NCEO THE NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

THE DECISION-MAKER'S GUIDE TO EQUITY COMPENSATION

An easy-to-understand guide to choosing and using equity compensation in any company

SAMPLE CHAPTER

Many books discuss the tax, legal, and other aspects of equity compensation, but this book is different: It is exclusively focused on helping people who are designing plans decide what kinds of equity to choose, and who should get how much and when. Are options a better fit than restricted stock? What are the pros and cons of phantom stock and stock appreciation rights? Should employees be able to buy stock? If so, how? Who will be eligible and under what rules? How will awards be earned, and how will the company provide liquidity for the awards?

All too often, these and other issues are ignored or dealt with by guessing, applying rules of thumb, or applying the approach that someone else happens to be familiar with. This book is designed to help its readers make educated, reasoned decisions about the equity compensation strategies *they* need, not the ones that someone else might want them to use. At the same time, the book also covers the general legal, tax, and other rules applicable to each plan type.

The book also includes a CD-ROM with an audiovisual presentation by coauthor Corey Rosen on sharing equity through stock options, restricted stock, phantom stock, stock appreciation rights, and other means.

See www.nceo.org for more information or to order

Creating an Equity Compensation Plan That Works for Your Company

COREY ROSEN

In 2006, a national survey showed that 38% of the employees who worked for companies that have stock own at least some employer stock, or hold stock options or some other equity right. At the same time, equity compensation is making up larger and larger portions of executive pay, especially in larger companies. The growing importance of equity as an element of compensation is not surprising. Since the 1970s, inflation-adjusted wages have grown at less than 0.3% per year, while inflation-adjusted returns on equity during that time have been about 6% per year. So over the past 30 years, an investment in the market of $50,000 would be worth about $287,000, in real dollars, while an "investment" in wages of $50,000 would still be less than $60,000. This disparity is a historical anomaly. In the past, wages and return on capital have grown more or less in tandem. There are lots of explanations for this—globalization's downward pressure on wages, the economy's shift from manufacturing to service industries, "winner take all" compensation structures, and others—but the result is that more people want to get a piece of the equity pie.

At the same time, companies have put more emphasis on equity pay as their cultures shift from traditional, hierarchical management to leaner and more open participative approaches in which more employees at all levels are given increasing responsibilities to make more decisions (or at least to have input into more decisions) about more things more quickly. Traditional control mechanisms—threats, close supervision, individual incentive pay, highly structured and simplified tasks—are giving way to engagement models that rely more on employees' internal motivation. In effect, employees are being asked more and more to think and act like owners. In this environment, employees need a reason to care, and what better reason than to actually be owners?

Finally, employees are less loyal than they had been, in part because they believe employers are less loyal to them. An astonishing 75% of the respondents to a 2004 survey by the Society for Human Resource Management said they were looking for new jobs. The desire for better pay and better career opportunities, and unhappiness with their current jobs were (in that order) the main reasons. Even at the executive level, job tenure has become increasingly short, with average CEO tenure falling to about five years in public companies (comparable data are not available for private companies). Yet as employees have been given more responsibility, the costs of employee turnover have grown. When companies had mostly highly segmented, routine tasks, new employees could be trained quickly because there were so few things to learn. Now there is so much more to master, much of it company-specific, that even replacing line employees is very expensive, let alone key executives. A Mercer Human Resource Consulting study in 2005 found that 43% of respondents put the cost of training a new employee at $10,000; one-fifth put it at $30,000. Attracting and retaining good people, therefore, has become more essential than ever, yet also much harder. In an economy in which virtually every company proclaims "people are our most important asset," a company's actual treatment of employees may be the key differentiator between winners and losers.

Research on equity compensation plans indicates ownership can be a powerful tool in this effort. Turnover rates at companies with broad-based ownership plans are significantly lower than at companies without these plans. A study by WorldatWork found that, dollar-for-dollar, stock options were the most cost effective of several approaches to decreasing turnover. Research by the NCEO has shown that the more stock employees get in employee stock ownership plans (ESOPs), the less likely they are to leave. Turnover rates in 100% ESOP companies, in fact, are about half of that in comparable non-employee-owned companies. Employees also consistently report that, other things being equal, the more equity they have, the more they like their jobs regardless of whether the equity is in the form of options or in an ESOP.

There are many ways in which to share ownership with employees. These include stock options, restricted stock, restricted stock units (RSUs), and performance shares, all ways to provide employees with direct share ownership rights. Phantom stock is designed to give employees the equivalent value of ownership, but not actual shares. Stock appreciation rights (SARs) can be designed to pay out in either shares or cash. Tax-qualified employee stock purchase plans (ESPPs) and direct share purchase plans allow employees to purchase shares directly. And a form of retirement plan called an ESOP is funded by the company and provides ownership to most or all employees through a trust. How do you choose which one vehicle or combination of vehicles makes sense?

Cultural Concerns

Of course simply handing out equity is not a magic bullet. Effective ownership companies also create what we call "ownership cultures" by sharing information about company financial and substantive progress, providing structured opportunities for employees to have input into decisions affecting their work, and training them not just in their jobs but in how the company works. The NCEO has publications and other materials on creating such cultures; other NCEO publications provide in-depth looks at various kinds of plans and offer model plan documents. This book discusses the various forms of employee equity arrangements, including the basic tax, securities law, accounting, financial, and practical implications of each. We also discuss key issues in designing any kind of equity plan, such as who should get how much subject to what conditions.

Overview of Equity Alternatives

Subsequent chapters will explore the various forms of equity in more depth. It's useful, however, to start with an overview. The remainder of this chapter looks briefly at the kinds of equity programs available.

Basic Forms of Individual Equity Plans

There are five basic kinds of individual equity compensation awards: stock options, restricted stock, SARs, phantom stock, and direct stock awards. Many of these have variations as well. Each form provides employees with some special consideration in price or terms. We do not cover here simply offering employees the right to buy stock as any other investor would receive.

Stock options give employees the right to buy a number of shares at a price fixed at grant for a defined number of years into the future. As with other forms of stock awards described here, the right to exercise the award is usually available only after certain vesting requirements are met, most often working a certain number of years or meeting a performance target. *Restricted stock* gives employees the right to acquire shares by gift or purchase at fair market value or a discounted value. Employees can take possession of the shares, however, only once certain restrictions lapse, usually meaning once vesting restrictions are satisfied. *Phantom stock* pays a future cash or share bonus at a specified date equal to the value of a certain number of shares. *RSUs* are essentially phantom stock awards settled in the form of shares. *SARs* provide the right to the increase in the value of a designated number of shares, paid in cash or shares. Unlike phantom stock, SARs can be freely exercisable after vesting, although they sometimes pay out at a specific date or upon a specific occurrence. *Stock awards* are direct grants of shares to employees. In some cases, these shares are granted only if certain corporate, group, or individual performance conditions are met. These awards are usually called *performance shares*.

All of these individual equity award types can be provided to any employee on any terms the company chooses, with some very limited exceptions. Companies can make decisions about who gets the awards, how much they get (with some limits for one kind of stock option), how the company will make a market for the shares, and, within some limits, terms and conditions for the award (such as vesting and how long the award can be exercised). Generally, awards are taxable to the employee as ordinary income when the employee has a nonforfeitable right to them; the employer then gets a corresponding deduction. One kind of stock option, called an incentive stock option, allows an employee the possibility of paying only capital gains taxes on the award, but in that case, the company does not get a deduction.

Stock Purchase Plans

Employees can purchase shares directly or through a specialized kind of plan for this purpose called an employee stock purchase plan (ESPP). When employees simply purchase shares directly, they use their after-tax dollars to do so. In some cases, the employer may make loans to the employee to buy the stock. Under the Sarbanes-Oxley Act of 2002 companies are not allowed to make loans to company insiders; however, they can provide loans to other employees. To avoid tax and securities problems, the loans should be recourse notes with an interest rate at or above the applicable federal rate. Companies can choose which employees can buy stock, based on whatever criterion they choose.

Many ESPPs, by contrast, are designed to meet the requirements of Section 423 of the Internal Revenue Code (for simplicity, in this chapter we will refer to plans that comply with Section 423 as ESPPs and to those that don't as direct stock purchase plans). Under that tax code section, the plan must be available at least to all full-time employees except for those who would, after the ESPP grant, own 5% or more of the company; they must be excluded. However, the company can restrict participation to those who have been employed for at least two years and/or those who work more than 20 hours per week or more than five months per year. The plan must be offered on the same basis to all employees who participate, and no employee can acquire more than $25,000 in stock in one year, based on the stock's fair market value on the first day of the offering period. Employees typically agree to have some of their after-tax pay reserved to save toward purchasing shares during an "offering period" that can be a few months to a few years. Companies can (but are not required to) allow employees to buy stock at either the lower price at the beginning or end of the offering period and at up to a 15% discount off the stock's fair market value on the date when the purchase price is set. If the stock price is $10 at the start of the offering period when the employee begins to set payroll aside, and the employee buys stock at the end of, say, a six-month offering period when it is worth $12, he or she might be able to buy it for as little as $8.50 (i.e., 15% off the $10 price from the beginning of the offering period); if it drops to $6 at the end of six months, the employee could buy for $5.10 (i.e., 15% off the $6 price at the end of the offering period). If certain requirements are met, the employee can usually receive better tax treatment than with a nonqualified ESPP.

Any kind of stock purchase plan must comply with state and federal securities laws. These laws generally provide exemptions from stock registration requirements for offers to employees meeting certain rules, rules almost every closely held company can meet without compromising what it wants to do with the plan. But all plans offered broadly to employees must provide for detailed financial disclosure and investment risk discussion. Moreover, if companies end up with 500 or more shareholders (a number that currently includes option holders[1] unless the company has received an exemption letter for option holders from the SEC), they can become *de facto* public companies. For these reasons, ESPPs are primarily, albeit not exclusively, found in public companies.

ESOPs, 401(k) Plans, and Profit Sharing Plans

ESOPs, 401(k) plans, and tax-qualified profit sharing plans are all covered by the Employee Retirement Income Security Act (ERISA). All provide means for employees to accumulate assets on a tax-fa-

1. As of mid-2007, the SEC had proposed excluding option holders from this number if certain conditions are met.

vored basis over the term of their employment. Employers get tax deductions for their contributions to these plans, and employees don't pay taxes on the money they or their employers contribute to their accounts until they withdraw the money. All of these plans operate through trusts overseen by plan fiduciaries charged with operating them in the best interests of plan participants, and they all are subject to a variety of rules to assure that the benefits of the plan are provided to all qualified employees and on a basis that does not discriminate against lower-level employees. While benefits in the plan can be based on relative compensation (within limits) or on how much employees choose to defer, all employees with at least 1,000 hours of service in a year must be eligible to participate in the plan, and their benefits must be vested over not more than three to six years, depending on the plan and how vesting occurs.

More than 9,000 companies provide ownership to employees through ESOPs, a very specific creature of U.S. tax law with very specific rules and benefits. Unfortunately, this term is often incorrectly used to refer in a generic sense to any kind of ownership plan. Sometimes a stock option plan will be called an "ESOP" as though it were an acronym for "employee stock option plan" instead of for "employee stock ownership plan." (Other countries sometimes use the term in different contexts—for example, "employee share option plans" in India are referred to as ESOPs, but are not the same as U.S. ESOPs.)

Almost all U.S. ESOPs are found in closely held companies. They are generally entirely funded by the employer. They provide a variety of tax benefits to everyone involved. In addition to the employer's ability to deduct contributions to the plan, the business owners who sell their stock to the ESOP can in some circumstances defer taxation on the money they receive from the sale. S corporations that have ESOPs avoid taxes on profits attributable to the ESOP's share of ownership. As a result, S corporations that are 100% owned by their ESOPs do not pay federal income taxes. C corporations can deduct from their taxes both the principal and the interest on any loans their ESOPs had to procure to pay for the shares.

Although ESOPs are most commonly used to provide a market for the shares of a selling owner in a closely held corporation, they can also be used to finance growth or just to provide employees with an ownership interest in the company. They cannot, however, be set up in LLCs or partnerships because they must own employer stock, not some equivalent.

Employers that want to offer company stock in tax-qualified retirement plans can also use 401(k) plans and profit sharing plans as vehicles for employee ownership. Companies can simply make their contributions to the plans in the form of shares, provided they can establish a fair market value for the stock (such as by having an appraisal or being publicly traded), but in 401(k) plans they must allow employees to diversify out of company stock after they've held it for three years. Employees can also buy company stock in a 401(k) plan, subject to securities law requirements that may make this difficult in closely held companies. They cannot, however, be forced to hold company stock in their 401(k) accounts. This book discusses ESOPs in more detail than 401(k) or profit sharing plans, because ESOPs are clearly the most tax-favored and effective means to use an ERISA-qualified plan to share ownership broadly.

Kinds of Equity

Companies can offer employees a variety of kinds of equity in their plans, with some restrictions. ESOPs, for instance, must own stock with the highest combination of voting and dividend rights (typically Class A common) or stock that is convertible into that class of stock. Profit sharing and 401(k) plans cannot own options or other forms of equity rights. The necessity that the ESOP get shares that carry voting rights (or shares convertible into such shares) is, as we will see later, not really a problem and should not be a factor in choosing or not choosing an ESOP as it does not mean that owners who want to maintain control of the company must cede that control to workers.

There is no such voting rights requirement for stock option, restricted stock, performance share, or stock purchase plans. Although they all typically provide the right to buy or own common stock, they could just as well offer preferred shares or some other variety of common stock. (Preferred and super common stock typically have higher dividend and/or liquidation rights; in a few cases, special classes of common with special voting rights have been created.) The shares may or may not have voting rights, although the existence or lack of these rights may affect how the shares are valued. A company that does not have stock because it is an LLC or a partnership, for example, can offer ownership by granting partnership rights or units instead of stock.

The issue of whether unvested or unexercised equity awards can pay dividends is specific to each type of vehicle and thus is discussed in the individual chapters. In some cases, dividends paid on such awards lead to steep taxes for the award recipient under the tax rules governing deferred compensation.

Making the Decision

The chapter on designing equity plans will help readers think through the various issues involved in choosing a plan or plans and deciding on their features. Before thinking through the nitty-gritty of plan details, however, spend some time thinking about what the plan is for. Is it for business transition? Is it to reward all employees or just some? Is it to motivate employee behavior, and if so, is it aimed at some people or everyone? What kind of ownership rights are you prepared to share (plans can be designed to provide almost none, some, or all of the rights)? Do you want ownership to be a right of employment, or should there be hurdles to getting it? Does it matter to you whether employees actually become shareholders or is your primary concern that they be rewarded for gains in the company's share price?

Table I-1 looks at the various reasons why a company might set up an employee-ownership plan on the column side of the table and the attributes of plans owners may want on the row side. You can use it as a guide to help think through some of the key issues in picking a plan.

After learning about the basics of equity plans, the next step should be to talk to other businesses about their experiences with sharing ownership. If you do not know any companies that share ownership, you can go to a conference where companies with vari-

Table I-1. Characteristics of Employee Ownership Plans

	Incentive for selected employees only	Incentive for all employees	Raising capital	Generate corporate tax savings*
Retain management control	Any individual equity award Subsidized stock purchase plans	ESOPs, 401(k), profit sharing plans Broadly granted equity awards ESPPs	Direct stock purchase plans, ESPPs	ESOPs, 401(k), profit sharing plans
Base awards on merits or other individual criteria	Any individual equity awards Subsidized stock purchase plans	Any individual equity awards Subsidized stock purchase plans	Subsidized or unsubsidized stock purchase plans	None
Employees must be willing to put up their own money	Subsidized or unsubsidized stock purchase plans Restricted stock plans requiring share purchase ESPPs	ESPPs	ESPPs Subsidized or unsubsidized stock purchase plans	None
Simplicity	Phantom stock, SARs	Subsidized or unsubsidized stock purchase plans	Subsidized or unsubsidized stock purchase plans	None
Do not issue actual shares	Phantom stock, cash-settled SARs	Phantom stock, cash-settled SARs	None	None
Provide ownership transition	Any kind of stock purchase plan	ESOPs or direct stock purchase plans available to all employees	Any kind of direct stock purchase plan	ESOPs

*Employers can deduct equity compensation benefits paid to employees except for incentive stock options and tax-qualified ESPPs (but even with these two plans, the company is eligible for a deduction if the employee fails to meet the holding period requirements for capital gains treatment). Here, we focus only on plans that generate tax savings beyond those normally available for the payment of compensation.

ous sorts of plans, from ESOPs to options, are represented (such as the NCEO's annual conference) or, if you are an NCEO member, call us for suggestions. Finally, when you are ready to proceed, make sure you find qualified professional advisors who actually have set up many of the specific kinds of plans you choose.

In other words, make this decision as seriously as you would any other essential strategic decision, such as selling the company, making an acquisition, or going into a new line of business. Ownership is a powerful tool that can work very well or very badly. It needs to be carefully thought through.

The Plan of This Book

The following chapters look at several key issues:

- Considerations in choosing and designing any equity plan
- Stock options
- Stock grants, stock purchase arrangements, restricted stock, and restricted stock units
- Phantom stock and stock appreciation rights (SARs)
- ESOPs, profit sharing, and 401(k) plans
- Deferred compensation rules
- Accounting issues
- Securities law considerations
- Special considerations for public companies
- Designing an equity incentive plan
- Issues in providing equity compensation to executives

In chapters on specific forms of equity compensation, we discuss their tax and legal implications and look at plan design alternatives.

We hope you find the book useful. It draws on more than 25 years of experience at the National Center for Employee Ownership. We can always learn from your comments, however, and warmly invite them.