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Equity and Incentive Compensation Arrangements for Employees of Startup Companies

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This practice note provides a brief introduction to the equity and incentive compensation plans and agreements that startups often use to attract and retain key personnel. To effectively advise startups, and the investors that frequently finance them, it is imperative to understand startup equity and incentive compensation structures, and why and how they may differ from those offered by more mature companies. The following is a general discussion of compensation practices of investor-backed, Kickstarter-funded, and bootstrapped startup enterprises, where the founders' intended trajectory is to quickly grow the company (and its value) in the hopes of an exit or liquidity event via an initial public offering (IPO) or sale. It is a world of short- to mid-term time horizons where investors (and founders and senior executives) demand significant growth and substantial returns. This is distinct from the mentality driving many new small businesses or family-owned businesses. It is also different than the approach often adopted by more mature private and public companies. One important distinction between mature enterprises and startups is that startups frequently have much less cash available to compensate employees and instead rely more heavily on equity-based compensation arrangements.

The practice note is organized into the following sections:

- Typical Equity and Incentive Compensation Arrangements for Startups
- Some Common Provisions in Startup Equity Compensation Agreements
- Comparing Compensation Practices of Startups versus More Mature Companies

A caution about the scope and applicability of this practice note:

Diversity among startups. Because myriad types of startups exist, this practice note presents only a general discussion of startup equity and incentive compensation proclivities. Many startups will have compensation practices different from those discussed here.

Regional and industry differences. Compensation practices tend to vary by region and business sector. For example, employee stock options in a New York or Massachusetts startup may contain significantly different terms (e.g., forfeiture or forced repurchase terms), and significantly different amounts (in terms of percentage equity in the employer) than employee stock options offered by a Silicon Valley startup.

Market terms. In addition to understanding compensation arrangement basics, it is also important to know current market rates for startup equity and incentive compensation structures in the region and business sector under consideration. Compensation consulting firms can provide this type of information.

Covered employees and growth. Some of the compensation arrangements and terms discussed below are typically offered only to certain individuals who are vital to the success of the enterprise. This may include a startup's founders and senior executives, and sometimes other early employees (e.g., employees who join the startup before the company's first equity financing). Generally, as a startup grows, its leverage in employment compensation matters increases vis-à-vis most employees, although senior executives and key technologists it seeks to employ later in its life cycle may have significant leverage in their employment negotiations.

Typical Equity and Incentive Compensation Arrangements for Startups

The following list is a brief introduction to several equity and incentive compensation plans and agreements that startups commonly offer. Each arrangement is discussed in detail in the sections further below.

- **Founders restricted stock purchase agreements** (FRSPAs) are agreements providing for the sale of a startup's stock at a nominal price, typically to the company's founders and sometimes to other key non-founder employees. FRSPA stock is owned by the employee but is usually subject to a repurchase right by the company at the original purchase price until the recipient vests in the shares. As discussed further below, an employee who files a Section 83(b) election will generally be taxed at the capital gain rate for any increase in value from the grant date when the stock is sold. Note: FRSPAs are sometimes called restricted stock purchase agreements, although to avoid confusion this practice note uses the term "restricted stock purchase agreements" only in connection with its discussion of early exercisable stock options.

- **Employee stock options** grant the recipient the right (usually subject to vesting conditions) to purchase a certain amount of an employer's common stock at a set price (called the exercise or strike price) during a specified time or following a specified event. The exercise price per share is usually set at the stock's fair market value (FMV) at the time of grant. Employee stock options are either incentive stock options (ISOs), which receive beneficial tax treatment, or nonqualified stock options (NQSOs), as described further below.

- **Early exercisable stock options** allow employee grantees to exercise their stock option at the outset of the grant (or later during the term of the option), even if the stock subject to the options is not vested. The award agreements provide that the startup may repurchase the issued but unvested stock at the option exercise price if the employee departs the employer before the specified vesting date(s) or event(s). Depending on the type of option issued and the employee's financial and tax situation, the employee may be able to obtain more favorable tax treatment through an early exercise, similar to a FRSPA.

- **Phantom equity agreements** provide for a payment to an employee, usually in the form of a cash bonus based on the appreciation of the employer's stock or enterprise value. The bonus amount generally parallels the gain the employee might have received by owning the employer's equity while the arrangement is in effect, but phantom stock payments are typically taxed as ordinary income. Stock appreciation rights (SARs) are an example of a phantom equity award.

- **Profits interests** in a limited liability company (LLC) are membership interests that provide for a right to a future income stream from the LLC's profits and/or a share of the proceeds upon a liquidity event, but which generally do not carry the same rights as the LLC's capital interests. Allocations paid to an employee holding a profits interests may be taxed as ordinary income or capital gain, depending on the determination at the LLC level. Equity (stock) may be substituted for profits interest if the LLC converts to a C corp or goes public.

- **Commission plans**, which may be capped or uncapped, are cash (non-equity) incentive plans commonly used by startups to incentivize sales personnel. Payments under a commission plan are taxed at ordinary income rates.

- **Change-in-control agreements** provide additional equity, cash compensation, acceleration of vesting, post-change-in-control employment protection, or other benefits to an employee if the employer undergoes a change in control (e.g., the startup is sold to an acquirer). Change-in-control benefits may be taxed as ordinary income or capital gain, depending on the benefits, and may also trigger golden parachute taxes in some situations.

- **Management carve-out agreements** reserve part of the sale price of a company for the payment of a cash transaction bonus to an executive, or to members of an executive pool or class of employees, in circumstances where additional retention incentives may be needed in anticipation of a company sale. Management carve out payments are typically taxed as ordinary income, but they may trigger golden parachute taxes under certain circumstances.

- **Retention agreements** provide additional equity, cash compensation, or other benefits to an employee who continues to work for an employer through a predetermined date or event. Retention agreements may be used in place of or alongside change-in-control agreements.

- **Cash bonus arrangements** of various types are also used by startups, but because of the relative lack of cash flow, startup cash bonus programs tend to be less rich and more narrowly targeted than for more mature companies.

Founders Restricted Stock Purchase Agreements

In a FRSPA, the startup sells to a founder or other key employee a certain amount of the company's stock, some or all of which is unvested and subject to repurchase by the company if the purchaser's employment with the company terminates. FRSPA restricted stock is almost always common stock, and the purchase price of unvested shares is almost always the stock FMV at the time the shares are issued. Because most early-stage startups' stock is worth very little, the FMV is often nominal (e.g., as little as $0.001 or $0.0001 per share). FRSPA stock becomes valuable to the employee only if the startup's enterprise value increases.

Typically, the startup's repurchase right lapses over time pursuant to a vesting schedule in the FRSPA, incentivizing the purchaser to remain with the startup and help increase its value in hopes of obtaining unencumbered, valuable shares. The vesting condition is a retention tool that protects investors against the employee departing "early" with a substantial (from the investors' perspective) windfall ownership of the company. Sometimes the startup retains a repurchase right to vested FRSPA shares, but the price paid for the post-vested stock is typically significantly higher (assuming a successful startup) than for unvested stock (e.g., repurchase of vested stock at FMV at time of repurchase as compared to repurchase of unvested stock at original purchase price).

FRSPA vesting schedules may have an initial cliff period (e.g., one year) before any shares vest. For example, 25% of the shares may vest on the one-year anniversary of the issuance date, followed by pro-rata vesting of the remaining shares monthly over the subsequent three years. Alternatively, the repurchase right may lapse over some other increment of time, or vesting in whole or in part could be based on performance.

As further retention protection, investors (e.g., venture capitalists) who initially invest after the formation of a startup often demand (as a condition to their investment) that the founders (and possibly other senior executives) subject their previously acquired unrestricted stock to a new vesting schedule, or other restrictions. Sometimes investors require founders and others to begin "re-vesting" some of their previously vested stock if the founder (or executive) becomes "too vested" from the perspective of the investor (e.g., the founder is more than 50% vested). Founders and senior executives often agree to new vesting or re-vesting because they want the investment being offered to the startup so that they have the opportunity to grow their company and increase the value of their stock.

Note that a startup's restricted stock purchase agreement is very different than public company restricted stock agreement of the same (or similar) name, which after vesting typically requires the delivery of freely tradable stock to the public company employee.

Tax Considerations for FRSPAs

FRSPAs can be tax efficient compensation vehicles because the employee may be taxed at capital gain rates instead of ordinary income rates on the appreciation in value of the shares. Internal Revenue Code (I.R.C.) section 83 (Section 83) governs the taxation of property (such as restricted stock) transferred in connection with the performance of services. Under the default Section 83 rule, a purchaser of stock under a FRSPA would not pay any associated income taxes until the stock vests (i.e., when the restriction of the repurchase right lapses). At that time, any portion which becomes vested would be taxed at ordinary income rates on the difference between the price paid (if any) for the vested portion of the stock and its FMV on the vesting date. However, I.R.C. § 83(b) permits the purchaser to make an irrevocable election (Section 83(b) election) to include in income any taxable amount on the FRSPA stock as of the date it is purchased by the employee, provided the Section 83(b) election is filed with the IRS on or before the 30th day thereafter.

The effect of the Section 83(b) election is that the employee pays tax for the year of issuance at ordinary income rates on the excess (if any) of the issuance-date FMV over the employee's purchase price (a difference of $0 for FRSPA stock sold at FMV). Then, if the employee holds the shares for at least one year before selling them, any appreciation in share value would be taxed at the more favorable long-term capital gain rate. As a result, a founder entering into a FRSPA usually files a Section 83(b) election. Note, however, that if the recipient does not pay for the stock (e.g., where the stock is issued as compensation for services provided) and makes a Section 83(b) election, but then leaves the company prior to vesting and forfeits the shares (or has them "repurchased" for $0), the employee is not entitled to a credit for any amount of income tax paid on the forfeited shares for the year of grant.

For more information on equity compensation taxation, see Understanding Types and Taxation of Equity Compensation.

Employee Stock Options

Startups may issue stock options to their employees pursuant to a stock option plan and agreement. The employee stock option agreement grants the employee an option to purchase a fixed amount of an employer's stock at a fixed price (called the exercise or strike price). Employee stock option agreements are almost always issued pursuant to, and subject to, the startup's qualified equity incentive plan.

The equity incentive plan is a formal governing document authorizing the company to issue equity (and, perhaps, phantom equity) to employees and consultants. It is approved by the company's board of directors and stockholders. Equity plans are also usually designed to meet the eligibility conditions for the Rule 701 exemption to the registration requirements of the Securities Act of 1933 and similar state securities law exemption rules. For further information on this topic, see Drafting a Private Company Equity Compensation Plan.

To qualify for an exemption from the nonqualified deferred compensation rules under I.R.C. § 409A's tax rules (Section 409A), the per share exercise price of the option is typically no less than the FMV of a share of common stock of the employer on the date of grant. The exemption is important because most stock options are not able to comply with the requirements of Section 409A and the penalties for non-compliance can be severe. Therefore, startups need to take care to set their exercise prices carefully, including determining a grant-date FMV in accordance with the Section 409A regulations. For more information on this topic, see Understanding Nonqualified Deferred Compensation Arrangements and Internal Revenue Code Section 409A.

Employee stock options typically vest, meaning the employee acquires the right to exercise the option, only over a period of time or on the occurrence of a future event, often conditioned in either case on remaining employed by the company. That is, vesting is either time based or performance based (sometimes it is a combination of both). With a time-based vesting stock option, the employee's right to exercise the option and purchase the company's stock vests over a period of time, typically providing that the employee remains employed by the company through the vesting date. For example, an option may vest 25% on the one-year anniversary of the grant date and pro-rata monthly thereafter (i.e., monthly vesting of 1/48 of the total amount of granted stock over the next three years, which is the same as vesting of 1/36 of the total amount of unvested stock remaining after the cliff vesting date).

With performance-based stock options, the employee's right to exercise the stock option vests when the predetermined performance milestones described in the stock option award are achieved. For example, the vesting clause may provide that 50% of the option vests if the startup's aggregate revenue exceeds $5 million on or before the one-year anniversary of the option grant date.

Many startups will reserve a certain percentage of their equity for option grants to employees. This reserve of equity is frequently called the employee stock option pool. The startup typically initially reserves 10% to 25% of its total equity for the employee stock option pool, and may expand the amount of stock reserved for grants to its employees after all the options are granted or in connection with subsequent financing rounds.

Tax Considerations for Stock Options

As noted above, stock options are either ISOs, which receive beneficial federal tax treatment, or NQSOs. Certain requirements must be met to qualify as an ISO, including a cap on the value of ISOs that can be granted to a single individual (described further below).

<u>Federal Taxation of NQSOs</u>

With NQSOs, employees pay taxes for the year in which any portion of the option is exercised for vested stock. The employees are taxed on the difference between the exercise price and the FMV of the stock acquired as of the exercise date. NQSOs are taxed at the employee's ordinary income rate. Subsequently, upon a disposition of the acquired shares, the employee has another taxable event, which will result in either a short-term or long-term capital gain (assuming appreciation in value of the shares), depending on whether the stock is held for at least one year, on the difference between the sale price and the exercise price. Exercise of NQSOs is subject to payroll tax and employer withholding obligations. See the section entitled "Early Exercisable Stock Options" below for the implications on the exercise of unvested NQSOs.

<u>Federal Taxation of ISOs</u>

ISOs are eligible for more favorable tax treatment, but are subject to the following conditions:

- No more than an aggregate of $100,000 (as determined by the exercise price of the stock option) in value of shares subject to ISOs may be first exercisable in any calendar year to one employee. Any options that are over an employee's $100,000 per-year limit are considered NQSOs.
- Only employees are eligible to receive ISOs, not independent contractors or other non-employees (e.g., directors or advisors).
- The recipient must exercise the ISO while still employed with the company or within three months following termination of employment.
- The ISO exercise price must be at least 100% of the grant-date FMV (or, for a recipient already holding 10% or more of the stock of the employer, at least 110%).
- ISOs cannot be exercised more than 10 years after the grant date (or five years for an ISO granted to a 10% owner).
- ISOs must be granted pursuant to a plan that is approved by the stockholders and contains certain provisions.

For additional information on ISO requirements, see Incentive Stock Option Checklist Considerations.

With vested ISOs, exercising the option does not incur any regular federal income tax liability, although the difference, if any, between the exercise price and the FMV of the stock on the date of exercise will be treated as income for federal alternative minimum tax (AMT) purposes and may cause the employee to owe AMT in the year of exercise.

If the employee holds the vested stock purchased via ISO exercise for both one year after the date of exercise and two years after the date of grant, then the gain between the sales price of the stock upon disposition and the exercise price of the stock option is taxed as a long-term capital gain when the stock is sold. However, if either holding condition is not met (a so-called disqualifying disposition), then the tax treatment is largely the same as that applicable to NQSOs (the difference between the exercise-date FMV and the exercise price is taxed as ordinary income, and any gain in value from the exercise date to the disposition date is taxed as either a short- or long-term gain, depending on whether the shares are held for at least one year). An ISO that is exercised after the day that is three months after termination of employment, or any portion of an option that exceeds the $100,000 per-year limit, is disqualified for ISO tax treatment and is, thereafter, treated as a NQSO.

Unlike NQSOs, the exercise of an ISO does not result in the imposition of payroll taxes or employer withholding obligations under federal tax law (even if there is a later disqualifying disposition). There are, however, employer tax reporting requirements for ISO exercises (see IRS Form 3921). Note also that employers are not eligible for any compensation deduction with respect to an ISO (unless there is a disqualifying disposition). See the following section for tax implications on the exercise of unvested ISOs.

Early Exercisable Stock Options

An early exercise clause in a stock option agreement permits the employee to exercise the stock option before the option vests. When the employee does so, the employee usually is required to enter into a restricted stock purchase agreement (RSPA), whereby the startup retains the right (but not the obligation) to repurchase the acquired but unvested stock at the exercise price, or at the lesser of the exercise price or FMV as of the repurchase date. In the later formulation, for example, if the employee exercises the stock option early, the company's stock price falls, and then the employee leaves the startup, the employer may repurchase the unvested stock at the current FMV, notwithstanding the higher exercise price paid by the employee for the shares. Alternatively, the startup may keep the money the employee paid to exercise the stock option and allow the employee to retain the stock.

Tax Considerations for Early Exercise Stock Options

Most employees who early exercise their stock options do so because they expect the stock to appreciate in value and want that increase in value taxed at the long-term capital gain rate rather than the ordinary income rate. Since the option shares are acquired as unvested restricted stock, the I.R.C. § 83(b) rules allow for similar tax treatment as discussed above for FRSPAs. Thus, employees may early exercise the stock option shorty after receiving the option grant and file a timely Section 83(b) election with the IRS within 30 days of the exercise date.

The Section 83(b) election allows the employee to pay the taxes due on the acquisition of the unvested stock in the year of exercise (instead of at a later time as the issued shares vest), at ordinary income rates calculated on the difference between the exercise price of the unvested stock and its FMV on the option exercise date. If the employee exercises the option immediately after grant, in most cases, the FMV will be the same as the exercise price, meaning the employee pays $0 in taxes on the acquisition of the stock.

By exercising early and filing the Section 83(b) election to pay the resulting taxes on the exercised stock up front, any increase in share value after the election date would then be taxed at long-term capital gain rates (assuming the stock is held for at least one year) at the time the employee sells the stock.

There may be an additional tax benefit for ISO grantees who have an early exercise option. As mentioned in the previous section, the spread between an ISO's exercise price and the exercise-date FMV is treated as income for calculation of the AMT. Early exercises of ISOs (when available) may help avoid or lessen the amount of AMT since the spread at the time of an early exercise (if any) will likely be smaller than it would be at a later exercise date. However, there is some uncertainty about how the Section 83(b) rules apply to ISOs and whether or not the Section 83(b) election is only effective for AMT purposes but not for regular income tax purposes. Thus, some believe that only NQSOs should be used for the early exercise of stock options.

Other advantages to early exercising stock options is that early exercising starts the clock on the one-year holding period to qualify as a long-term capital gain, and allows the employee to be a stockholder with voting, information rights, and perhaps other stockholder protections.

Early exercising, however, is not without disadvantages. When the employee early exercises his or her employee stock option and files a Section 83(b) election, the employee takes the risk that he or she will lose the money paid for the stock. If the startup fails, the startup's stock will have no value. Another drawback of early exercise is that, even where the startup's shares increase in value, the acquired stock may be illiquid for many years.

Phantom Equity

A phantom equity agreement attempts to capture the economic benefit of an equity award without granting any equity. Phantom arrangements typically pay the employee an amount of money equal to the appreciation in value of the company's equity over the period of time the arrangement is in effect. The phantom equity agreement may provide for payment at a specific point in the lifecycle of the company (e.g., sale of the company), a specified date, an involuntary termination of employment, retirement, or some other event. However, if the arrangement is subject to Section 409A, the payment event must be permissible under the applicable rules. Some phantom equity agreements may also provide for the payment of so called dividend rights on profits (which are not true dividends and will be taxed as ordinary income). To provide a retention feature, depending on the state in which they are granted, phantom equity agreements may contain forfeiture clauses triggered by an employee's voluntary termination of employment prior to payment.

Employers who do not want to grant equity, but who desire to reward employees when the value of their entity grows, may find phantom equity agreements advantageous. The phantom agreement permits the startup and its founders to retain their equity ownership while incentivizing the employees to make that equity as valuable as possible.

Even though there is no dilution in the startup's equity pool when the startup offers phantom equity to its employees, startups may find phantom equity arrangements disadvantageous because the end result typically is a cash payment (sometimes a very large one) that is paid out before distributions to actual equityholders. Startups generally attempt to avoid large cash outlays (at least, to non-sales employees). For their part, employees may find phantom equity agreements disadvantageous compared to other types of incentive compensation because phantom equity is not actual equity, and thus "gains" on the phantom equity are taxed as ordinary income. In addition, there are no voting or other stockholder rights associated with phantom equity.

Tax Considerations for Phantom Equity

As with other types of cash compensation, tax on phantom equity payments is generally incurred at ordinary income rates for the year in which payment under the applicable agreement is made. However, if the arrangement is subject to Section 409A and does not comply with the applicable rules, income recognition may be accelerated to the extent any amount deferred under the arrangement is no longer subject to a substantial risk of forfeiture (whether or not payment is made), and the employee is subject to an additional 20% tax on the deferred amount.

Profits Interests

Startup LLCs may use profit interests to incentivize their employees, just as C corp startups use stock options. A simple profit interest grants an employee a right to some part of the future (from the date the profits interest is issued) profit stream of the company. They can also be structured so that the profits interest holder shares in the distribution of proceeds upon the sale of the LLC (but only with respect to increases in enterprise value from the date the profits interest is issued). The principal distinguishing feature of a profits interest, as compared to a typical unit interest in the LLC, is that the holder may not acquire any interest in the value of the company or its capital account balances relating to any period up to the time the profits interest is granted. That is, profits interests only reward the holder based on future profits or future appreciation in enterprise value.

As with the other incentive compensation arrangements discussed here, profits interests are creatures of contract, so the LLC startup has considerable latitude when drafting its terms. For example, the startup may require the employee to satisfy time based or performance-based vesting conditions to accomplish retention or motivational objectives. One potential advantage of a profits interest is that the startup need not impose any exercise price, and may simply grant its employee the profit interest in exchange for the employee's services. One downside is the potentially costly administrative burden of the profits interest.

The details of a profits interest are described in the LLC's operating agreement and a profits interest agreement that the LLC startup and employee enter into. Profits interest holders become members of the LLC (although their membership rights are usually limited, e.g., they are often not eligible to vote on most LLC matters or participate in tag-along rights provisions when third parties acquire units of the LLC). Issuing a profits interest also has employment-related consequences because the recipient effectively becomes a member of the LLC for tax purposes. As a result, among other things, compensation from the LLC is reported on a schedule K-1 instead of a Form W-2; thus, the individual may need to pay self-employment taxes and will not be eligible for certain tax-advantaged benefits that regular employees receive (e.g., paying health plan costs on a pre-tax basis).

For more information on compensating employees with profits interests, see Profits Interest Plans and Employee Equity Compensation for Limited Liability Companies.

Tax Considerations for Profits Interests

Federal taxation of profits interests is complicated and somewhat uncertain. In addition, IRS might change its approach to taxation of LLC profits interests in the future. Under the current IRS safe harbor rule, a properly structured profits interest will not create a taxable event at the time of grant (whether or not the interest is vested). If the interest is sold at a later date (e.g., upon a company sale), then any appreciation in value will be taxable at short- or long-term capital gain rates, as applicable. (The tax treatment of interim distributions of the LLC's profits to the interest holder depends on the tax character of the related income to the LLC.)

Note that the safe harbor will not apply, and the granting of the profits interest may be treated as a taxable event, if the interest:

- Provides for distributions relating to a substantially certain and predictable stream of LLC assets or revenue
- Is disposed of within two years after grant –or–
- Is a limited partnership interest in a publicly traded partnership

In addition, IRS guidance makes clear that the LLC must treat holders of unvested profits interests as a bona fide LLC member (although it is not necessary to grant profits interest holders all of the same membership rights as other members). A Section 83(b) election is not necessary for a profits interest that satisfies the safe harbor, but it is recommended that recipients make a so-called protective

Section 83(b) election (indicating a $0 FMV for the property transferred) in case the intended tax treatment is not recognized by the IRS.

For more information on the tax treatment of profits interests, see 2-13 Tax Planning for Partners, Partnerships, and LLCs § 13.06 and Rev. Proc. 93-27, Rev. Proc. 2001-43, and Rev. Proc. 2005-43.

Commission Plans

Commissions are sales-based compensation payments intended to incentivize sales employees and executives to promote a new product, increase market share, and/or ensure sales volume. Since the compensation payments are dependent in some manner on sales activity, even cash-strapped startups are usually able to implement cash-based incentive arrangements. Startups use many types of bonus and commission plans, with payments triggered by a host of different milestones and management-based objectives. For example, commissions may be determined as a simple percentage of sales consummated. Alternatively, bonus payments may kick in for hitting certain sales goals. Or there may be more complex formulas and other conditions to payment.

The employee's offer letter or employment agreement may set forth individualized terms and conditions for a commission or bonus. Frequently, however, startups establish bonus or commission plans that apply to groups of employees and/or executives.

Early stage startups sometimes choose not to cap commission plans. When startups offer uncapped commissions, they may do so for a number of reasons. One is to attract successful sales professionals to the company. A startup with a new product and little or no track history in sales, with investors who demand significant year-over-year growth, may need to attract high-quality sales professionals quickly, and offering the prospect of unlimited compensation via an uncapped sales commission plan is one way to accomplish this goal.

The uncapped commission plan also motivates sales professionals to work hard to find new markets for the startup's innovative products, or to encourage aggressive sales of a new product in an already-competitive market. In an environment where cash in king and the prospect of "unlimited" cash exist, sales employees may work longer and more diligently than otherwise to achieve their personal revenue goals

As their revenues increase and their products receive acceptance in the marketplace, maturing startups sometimes cap their commission plans. Occasionally newly hired executives come to believe that their maturing startup's sales professionals are "earning too much" or that costs can be reduced by capping sales commission plans.

The capping, in turn, may encourage some of the startup's most successful sales professionals to leave in the year or two following the commissions limiting event. Sales professionals who resent the newly imposed limitation on their upside earning potential and who seek out startups with uncapped commission plans as part of their personal economic model may jump ship to a new startup with an uncapped commission plan.

Tax Considerations for Commission Payments

As for other types of cash compensation, tax on commissions is usually incurred at ordinary income rates for the year in which payment is made. Some commission plans may implicate the nonqualified deferred compensation rules under Section 409A if payments are not made within a short period following the time they are earned. A review of commission plan design and documentation is recommended to determine whether Section 409A applies and, if so, to ensure compliance with the applicable rules.

Change-in-Control Agreements

A corporate change in control typically occurs when those controlling the corporate governance of an employer lose control (or no longer have control) of either the governance of the corporation or the corporation's assets, for example, through a sale to an acquiring company or a buyout by new investors. The uncertainty of life in a post-change-in-control world, or the perception by the management team that a change in control is not in the team's best economic interest, may cause many "unprotected" executives to shy away from potential acquisition offers. This, of course, may not be in the best interests of the startup, which might be better off, as a business matter, if it is sold to another corporation. Probably significantly more important, however, a go-slow-on-sale management team may not be in the best interests of the startup's investor shareholders. Those shareholders might desire a near-term liquidity exit for one reason or another.

Startups sometimes offer their management team benefits and protections in the event of a change in control to incentivize the management team to work toward a corporate transaction. These benefits may be offered in employment contracts, stand-alone individual agreements, or pursuant to a change-in-control plan covering selected employees. From the startup's perspective, the change-in-control agreement's economic incentives align company executives' financial interests with the interests of the startup's shareholders.

Most change-in-control agreements will:

- Define when a change-in-control event occurs for purposes of the agreement (e.g., will an IPO or a sale of a subsidiary or business unit trigger the benefits)

- State if benefits are single trigger of double trigger (described below), or whether there are different single-trigger and double-trigger benefits –and–

- List the benefits the employee will receive if the payment triggering event(s) occur

Single- versus Double-Trigger Change-in-Control Benefits

When benefits are triggered solely by the occurrence of a change in control, it is referred to as single-trigger protection. A startup may agree to a single-trigger change-in-control clause when the company strongly desires to be sold, or when an executive has significant leverage and uses the leverage to negotiate the provision.

In a double-trigger change-in-control agreement, benefits are provided only if employment is terminated (usually by the employer without cause or by the executive for good reason, as defined in the agreement) in connection with or after the change in control. The first trigger is corporate change in control; the second trigger is termination of employment. The protection may be for a limited time after a change in control (12 months is common), or may be unlimited by time. In addition, employment protection is sometimes in effect for a short time prior to the consummation of the transaction. Startups (and more mature companies) generally prefer double-trigger clauses. Sometimes the startup's change-in-control agreement will provide for both single- and double-trigger benefits. This type of hybrid agreement offers benefits on a change in control and additional benefits if there is a qualifying termination of employment (or other predetermined event or occurrence) after the change in control.

The single-trigger/double-trigger nomenclature used in this practice note should not be confused with the very common single-trigger/double-trigger references used when the discussion/negotiation is focused on severance and the timing of separation pay (and possibly other benefits). In the separation pay context, single-trigger protection refers to the payment of separation pay in the event of a termination of employment only, generally without cause by the employer or for good reason by the executive. In this context, double-trigger protection refers to payment of separation pay only after both a change in control (first trigger) and termination of employment (second trigger) occur. Thus, in the separation pay context, an employee with single-trigger protection will receive separation pay (e.g., six months of base salary), and perhaps, other benefits (e.g., six months of paid COBRA premiums) if the employee undergoes a qualifying termination of employment regardless of whether a change in control has occurred, whereas an employee with double-trigger protection receives separation pay only if the qualifying employment termination occurs after (or in some cases shortly before) a corporate change-in-control.

Because a startup often does not survive a change in control, many employees seek accelerated vesting of their equity upon, or in connection with, a change in control. The amount of equity to be accelerated, if any, upon or post-change in control differs from company to company. Some startups will offer full vesting of unvested equity as an incentive to their employees, whereas others insist on lesser amounts, providing for only partial accelerated vesting. Still others offer no change-in-control protection.

In addition, equity acceleration may be single trigger (e.g., 100% of all unvested equity vests upon the change in control), double trigger (e.g., 100% of all unvested equity vests upon a qualifying termination of employment after a corporate change in control) or a hybrid of the two. The acquiring or surviving entity may also offer a substitute incentive award to affected individuals to replace any unvested equity in the startup that is lost upon the change in control, but there is usually no obligation to do so.

Tax Considerations for Change-in-Control Benefits

Change-in-control benefits consisting of cash payments (e.g., transaction bonuses or enhanced severance payments triggered by a termination following a change in control) are taxed as ordinary income, usually for the year in which the payment is made. Tax treatment may differ for other types of benefits.

Many change-in-control arrangements are subject to Section 409A and need to be structured to comply with those rules. In addition, change-in-control benefits may trigger golden parachute excise taxes for certain individuals in some cases. For more information on the golden parachute rules, see IRC Sections 280G and 4999: Understanding the Excise Tax and Lost Tax Deduction for Excess Change-in-Control Compensation.

Management Carve-Out Agreements

The management carve-out agreement is a type of change-in-control agreement that startup boards sometimes use to motivate certain executives or the management team (and in some cases other employees) to work for and build the startup in anticipation of a company sale in circumstances where they may otherwise have little economic incentive to continue working for the company or bringing a corporate transaction to fruition. The management carve-out agreement allots money from the sale proceeds of the company for bonuses to be paid to designated employee(s).

The need for a management carve-out agreement often arises at a struggling startup with a large overhang (high liquidation preferences), where investors own preferred stock in the startup but management owns (or has stock options granting the right to acquire) only the startup's common stock. If the preferred stockholders' right to guaranteed payments from the sale will consume most or all of the sale proceeds so that the management equity will be of little or no value, without a management carve out plan, the employee may have little incentive to stay or help obtain the maximum sale price for the startup. Rather, employees who are looking for an equity play will be inclined to find new employment elsewhere. For their part, employees who value cash compensation (e.g., salary, bonuses, commissions) may have little incentive to contribute toward a company sale that could jeopardize his or her job. A management carve-out agreement can encourage these individuals to diligently work toward a successful exit by guaranteeing them a share of the sale proceeds.

Management carve-out agreements come in many types. The size of and method for calculating the carve out (e.g., whether it is based on total or net proceeds), the payment triggers, the level of employment required to share in the carve out, and the allocations among participating employees are often the subject of negotiation between a company's board (or the company's investors) and the top executives or management team. For example, a board may decide to establish a management carve-out pool, comprised of identified management team members, who will each receive equal shares of 5% of the purchase price if the company is sold for $50 million to $75 million, 6% if the purchase price is $75 million to $100 million, and 7.5% if the price is in excess of $100 million, provided in all cases that the sale closes in 18 months after the date of the agreement. Another board, however, may adopt completely different metrics for its management carve out plan.

Retention Agreements

As the name implies, startups use retention plans or individual agreements to retain the services of employees important to the startup's success (which may be all employees) in situations where they are likely to look for other employment. The retention agreement provides for compensation (in the form of cash or equity), and perhaps other benefits, if an employee works for the startup through a specific date or through a specific event or set of events.

Startups use retention agreements in a wide variety of circumstances to incentivize employees to continue working for the company. For example, a startup may use a retention agreement in conjunction with, or instead of, a change-in-control agreement or management carve-out agreement to provide a financial incentive for its employees to remain employed for a fixed period of time or until a particular agreement is executed. Alternatively, a retention agreement may be used by a failing startup to encourage employees to remain employed with a company that is going out of business (e.g., until a particular project is completed). Typically, if the triggering event does not occur, the startup does not incur any added cost as a result of the retention agreement.

Tax Considerations for Retention Agreements

Most retention bonuses consist of cash payments that are taxed as ordinary income for the year in which the payment is made. Tax treatment may differ for other types of benefits. Retention bonuses are usually structured to qualify for the short-term deferral exception to Section 409A.

Cash Bonuses

Startups offer many types of bonuses, whose payments may be triggered by a host of different milestones and management-based objectives. Like commission plans, the terms and conditions of a bonus may be individualized and set forth in an individual's offer letter or employment agreement. Frequently, however, the startup provides a bonus plan to a group of employees or executives to incentivize a team to focus on a particular objective or set of objectives.

Bonuses may be discretionary, non-discretionary, or a combination of the two. A non-discretionary bonus promises payment upon the achievement of predetermined objectives, metrics, or milestones. The startup's board will typically establish the terms of the non-discretionary bonus plan on an annual basis for top executives. Executives, in turn, may establish the terms of the bonuses for their subordinates. Careful selection of performance criteria and the required achievement level allows the startup to establish organizationally meaningful targets for its employees to work toward and choose the degree of success at which a bonus payment (or partial payment) is appropriate.

Discretionary bonuses are left entirely to the discretion of the startup's board of directors and management team. The startup may provide its employees with as large or small bonuses as it wishes. The startup may pay the bonuses proportionately among a class of employees or may pay each employee's bonus amount individually. Discretionary bonuses do not provide the structure and predictability of non-discretionary bonuses, but they may encourage employees, or teams of employees, to work hard to stand out from their peers. Discretionary bonuses also offer significant flexibility to the startup.

Tax Considerations for Cash Bonuses

Cash bonuses are taxed as ordinary income for the year in which the payment is made. Most annual bonus programs are structured to qualify for the short-term deferral exception to Section 409A, but long-term incentive plans (LTIPs) are more likely to implicate Section 409A and should be reviewed for compliance or qualification for an exception to the rules.

For further discussion on bonus programs, see Drafting Short- and Long-Term Incentive and Bonus Agreements.

Some Common Provisions in Startup Equity Compensation Agreements

Acceleration Clauses

Compensation vehicles with vesting provisions can be fitted with a clause that accelerates the vesting schedule upon the occurrence of certain events, such as if the employee's employment is involuntarily terminated by the startup (other than for cause), or the employee resigns for good reason (sometimes called a constructive quit, constructive termination or good leaver termination), or in connection with a corporate change in control.

Acceleration of vesting can be complete or partial. For example, a stock option may contain a clause that accelerates all unvested shares in the event the startup involuntarily terminates the employee's employment without cause. Or, an LLC startup's profits interest agreements with various executives may contain an acceleration clause requiring the acceleration of 50% of all unvested profits interests in the event of a change in control.

Some startups' compensation plans contain acceleration clauses that apply to all employees. For example, an equity incentive plan may provide that 25% of all employees' unvested equity accelerates in the event of a corporate change in control. More common, however, are vesting acceleration compensation plans that apply only to a class of employees, such as to management team members or to all employees at the vice president level and above.

Those employees who have more negotiating leverage vis-à-vis the startup may be in a position to demand the inclusion of a vesting acceleration clause when negotiating their offer letter, employment agreement, or equity agreement. This means that, in general, a startup is much more likely to have vesting acceleration clauses in place with its founders and senior executives than with more junior and later hired employees.

Forfeiture, Anti-Acceleration, and Forced Repurchase Clauses

Compensation vehicles that are subject to vesting may also include forfeiture, anti-acceleration, and/or forced repurchase (often referred to as buy-back or buy-out right) clauses, depending on the startup and applicable state law.

Forfeiture clauses provide that employees' unvested (and sometimes vested) equity is forfeited if a certain event occurs, such as a termination of employment. Some states only permit forfeiture clauses in equity contracts for employees terminated for cause. Some states prohibit their use for vested amounts in certain types of compensation arrangements.

Anti-acceleration clauses are a type of forfeiture clause governing the treatment of unvested equity awards when a startup undergoes a corporate change in control. Anti-acceleration clauses provide that in the event of a corporate change in control, all of the employees' unvested equity is forfeited (if not assumed or substituted for by the acquiring entity). A startup's investors may require the inclusion of anti-acceleration clauses in the startup's stock option agreements or equity plan.

Forced repurchase (buy-back or buy-out right) clauses permit the startup to repurchase vested equity from employees at certain times or if certain events occur. The repurchase price may be FMV, or (depending on state law) some other predetermined value (e.g., book value) or a formula (e.g., a multiple of EBITDA). Termination of employment is a common triggering event in equity contracts with forced repurchase clauses.

Forced repurchase clauses should not be confused with provisions providing for rights of first refusal (often referred to as ROFRs). The overwhelming majority of startup common stock equity contracts with founders, executives, and employees contain rights of first refusal that provide the employer (or its investors or other assignees) with the right to meet the price of a third party's bona fide offer to purchase the common stock from the employee, and once the price is met, require the individual to sell the common stock to them instead of the third party.

Comparing Compensation Practices of Startups versus More Mature Companies

Driving Forces

Startups are typically new, cash-limited, high-risk enterprises in which key players (e.g., founders, investors) demand rapid growth, substantial returns, and a relatively quick "exit" (liquidity event for the company's illiquid capital) via a sale or IPO. Startups demand very long hours from their employees, but offer little in terms of long-term job stability because there is a real risk that they may go out of business if they do not grow. More mature companies generally provide greater job security.

Startups typically do not have the cash to pay their employees the salaries, large cash bonuses, and long-term incentive awards that more mature companies do. Startup managers often talk of run rates or burn rates, and how far the money in the bank will go until the next round of capital must be raised. Even successful, cash-flow positive startups frequently spend most, if not all, of their additional resources on growth, building markets, R&D, and other early development projects, rather than cash-heavy compensation (other than, perhaps, for sales employees).

In short, startups are a risk proposition for potential employees. Startups tend to incentivize their employees with compensation arrangements that hold the promise of a potential high reward but that minimize up-front costs. They frequently offer equity-based compensation and, for their sales employees, revenue-based commission arrangements, which are sometimes uncapped.

The Equity Play

Many startups make up for relatively low salaries and lack of job security by offering high-risk, potentially high-return equity arrangements, and they typically offer the equity deep, if not all the way, into the employee pool. The equity incentivizes the startup's employees to work the long hours necessary to make the startup successful. Stock options (including early exercisable stock options) and low-cost restricted stock purchase agreements, especially for early joiners, are common.

Startups with significant valuation typically do not offer unpaid-for restricted stock or stock-settled restricted stock units (RSUs), which many public companies offer. Why? Because the employee experiences a taxable event at the time the restricted stock vests or RSU shares are issued. And few, if any, employees want (or have the resources available) to pay tax on illiquid stock, no matter how valuable it is.

The flip side – the employee side – of the employer's emphasis on equity is the "equity play." Employees – particularly startup founders and executives – often see their startups as a place where they will earn below mature company market salary and cash compensation, but where the potential upside – in terms of equity that may one day become tremendously valuable – is great.

Startup directors, officers, and investors (themselves involved in the equity play) know all about this mentality and often sell their startup that way to prospective hires (e.g., "we are a great company and if we make it your stock could be worth $__________, so why work for anyone else….").

Startups hesitant to provide equity to employees sometimes offer phantom stock rather than actual stock. Some reasons for a reluctance to grant startup equity include the desire of founders and investors to maintain voting control and minimize dilution, and in some cases securities law limitations on unaccredited investors or the total number of stockholders

The Uncapped Sales Commission Plan

As discussed above, uncapped sales commission plans can be a good way to attract top sales professionals to a startup with a new product and little or no track history in sales, particularly if investors are demanding significant year-over-year growth. To many in sales, equity is great, but cash is king. The prospect of unlimited earnings—via a promising new product and an uncapped commission plan—may help attract top sales professionals, allowing a startup to build an excellent sales team very quickly, notwithstanding the company's lack of history and the fact that the product is untested in the marketplace.

By contrast, mature companies usually have more developed markets and channels for their products, as well as sales teams that have been in place for some time. Consequently, their sales commission plans are almost always capped plans and often incorporate highly calibrated performance targets based on a product's track record.

Change-in-Control and Retention Agreements

Change-in-control agreements, including management carve-outs and retention agreements, are common at both startups and mature employers. The terms of these arrangements and the circumstances in which they are employed are highly context specific.

One critical difference between start-up and public company change-in-control agreements is their treatment under the IRS parachute payment rules under I.R.C. §§ 280G and 4999. These rules are complex, but generally if a public company employees' change-in-control agreements provide benefits that exceed the applicable threshold, then the employees will be subject to an additional 20% excise tax on the so-called excess parachute payments, without exception. In the past, public companies sometimes provided their executives with a tax gross-up for any excise tax liability, which resulted in the executives taking home as much after-tax income as they would have taken home absent the 20% excise tax. Institutional investors, however, have hit hard on tax gross-ups in recent years, and they are currently seen by many as a disfavored pay practice.

By contrast, the Internal Revenue Code provides several exceptions to the parachute payment rules for start-up companies and their employees. First, entities that are not C corporations (i.e., S corporations, partnerships, and most LLCs) are provided a blanket exemption from the parachute payment rules, as are C corporations that are eligible to make an S corporation election. Second, there is an exception to the effects of the parachute payment rules for start-up employees (as well as employees of other private companies) if (1) the employees agree to subject the payment of their change-of-control bonuses to a vote of the shareholders of the company that is separate from any vote to approve the transaction itself (commonly referred to as a 280G vote), and (2) more than 75% of the company's disinterested shareholders approve of the change-of-control bonuses in the 280G vote, having received thorough disclosure of their details.

For more information on the golden parachute rules, see IRC Sections 280G and 4999: Understanding the Excise Tax and Lost Tax Deduction for Excess Change-in-Control Compensation.

Comparison Table of Equity and Incentive Compensation Tools Used by Startups and Mature Companies

The following table summarizes general tendencies in the use of equity and incentive compensation vehicles discussed in this practice note by startups as compared to more mature companies. The table only reflects broad trends. Companies largely have wide discretion in structuring compensation arrangements and many exceptions to these general tendencies exist.

Type of Equity or Incentive Compensation	Startups	Mature Companies
Nominal Value Restricted Stock	Yes	Not applicable (public employers may offer FMV restricted stock to employees)
Stock Options	Yes, frequently offered to a broad range of employees	Yes, but awards may be limited to senior managers
Early Exercisable Stock Options	Yes, but awards may be limited to senior managers	Uncommon
Phantom Stock	Yes	Yes
Profits Interest	Yes, for LLC Startups	Yes, for a mature company that remains a LLC (not applicable to C corps)
Uncapped Sales Commission Plans	Yes	Rare
Capped Commission Plans	Yes	Yes
Change-in-Control Agreement	Yes	Yes
Management Carve-Out	Yes	Yes
Retention Agreement	Yes	Yes
Cash Bonuses	Yes, but generally not as lucrative or widespread as those offered by mature companies	Yes
Restricted Stock/Restricted Stock Units	Uncommon as the startup's stock price rises	Yes
Long-Term Incentive Plans (LTIPS)	No	Yes
High-End Perquisites (e.g., airplane travel, club memberships, etc.)	No	Sometimes
Low-End Perquisites (e.g., free meals, games at the office, dogs allowed in the office, etc.)	Yes	Sometimes

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