

Employee Incentive Strategies for Private Venture-Backed Companies

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All venture-backed companies confront employee incentive issues as they evolve from start-ups to fully integrated companies. To advance a venture-backed company to its next phase of growth, founders and venture capitalists (VCs) must strategically manage these issues by offering meaningful equity and/or cash incentives to motivate and to retain key individuals. These issues are amplified for private venture-backed companies that are experiencing reduced valuations or involved in “down round” financings where existing common stock holders experience undesired dilution of their equity ownership in the company. As a result, it is imperative for venture-backed companies to address employee incentive and retention issues to recruit and retain the quality management that makes these ventures a success.

Summarized below are various strategies to motivate and to retain key individuals—other than granting additional stock options—for founders and VCs to consider implementing. These strategies include addressing underwater stock options and implementing retention, carve-out, and other bonus arrangements. This summary is not an exhaustive list of strategies, and other strategies may be considered. Each strategy has its own set of advantages and disadvantages; raises securities, tax, employment, and accounting considerations; and often requires formal corporate action, including shareholder approval.

Underwater Stock Options

Equity compensation (which includes stock options and restricted stock grants as the most common forms) is the incentive most often used to financially reward key individuals of venture-backed companies. Current market conditions, however, have prompted many venture-backed companies to reexamine their equity incentive programs and consider various techniques to restore the intended incentive and value of stock options that have become “underwater” (i.e., the exercise price for the stock option on a per share basis exceeds the fair market value of the underlying shares).

Aside from granting additional stock options, there are various techniques for addressing underwater stock options, including option repricing and option buyout, each of which is summarized below.

Mechanics of Option Repricing

The term “option repricing” is often used to encompass any action taken to address underwater stock options, including a simple reduction of the exercise price of the stock option or an option exchange.

In a simple reduction, the only change to the stock option is an amendment to reduce the exercise price per share of the stock option to the current fair market value of the underlying shares. Some advantages of this are that it results in minimal change to the outstanding stock options, avoids the necessity of creating an exchange valuation formula, and if the stock option is a nonqualified stock option, no consent to the change is required. A disadvantage is that it does not create any additional incentive beyond the change in the exercise price of the stock option since the vesting schedule remains the same.

In an option exchange, the underwater stock options are canceled and exchanged for other stock options or another type of award (e.g., restricted stock, restricted stock units (RSUs), or a combination of these). One search technology company recently offered eligible option holders a one-for-one exchange for their underwater stock options. Other companies have established a value-for-value exchange ratio, whereby they ensure that the aggregate value of the new awards equals the aggregate value of the canceled stock options by using an option valuation method. In such an exchange, the exchange ratio is often less than one-for-one (e.g., three-for-one or based on a ratio that depends on the original exercise prices for the outstanding underwater stock options). The exchange is accomplished through an exchange offer by canceling the appropriate number of stock options and granting the new awards. The terms and conditions of the new awards (e.g., vesting and posttermination exercise periods, if a stock option is granted) may be the same as those of the canceled stock options or may be new (often companies extend the vesting schedule of the new award for retention purposes). If new stock options are granted, they will have a new exercise price that is equal to or greater than the fair market value of the underlying shares of stock on the date of grant of the new stock options.

The advantages of granting new stock options include providing option holders with an award that is easy to understand and eliminating the need for a new administrative structure. However, a disadvantage is the possibility that the repriced stock option may subsequently become underwater.

Granting restricted stock or RSUs also has its advantages, including the ability to deliver immediate value to the employee and to offer employees the certainty that declines in the stock price will not render the award worthless. There will always be value in this grant (so long as there is value in the common equity of the company) because it is not tied to a designated exercise price. Disadvantages of an exchange for restricted stock or RSUs include that the individuals will have less control over the taxable event, and that restricted stock and RSUs do not provide the same incentive of future appreciation of the stock as do stock option grants, because restricted stock and RSUs provide full value in the equity from the date of grant. This disadvantage is generally less of an issue where the VC has structured its equity as participating preferred stock.

Mechanics of Option Buyout

In an option buyout, underwater stock options are purchased by the issuer for cash. The cash payment is typically calculated through a stock option valuation methodology. The payment may be subject to future vesting or forfeiture conditions. Advantages include providing option holders with an award that is easy to understand and the reduction of equity dilution. Disadvantages include requiring a cash outlay by the company (which may not be feasible for companies with liquidity concerns), the need to issue replacement equity compensation, potential interpretive issues under the applicable equity plan as to the status of repurchased stock options with respect to share reserve, and individuals having less control over the taxable event, as cash payments would be taxable upon receipt.

Securities Considerations

Private companies must comply with the securities laws that apply to tender offers in order to effectuate most option repricings. If the repricing is deemed to be a tender offer, the company would be required to distribute exchange offer documentation to option holders and the offer must remain open for at least 20 business days, as required under the federal securities laws.

Accounting Considerations

Under Statement of Financial Accounting Standards No. 123 (revised 2004) (FAS 123(R)), the measurement and recognition of compensation expense for awards of equity instruments is based on estimated fair values (not intrinsic values). For a nonpublic entity, if it is not possible to reasonably estimate the fair value of awards of equity instruments, the entity will account for those instruments based on a different value determined pursuant to FAS 123(R). When a stock option is repriced, FAS 123(R) requires an incremental compensation cost, if any, equal to the fair value of the new award (e.g., stock options or other securities issued in exchange for the underwater stock options) over the fair value of the original award immediately before the modification. Under FAS 123(R), value-for-value exchange programs are often structured to avoid any incremental accounting charge. The calculation will vary if the canceled stock options were accounted for under prior accounting rules (e.g., APB 25 or FIN 44).

Tax Considerations

The cancellation and repricing of stock options pursuant to an exchange offer is generally structured as a nontaxable exchange under U.S. federal income tax laws. Cash or stock payments, however, are immediately taxable upon receipt, unless they are subject to vesting or other forfeiture conditions.

Repricing techniques must be properly structured to comply with the complex deferred compensation restrictions of section 409A of the Internal Revenue Code of 1986, as amended (Code), which apply to all stock options granted or vested on or after January 1, 2005. For example, the new exercise price of a repriced stock option must be at or above the fair market value of the stock on the date of grant. In addition, depending upon the facts and circumstances, a series of repricings of the exercise price of a stock option may indicate that the original option had a floating or adjustable exercise price, which could raise issues under section 409A of the Code.

Option repricings may result in the potential loss of incentive stock option (ISO) status under section 422 of the Code unless certain technical requirements are satisfied. For example, a reduction in the exercise price of an ISO is considered a modification that constitutes a new grant. Thus, the new grant would restart the holding period requirements (i.e., the longer of two years after the grant date and one year from the date of exercise) to obtain capital gains treatment. Furthermore, if an exchange offer remains open for 30 or more calendar days, any stock options intended to be ISOs will be considered newly granted and the measurement period required to be eligible for favorable tax treatment would restart (i.e., the longer of two years after the exchange offer commenced and one year from the date of exercise), irrespective of whether the option holder accepts the offer. In addition, ISO limitations must be preserved (i.e., the maximum fair market value of stock with respect to which ISOs may become exercisable is \$100,000 in any calendar year) and if an ISO is repriced, the stock options scheduled to become exercisable in the calendar year of the cancellation would count against the \$100,000 limit, even if cancellation occurs before the stock options actually become exercisable.

Employment Law/Overtime Considerations

There is an important wage and hour/overtime consideration in connection with option repricings applicable to employees who are nonexempt from overtime pay under the Fair Labor Standards Act of

1938, as amended (FLSA). Unless the employer complies with the requirements in section 7(e)(8) of the FLSA, any value or income resulting from the stock option repricing would be included in the nonexempt employee's regular rate for calculating overtime pay. Therefore, if any nonexempt employee is included as an eligible participant in the option exchange, the employer's exchange program should comply with certain conditions, including the following: (i) the new award must be subject to a vesting condition of at least six months from the date of grant (with exceptions for death, disability, retirement, or a change of control); (ii) the exercise of any grant or right is voluntary on the part of the employee; and (iii) if the new award is based on performance, such performance conditions comply with the provisions of the FLSA.

Retention, Carve-Out, and Other Bonus Arrangements

Venture-backed companies may also consider implementing retention bonuses for key individuals. Venture-backed companies have flexibility in designing retention arrangements, including the class of eligible individuals, the amount of the bonus (which could differ for various levels if desired), the timing and manner of payment, the consequence of a participant's interest if certain events occur (e.g., termination of employment), and other forfeiture events. Various retention arrangements are discussed below, including retention arrangements where payment is tied to a specified date, change-of-control bonus arrangements, and management carve-out plans. Note that the recipient is generally taxed at ordinary income rates at the time of cash payment under all of these non-equity-based retention arrangements.

Retention Arrangements

Retention bonuses with awards of cash and/or equity to identified key individuals of the venture-backed company can be structured so that the payment will be made as long as the individual remains employed with the company through a designated period (e.g., two years from the date of the agreement) or through completion of a specific event.

Change-of-Control Bonus Arrangements

Another retention alternative could be implemented if the goal is to retain key individuals through the date of a change of control or for a transition period following a change of control. Key individuals may be anxious about their future with a new owner. This anxiety may distract key individuals from focusing on their job responsibilities, and may lead them to explore alternative, more secure, employment. From the perspective of the company, allaying these concerns is important if the continued service of key individuals is important to the performance of the company and/or a potential buyer. Potential buyers may value retention arrangements because they can preserve a skilled workforce by retaining key individuals.

There are numerous variations on retention incentives in the deal context, including the following approaches: (i) a bonus payable (in part or in full) upon the closing of a sale transaction and that may be conditioned on continued employment through specified vesting dates (generally referred to as a "stay bonus"); or (ii) a payment made if the key individual's employment or service is terminated by a buyer following a change in control of the company (generally referred to as a "parachute payment").

Management Carve-Out Plans

Management carve-out (or incentive) plans are another strategy that can be used to encourage eligible participants to contribute materially to the growth of a company, and, in certain instances, to align the economic interests of the participants with those of the stockholders.

Typically, a management carve-out plan provides for the award of cash and/or equity to identified key individuals of the venture-backed company upon certain triggering events. The triggering event results in the equity or cash becoming payable. Typically, the triggers for awards under a management carve-out plan resemble the triggers utilized for the payment of preferred liquidation preferences.

If the management carve-out plan provides for cash payments, the plan proceeds can be calculated as a percentage of the proceeds from the triggering event. Each participant is then entitled to receive an amount based on his or her *pro rata* share of the proceeds. Payments would be made within a certain time following the consummation of the triggering event. Alternatively, a participant's payment amount could be tied to the value of the preferred stock at the time of the specified triggering event.

Venture-backed companies have significant flexibility in designing retention arrangements. In most cases adopting retention arrangements require board approval and some level of stockholder or investor approval. Furthermore, retention arrangements must be properly structured to comply with the complex deferred compensation restrictions of section 409A of the Code and, depending on corporate structure, could be subject to the golden parachute tax rules of sections 280G and 4999 of the Code.

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