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New Brunswick Innovation Foundation

Employee Stock Option Plan Guidelines [ESOP]

About NBIF:

The New Brunswick Innovation Foundation (NBIF) is an independent, not-for-profit corporation that makes venture capital investments in new start-up companies, provides innovation vouchers for established businesses, and invests in applied research projects at publicly funded research institutions across New Brunswick.

To find out more about NBIF, please visit our website at www.nbif.ca or call us at 1-877-554-6668 (North America only) or email info@nbif.ca

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Introduction

Employee stock option plans, also known as ESOPs, have been popularized by the success realized by technology firms such as Microsoft and Cisco Systems in that the implementation of stock option plans has resulted in great personal wealth for the early employees of these companies. ESOPs however represent much more than a scheme whereby high tech employees can expect to get rich quickly off their stock options. These plans represent a means for a given enterprise's various stakeholder groups to mutually benefit and generate lasting wealth, not only for the individuals associated with the company, but also for the region in which it is located.

From the perspective of a given firm, the benefits of an ESOP include:

Use as a tool to attract and retain key or skilled employees;
Creation of an ownership mentality among employees;
The recognition and valuation of the contribution of employees;
Productivity and competitiveness boosts;
Use as a potential exit strategy for owners; and
Lower the expectation for a company pension plan.

From the perspective of an employee, the benefits of an ESOP include:

- Ability to directly share in the success of the enterprise;
- Representation of worth to the employer;
- The potential for significant tax savings upon share disposal; and
- Instillation of pride due to ownership mentality and job satisfaction.

From a broader social perspective ESOPs also provide value in that they

Represent an opportunity for relative advantage within an increasingly competitive global economy;
Compatible with the trend toward broad-based stock ownership;
Have the potential to create long-term, capital-based wealth among employees;
Represent a tangible solution in narrowing the ever increasing real wage gap; and
Provide an alternative to government-sponsored/-provided retirement plans.

The benefits and past successes of such plans are apparent but the implementation of an ESOP should not be interpreted as an instant guarantee of success. Significant care must be taken to ensure that an established plan meets both corporate objectives and the needs of the employees.

What is an ESOP?

In formal terms, an ESOP is an employee equity ownership plan that can include stock, stock options or what is often referred to as phantom stock.

Stock equity is a legal transfer of ownership of a share of stock issued by a company. This ownership may or may not come with additional rights such as voting or dividend receipt. The ownership of stock in a firm places the employee in a risk-reward situation such that the firm's success should result in the accrual of value to his/her equity position.

Stock options represent terms under which the company proposes to sell equity to its employees at some point in the future with the price fixed in the present day. The risk-reward profile of stock option entitlement is lower than that of equity ownership given that if the value of the company's shares decline over time the options are simply not exercised with no actual net loss realized by the employee. Stock option plans are widely applied particularly in the technology sphere given they represent a fairly low-cost source of employee compensation for the firm and provide maximum benefit to the employee.

Phantom stock (or participation plans) units mirror real stock equity other than the exclusion of actual voting rights. No legal transfer of ownership generally takes place until a liquidity event occurs at which point the phantom stock is fully convertible to real stock equity. Phantom stock is also known by the term SARs (Stock Appreciation Rights). Such plans are often restricted to key management or implemented in firms where the owners are unwilling to share control of the enterprise.

The key elements of a successful ESOP include

a) Compatibility with the long-term strategic goals of the enterprise;
b) Compatibility with the culture and structure of the enterprise; and
c) Proper degree of flexibility with regard to the implementation of the plan.

One of the keys to successful ESOP implementation is flexibility so that a plan can apply to a small number of employees or be spread across the entire business. It might consist exclusively of shares or alternately a combination of the three above-mentioned forms of equity. A firm's management has the flexibility to design and implement an ESOP that most closely matches up with both the company's long-term strategic objectives as well as its corporate culture.

The decision as to which instruments should be used in the establishment of an ESOP is usually based on corporate strategy, corporate culture and management style. This analysis is an oversimplification however as the motive for the establishment of an ESOP must also be considered in any such analysis. Firms that wish to attract and retain key employees and/or restrict cash employment expenses are better candidates for stock option plans whereas a company wishing to provide its employees with an alternative to a formal pension plan or those which intend to use an ESOP as a liquidity event for current ownership should consider a stock equity plan.

ESOP Objectives

From the perspective of an individual company, the high level objectives of ESOP implementation include addressing such issues as

- Employee recruitment and retention;
- Employee productivity;
- Company competitiveness;
- Firm profitability;
- Low cost business financing; and
- Succession planning.

Numerous studies and surveys indicate that ESOPs do indeed help to attract and retain a motivated work force with the added benefit of increased productivity and profitability. Virtually every commissioned study supports these conclusions. For further discussion of this matter, visit the National Center of Employee Ownership (NCEO) website at www.nceo.org.

The consensus is that ESOPs tend to foster a corporate culture where a motivated work force sees the benefits in sharing ideas, trimming costs and working more productively. A key benefit to the employer of ESOP implementation is undoubtedly the ability to attract and retain motivated workers. A key asset for any firm, large or small, is the caliber of its employees with both the value and knowledge they provide to the enterprise. A broad-based ESOP, specifically a stock option plan, is often a prerequisite to guaranteeing access to skilled & motivated employees and a key to retaining these individuals for extended periods.

The productivity and competitiveness benefits are evident from the studies conducted. Some of the other benefits require further explanation however. From a business financing perspective, ESOP-adopting firms (particularly start-up and/or high tech firms) are able to develop broad compensation schemes that enable the companies to save valuable cash and effectively pay their employees wages either at or below prevailing market rates in exchange for equity in the company. Most stock option plans also explicitly require a reasonable purchase price on the part of the employee thus generating another source of capital for a young firm.

From a succession planning perspective, an ESOP can provide great flexibility for privately held companies. A primary issue facing many business owners is how to retire from and sell a long-held company. In many cases, the best solution, for a variety of reasons, is to sell out to the firm's employees. In this instance an ESOP ensures that an owner can remove his/her money from the company over time and ensure its continued operations in a fairly seamless manner. There are many benefits to such a transaction including a close hold on financial information, the assurance of continued stewardship of the company, lower transaction fees and numerous tax advantages that may accrue under such mechanisms.

ESOP Costs versus Benefits

The benefits of an ESOP tend to accrue to both employees and employers. As noted previously employers tend to benefit via

- Higher productivity;
- Increased profitability;
- Employee motivation; and
- Employee retention, among other factors.

Employees derive a direct benefit from such plans by virtue of

- Sharing in employer's success;
- Increased job satisfaction;
- Favourable tax treatment (deferral of income) by CRA;
- Financial upside (often with limited risk); and
- Potential to progress from employee to owner over time.

The benefits do not come without some costs however and from the perspective of the employer these relate primarily to ownership dilution for the existing shareholders, the cost & effort of plan establishment and the cost & effort of plan administration. From the perspective of the employee, the tradeoff is often lower direct cash compensation and the increased financial risk in that their wealth is tied up in the enterprise in exchange for the upside of ownership. And finally, many plans have few voting rights so in some respects the employees can be highly invested relative to their overall net worth but have minimal direct control over the investment.

Notwithstanding these issues, the benefits of ESOPs are generally perceived to outweigh the costs in most instances. For example, even in the smallest firms, stock option plans can be established with very low cost and minimal recurring effort. The potential value of such a plan for a small firm cannot be overstated given the probable positive impact on employee recruitment, retention and productivity.

Stock Options for Start-ups and Small Companies

A stock option plan gives an employee the right to buy a certain number of shares in the company at a fixed price for a certain number of years. The price at which the option is provided is called the strike price and is often the market price (or fair market value - FMV) at the time the options are granted. Option holders hope that the share price will rise and that they will be able to "lock in" such gains by exercising (purchasing) the stock at the lower strike price and either holding the shares or selling the stock at the current market price, realizing an effective gain in either instance. Most shares granted under an ESOP are only saleable however either upon an employee's departure from the firm or a liquidity event such as the sale of the company to a third party or an initial public offering (IPO).

Under a typical plan, the options are generally subject to vesting so an employee might get, for example, the right to purchase 25% of the shares available under the grant after two years (the “cliff”), 50% after three, 75% after four, and 100% after five. A common exercise term would be in the seven- to ten-year range. It is worth noting however that a vesting schedule can be as simple as the one shown above or it can in fact be quite complex with any number of input variables and contingencies in place. It is the responsibility of the firm’s management to ensure that the choice of a schedule is consistent with both the firm’s business plan and its motives for the creation of an ESOP. Significant care must also be taken to ensure that the plan’s vesting schedule is not too complicated so as to alienate and/or confuse the employees it is intended to benefit.

Stock options grants are typically allocated either as a proportion of an employee’s total compensation package (e.g., annual option grant bonus of 15% of base salary) or as a proportion of the total shareholders’ equity of the firm (e.g., employee can earn up to 5% total ownership via ESOP over 10 years). The second mechanism, where options are allocated on the basis of total firm equity is perhaps the better option from the perspective of the alignment of long-term interests between employer and employee but it is the first scheme, whereby the allocation is a proportion of salary that may appear more attractive to employees. It is management’s prerogative to pursue the course that best benefits both the firm and its employees.

Traditionally, stock option plans have been used as a way for companies to reward top management and key employees and link their interests with those of the company and other shareholders. More and more companies, however, now consider all of their employees as key. As a result, there has been an increase in the popularity of broad-based stock option plans, particularly since the late 1980s. Such plans are now the norm in high-technology companies and are becoming popular in many companies in other industries as part of an overall equity compensation strategy. As of 2001, the NCEO estimates that, within the United States, up to 10 million employees receive stock options as part of their compensation packages. Stock option plans are now viewed as a flexible way for companies to share ownership with employees, reward them for performance, and attract/retain a motivated staff. For growth-oriented smaller companies, options are a great way to preserve cash while giving employees a piece of future growth. The dilutive effect of an option grant is typically very small and should be offset by the potential productivity and employee retention benefits.

The ultimate impact of any employee ownership plan, including a stock option plan, depends a great deal on the company and its goals for the plan, its commitment to creating an ownership culture, the amount of training and education it puts into explaining the plan, and the goals of individual employees (whether they want cash sooner rather than later). In companies that demonstrate a true commitment to creating an ownership culture, stock options can be a significant motivator. One of the most important considerations for the plan design is its purpose: is the plan intended to give all employees stock in the company, or just provide a benefit for some key employees? Does the company wish to promote long-term ownership or is it a one-time benefit? Is the plan intended as a way to create employee ownership or simply a way to create an additional employee benefit? The answers to these questions will be crucial in defining specific plan characteristics such as eligibility, allocation, vesting, valuation, holding periods, and stock price.

ESOP Example

A typical outline for a stock option plan agreement should delineate the following sections, at a minimum (Note - the items with bullets are examples of information which may be found within the appropriate subsection):

1. **Interpretation**
    - List of legal terms and definitions
    - Indication of legal jurisdiction

2. **Purpose**
    - Description of purpose behind plan
    - Brief description of underlying shares in question
    - List of counterparties to agreement

3. **Administration**
    - Description of plan administrator (typically Company's Board of Directors)
    - Description of administrator's authority

4. **Securities Subject to Plan**
    - Detailed description of securities underlying the plan as well as the number of shares outstanding under the plan

5. **Participation**
    - Detailed description of persons eligible to participate in the plan
    - Brief description of option granting process

6. **Terms and Conditions of Plan**
    - Detailed list of terms and conditions governing the granting process and the features of the options granted including, but not limited to:
        a. Price
        b. Payment
        c. Term
        d. Vesting Period
        e. Exercise
        f. Termination Clause
        g. Regulatory Matters
        h. Transferability Issues

7. **Conditions of Option Grant**
    - Description of option plan status under a variety of liquidity events
    - Reference to participation in any Shareholders' Agreement(s)
    - Description of option plan status under events of company default or reorganization

8. **Adjustments to Underlying Securities**
    - Description of anti-dilution provisions for plan subscribers

9. **Amendment and Termination of Option Plan**
    - Description of conditions and events required to alter the structure or administration of the plan

10. **Effective Date and Duration of Plan**
    - Start and end dates for the plan as well as any other important events and dates

Stock Option Plan documentation tends to be generated by legal professionals or along the guidelines provided by legal advisors

Conclusion

ESOPs are an invaluable tool for the modern enterprise. From long-time devotees such as Microsoft to new startups, history dictates that a firm's stakeholders can derive a long-term benefit from these plans as they enable the recruitment & retention of talented staff, foster an entrepreneurial environment and provide a mechanism for the alignment of interests between employers & employees. Over time and in the wake of successful companies, these plans also tend to build sustainable wealth for employees and their communities.

ESOPs represent an opportunity for companies to establish a relative advantage in an increasingly competitive global marketplace. The flexibility available to a firm contemplating ESOP implementation is also an important factor, as these plans should be tailored in order to support the long-term strategy of the enterprise. While these plans typically come at a cost to both parties, be it dilution and out of pocket expenses for the employer or lower cash compensation and an illiquid investment for the employee, the overall benefits of such plans have been historically shown to outweigh the related costs for both stakeholder groups.

NBIF supports the implementation of Employee Stock Option Plans by its investee firms as the prevailing belief that long-term enterprise value is driven by competitive advantage, employee productivity and business plan execution, all of which are demonstrated effects of ESOP implementation. The residual effect of long-term wealth creation in New Brunswick via stock ownership is yet another reason for this policy as NBIF moves forward in its goals of fostering innovation and building long-term, sustainable wealth within the Province.

Glossary of Terms

Employee Share Ownership Plan (ESOP): A plan established by a company whereby a certain number of shares are reserved for purchase by key employees. Such shares typically vest over a period of time to serve as an incentive for employees to build long term value for the company.

Exercising Options: The company must make shares available at the previously agreed upon strike price when an employee wants to convert vested options into shares. The firm either buys shares from other shareholders or issues new shares. As options are exercised, the employee can either pay the company cash or make a "cashless" transaction by forgoing some other form of compensation in order to pay for the shares.

Liquidity Event: An event that allows an investor to realize a gain or loss on an investment. Most common exit routes include company buyouts, Initial Public Offerings [IPOs] and buy backs.

Option Pool: The number of shares set aside for future issuance to employees of a private company.

Stock Cliff: The period of time between the grant date of a set of options and the date that the first allotment actually vests. For example under a grant of 1000 options that vest over 4 years, the first 25% may vest after a period of 12 months and after that an equal amount per month will be made available over the remainder of the 4 years. The first 12 months is what is known as the cliff, a mechanism intended to retain employees for at least that period of time.

Stock Options: A widely used form of employee incentive and compensation. The employee is given an option to purchase its shares at a certain price (at or below the market price at the time the option is granted) for a specified period of years.

Strike price: The price at which an option or warrant can be exercised. Also known as exercise price.

Vesting Period: Option grants usually have vesting periods. This means that the holder's ability to cash in options for actual stock will grow over time or may be restricted until a certain future date. Companies often set a three to five year vesting period

Vesting schedule: The timetable for stock grants and options mandating that employees earn (vest) their equity stakes over a number of years, rather than upon conversion of the stock options. Such a schedule guarantees to investors and employers that the employees will remain with the firm rather than quickly converting and cashing in their shares and subsequently leaving the employ of the company.

Resources

For more information about ESOPs and stock option plans please review the following list of books and websites.

Books:

Employee Share Ownership Plans: How to Design and Implement an ESOP in Canada by Perry Phillips (Wiley and Sons)

Employee Ownership: The New Source of Competitive Advantage by Carol Beatty (Wiley and Sons)

Websites:

http://www.esop-canada.com/

http://www.nceo.org/

http://www.esopassociation.org/