

Equity Compensation: Key Issues for Start-Up Companies

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Equity Issuances Generally

- Allocation of Equity
 - Founders vs. Non-Founders
- Dilution
 - Planning for New Hires
- Authorized, Issued and Reserved Shares
 - Founder Issuances and Option Pool Reservation
- Vesting
- Securities Laws Compliance



Forms of Equity Incentives

- Restricted Stock
- Stock Options
 - Incentive Stock Options
 - Nonstatutory Stock Options



Restricted Stock

- What is restricted stock?
 - Restricted stock vs. restricted stock units
- Taxation of restricted stock
 - Section 83(b) election
 - Section 409A issues
- Imposing restrictions on already owned stock
- When do you use restricted stock?
- Accounting Treatment



Stock Options

- What is a stock option?
- Benefits of stock options
- Either Incentive Stock Option (“ISO”) or Nonstatutory Stock Option (“NSO”)
- When do you use options?
- Accounting Treatment



Incentive Stock Options

- Must comply with tax rules
 - Granted under shareholder approved plan
 - Option holder must be an employee
 - Exercise price must equal FMV at time of grant
 - \$100,000 limitation
- Generally more favorable tax benefits to employees as compared to nonstatutory stock options



Nonstatutory Stock Options

- No specific tax rules
 - Does not have to be a plan in place
 - Can be issued to any service provider, i.e., employee, director, independent contractor
 - Exercise price (theoretically) can be less than FMV
 - ▶ Caution – Section 409A issues
- Generally less favorable tax treatment for employees as compared to ISOs



What is Fair Market Value?

- Historically, option exercise prices were established based on the Board's determination of FMV
 - Rules of thumb based on rounds of financing
- Today, valuations by independent appraisers are common because of Section 409A
 - Valuation must take into account all relevant qualitative and quantitative factors (value of tangible and intangible assets, discounted cash flow, recent transactions in the stock, values of comparable companies, etc.)
 - Violations of Section 409A result in significant adverse consequences for optionholders and the company



Frequently Asked Questions

- When should we obtain our first 409A valuation? If we don't obtain one, what are the risks? If we determine fair market value ourselves, how should we approach it?
- When should we obtain a new, or updated, 409A valuation?
- What is the typical cost of a 409A valuation?
- How and when will the valuation be questioned?
- What is the benefit of an ISO to an employee vs. a NSO?
- How frequently is ISO treatment preserved and not lost?
- Why issue restricted stock and not an option?
- What must be included in an 83(b) election?
- Why should we discuss number of shares and not %'s?



Summary

- Restricted stock
 - Best tax benefits for founder and early employees
- Stock options
 - ISOs generally for employees to extent of limit
 - NSOs for directors, non-employees
- Deferred compensation – Section 409A issues
- Accounting issues



Questions?

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