Staying Private:

Liquidity Options for Employee Equity Compensation

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Agenda

1. Design with Liquidity in Mind
2. Internal Redemptions of Employee Equity Awards
3. Selling to Employees and Investors
4. Dividend Equivalents as Interim Value Delivery
5. Secondary Markets
6. Becoming an ESOP
7. Private Equity and ESOPs: Combining Two Possibilities
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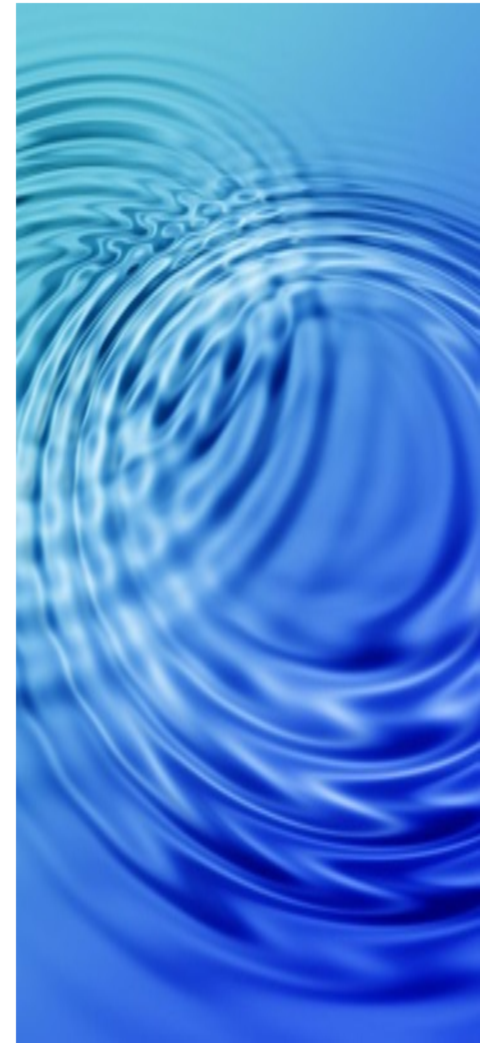
Design with Liquidity in Mind

- Ownership is the Enticement, Liquidity is the Reward
- Design beyond the traditional liquidity events of IPO and Acquisition
- Uncertainty drives decreased value. Decreased value drives more dilution. Dilution creates pressure on everyone.
- Nearly all employee equity has a defined expiration. Liquidity is best if it's potential is understood long before the equity disappears.
- Nearly all employee equity results in income and taxes. Without liquidity, most employees find it difficult to take advantage of their equity.
- Stock options have the added hurdle of an exercise price. This is often too great a hurdle for many employees to navigate.
- Liquidity possibilities can be designed to support your cash flow and other concerns. Designs can clearly define the limits and potential of liquidity while still communicating real value.
- Valuation and Appreciation should be clear and consistent. The cost of this process is nominal when compared to the value it delivers.

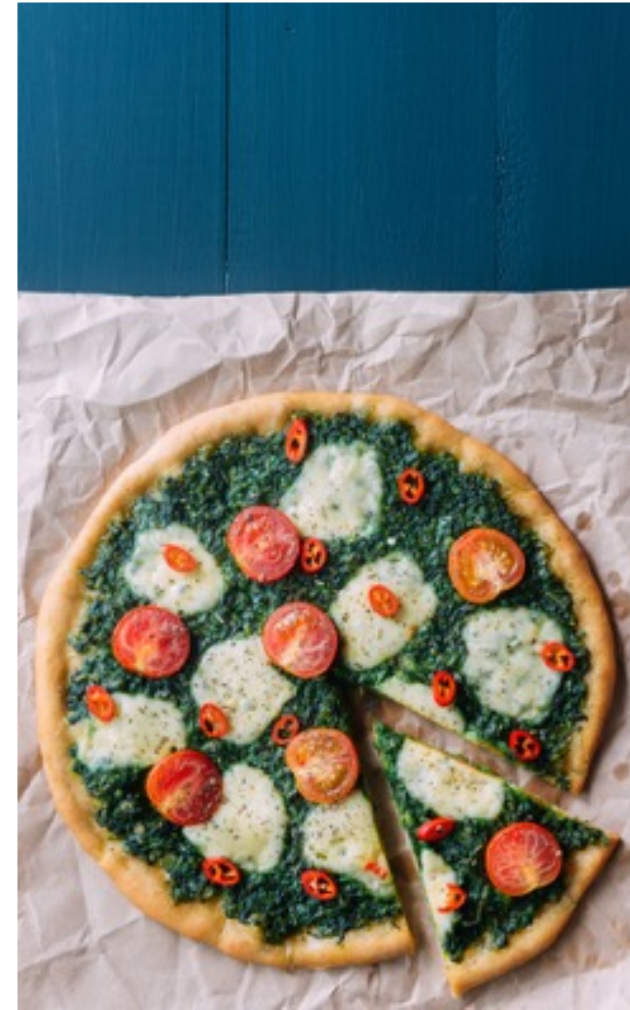


Redemptions

- <u>Buying the Shares from Your Employees</u>
- The company must purchase the stock with after-tax funds.
- Shares held for a sufficient period after acquisition may be taxed at Capital Gains or Dividend rates.
    - Review IRC Section 302 for Capital Gains requirements
    - Capital Gains treatment may be a hurdle for majority shareholders
- Redemptions of shares resulting from recent transactions from equity plans such as stock options, RSUs, restricted stock, and similar programs will receive the tax treatment defined for that award type.
- Redeemed shares may be recycled or retired. Retirement may result in a higher per-share value.
- Redemptions are **not tax-deductible** events for the company.

Sales to Employees

- Letting Your Employees Buy a Bigger Piece of the Pie
- The company can allow, or even facilitate, the purchase of employee equity by other employees.
- Tax treatment for the company is similar to a redemption.
- This approach can be used to allow the purchase by several employees, of one individuals large position (including an executive or founder).
- The company can help fund this purchase by providing the purchase employees with a Bonus or Loan to cover the cost.
- The company can also create an internal market for company stock. This can be an active market, or something
  more limited that allows for infrequent purchases.
- State and Federal securities rules will apply to these transactions, but the restrictions are fairly limited when the company or values are small.



Outside Investors

- Opportunities for Investors and Employees
- Allow investors to exit according to their timeline. Bring in new investors who are enthusiastic about the future.
- Allow employees to “tag along” in this type of sale. May create a “release valve” for long-term employee equity holders. May also reduce dilution and open up opportunities to grant new equity to employees.
- New investors seldom purchase for the same basic rights as legacy shareholders. They may leverage the transaction through Board seats, Preferred Stock, guaranteed minimum returns, and more.

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Dividend Equivalents

- Interim Value for Employees When Liquidity is Difficult
- Dividend Equivalents can be built into any employee equity plan.
- Most commonly they are essentially a cash bonus where value is delivered based on a pro rata amount of the employee's equity outstanding.
- Can be delivered to employees even if no dividend is paid to shareholders. This may require some convincing for investors.
- Allows a limited and structured release of pressure on outstanding equity without changing ownership structures or requiring additional fees and transaction costs.
- Can be delivered only when the company has available
  funds that do not impact other strategic or tactical needs.

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Secondary (and similar) Markets

- When You Are a Hot Commodity, but Not Ready to Go Public
- There are now secondary markets such as NASDAQ's SecondMarket and SharesPost, and similar tools like EquityZen, that allow investors to buy equity.
- Participants are almost exclusively highly valued, pre-IPO, companies who are still years from an IPO.
- Activity being driven by longer pre-IPO periods and high pre-IPO valuations.
- Lack of liquidity for individuals (founders and employees) with high-cost, high-value equity has made this increasingly desirable.
- Not without risk. Investors have expectations similar to those on the public markets, but with limited access to company financial information. Boards must create new methods for engaging these investors.
- Companies can control how much equity can be made available and when it can be made available.

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ESOPs

- Liquidity for Some, Ownership for All
- Employee Stock Ownership Plans (ESOPs). Tax favored structure allowing companies to sell shares into an employee benefit trust.
- Similar to a trust used to hold company stock from a defined profit-sharing plan or 401(k).
- Purchase (Redemption) of shares can be made with pre-tax funds. Purchased shares are then allocated, within the trust, to employees.
- Full-time employees must be included. Shares are allocated pro rata based on relative pay, or a formula designed to level set values.
- Sellers (often closely held shareholders) can defer capital gains on the sale.
- S-Corps can reduce their tax obligation by the % of outstanding shares owned by the ESOP. S corporations solely owned by an ESOP are exempt from federal income tax.
- Supports a strong ownership culture. May restrict companies ability
  to provide market-level executive incentive pay in some industries.

Private Equity and ESOPs

- ESOPs with a Twist
- PE firm invests in a company by:

lending the company subordinated debt with warrants,

the proceeds of which are lent by the company to the ESOP, which, in turn,

buys the selling shareholders' equity in the company.

- In most cases the selling shareholder does not cash out completely. Co-invests part of their proceeds alongside the PE firm in the same security purchased by the PE firm.
- The ESOP is left as the sole shareholder of the target company, which would elect to become an S corporation post-transaction if not one already.
- If the company was a C corporation prior to the transaction, this effectively allows a selling shareholder to indefinitely defer or eliminate capital gains taxes if he or she sells shares to an ESOP.
- To qualify:

selling shareholders must have held company stock for at least three years;

ESOP must own at least 30% of the company stock after the transaction;

selling shareholder must rollover the proceeds into qualified replacement property, generally consisting of stocks or bonds of U.S. companies.

Conclusions

1. Design with Liquidity in Mind.
2. Be aware of who your company may become and what you may face in the future.
3. Understand how long it may take to achieve ultimate liquidity. Plan for interim possibilities if it will help you reach your goal.
4. The "best" answer may change over time. Prepare to review your possibilities at least once a year.
5. Liquidity may not mean an exit.
6. Liquidity may not mean you leaving the company.

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Questions?

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