting period of the option. In this example, the charge is likely to be significantly less than the \$4 reduction in the exercise price. The new deferred compensation rules, however, greatly restrict the ability to amend outstanding options without adverse tax consequences.

**9. Buy Backs.** While there is no “market” standard for treatment of vested equity awards when an employee departs, many private issuers include in award agreements a right to buy back vested shares. The repurchase price is usually FMV, determined by the board or by appraisal, and sometimes the lower of cost or FMV if the termination is for cause. Another variation that has gained some popularity is a non-compete claw back, where shares are forfeited if a non-competition provision is breached. Call rights are usually accompanied by transfer restrictions.

Buy back rights are waived in many cases and usually disappear upon an IPO. For a closely-held company, however, the right to buy back shares from an employee who leaves on bad terms can avoid future conflicts, and permits recycling of the equity to successors or other employees who will build the issuer’s future value. It is important to remember that all shareholders, including disgruntled former employees, have broad inspection rights and are owed fiduciary duties. In addition, there is a possibility that future IRS guidance under the new deferred compensation tax rules may impact how buy backs may be structured and effected.

**10. Notes.** During the dot com boom, the exercise price of options and the purchase price of restricted stock were often paid with full or partial recourse promissory notes. As markets returned to earth, many obligors under such notes found themselves either paying a bankruptcy trustee for worthless stock or recognizing forgiveness of indebtedness income. As a result, and also because Sarbanes-Oxley prohibits executive officers of public issuers from having outstanding loans from the time a registration statement is filed, note arrangements have become far less common.

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