NP&C Newbury Piret&Co.

VALUATION INSIGHTS

Putting a Price on Talent — Compensating Key Players in a Startup Company

By Alexander Woods, AVA
July 27, 2010

"Our employees are our greatest asset. I say we sell them."

Source: ahajokes.com

The Start-up Story

During the early stages of a company's life, it is not uncommon to find the firm's founders working diligently to develop their business idea into a feasible product or service. More often than not, they will compensate themselves with below market salaries with minimal, if any, benefits in order to effectively utilize and conserve the capital raised from their angel and venture capital investors.

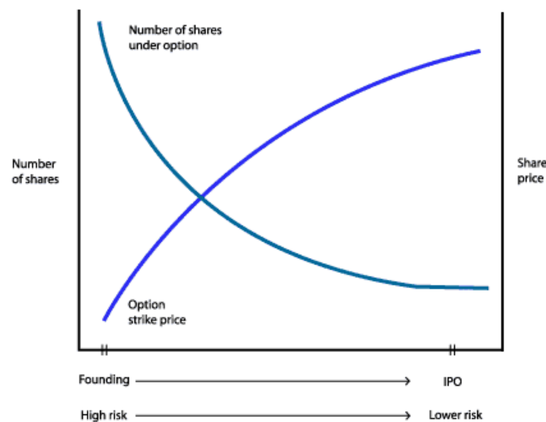
This balance can become more difficult to maintain as the needs of the firm evolve with its progression and additional job functions are required to maintain growth. At this juncture, management will need to consider a wide variety of compensation packages in order to attract and retain key employees, but must also minimize their impact on the firm's bottom line. These goals can be accomplished through a combination of both salary and equity awards, each component varying based on the nature and length of the employment agreement.

Got Options?

One of the most common forms of equity offered in an employment agreement is employee stock options ("ESOs"). These financial instruments provide economic incentives to employees by offering ownership and participation in the firm's profits, while enabling the company to manage salary related expenses and to attract talent to the firm.

ESOs are usually granted upon one of two occasions: annual grants or hire grants. In start-up companies, it is common to find large hire grants, with no or minimal recurring annual awards. Typically, the size of the grant has an inverse relationship with the option's exercise price in order to capture value for the individual receiving the options early in the company's development.

Early employees take more risk, get more shares.



Source: Salary.com

ISOs & NSOs

There are two classes of ESOs that management can grant: incentive stock options ("ISOs" or "qualified stock options") and non-qualified stock options ("NSOs"). Both play an important role in compensating key contributors, but have very different tax treatments and issuance requirements of which management should be aware of.

200 State Street, 12th Floor Boston, Massachusetts 02109
Telephone: 617-367-7300 Fax: 617-367-7301
A Member of FINRA

Incentive stock options were designed by the IRS to receive favorable tax treatment, but are limited to company employees. Non-qualified stock options on the other hand can be granted to employees and non-employees alike, offering greater flexibility to management at the cost of a higher tax burden for the shareholders.

Utilizing both ISOs and NSOs when negotiating compensation agreements is not uncommon. Finding the equilibrium between cash and stock is important when compensating founders or management, while paying consultants in NSOs allows the company to retain needed services without experiencing a significant cash outlay.

The Devil is in the Details

When granting stock options to employees or consultants, it is critical for management to be cognizant of the fact that both ISOs and NSOs are regulated by several internal revenue codes ("IRC"). One of the most well known, IRC Section 409a ("IRC 409a"), regulates all non-qualified deferred compensation, which includes non-qualified stock options. IRC 409a discourages the granting of "discounted" (exercise price set below the fair market value of the stock) stock options by levying burdensome tax penalties on their recipients. In order for management to avoid unintentionally penalizing those they wish to reward, they must have an accurate of the fair market value ("FMV") of their common stock is. IRC 409a grants management three safe harbor valuation methods, which if used, shifts the burden of proof as whether the value is reasonable or unreasonable from the company to the IRS. These safe harbor methods include using:

- A qualified independent business appraiser;
- A non-lapse repurchase formula consistent with Code Section 83; and
- A qualified individual with substantial financial accounting experience or who is familiar with similar valuations (Illiquid Start-up Presumption). This method is available for start-up companies that meet certain criteria.

By using one of the aforementioned methods, management can avoid granting NSOs that are subject to IRC 409a tax penalties.

So 409a has no bearing on ISOs, Right?

Yes and no; though ISOs are not directly regulated by IRC Section 409a, they can lose their preferential tax treatment if it is found that they were issued with an exercise price below the fair market value of the company's stock. If this were to happen, the options would no longer qualify as ISOs, and would be classified as NSOs granted at a discount. In this scenario, the options would be subject to tax penalties under IRC Section 409a.

Food For Thought

Whether the company is granting qualified or non-qualified stock options, it would be in the best interest of management to enlist the aid of a qualified valuations expert who has extensive experience in dealing with IRC 409a to ensure that the valuation is done properly. If you have any questions regarding this topic or are interested in an appraisal, please contact Alexander Woods, at 617-933-2019 or awoods@newburypiret.com.

Founded in 1981, Newbury, Piret & Company, Inc. is one of New England's leading valuation and investment banking firms. We provide both IRS and financial accounting related valuation services to middle-market companies and family businesses throughout North America and Europe.