Motivating Employees Through Company Equity – Scenarios

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Scenarios
I. Start Up/Formation

- Several founders
- Not much money to start the company
- Sweat equity component for some of the founders
- IP contribution
  - Restricted stock with vesting schedule
  - Considerations
    - Beware of immigration issues
    - Beware of Illinois Wage Payment and Collection Act
    - No unpaid interns unless stockholders
    - 83(b) election likely appropriate

Scenarios
II. A Little Further Along

- Founders already established
- Need to attract some knowledgeable employees (perhaps post doc level people)
- No significant outside investment that has set a valuation on the company
  - Restricted stock with vesting schedule
  - Stock options with vesting schedule (implement stock option plan)
  - Considerations
    - 83(b) election likely appropriate
    - Illiquid start up valuation method likely available
    - Implement option pool

Scenarios
III. First VC Round

- Post-money valuation of $1.5M
- Investors have a lot of leverage

  - Stock options
  - Restricted stock likely not optimum as it would generate adverse income tax consequences

  - Considerations
    - Workout size of option pool with investors
    - Illiquid start up valuation method likely available

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Scenarios
IV. Later Stages

- Stock options
- Restricted stock likely not optimum as it would generate adverse income tax consequences

- Considerations
  - Size of option pool is set
  - Approval of stockholders/investors is needed to increase the size of the option pool
  - Outside valuation most likely needed – illiquid start up valuation method likely not available as the company is no longer a start up (older than 10 years) or company is "too big"

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Scenarios
V. "Rearranging" Founder Equity

- Three founders each owning one-third of the company equity
- One agreeing to leave
- Possibilities:

  - Restricted stock which is not vested is forfeited
  - Fully vested stock may be:
    - Repurchased by the company (redemption)
    - Purchased by the other stockholders
    - Gifted (gift tax provisions apply – $14,000 annual gift exclusion in 2014)
  - In all cases at FMV

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Scenarios
VI. Very Mature Stage – Sale to an ESOP

- 50M in revenue
- Founders seek to be bought out yet reward employees and keep the business running
- Stock is held in a trust for employees meeting minimum service requirements and allocated to employees
  - Champaign based companies Hobbico and Human Kinetics

- Considerations
  - ESOPs are funded by the employer, not the employees
  - Potential beneficial tax treatment for seller
  - Owner can stay with the business or retire
  - FMV must be determined at least annually by an outside, independent appraiser
  - The company is making enough money to buy out an owner
  - Management continuity must be provided
  - Maintenance of ESOP is costly and complex

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