EMPLOYEE EQUITY

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Your top salesperson, Lucy, just quit. After many great years together, she was crushed to tell you she's leaving. Heck, it was tough on both of you, tears and lower chin quivers on both sides of the desk. But, she got an offer she couldn't refuse. Not money—you would have matched that in a heartbeat and she knew it. She's going because her new boss is giving her a piece of the company.

Not everybody wants to be the boss. But everybody wants a slice of the pie.

So, even though you have a great business, you've lost three All-Stars in the last couple of years. What do you do? Make the superstars happy and match the competition. Give equity—stock or membership interests—or equity substitutes to key employees.

Whether you're a corporation or a limited liability company (LLC), giving equity to employees has a lot of potential benefits:

- No question—it is an outstanding retention tool. They're owners now. It is difficult for a competitor to pry someone away from you with a simple job offer.

- Morale goes up.

- They're not just happier. Now, they're paying more attention to company goals. The corner office guy who was so worried about his parking space, perks and promotions is more focused on sales, profits and selling the company. You get less "Me" and more "We."

It's a good thing that there are significant benefits, because the process is difficult. In fact, the only easy thing about giving away equity is saying it. After that, everything gets complicated.

Stock Grants

When you give stock to an employee, you're facing a lot of headaches:

- Taxes: Generally, the employee must pay taxes on the value of the stock, just as if it was a bonus.

- Valuation: In order to calculate the tax owed, the company must obtain a valuation of the business, which may require an appraisal.

- Paperwork: Now that you have another stockholder, she or he should sign agreements that protect the company. For example, if you are a Subchapter S corporation, you need to make sure that no one violates the rules and ruins your Subchapter S status. That's just the tip of the iceberg. You will need to address a lot of situations in a comprehensive shareholder agreement.

- Voting: One share, one vote. That's the general rule. Give away enough and you've got another Socialist Republic on your hands. So keep count and don't give away too much.

- Decisions, Decisions, Decisions: When you give stock to an employee, you need to consider the big picture. You will probably do it again. So, you need a plan that works for a number of employees. This means you will need to consider a lot of important issues. For example, how long does an employee need to work for you before the stock "vests"? When stock vests, generally that means the employee owns the stock and you must pay full price to get it back. But, you also need to decide the situations in which you have the right to buy back the stock and you need a formula for the price you'll pay. What if they start drinking on the job? What if you get a great offer to sell your company? If you're buying back at fair market value, do you want an appraiser to determine the price? Do the employees have the right to require you to buy back their stock? If so, what if there is a line of employees who want to sell? Who gets to sell first? You get the point. You need to consider a long list of questions.

Limited Liability Companies

A limited liability company (LLC) can also give away equity—membership interests. Generally, the rules and problems associated with giving away equity are the same for LLCs and corporations, although LLCs have a bit more flexibility.

There are also alternatives to giving away equity. Unfortunately, they don't avoid the complexity. Still, these equity substitutes do solve other problems.

Equity Substitutes

Many companies provide their employees with substitutes for stock or membership interests. These substitutes can provide the economic benefits of equity ownership, without the voting rights. Similarly, you can avoid certain legal requirements that apply to the owners of equity, such as participation in meetings and decisions. You can also avoid—or postpone—dealing with a number of sticky, and massive, tax issues. That's why there are a lot of substitutes.

Two of the most popular equity substitutes are Phantom Stock and Unit Appreciation Rights (UARs). They share certain features:

- They are contract rights, not property. So, the employees don't pay taxes when they get these rights. Instead, they pay taxes when they cash-in the Phantom Stock or UARs. But, the taxes are the higher ordinary incomes taxes, not the lower capital gains taxes.

- The company gets a deduction for the amount it pays the employees for their Phantom Stock or UARs. This is a considerable bonus to the company and can significantly reduce a company's tax bill for the sale of the business if it pays out a lot of money for Phantom Stock or UARs.

How do these programs differ? Notably, Phantom Stock provides payment for the full value of a share of stock. If a share of Phantom Stock is worth $90 when the employee sells it back to the company, the employee gets the full $90 (minus taxes), as if the employee bought it for $0 and then sold it back to the company for the full price of $90. In contrast, UARs only pay out an amount equal to the increase in the value of the UAR after it is granted to the employee. If a UAR is worth $45 when the employee gets it, and then the employee sells it back when it is worth $90, the employee only gets the other $45—hence, the "appreciation" in Unit Appreciation Right. The logic in the UAR is that the employee only gets to share in the value that the employee helps create after she or he receives the UAR. There is no built-in value in a UAR.

There are many other equity substitutes. However, some have fallen out of favor. For example, stock options were once very popular. But, adverse changes in tax laws reduced their favorability. In addition, some companies opt for simplicity and adopt bonus plans or make contributions to 401(k) plans. But, these "easy" methods don't come close to grants of equity and equity substitutes in motivating employees and aligning them with the goals of the company.

Yes, grants of equity and equity substitutes come with significant benefits and a host of hassles. Can you gut it out through a few dozen decisions, endure the paperwork and manage the process? If so, the win goes to…you AND your employees. You just solved one of your biggest problems—and theirs. You retain and motivate your best employees. And they get a slice of the pie.

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