# Equity incentives for employees: options that don't surrender control of the business

Owner-managed and family-owned businesses are often faced with the quandary of how to effectively motivate their teams to build and maintain value for the enterprise. Incentivizing employees for the long haul can be confusing territory, and owners should know that options are available in the grey area between cash bonuses and equity ownership.

Offering creative packages that link employees to the growth of the company can have an immediate, positive impact on a company's cultural and financial future. Yogurt maker Chobani, for example, made headlines when in early 2016 the privately-held company granted an ownership stake to its 2,000 full time employees. The shares are worth up to 10% of the company upon a sale or IPO, and while employees do not have voting rights, they have a direct hand in whether the company grows.

As one key employee told the New York Times, the shares recognize how much the employees have put into Chobani. "It's better than a bonus or a raise…It's the best thing because you're getting a piece of this thing you helped build."

Whether for one senior level player or as a company-wide incentive, programs like Chobani's provide a sense of ownership without prompting the obligations of a legal partnership.

One of the major issues that challenges owners is avoiding having minority stockholders to whom they must owe fiduciary duties. Non-voting stock alone does not do it – in that case, owners still owe a fiduciary duty to all shareholders. To address this there are several equity incentive plans that business owners can implement to achieve a unified business environment while maintaining full control of the company and avoiding the quagmire of fiduciary duty to minority employee shareholders.

- ## Offering Classic Stock Options

Classic stock options often come to mind as the simplest form of ownership-related incentive for both corporations and LLCs. An option takes the form of a contract to purchase a share of stock, but carries no fiduciary obligation. This is because the duty is only owed to the option holder when the shares are issued upon exercising the option. To protect against an early exercise of the option, business owners can impose vesting limitations so that options are only exercisable when the company is sold, goes public, or when the employee retires or voluntarily leaves the business. To protect the company when an employee leaves, the business owner can implement a buyback right upon the employee's departure – and also build in different buyback price structures that reduce (or eliminate) the buyback price if the employee is fired for cause or leaves without good reason.

The employee is not taxed when the option is granted, and employees are usually only taxed when the option is exercised.

- ## Cash incentives that feel like equity

"Phantom stock" can be effective in aligning interests without dispensing equity, and can be used by corporations and LLCs alike. At its heart, phantom stock is not much different from a cash bonus – but tying it to company performance as measured by the increase in the company's stock price makes it feel very much like equity to employees.

In sum, the phantom stock is merely an accounting unit that is valued at the price of a share of stock on the date of grant of the phantom stock unit. When a trigger event occurs (a sale of the company, an IPO, retirement, or a mutually agreed upon departure) the employee is paid a cash amount equal to the increase in the value of the stock since the date of grant. They are thereby incentivized to have the share value of the company increase over time, the same goal of the actual shareholders. The payment can be made all at one time or over a period of time to protect the company cash flow. This sends a clear message to employees/managers: if they help raise the value of the business, they will share in the appreciation.

The good news for employees is they are not taxed until they are cashed out, and the good news for owners is that they do not have to pay the cash up front. When the cash is paid it is taxed to the employee as ordinary income. In addition, the company gets a deduction when the payment is made. If necessary to meet employee needs, a simultaneous additional bonus can help offset the taxes, but that may significantly increase the total payout.

This type of equity incentive is attractive to employers and employees alike, as it incentivizes employees to help raise the equity value of a company – in turn allowing them to reap the benefits of stock appreciation.

- ## Tapping the benefits of an LLC

Owners of limited liability companies (LLCs) are held to a fiduciary standard that requires them to act in the best interest of the LLC and its owners (so-called members). However, owners of LLC's formed in Delaware are afforded a great degree of freedom and flexibility that in large part can exempt them from these fiduciary duties to all or certain classes of members. This allows the owners to grant actual equity to employees and to be able to structure that equity so that there is no fiduciary duty owed to the owner of the equity. In addition, the interest granted to employees can be non-voting and have no rights other than to get the allocable amount of profits attributable to the interest.

There are two principal kinds of equity interest that can be granted. A capital interest is more straightforward and will be taxed when received. A profits interest, however, is not taxed when granted. The difference between the two is that the grantee of a profits interest does not get the value of the company as of the date it is granted. The employee only gets the amount by which the interest appreciates over that value. This again aligns the employee's interest in creating appreciation with that of the owners.

In either case, owners can implement contractual provisions within their agreements such as buy backs, tag-along, and drag-along rights. Buybacks enable a company to repurchase any outstanding shares from the employees. Tag-along rights create options that enable shareholders to join the transaction of a sale of majority shareholder's interest, and drag-along rights are obligations that force shareholders to participate in the sale of a company.

Incentivizing employees is an age-old business challenge, and can spell the difference between fast growth with a unified team or stagnating amidst constant employee churn. Owners should familiarize themselves with the options available to them based on their company's entity classification (LLC or corporation), and develop a package that keeps employees engaged and enthusiastic about shared growth.



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