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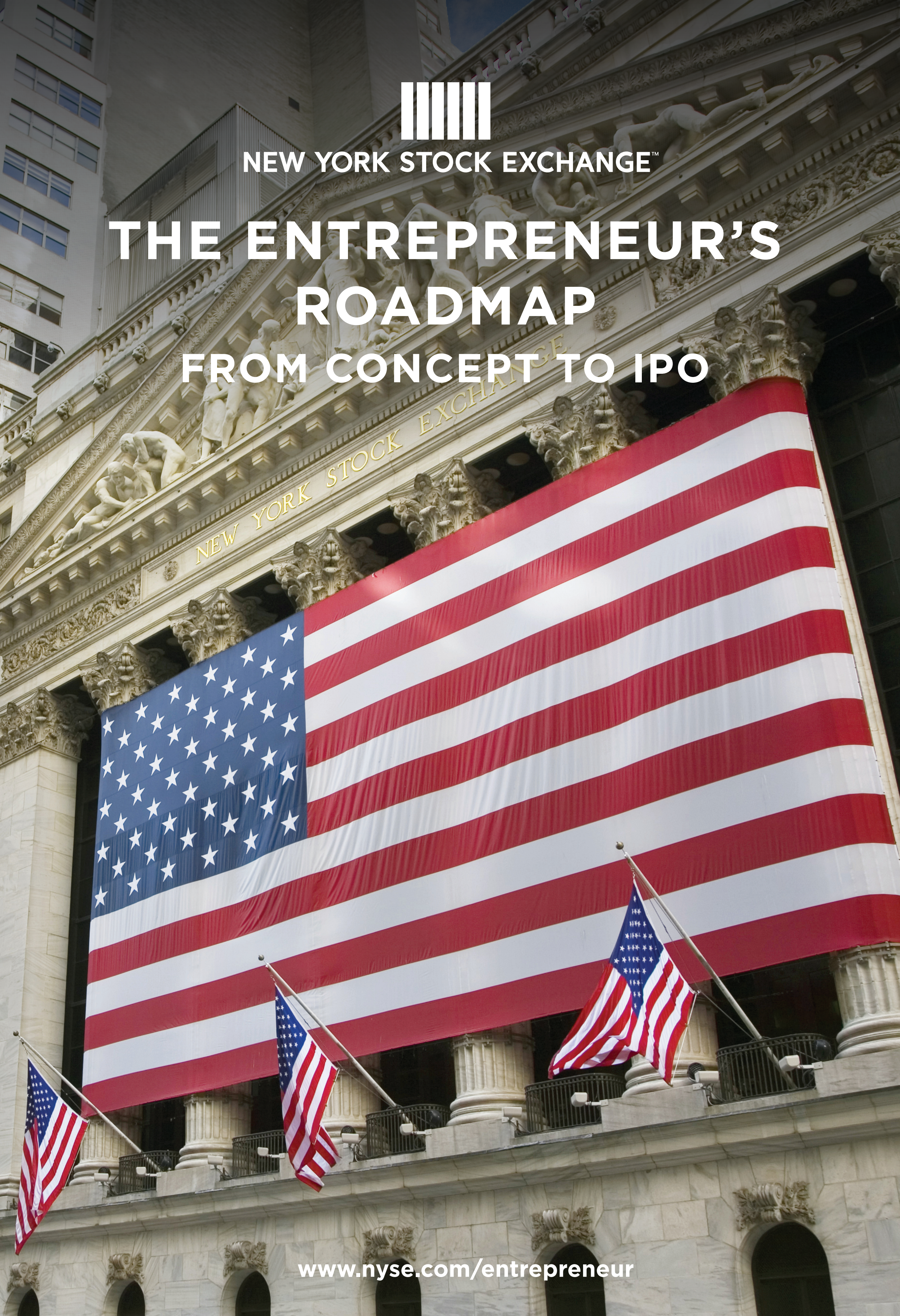

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INCENTIVIZING THE EXECUTIVE TEAM BEFORE AN IPO OR SALE

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Achieving the business objectives that drive a company toward a successful exit event requires careful consideration of an effective executive compensation program that uses an array of incentive tools, including short- and long-term bonus opportunities, equity-based awards, severance benefits, and change in control benefits.

BALANCING COMPETING INTERESTS WITH APPROPRIATELY CALIBRATED INCENTIVES

Realizing the business goals that result in the opportunity for an initial public offering or sale of the company requires that companies attract, retain, and motivate their executive team. Each company must determine the right balance between amounts of realizable compensation, short-term and long-term incentives, and the appropriate mix of equity incentives.

An effective executive compensation program balances the competing interests of the executive team, employees, stockholders, and other stakeholders. Insufficient rewards provide inadequate incentive and retention effects in competitive labor markets. Overly generous and poorly designed reward packages result in excessive management costs and a misallocation of resources. Misplaced incentives further constrain the board's flexibility to make personnel changes without undue cost and leave less consideration to allocate among employees, stockholders, and other stakeholders.

SHORT-TERM INCENTIVES

A mix of short-term incentives, granted over a number of award cycles, can drive business outcomes that serve the long-term interests of the company. Multiple performance objectives tend to be superior to a single performance objective. For example, a short-term incentive program that singularly rewards either sales or profitability, to the exclusion of the other objective, will not drive sustainable long-term value creation as well as a balanced incentive program that rewards both increased sales and profitability on those sales.

Short-term incentives that provide for disparate payouts based on small differences in actual achievement risk creating incentives that reward questionable behavior. Such perverse incentives can be mitigated by setting minimum and maximum payout thresholds and applying linear interpolation between these thresholds.

EQUITY-BASED INCENTIVES

As maturing companies build toward an initial public offering or sale, a mix of equity incentives helps drive business goals. Equity awards that derive their value from an appreciation in the value of the company, most commonly in the form of stock options, reward executives for increasing the stock price but subject executives to the risk of earning no value if the stock price decreases. Excessive appreciation equity awards may encourage excess risk-taking through “all-or-nothing” payment outcomes. Equity awards that derive their value from the whole value of the company, most commonly in the form of restricted stock and restricted stock units, encourage retention and sustainable value creation by exposing executives to downside risk. However, excessive awards of such equity awards may not encourage an appropriate level of risk-taking that is necessary to differentiate the company in a competitive field.

COMPENSATION REVIEW

When an initial public offering or sale is being considered, the board should conduct a review of the compensation arrangements of the executive team and evaluate their compatibility with the desired business goals. A compensation consultant can assist with the effort to select a peer group for comparison and benchmarking purposes and determine the appropriate mix of incentives. After deliberation, the board often finds it necessary to adjust base salaries, establish short-term incentives that pay cash bonuses upon the achievement of performance goals in coordination with the strategic business plan, and establish long-term incentives with equity awards.

EQUITY INCENTIVES

Equity-based awards are powerful tools that align the interests of executives and stockholders, drive business strategy and growth, and enhance stockholder value. Broad-based awards of equity incentives to employees generally fosters an “ownership culture” that motivates employees at all levels of an organization to think and act like business owners. The use of equity awards also permits companies to conserve cash that may be invested in the business.

CONSIDERATIONS FOR EQUITY AWARDS

Tax efficiency can be achieved by qualifying more profits as long-term capital gain rather than short-term capital gain or ordinary income, both of which are generally subject to higher tax rates. In general, more favorable tax consequences involve greater investment risk. Executives may invest early for an opportunity to save on taxes but risk losing some or all of their investment, with no guarantee of a public market or liquidity for the company’s shares. Deferring investment and waiting for a public market or liquidity event permits the acquisition of company shares and the payment of an exercise price (if applicable) and satisfaction of tax liabilities without cash outlay. Less investment risk tends to involve higher tax rates.

Equity-based awards are generally subject to a vesting schedule tied to continuing service or the achievement of specified performance objectives. Vesting is a mechanism by which the executive earns the right to hold shares that participate in the future success of the business should he or she depart from the company. Except in situations where severance benefits are paid, cessation of employment generally results in the forfeiture or repurchase of unvested equity.

TYPES OF EQUITY-BASED AWARDS

The value of appreciation awards, such as stock options, increases as the value of the underlying stock exceeds the exercise price of the option. Value is realized by the executive when the option is exercised. If the value of the stock is less than the exercise price, the option will not have economic value until the stock value exceeds the exercise price. Such an underwater option can be held in the hope that the underlying stock value will increase.

Unfortunately, studies suggest that underwater options have negative (as opposed to zero or modest) incentive and retention effects.

The value of full-value awards, such as restricted stock and restricted stock units, persists as long as the company's common stock retains some value. Accordingly, economic value is delivered even if the value of underlying stock has decreased from the time when the awards were granted.

Stock Options

A stock option confers the right to purchase a fixed number of shares at a fixed price. Stock options become more valuable as the value of the company's stock increases. Although they entail no ownership rights, stock options allow participation in the growth of a company without an immediate payment of cash, taxes, or risk of loss until the options are exercised. If a company remains privately held and the executive must exercise the option, such as following termination of employment, the executive will need to invest funds to pay the exercise price and applicable taxes in order to acquire company shares. As a company becomes more valuable, exercising an option tends to require a larger cash outlay for the exercise price and taxes (depending on the type of option).

A stock option gives the optionee flexibility to choose when to exercise and thereby when to recognize taxable income. As long as an executive is not forced to exercise an option, exercise can be deferred until a liquidity event, such as after an initial public offering or a sale of the company. An option allows the acquisition of company stock at an earlier time in the expected life cycle of the company, when the value of the stock is relatively inexpensive. As a result, the capital gain holding period can begin at an earlier time, and more profits may qualify as long-term capital gain, rather than as ordinary income, upon a subsequent sale of company shares.

Stock options are subject to a potentially draconian tax regime under Section 409A of the Internal Revenue Code if the exercise price of the option is deemed to be less than the fair market value of the underlying stock on the date of grant. If the Internal Revenue Service determines that a stock option is "discounted," income tax is imposed on the vested portion every year the option remains outstanding (whether or not the option is exercised), plus an additional 20 percent tax and an interest penalty. Such a tax regime results in the confiscation of nearly all profits through taxation.

To reduce the risk that Section 409A applies to options, most startup companies obtain a third-party valuation. Despite the added inconvenience and expense, most early- to mid-stage startup companies find the flexibility and other advantages of stock options to outweigh their disadvantages.

Restricted Stock

A grant of restricted stock immediately transfers shares of company stock to the recipient, generally subject to a vesting schedule. The transferred shares typically come with voting and dividend rights. If granted for services, restricted stock delivers greater value than options on a share-for-share basis because no exercise price needs to be paid to acquire the shares.

Restricted stock can be either purchased at its fair market value or granted for services, subject to compliance with state corporate law. Paying the fair market value for the stock with cash, check, or a substantially recourse promissory note generally results in no tax consequences.

Granting stock in exchange for services can result in combined federal and state income and employment withholding taxes of about 45 percent of the value of the stock under current rates. These taxes may be satisfied by an executive delivering cash or a check to the company. Alternatively, the company can pay the taxes subject to the executive entering a promissory note that is either full-recourse (upon default of note, borrower is personally liable if value of shares is less than note balance) or nonrecourse (upon default of note, borrower is not personally liable).

The advantage of restricted stock is that it starts the capital gain holding period. It also presents the opportunity to characterize more profits as capital gain, rather than ordinary income, upon a subsequent sale of the shares. In addition, it generally avoids the draconian tax regime of Section 409A. However, depending on the value of the stock, the cost of acquiring the restricted stock (whether paying the fair market value or entering a promissory note for the taxes) may be cost prohibitive for all but the wealthiest executives with risk capital.

Promissory notes are a solution to the lack of liquidity but entail real economic risks. Many executives do not appreciate that loans can be subject to collection by the company, its creditors, or a bankruptcy trustee. In addition, if the company forgives the note, the executive will recognize taxable income, and the company will have a withholding obligation. Finally, executive officers may not hold promissory notes at the time that the company commences the public offering process with the SEC (even if the IPO is withdrawn).

Because of its drawbacks, restricted stock tends to be awarded at early stages of companies when stock may be purchased at nominal cost or acquired with nominal tax consequences.

Restricted Stock Units

Restricted stock units, or RSUs, represent the right to receive payments in the future based on the value of the company's stock when vesting conditions have been satisfied. RSUs are settled and paid by delivery of shares of company stock or their cash equivalent, with each RSU having the economic value of one share of stock at the time of settlement.

As contrasted with restricted stock, RSUs are merely a promise to deliver shares in the future rather than an immediate transfer of shares. As a result, no capital gain holding period starts until the shares are delivered. RSUs also have no voting rights and typically do not include dividend rights. However, unlike stock options, there is no need to invest funds to pay an exercise price or purchase price to receive shares, although settlement of the shares requires a source of cash to satisfy applicable withholding taxes.

Private companies can grant RSUs that vest upon the later of the satisfaction of a time-based service requirement and a liquidity event requirement. The time-based requirement is satisfied by providing continuing services for the company. The liquidity event requirement is satisfied by the occurrence of an IPO or sale of the company.

Upon termination of employment, RSUs for which the time-based requirement is not yet satisfied are forfeited. RSUs for which time-based requirement is satisfied as of termination remain outstanding and will vest should the liquidity event requirement be satisfied within some period thereafter. RSUs for which the time-based requirement is satisfied but for which the liquidity event requirement does not occur within some period of time after termination are forfeited. If RSUs vest after meeting both the time-based and liquidity event requirements, they are settled in cash or stock.

Such dual-vesting event RSUs are commonly used in later stages when the value of company stock is high and employees perceive less upside value in stock options. The RSUs postpone the tax liability until a time of liquidity but at the cost of higher taxes in general.

SEVERANCE BENEFITS

Severance benefits are designed to mitigate executives' uncertainty about potential involuntary termination of employment. Severance benefits help attract and retain executives by permitting them to focus on performing their duties rather than their employment situation. These benefits typically include payment of some portion of base salary or bonus in cash, continued medical benefits, and partial or full acceleration of equity-based awards.

Severance benefits are usually triggered by an involuntary termination of employment without a condition that justifies a termination for cause. Such conditions generally include reasons other than theft or misappropriation of real or intellectual property, failure to perform assigned duties, gross negligence, willful misconduct, and commission of serious crimes. Because severance benefits are not paid if an executive is terminated for "cause," the conditions constituting cause are carefully scrutinized, with broader definitions favoring the company and narrower definitions favoring executives.

Severance benefits may also be triggered by a voluntary termination for good reason. Such "good reason" conditions typically include adverse changes in compensation, authority, duties, responsibilities, reporting relationships, or work location.

CHANGE IN CONTROL AND RETENTION BENEFITS

Change in control and retention benefits are a tool to reduce management anxiety and the inherent uncertainty during periods of merger and acquisition (M&A) activity. Management departures during such times can be disruptive and adversely impact the value of the business from the buyer's perspective. By assuring that executives will receive consideration upon a successful exit, retention incentives help the management team focus during uncertain transition periods that may require performing additional job duties.

Although change in control and retention benefits represent a real cost for buyers, buyers often prefer modest retention incentives because these promised benefits offer assurance that the management team will remain in place for some duration after closing of the sale transaction.

Change in control and retention benefits generally provide for the payment of cash consideration or acceleration of all or part of an equity award. They are typically structured as follows:

- "**Single trigger**" benefits are paid upon the consummation of a sale of a company. Such benefits permit the executives to capture a part of the value that they have helped create, with such value measured and paid at the time of the sale. Such arrangements are disfavored as an undeserved windfall to executives.
- "**Double trigger**" benefits are paid if there is a sale of the company and an involuntary termination or resignation for good reason occurs, usually within some period of time before or thereafter.
- "**Walk right**" benefits are a blend of single- and double-trigger benefits. Such arrangements allow an executive to resign for any reason within a short period after the closing of a sale transaction and receive severance benefits. This provides executives with an opportunity for a probationary period to determine their role and compatibility with the buyer after closing.

CARVE-OUT PLANS

Despite their best and diligent efforts, some startup companies are unable to raise money at an acceptable valuation and level of dilution, and likely exit scenarios fail to cover the liquidation preferences held by investors. In these situations, the value of common stock approaches zero, and equity awards lose their motivation and retention effects.

A carve-out plan is an incentive tool that sets aside in a pool for key employees amounts that would otherwise be payable to investors as merger consideration. This arrangement provides management with the incentives to maximize the value of the company in the sale transaction and remain engaged through the completion of the sale.

The desire for flexibility to modify allocations of the carve-out pool as business needs change needs to be balanced against the retention incentives that are served by providing certainty to the executives. Some carve-out plans set fixed allocations for each member of management. Others permit changes to allocations by board approval or majority vote of the plan participants.

TREATMENT OF EQUITY AWARDS IN AN IPO OR SALE TRANSACTION

Following a successful initial public offering, the company's shares are usually freely tradeable, subject to securities laws restrictions and a lockup imposed by the underwriters to limit sales by company insiders and help build an orderly market in the company's shares.

The treatment of equity awards in a sale transaction depends on the interaction between the contractual terms of the equity awards and the sale agreement, and typically includes one or more of the following:

- Equity awards are converted into the right to receive their economic equivalent in stock of the buyer at the time of the sale, with the vesting schedule continuing after closing.
- Unvested equity awards that are not converted into the right to receive their economic equivalent in stock of the buyer at the time of the sale are either accelerated and paid in full at closing, or canceled without the payment of any consideration.
- The economic equivalent delivered for vested and unvested equity awards may be paid in either cash or stock.

Equity awards that are converted into buyer's equity are sometimes referred to as "rollover equity." Rollover equity benefits the buyer because it reduces the cash outlay and aligns the seller's interest with the success of the combined company. Rollover equity also benefits the seller because it allows the seller to participate in the upside of the combined company in a subsequent sale or liquidity event. In addition, rollover equity typically can be structured to defer taxes until a future liquidity event.

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Mark Bradford is a partner at VLP, specializing in executive compensation, equity compensation, and employee benefits for clients ranging from startups to emerging growth public companies. He also represents individual executives in negotiating employment agreements, terminations and severance, and entire management teams in significant M&A transactions. Mark has over 16 years of experience as an executive compensation and employee benefits attorney. He has represented buyers and sellers in over 200 cross-border and domestic M&A deals, with transactions ranging in size from a $1 million acquihire to a $7 billion sale of a major client. In connection with these transactions, Mark has negotiated and drafted deal-related agreements, including employment, incentive, retention, severance, and noncompetition, and worked on post-closing integration matters. He has also worked with more than 35 companies on compensation matters arising out of their initial public offerings. Mark has drafted hundreds of executive employment, equity and cash incentive, change in control, retention, and severance plans and arrangements for emerging growth companies. He brings a wealth of experience and perspective regarding the culture and business needs of Silicon Valley companies when providing counsel to in-house legal, human resource, finance, tax, and stock administration professionals.