Employment Agreements and Equity Compensation for Management and Employees

David Schneider, Esq.

BERNSTEIN SHUR

Executive Employment Agreement

Bottom line: The most senior executives of a company should have an employment agreement.

1. **Defines**

2. **Protects**

Main Deal Points

1. Compensation “Mix”
2. Severance
3. Non-competes and Non-solicits

Compensation Mix

	Fixed	Variable	Short-Term	Long-Term	Goal
1. Base Salary	X		X		Attract and retain
2. Annual Bonus		X	X		Short term performance goals
3. Equity Compensation		X		X	Long term growth

Severance

1. Cause

2. Good Reason

3. Change in Control – single trigger vs. double trigger

Restrictive Covenants

1. Non-compete
   a. Geographic limitations

Worldwide

State-wide / 100+ mile radius

Customer-based; Business-based

   b. Time limitations:

5+ years

3-5 years

1-3 years

2. Non-Solicit of customers and employees

Why Equity Compensation Is Important

Equity compensation is a tool to:

1. **Attract and retain employees; and**
2. **Incentivize employees to increase the value of the company.**

Bankruptcy + Executive Compensation

Metro Goldwyn Mayer
TRADE MARK
MGM

Equity Compensation

1. Equity Vehicles

2. Vesting

BERNSTEIN SHUR

1 2

Equity Vehicles

Vehicle	Value	Tax Event
Nonqualified stock options	FMV on exercise date *minus* exercise price	Ordinary income on exercise date
Incentive stock options	FMV on stock sale date *minus* exercise price	Capital gains on stock sale date
Restricted stock	FMV of stock on vesting date (unless Section 83(b) election)	Ordinary income on vesting date
SARs	See Stock Options	Ordinary income on exercise date
Restricted Stock Units	See Restricted Stock	Ordinary income on payment date (usually vesting date)
Profits interests (LLCs only)	Percentage of distributed profits beginning on grant date (no capital interest)	Capital gains on payment date

Non-Qualified Stock Options

- Overview: The right to purchase stock from the company at an exercise price (typically fair market value). This right may subject to vesting requirements.
- Value: Fair market value on exercise date *minus* exercise price
- Tax Treatment: Ordinary income on the exercise date

- Example: Employee is granted an option to purchase 100 shares of stock at $5 per share. Five years later, a share of stock in worth $15 per share. If employee exercises the option, the employee will recognize $1,000 of ordinary income

(100 shares x ($15 - $5)).

Incentive Stock Options

- Overview: Same as nonqualified stock option, except must satisfy certain ISO requirements, including holding period (hold stock at least 1 year after exercise and 2 years after grant).
- Value: Fair market value on stock sale date *minus* exercise price
- Tax Treatment: Capital gains on the stock sale date

- Example: Same facts as prior example, except assuming ISO requirements satisfied, if employee exercises the option, the employee will recognize $0 of ordinary income. Ten years later, employee sells stock when value is $30 per share. Employee recognizes capital gains of $2,500

(100 shares x ($30-$5))

Restricted Stock

- Overview: Stock of the company issued to employee, but will be forfeited unless certain vesting requirements satisfied.
- Value: Fair market value on vesting date
    - Except: Fair market value on grant date if 83(b) election made within 30 days of grant date
- Tax Treatment: Ordinary income on vesting date (or grant date if Section 83(b), but appreciation taxed at capital gains rate)

- Example: Employee is granted 100 shares of restricted stock (valued at $5 per share) that vests 100% upon three years of service. Three years later, the restricted stock vests when a share of stock in worth $15 per share. Employee will recognize $1,500 of ordinary income (100 shares x $15). If employee made 83(b) election, employee would have recognized $500 on the date of grant (100 shares x $5) and any appreciation of stock value would be taxed at capital gains rate.

Stock Appreciation Rights

- Overview: Contractual right to receive the excess of exercise date fair market value over exercise price. This right may subject to vesting requirements. (Typically no right to receive stock)
- Value: Fair market value on exercise date *minus* exercise price
- Tax Treatment: Ordinary income on the exercise date

- Example: Employee is granted SARs equivalent to 100 shares of stock when one share is $5 per share. Five years later, a share of stock in worth $15 per share. If employee exercises the SAR, the employee will recognize $1,000 of ordinary income

(100 shares x ($15 - $5)).

Restricted Stock Unit / Phantom Shares

- <u>Overview</u>: Contractual right to receive the value of a share of stock. This right may subject to vesting requirements. (Typically no right to receive stock)
- <u>Value</u>: Fair market value when paid to employee
- <u>Tax Treatment</u>: Ordinary income when paid to employee

- <u>Example</u>: Employee is granted RSUs equivalent to 100 shares of stock that vests 100% upon three years of service and is then value is immediately paid to employee. Three years later, the RSU vests when a share of stock in worth $15 per share and employee is immediately paid $1,500. Employee will recognize $1,500 of ordinary income (100 RSUs x $15).

Profits Interest (LLC Only)

- Overview: Right to receive percentage of future profits. This right may subject to vesting requirements. Recipient may not have right to receive any portion of company's FMV as of the grant date upon a sale of the company.
- Value: Percentage of future profits
- Tax Treatment: Ordinary income when distributions paid to employee; capital gains upon a sale of the company.

- Example: Employee is granted a 10% profits interest when the value of the company is $1,000,000. Over the next 5 years, the company's distributes $100,000 per year to the members (employee will receive $10,000). In the fifth year, the company is sold for $5,000,000. Employee will receive $400,000 (10% x ($5M - $1M))

1 2

Vesting

1. Time-vesting – promotes longevity
2. Performance-vesting – promotes achieving performance targets
3. Change in control – promotes achieving a liquidity event; cooperation
4. Accelerated vesting upon certain terminations of employment