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Equity: The Golden Handcuffs

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Summary:
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Article Body:
Last month, I wrote about positioning your company to attract and keep top performers. One very effective way to do both is to compensate your key employees with equity.

Performance pay has become a critical factor in keeping top talent; combine it with a sense of ownership and a stake in the future of the business, and you've got a powerful set of incentives.

That is what equity does. The basic theory behind equity compensation is simple: generously pay your people in the future, with the financial value they help create, and make it very expensive for them to leave. In this article we'll look at three ways to do that.

Why use equity and not some other variable compensation such as performance bonuses or profit sharing? Both bonus and profit sharing plans tend reflect past period performance, rather than current and future endeavors, which is where you want your people's attention. They are fixed sums of money, and once paid out, no amount of creativity, imagination or hard work can make them larger. Bonuses and profit sharing are typically one-time payouts, which in today's what-have-you-done-for-me-lately atmosphere are quickly forgotten. Finally, bonuses require cash - and profit sharing requires profits. In a rapidly growing company, either (or both) of these may be in short supply.

Equity addresses these shortcomings. Equity is the bonus that keeps on giving. The value of equity compensation is likely to increase over time, often considerably. Equity acknowledges your employee's past contribution, but its real payoff is for work still to be done - and your people have to stay around to reap the rewards. In real terms, the current cost of equity compensation is cheap, especially relative to the loyalty it can purchase. Plus, since no cash changes hands at the time of the equity bonus, you can use it as a reward even if your company is cash-strapped.

There are other plusses to equity. Especially if your business is likely to go public or be acquired, equity helps top talent choose between your smaller company and job offers from larger, well-heeled public companies. Also, equity highlights and underscores the common interests between your company's owners and the "rank-and-file", and helps top performers feel like the business is theirs.

Outright Stock Grants

Outright Stock Grants are simple to implement. Your company grants a key employee a specific number of shares, the value of which is the total company value divided by the number of outstanding shares. That's it. More than any other form, shares are tangible. Stock makes your key people feel like owners, and when people really see themselves as shareholders they rarely want to leave.

But there are drawbacks. One is the lack of a vesting period - ownership occurs at the moment of the stock grant - which means if someone has a better offer, they can leave and take it with them. It also leads to the second drawback: the stock value is taxed as ordinary income for the employee in the current year - resulting in a double whammy - no extra cash to spend and a tax liability to boot. Stock grants can also dilute your control and decision making power.

Critical Success Tip

To use stock as an employee retention vehicle, require a holding period before the shares can be sold. Remember to retain the right of first refusal on any sale - you don't want those shares finding their way into unfriendly hands. Plus, require the shareholder to offer the shares for buyback in the case of termination. (Offer - don't require your company to buy them.) Lastly, if you don't want to share decision-making power, create two classes of shares: voting and non-voting.

Non-Qualified Stock Options

Non-Qualified Stock Options are a powerful and efficient way to keep your employees. An option holder has the right to purchase shares in the company at the "grant price", which is typically the current share value. As your company gains in value, the value of the option rises. Options often have a vesting period before they can be "exercised" to purchase shares, requiring employees to stick around and keep contributing to the company. A benefit for employees comes from the tax-deferral feature: there is no tax due until the option is exercised. Importantly, options themselves do not carry voting rights.

Critical Success Tip

Since you can grant non-qualified options on a totally discretionary basis, use them to reward performance on individual, team and company levels. Also, establish the vesting period to occur on an "stair-step" basis - for instance, 50% vest in two years, the second 50% vest in another two years. This type of structure gives your employees the "choice" to leave, but holds out a significant carrot for staying.

Phantom Stock

Phantom Stock is an accounting fiction which enables top people to partake of increases in company value. Unlike "real" stock, phantom stock does not convey any actual ownership in the business. A phantom share is a credit in an employee account for an amount equal to the value of your company's "real" shares. Over time, the account is credited with changes in share value, along with dividends and other distributions. There is no taxable income for the holders of phantom shares until they are "redeemed" by the employee.

There are two types of phantom stock plans, "growth" and "basic". Under the growth plan, at redemption, employees receive an amount equal only to the appreciation in the share account. Under a "basic" plan, employees receive the total of the appreciation, plus the original value of the shares.

Critical Success Tip

Phantom shares are the equity vehicle of choice when you don't want to dilute either ownership or control, or when you have a Subchapter S and can't exceed the maximum of thirty-five shareholders. Establish a vesting period for phantom shares: grant the shares, but require a minimum holding period. If the employee leaves before the holding period expires, he or she forfeits the value of the shares. You can also establish a payout period, after which time you will redeem the phantom shares for cash. In other words, your people don't have to leave to cash in.

Valuation

For public companies share value is determined in the marketplace. Private companies must engage in some kind of valuation process, which is outside the scope of this article - but a few "success rules" apply.

1) Perform the valuation at regular, published, intervals - at least once per year.

2) Document your valuation process so that your shareholders can understand it.

3) Establish a capital reserve to enable share redemption, and publicize it.

Following these three rules will increase your employees' sense that their shares (and options) have real value, and will have them want to remain and continue participating in the upside.