Employment Incentive Plans for Privately-Held Companies

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With the downturn in the capital markets and the economic difficulties faced by many technology companies, many small, privately-held technology companies are facing reduced valuations and highly dilutive financings, frequently referred to as "down rounds."

A common issue faced by companies involved in a down round is retention of management and key employees who were attracted to the company in large part for the potential upside of the option or stock ownership program. When preferred stock values drop significantly, common stock values also drop, including the value of common stock options held by employees. In addition, the common stock ownership of the company also suffers a significant reduction in overall percentage ownership of the company as a result of a down round, with an increasingly larger percentage being held by the holders of the preferred stock.

Consequently, reduced valuations and "down round" financings frequently cause two results: (i) substantial dilution of the common stock ownership of the company and (ii) the devaluation of the common stock, particularly in view of the increased aggregate liquidation preference of the preferred stock that comes before the common stock. The result is a company with common stock that can be relatively valueless and unlikely to see any proceeds in the event of an acquisition in the foreseeable future.

In the face of substantial dilution of the common stock and significant devaluation, companies are faced with the difficulty of retaining key personnel and offering meaningful equity incentives. Potential solutions can be very simple (issuing additional options to counteract dilution) or quite complex (issuing a new class of stock with rights tailored to balance the concerns of both investors and employees). Intermediate solutions range from effecting a recapitalization that will result in an increase in the value of the common stock to implementing a cash bonus plan to employees that is to be paid in the event of an acquisition. Each approach has its advantages and disadvantages, and each may be appropriate depending on the circumstances of a particular company, but the more complex options can offer companies greater flexibility to satisfy the competing demands of employees and investors. This article will briefly review some of the solutions that are implemented-

-the use of additional options, recapitalizations and retention plans (cash and equity based).

Granting Additional Options

The simplest solution to address the dilution of common stock is to issue additional employee stock options. For example, assume that, prior to a down round, a company had 9,000,000 shares of common and preferred stock outstanding and the employees held options to purchase an additional 1,000,000 shares. Also assume that, in the down round, the company issued additional preferred stock that is convertible into 10,000,000 shares of common stock. On a fully-diluted basis (i.e., taking into account all options and the conversion of all preferred stock), the employees have seen the value of their options reduced by 50%, from 10% of the company to 5%. In such a case, the company might issue the employees additional options to increase their ownership percentage. It would require additional options to purchase in excess of 1,000,000 shares to return the employees to a 10% ownership position, although a smaller amount would still reduce the impact of the down round and might be enough to help entice the employees to stay.

If the common stock retains significant value, the grant of additional options can be an effective solution. It is also relatively straightforward and, at most, stockholder approval may be required for an increase in the option pool. In many cases, however, the aggregate liquidation preference of the preferred stock is unlikely to leave anything for the common holders following an acquisition, particularly in the short term. In that event, the dilution of the common stock becomes less relevant--5% of nothing is the same as 10% of nothing. Companies with this kind of common stock devaluation will need to consider more intricate solutions.

Recapitalizations

If the common stock has been effectively reduced to minimal value, a company could increase the common stock value through a recapitalization. A recapitalization can be implemented through a decrease in the liquidation preferences of the preferred or a conversion of some preferred into common, thereby increasing the share of the proceeds that is distributed to the common upon a sale of the company. This solution is conceptually straightforward and certainly effective in increasing the value of the common stock. In most cases with privately-held venture capital backed companies, however, the holders of the preferred stock are the investors who typically fund and implement down rounds that lead to common stock devaluation, and in nearly all cases the preferred stockholders have a veto right over any recapitalization. Accordingly, implementing such a recapitalization would require the consent of the affected preferred stockholders, which may be difficult to obtain, particularly because the preferred stockholders may not like the permanency of this approach. In addition, a recapitalization may be quite complicated in practice, raising significant legal, tax and accounting issues.

Retention Plans

Another approach is the implementation of a retention plan. Such plans can take a number of forms and can use cash or a new class of equity with rights designed to satisfy the interests of both the investors and employees. These solutions are more complicated, but also more flexible.

Cash Bonus Plan

In a cash bonus plan, the company guarantees a certain amount of money to employees in the event of an acquisition. This amount can either be a fixed sum or a percentage of the sale price, to be allocated among the employees at the time of the sale, or it can be a fixed amount per employee, determined in advance.

A cash bonus plan is easy to understand, provides the employees with cash to pay any taxes that may be due and can be flexible if the allocations are not determined in advance. However, there are a number of hurdles. Many acquisitions are structured as stock-for-stock exchanges (i.e., the acquiring company issues stock as payment for the stock of the target company) because such exchanges may be eligible for tax-free treatment. A cash bonus plan may interfere with the tax-free treatment and, thus, may reduce the value of the company in the sale or may be a barrier to the transaction altogether.

A cash bonus plan can also be problematic in that it requires cash from a potential acquirer in the event there isn't sufficient cash on hand in the target company. A mandatory cash commitment from an acquiror may also make the company considerably less attractive as a target. Typically, a cash bonus can be adopted by the board of directors, although a cash bonus plan creates an interest that may potentially in effect be senior to the preferred stock, which may require consideration as to whether the consent of the preferred holders is required.

New Class of Equity

A stock bonus or option plan utilizing a new class of equity, although more complicated, shares many of the benefits of the cash bonus plan, but avoids some of the major disadvantages. A newly created class of equity, such as senior common stock or an employee series of preferred stock, permits the use of various combinations of rights. The new class of equity can be entitled to a fixed dollar amount, a portion of the purchase price or both. These rights can be in preference to, participating with or subordinate to any preferred holders, and the shares may be convertible into ordinary common stock at the option of the holders or upon the occurrence of certain events. Referring to our earlier example, the company might return the employees to their pre-down round position by issuing them senior common stock entitled to 10% of the consideration (up to a certain amount) in any sale of the company. However, a return of the employees to their pre-down round position may not be acceptable to the preferred stockholders and may not be necessary to keep the employees incentivized, but the new class of equity can be tailored to fit whatever balance is acceptable to the investors.

This type of approach has several advantages. First, unlike a simple issuance of additional options, it gives real value to employees that were affected by a devaluation of their common stock. Second, unlike a cash bonus plan, it does not require an acquiror to put up cash when purchasing the company and the acquirer is less likely to discount the purchase price. Third, unlike a cash bonus plan, it will not affect the tax-free nature of certain stock-for-stock acquisitions. Finally, it provides certainty to the participants, who know exactly what they will be entitled to receive upon a sale of the company.

The main disadvantage of creating a new class of equity, at least from the employees' standpoint, is that the employee will either have to pay fair market value for the stock when it is issued or recognize a tax liability upon such issuance, when they may not have the cash with which to pay the taxes. This disadvantage can be partially ameliorated by the use of options for the new class of equity, rather than issuing shares up front, which at least allows the employee to control the timing of the tax liability by deciding when to exercise. Moreover, for many employees an option may qualify as an incentive stock option under federal tax law, thus allowing the employee to defer taxation until the sale of the underlying stock.

In addition, a new class of equity adds complexity from the company's perspective. It may raise securities and accounting issues, and shareholder approval of an amendment to the company's charter will be required. As with the other solutions that address the devaluation problem, there may be resistance from the existing preferred holders, whose share of the consideration upon a sale of the company would thereby be reduced.

These complexities are surmountable and companies may find that they are more than balanced by the advantages that a new class of equity provides over other solutions in addressing issues of reduced common stock valuations and dilution.

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