A New Concept In Employee Compensation

The Editor interviews ***Millicent M. Lundburg****, Of Counsel, Fish & Richardson P.C.*

Editor: Please tell our readers about your background and legal experience.

Lundburg: After graduation from the University of Texas Law School in 1989, I practiced in the New York office of Latham & Watkins, working with the corporate department predominately on M&A transactions. I then moved to Latham's Los Angeles office where my practice focused more on litigation, concentrating later on the broad arenas of intellectual property and employment law. In 1994 I moved to Silicon Valley and was a partner at Wilson Sonsini, working with technology companies, predominately in the employment and compensation areas, for the rest of the 90's – during the technology hey day. The mid-nineties were particularly exciting times as many of the later successes were beginning to take shape, and I had the opportunity to grow with many of the clients. There was much talk of not only new technologies, but new compensation strategies – stock options and the like. Although cash compensation became less of an issue because there was more cash on hand, many employees still wanted options because in the Valley (and probably across the United States), everyone had either made it big on options or had a friend who had. I then moved back to Texas and worked in Wilson's office in Austin for a short time period.

I joined Fish & Richardson about a year ago, and my practice has once again become a national one, having active practices in New York and California and a few places in between. I still concentrate on the employment law and compensation and benefits issues, but I am able to keep quite a broad practice. I describe my practice by indicating that if an issue touches an employee, I am able to handle it.

Editor: Why are equity-based incentive plans an important component of a compensation package?

Lundburg: There are a combination of reasons. Often it is simply old habits or the way things have been done, especially in the technology-related industries. With start-up companies we have the situation similar to the early to mid-90s, where start-up companies are once again often cash poor, so they prefer to compensate management in a cashless form. In addition, management often prefers equity incentives because it offers the opportunity for a tremendous upside in compensation if the company is successful.

Companies have been relying for a long time on stock option programs, both incentive stock options (ISOs) and non-qualified stock options (NSOs), as well as restricted stock grants, phantom stock programs and other similar systems in order to provide management with equity-based incentives. Even though these programs are effective, recent developments have taken away much of

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the value that employees and companies realized through these plans. For instance, the FASB requirement that companies expense stock option grants has reduced their value. Therefore, Joseph Bartlett, of counsel to our firm, and I have been working on developing a new mechanism for equity-based compensation without the drawbacks that are being encountered through the traditional plans.

Editor: Would you provide our readers with an overview of that new plan?

Lundburg: Under the system we developed, a young company would establish a new limited liability company (LLC) that would hold the stock which in former times might have been issued as a stock option to employees. The Compensation Committee of the board of directors would manage the new LLC and employees would receive a non-voting membership in the LLC which would entitle them to a profits interest in shares of stock. Distribution of that interests would be tied to the company's performance measured through its value so employees would receive the benefits of equity-based compensation. However, because the distributions are made through an LLC, the company will be able to implement policies that would reduce some of the burdens that are being faced by companies through the current incentive plans.

Editor: What disadvantages have companies and employees encountered through other plans?

Lundburg: Well, certainly we see the issues on the front page of many business sections about stock option backdating, spring options and the like when the actual grant date has been manipulated. Companies got in trouble with stock option plans in cases where a grant date was determined to be a date other than the date the options were actually issued. These companies would seemingly review the price performance of a stock over a month or quarter and select the date with the lowest prices as the grant date. Without opining on the legitimacy of such actions, this practice continues to be a major focus of SEC investigations. There is also the relatively new requirement under Financial Accounting Standards, FAS 123R, that stock option awards must be expensed by the company.

FAS 123R also applies to restricted stock; there is the added disadvantage of an employee having to pay for the restricted shares out-of-pocket. Also, an employee will possibly be taxed when the restrictions are lifted (i.e. when the stock "vests"), as opposed to upon disposition, as in the case of an option. Of course, a timely 83(b) election made by the employee allows for the tax to be measured at the time of grant, and then there is no tax upon vesting. If he or she holds the stock for more than one year from the date of grant, at the sale of the stock the entire gain from the date of grant to the date of sale is taxed at long-term capital gains tax rates – a benefit. However, there is also the case where employees who paid the tax upon grant and saw the value decline will suffer – they will not have the tax returned.

Companies would be able to avoid these concerns through the use of the LLC system. For example, the LLC agreement could establish a system for determining the fair market value based on an average trading price during the three months prior and three months after the date of grant. This would eliminate the concerns that have been raised as a result of stock option backdating.

Editor: Are there additional benefits that employees and companies would realize through the LLC arrangement?

Lundburg: If a company has an ISO program, employees cannot exercise their options for two years without disqualifying the ISO treatment. Under the LLC plan employees would not have to wait for two years in order to obtain their profits interest. A nonqualified ISO plan for a non-public company would most likely raise additional concerns with respect to deferred compensation under Section 409A with its attendant possible 20 percent penalties on employees and the requirement of an appropriate fair market valuation. Many companies do not have the money to spend on a formal valuation. Under the LLC model, employees would not have to wait for this period of time in order to receive their compensation.

Editor: Is this process reserved for companies seeking to issue an IPO or is it adaptable for more mature companies?

Lundburg: It would be adaptable. At the moment the clients who have expressed interest in this arrangement are in the pre-IPO stage. However, if the plan is approved by the IRS and SEC, there will be ways for mature companies to work with this arrangement. We will need to go through the various personal taxation and partnership taxation issues in order to develop ways for established public companies to implement similar arrangements. Public companies would also have to wrestle with additional concerns such as obtaining shareholder approval before this type of plan could be implemented.

Editor: Does the employee take possession of the shares?

Lundburg: Each employee receives a profits interests from the LLC. They do not have title to the stock but they do have a right to the profits gained from the stock. When shares are sold by the LLC, the corporation that issued the stock would recover the basis in the shares that were distributed to the LLC and the gains from the sale along with the dividends paid by the shares would be issued to each employee depending on their percentage. When an employee leaves the company, he or she would receive the residual profits interests that the shares gained.

The taxation implication of this arrangement are not fully known at this time. We will be in the process of requesting a private letter ruling from the IRS seeking guidance of this arrangement. Since the employees do not own the stock, one of the questions for the IRS is whether the profits interests can be taxed with a preferential tax rate as a dividend distribution.

Editor: How does the LLC handle dilution of profits interest when new employees qualify to participate?

Lundburg: The carrying value of the shares in the LLC are to be booked up at specified times for the purposes of measuring and allocating future profits to the capital account of each new grantee. This will level the playing field as new awards are granted.

Editor: Is this arrangement similar to that of a net profits interest for someone who invests in an oil and gas partnership?

Lundburg: The arrangement is similar. In fact many venture funds are setting up management arrangements similar to this one to provide managers with certain appreciation rights.

Editor: Are there limitations to the LLC approach?

Lundburg: The main concern right now is that we do not know how the IRS and SEC are going to receive this idea. As I indicated, we will ask the IRS to issue a private letter ruling and for the SEC to issue a no action letter with respect to such a plan. The discussion in those two documents will shed more light on how companies can take advantage of this new system.

Editor: What recommendations do you provide for companies that would like to learn more?

Lundburg: At any point when a company is concerned with its equity-based incentive programs or whether it should put one in place, it is a good idea to sit down with experts and discuss the potential for this arrangement and the various alternatives that are currently available. We believe that if the IRS and SEC issue positive comments on the proposal, many more companies will express an interest in implementing this type of arrangement.

Please email the interviewee at lundburg@fr.com with questions about this interview.