CARLTON FIELDS

Equity-Based Awards and Equity-Based Compensation

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The following summary is intended as general information and not specific legal advice. It serves as a basic guide to equity plans and deferred compensation plans for privately owned businesses. **Direct Equity** This form of award or reward involves the actual issuance of stock (or membership interests in the case of an LLC) to a participant. Usually, the grant is structured as a sale and the securities vest over time to assure continued service or employment. In some cases, the participant signs a promissory note to pay for the securities and the note is amortized through bonus payments over the life of the note. In other cases, the note is forgiven over time depending upon performance. The characterization of the payments can result in different tax consequences to the participant. Often, if income tax liability attaches, bonuses are often given on a grossed up basis to absorb the tax cost and results in no cash out of pocket to the employee. In the event of a sale of the company or an IPO where the participant sells his/her securities, the resulting gain is usually capital gain. In addition, in order to reward employees for their efforts in positioning the company for a sale or an IPO, all unvested shares typically will vest at the time of the transaction. The securities are “restricted,” meaning that they cannot be transferred or sold and if the participant leaves the company, there are usually buy-back provisions that assure return of the securities to the company. There are a variety of means for accomplishing this. For example, if the participant is terminated for cause, then the repurchase price might be book value, which could be less than the original purchase price. This type of securities program is typically known as a restricted stock purchase plan. Another type of direct equity program is one that permits eligible employees to purchase a certain number of company securities each year at then current value through payroll deductions. Again, the ownership of these securities typically vests over time to assure continued employment. This type of program also typically includes buy-back rights. In all of these cases, because stock or membership interests are actually issued to the participant, then to the extent ownership has vested, the participant can vote the securities – if they are voting securities – and he/she is also entitled to a pro-rata share of any dividends or distributions. In some cases, the restricted stock is issued into escrow thereby allowing for voting rights and dividend participation. **Options** Another form of equity programs involves the issuance of stock options to eligible participants. These options typically take two forms. The first type is known as an ISO or Incentive Stock Option. These options have certain income tax advantages and do not constitute compensation to the employee, either at the time of grant or at the time of exercise. An ISO gives the employee the right, but not the obligation, to purchase securities at a fixed price over a certain time period (no more than 10 years). To qualify as an ISO, the exercise price must equal the fair market value of the securities at the time of grant. If the employee exercises an ISO, he/she will be issued the number of shares covered by the option upon payment of the exercise price. In some plans, the purchase price can be evidenced by a promissory note. Typically, an employee does not recognize taxable income at the time of grant or at the time of exercise and upon sale of the underlying securities any gain on the securities is treated as capital gain. The second type of option is known as a non-qualified stock option, or NQSO. These options may be issued at exercise prices less than then current fair market value, but if so, there can be adverse tax consequences to the participant including tax penalties under some circumstances. Also, an NQSO can be exercised over a longer period than 10 years. Upon exercise, the difference between the exercise price and the market value of the securities at the time of exercise usually constitutes additional ordinary income for the participant and a corresponding deduction for the company for compensation paid. There are many nuances and complex tax issues relating to stock options. This is merely a very brief outline of some of the basic points. **Deferred Compensation and Equity-Based Programs** The two most often used forms of equity-based compensation programs are known as stock appreciation rights and phantom stock plans. Although they may seem to involve a form of equity, in reality they are forms of deferred compensation. Stock appreciation rights, or SAR's, grant to a participant the right to share in future value of a security. For example, if a security is worth $10 per share when an employee is granted an SAR, and the value of that security grows to $20 per share, then at the time the SAR becomes payable – which is usually at retirement or upon the occurrence of a liquidity event such as a merger or sale of the company – the employee would receive $10 per share. SAR's are not equivalent to actual securities. The holder of an SAR is not entitled to vote any shares or interests and usually is not entitled to be paid dividends or other distributions. Phantom stock plans are similar to SAR's. An eligible employee is awarded a certain number of units, usually based on some performance metrics, and those units are equivalent to a certain number of shares. When and if a liquidity event occurs, the employee will receive the value of those phantom shares. That value is not necessarily limited to the increased value since the date the phantom shares or units were issued and can relate back to a benchmark price or value from an earlier period of time. As with SAR's, holders of phantom stock units have no voting, dividend or distribution rights. Because these types of plans do not involve the actual issuance of securities, they do not result in the issuance of equity in the company. And the employees typically do not pay anything to receive SAR's or phantom stock units. As a result, the amounts paid to employees holding these types of performance-based awards will be treated as ordinary income, as opposed to capital gains, when and if they receive any cash for their units. The foregoing is a very basic overview of equity awards and equity-based compensation. The tax, accounting and securities laws issues that are involved with each of these programs are complex and intricate. For example, it is highly likely that a company may want to combine one or more of these types of programs and that is often done. However, that takes careful planning and analysis. This summary is intended only to give the reader a very broad-based outline of these types of programs. Please consult with your financial and legal advisors to discuss any specific programs. *IRS Circular 230 Notice: Any tax advice provided herein (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed on any taxpayer.*

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