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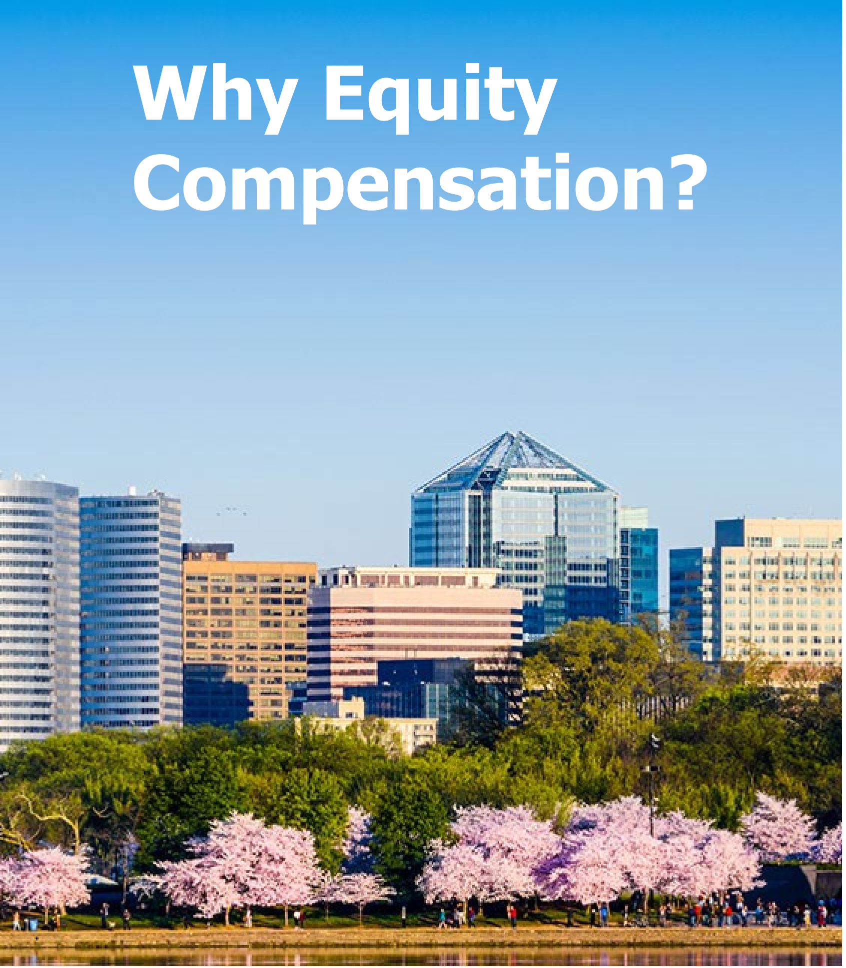
What’s in It for the Team and Me?
Discussing Your Company’s Equity Compensation

Patrick Rehfield | Christopher S. Ronne | Yongo Ding

Why Equity Compensation?



Most employees being hired into emerging growth companies expect to receive some form of equity compensation.

- Most emerging growth companies do not have enough cash to pay competitive salaries.
- Employees want to get in at an early stage when the equity has a low value and work to help increase the equity value over time.
- Goal is to hold equity on a liquidation event/sale of the company.

Expect to negotiate with employees over the amount, type and terms of equity compensation.

The following slides will highlight certain considerations as to the amount, type and terms of equity compensation commonly used in emerging growth companies.

Governing Law/Rules

- Internal Revenue Code
- Securities Act of 1933
- State corporate laws and securities laws
- Financial accounting rules

EQUITY COMPENSATION IN CORPORATIONS

Equity Compensation (Corporate)

Appreciation in Value

Stock Options

Stock Appreciation Rights

Full Value

Restricted Stock

Restricted Stock Units/Phantom Shares

Equity Compensation (Corporate)

What is a Stock Option?	Right to purchase a fixed number of shares at a fixed price
Types of Stock Options	Nonqualified Stock Options & Incentive Stock Options

Nonqualified Stock Options

Must have exercise price not less than fair market value to avoid tax issues under section 409A of the Internal Revenue Code

May be granted to any type of service provider (employee, director, consultant)

No tax at grant

Taxable at exercise on the spread (fair market value of the purchased shares at the time of exercise, less the exercise price of the purchased shares) at ordinary income rates

Deduction for company at time of exercise

Incentive Stock Options

May only be granted to employees

Must have exercise price not less than fair market value

Corporations Only

Other Internal Revenue Code requirements (e.g., hold shares for two years from grant and one year from exercise)

No tax at grant

No income tax at exercise (alternative minimum tax applies on the spread at date of exercise)

Taxable at sale of stock at capital gain rates if holding period requirements are met

If shares are sold before expiration of holding period, a portion of the gain is taxed as ordinary income

Equity Compensation (Corporations)

Example: NQSO Exercise

Stock value per share on exercise date	$15
Minus exercise price per share	-10
Equals ordinary income per share	$5
Times number of options exercised	X 10,000
Equals ordinary income (“spread”)	$50,000
Less: income tax at exercise (45%)	(20,000)
Net value	$30,000

Equity Compensation (Corporations)

Example: ISO Exercise

Sales price per share	$15
Minus exercise price per share (basis in the shares)	-10
Equals gain per share	$5
Times number of shares exercised	X 10,000
Equals total gain ("spread")	$50,000
Less: capital gain tax when shares sold (27%)	(13,500)
Net value	$36,500

Equity Compensation (Corporate)

Potential advantages of ISO compared to NQSO:	• Lower tax rate (capital gain) • Delayed tax (tax at sale of shares)
Disadvantages of ISO compared to NQSO:	• Company has no tax deduction if employee recognizes capital gain • Alternative minimum tax

Stock Appreciation Rights

Employee receives the spread between the value of the stock at exercise and the exercise price

The spread can be paid in stock or cash

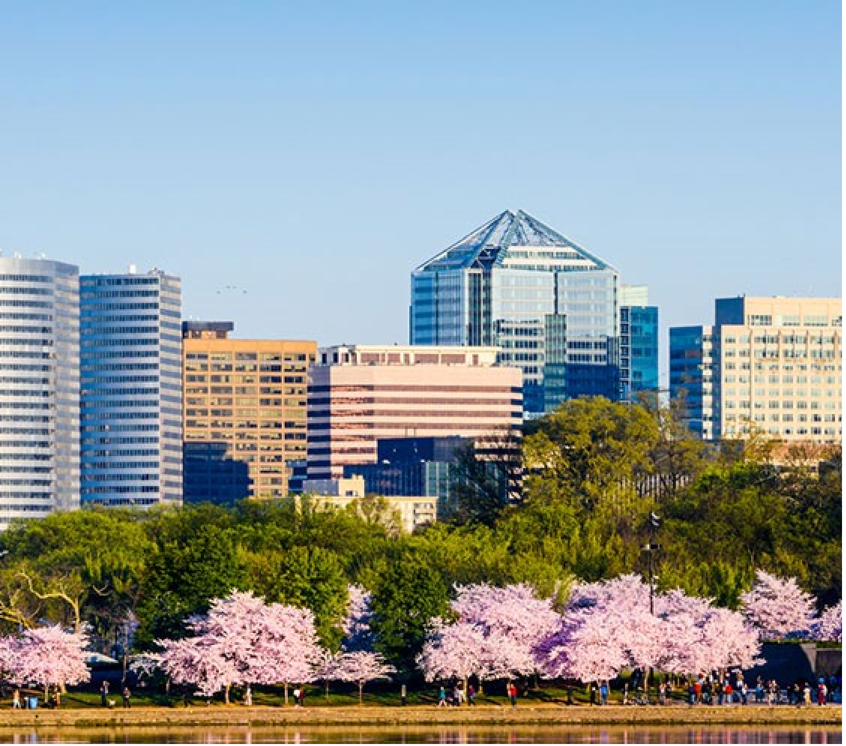
Must have exercise price not less than fair market value to avoid tax issues under section 409A

No tax at grant

Taxable at ordinary income rates on the fair market value of net shares or cash issued on exercise

Deduction for company at time of exercise

Restricted Stock



Generally taxed at time of vesting at ordinary income rates

83(b) Election

- Freezes ordinary income at date of grant
- Must be made within 30 days of grant/irrevocable
- Especially important where employee has paid purchase price for unvested shares
- No further taxation until shares are sold

Deduction for company at time of vesting or, if 83(b) election is made, at time of grant

Restricted Stock Units (RSUs)/Phantom Shares

Generally not taxed until distribution

Ordinary income; no 83(b) election available because no property transferred until distribution

Deduction for company at distribution

Can be paid in cash or stock

Performance-based RSUs have vesting based on achievement of performance goals

Distribution can be deferred beyond vesting, must comply with section 409A

EQUITY COMPENSATION IN LIMITED LIABILITY COMPANIES

Equity Compensation (LLCs)

Appreciation In Value	• Profits Interests • Options (Nonqualified only) • Phantom Appreciation Rights (More common than full-value phantom awards)
Full Value	• Capital Interests • Phantom Award

Equity Compensation (LLCs)

Profits Interests

- Provide appreciation in value
- Can be transferred to an employee of the LLC without current tax
- Generally should make 83(b) election at grant
- On liquidation of the LLC immediately after the grant of the profits interest, the profits interest would NOT allow the recipient to participate in liquidating distributions – the recipient only has a share in the future profits and appreciation in value of the LLC following the date of grant

Capital Interests

- Provide full value of membership interest
- Taxed at grant or vesting (similar to restricted stock)
- The recipient has a grant date economic right in the underlying capital of the LLC, as well as its profits and losses on a going forward basis
- Entitles the holder to share in the proceeds if the LLC's assets are sold at fair market value and the proceeds are then distributed in a complete liquidation of the LLC immediately after the interest is granted

Equity Compensation (LLCs)

- Ownership of profits interests or capital interests generally makes the holder a "member" instead of an "employee" of the LLC, so income is reported on Form K-1 instead of Form W-2

Equity Compensation (LLC)

Options (Nonqualified Only)

- Entitles a recipient to purchase LLC interests at a later date for a purchase price that is at least equal to the fair market value of the LLC interests on the date the option is granted
- Option holder is generally not an equity holder for tax and state law purposes with respect to the underlying option equity until the date of exercise
- No income tax upon grant
- Under Section 409A of the Code, options cannot be granted with an exercise price below fair market value
- Profits interests and options on LLC interests are economically similar, but there are tax advantages for holders of profits interests

Equity Compensation (LLC)

Phantom Equity

- Can be an appreciation award or full value award
- Bonus awards that mimic equity
- Not really treated as equity for state law or tax purposes
- Employee can participate in the financial rewards of ownership without voting and other rights associated with equity ownership
- Generally subject to vesting, whether time-based or performance-based
- Taxed like a nonqualified deferred compensation plan

KEY CONSIDERATIONS

Options/SARs

Advantages

- Gives employee appreciation in value without employee having to make an investment or pay tax currently
  - No tax at grant or vesting
- Employee can choose when to exercise the option/SAR
  - Employee can control date of taxation
  - Most employees wait until a liquidity event to exercise options/SARs because they don't want to pay for stock that may never be liquid
- ISO can result in capital gain if shares are held for holding period
- Often used for private companies

Disadvantages

- Options/SARs can go underwater (if fair market value is less than exercise price)
- Financial accounting charges are based on Black-Scholes value

Full Value Awards

Advantages	• Employee receives existing value of the shares/units, not just the appreciation
	• Full value awards do not go underwater
	• Financial accounting charge correlates to value delivered
	• Restricted stock/Capital interests:
	    • Can lock in tax event at grant or vesting, so future appreciation is capital gain
	    • Often used for founders shares
	• RSUs/Phantom equity
	    • Postpone tax until distribution date
	    • Often vest based on performance goals

Disadvantages	• Employee receives existing value of the shares/units; reward for breathing • Employee has little control over when the shares/units are taxed • Employee may have to pay tax before a liquidity event

Terms of Equity Grants

- Vesting
  - Employee – 25% cliff and 75% monthly (3 or 4 years)
  - Advisor – cliff and month (1 or 2 years)
- Consider early exercise feature on options for key employees/advisors
- Set fair market value of shares
- Repurchase rights by the corporation/right of first refusal
- Non-competition covenants/clawbacks
- Change of control
  - Single trigger
  - Double trigger
  - Need flexibility to cash out equity grants upon change of control

Terms of Equity Grants

- Levels of equity grants
  - Typical pool 5-20%
  - Key executive grants 1-5%
  - Advisor grants .1-1%
    - Varies based on level of experience and stage of company
- Hiring a new executive/advisor
  - What form of equity?
  - How much equity?
  - Terms?
  - Tax considerations?
- No backdating!
  - Importance of contemporaneous documentation
  - Consider employment agreement and advisor agreement

Accounting Consequences of Equity Compensation

FASB ASC Topic 718

Compensation cost for full-value awards is based on the market value of the stock on the date of grant, and amortized over the service period

- Restricted stock
- RSUs settled in stock

For securities issued on the vesting of restricted interests, a company is generally required to amortize over the vesting period a compensation cost equal to the fair market value of the underlying securities on the date of the award

Compensation cost for options and stock-settled SARs is estimated at grant date using an option-pricing model (usually Black-Scholes) and amortized over the service period

- Stock options
- SARs

Compensation cost for liability awards has to be remeasured at the end of each reporting period until exercise or settlement (variable accounting)

- Cash-based SARs
- RSUs settled in cash

Securities Law Requirements

Federal Securities Law

Rule 701 for private company

Private placement

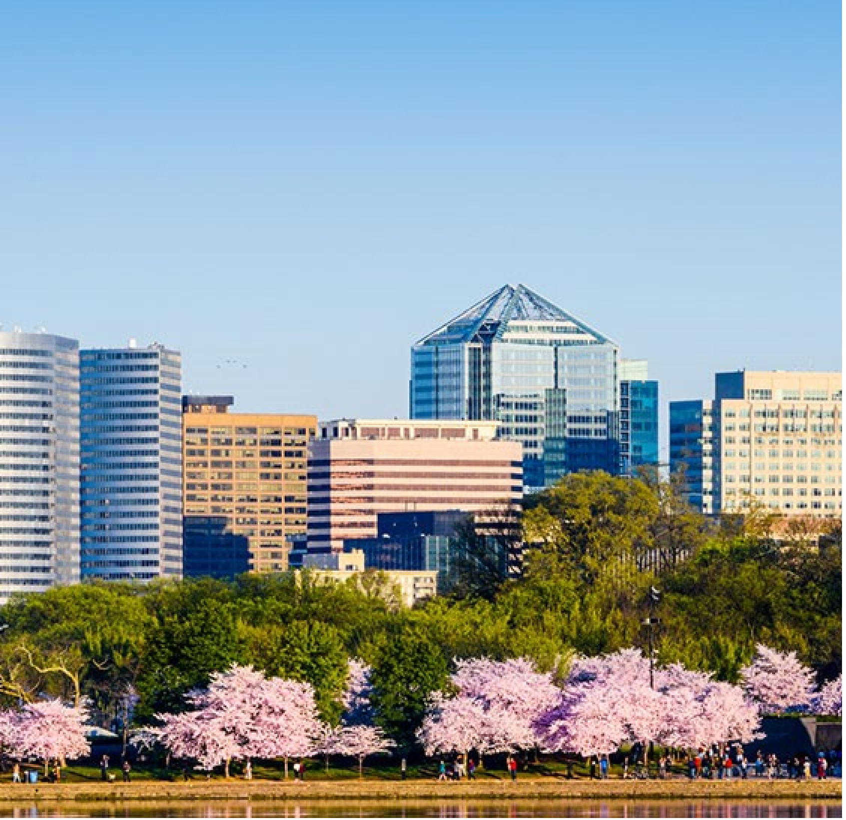
Form S-8 for public company

State securities laws (“blue sky laws”)

Executive Compensation Issues

- Shareholder approval of equity plans
- Golden parachutes/ change of control (Internal Revenue Code Section 280G)
- Internal Revenue Code Section 409A imposes penalty taxes on equity grants that are not properly structured
- IRS audits where documentation establishing fair market value at date of grant is incomplete
- Separate issues arise for equity compensation in limited liability companies

Key Takeaways



Restricted stock may be best for founders shares

- Do not forget 83(b) election; very short time frame

Options usually best for private company after stock starts to appreciate

It is worth the investment to have the equity plan and procedures set up correctly

IRS is auditing equity compensation, so it is important to keep accurate, contemporaneous board of directors minutes documenting equity grants

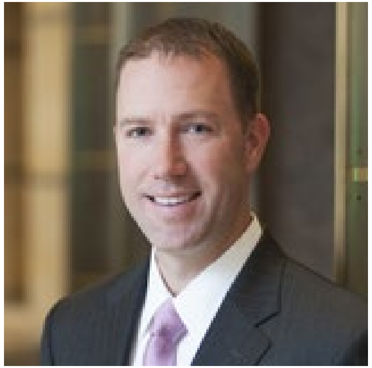
Expect to negotiate with the employee regarding the amount, type and terms of equity compensation

QUESTIONS?

Making the Most of Your Round – Preferred Stock Financing Topics

March 16, 2020 | 8:00am – 9:00am

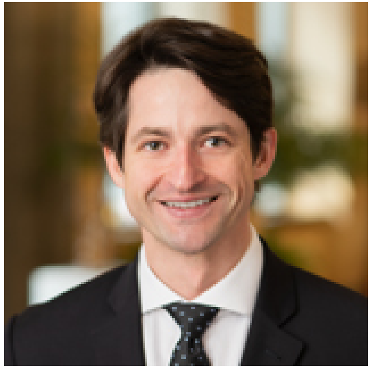
Biography



Patrick Rehfield
Washington, DC
+1.202.739.5640
patrick.rehfield@morganlewis.com

Patrick Rehfield focuses on matters related to executive compensation, payroll tax, and employee fringe benefits. He advises private and public companies on designing and implementing nonqualified retirement plans, equity compensation plans, and executive compensation arrangements. He also counsels publicly traded companies on reporting and compliance matters involving the SEC, with a focus on proxy and disclosure issues, executive compensation, and corporate governance. He advises public and private companies on employee benefit issues in mergers and acquisitions, including executive compensation matters for senior management.

Biography



Christopher S. Ronne
Washington, DC
+1.202.739.5561
christopher.ronne@morganlewis.com

Christopher S. Ronne counsels companies with respect to the federal securities laws, corporate governance, and activist shareholder engagement and campaigns. Before joining Morgan Lewis, Chris served as an attorney-advisor in the Division of Corporation Finance at the US Securities and Exchange Commission.

Biography

Yongo Ding
Washington, DC
+1.202.739.5462
yongo.ding@morganlewis.com

Yongo Ding advises employers on the design, operation, and compliance of qualified retirement plans, executive compensation plans, and welfare plans. He counsels clients on the legal issues arising under ERISA, the Internal Revenue Code, the Affordable Care Act, and HIPAA. Yongo also advises on payroll, withholding, and fringe benefits matters. Before joining Morgan Lewis, he worked at a boutique law firm in Washington, DC, focusing on qualified retirement plans and executive compensation plans.

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