

## Equity Compensation Considerations

### Pre- and Post-IPO

There are many important compensation-related issues to consider as a company prepares for an initial public offering of its common stock (an "IPO"). The approach to compensation and, particularly equity compensation, is quite different for pre-IPO companies as compared to post-IPO companies.

Accordingly, companies heading into an IPO should be prepared to allocate a fair amount of time and resources to this issue. In this discussion, we focus primarily on equity-related considerations as this aspect of the company's compensation program will likely undergo the most significant change.

### Valuation Issues

Accounting and tax issues can arise if pre-IPO companies grant stock options with exercise prices that are below "fair market value" on the date the stock options are granted.

For accounting purposes, a difference between the exercise price and grant date "fair market value" of the stock can lead to "cheap stock" accounting changes that must be taken into account at the time of the IPO (a large "cheap stock" accounting charge could even require the company to restate its financial statements).

For tax purposes, generally any stock option granted with an exercise price that is below the grant date "fair market value" of the stock will cause the option to be taxed under Section 409A of the Internal Revenue Code which will cause the option to be taxed "early" when the option vests (as opposed to when it is exercised) and taxed again at the end of every calendar year thereafter

until the option is cancelled, expires or is exercised. The tax rates that apply in this situation will include all applicable income and employment taxes, as well as an additional 20% federal tax and possibly late payment penalties and interest charges. Since the staff of the Securities and Exchange Commission will typically review the valuation of the company's stock related to stock option grants made during the 12-month period prior to the IPO, it is particularly important for the company to ensure during this time (and heading into this time) that the valuation of the company's stock is supported. As a result, many pre-IPO companies obtain independent, third-party valuations of its common stock during this period. Companies will typically seek these valuations on a regular basis that is more frequent than earlier stage private company valuations (e.g., quarterly) and will align the granting of stock options with the valuations such that there is no real time gap between the date of the valuation and the stock option grant date.

## Equity Plans

A company's pre-IPO stock plan will undergo significant change at the time of an IPO and is typically restated in its entirety at the time of the IPO. There are a number of reasons for this. First, pre-IPO stock plans often contain a number of provisions that apply only to private companies, including provisions restricting the transfer of company stock, rights of first refusal, lock-ups and securities rules only applicable to private companies. Also, post-IPO plans will generally include provisions allowing for all types of equity grants, including stock options, restricted stock, restricted stock units, stock bonuses and stock appreciation rights, and should include aggregate and individual award limits, as well as performance goals and rules applicable to performance awards that, in each case, comply with Section 162(m) of the Internal Revenue Code. Section 162(m) limits the compensation deduction that companies can take for certain executive officers, provided compensation that complies with certain requirements will be excluded from this limitation). Finally, as discussed below, the post-IPO stock plan share reserve will need to be considered.

## Share Reserve

A pre-IPO company will need to consider the size of its stock plan share reserve heading into IPO and should approve any increase to the share reserve prior to the IPO as it is substantially easier to obtain the necessary stockholder approval of the increase prior to the IPO as compared to after the IPO.

Pre-IPO companies should generally ensure that they have sufficient shares in the stock-plan share reserve to make grants under the stock plan for at least two to five years after IPO. By way of benchmarking, the stock-plan overhang (i.e., the total number of shares reserved under the stock plan and subject to outstanding stock options as a percentage of the company's fully diluted outstanding common stock) for a company going public typically ranges between 10 and 15%, although the stock-plan overhang for information technology companies is typically higher, ranging between 15 and 20%.

Many pre-IPO companies also implement "evergreen share reserve provisions" that provide for an automatic annual increase in the share reserve. This automatic annual increase is typically determined pursuant to a formula that specifies that the increase will be the lesser of (i) a specified number of shares, (ii) a percentage of the company's fully diluted outstanding common stock as of the last day of the prior fiscal year, and (iii) a lesser number of shares specified by the Board of Directors. It is important to note that institutional investors and proxy advisory firms are generally opposed to evergreen share reserve provisions. However, the majority of technology companies continue to include these provisions in their stock plan to increase flexibility and avoid having to seek shareholder approval of a share reserve increase for a period of years following the IPO. Of course, companies that include these provisions are not required to proceed with the full increase each year (the Board of Directors could choose to waive the increase for a particular year or approve a lesser amount) and are not required to grant all of the shares that are ultimately reserved for issuance under the stock plan. Companies that include an evergreen share reserve provision should expect that they will need to remove this provision the first time they seek shareholder approval of the plan post-IPO.

## Type of Grants

Due to the fact that options generally offer the maximum value to employees when there are significant gains in stock value, pre-IPO companies predominantly grant stock options. We should note, however, that a handful of technology companies have granted pre-IPO restricted stock units, largely due to intense recruiting pressure and competition with public companies for talent. Pre-IPO restricted stock units raise a number of complex issues that should only be undertaken with the assistance of legal counsel.

At the time of, and during the period just following, an IPO, many companies continue the pattern of granting primarily stock options. This is particularly

true for companies that are expecting substantial growth in equity value during the period following the IPO.

Eventually most companies will shift to a mixture of options and restricted stock units. Compared to stock options, restricted stock units offer greater retention value as the company's stock price flattens out and, in some cases, an assurance of some value in situations where the company's stock price goes down.

Performance awards tend to be less common in pre-IPO companies due to challenges associated with setting good performance goals that continue to be appropriate during the performance period (pre-IPO companies often experience dramatic shifts in their business operations, strategy and plans during the course of a year, making performance based awards challenging). This can continue to be true for many technology companies during the period just following an IPO. Eventually, post-IPO companies will inevitably shift to a mixture of non performance and performance-based equity awards. Properly structured performance awards are favored by stockholders, institutional investors and proxy advisory firms and can help to align company executives and other employees with the company's strategy.

## Timing of Grants

Pre-IPO companies have historically awarded equity grants when an employee is hired and then again upon certain events (e.g., a promotion). Since technology companies are now taking longer to go public, we have seen that more mature pre-IPO companies often shift to a program of new-hire awards and annual-equity awards, similar to what we see in post-IPO companies.

Post-IPO companies will generally award equity grants at hire and then annually thereafter. For stock options, annual-equity awards have the benefit of "dollar cost averaging" where the stock price is in

flux. Also, annual-equity awards have the benefit of ensuring the opportunity to vest in equity awards are consistently in place which can be an effective retention tool and performance driver.

As pre-IPO and post-IPO companies mature, the timing of equity grants should be considered as part of the company's broader compensation philosophy discussed in more detail below.

## Compensation Philosophy

Pre-IPO companies should formulate a post-IPO compensation philosophy. This philosophy should address all aspects of compensation for the company's executive officers, as well as the rest of the employee population and should include types of pay and pay mix, taking into consideration the company's goals for its compensation program in the near and long-term, as well as the market within which the company competes for talent.

Many pre-IPO companies engage compensation consultants to assist with this process. Compensation consultants can be extremely valuable in general, and particularly in helping companies identify an appropriate peer group of companies (with whom they compete for talent or who otherwise represent good benchmarks for the company's compensation program) and analyze the compensation offered by the peer group to better understand how the company's compensation program compares to compensation programs offered by comparable companies.

Peer group data should be only one factor the company considers in its compensation decisions. Another important consideration is retention and, in particular, executive retention. As many executives realize significant value from the company's IPO, it is critical to ensure that there are appropriate incentives in place to retain the company's key executives post-IPO and to drive their alignment with company

strategy and stockholder interests. Equity grants can play a significant role in creating appropriate retention and incentive vehicles for executives.

This compensation philosophy will ultimately serve as a guide for the company's compensation committee and human resources team and will help to ensure thoughtful consistency in the compensation program and alignment more generally with the company's business strategy. In closing, it is critical for companies going through an IPO to consider the company's compensation program generally, and in particular the equity compensation program, and to be thoughtful about how the company will manage compensation and the processes that need to be put in place to do that

post-IPO. This includes only a high-level discussion of a small subset of compensation issues that will need to be addressed at IPO. Companies should work with their legal advisors and compensation consultants to ensure that all compensation issues are addressed as the company goes through the IPO process.

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