Direct Stock Purchases in Closely Held Companies

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Sometimes a closely held company that wishes to permit employees to purchase company stock may desire greater flexibility and discretion than is allowed under a government-endorsed ("statutory") stock ownership program. This chapter explores alternative forms of motivating employees to improve a company's productivity and profitability through incentives that involve the direct purchase of company stock in closely held companies by employees outside of the traditional methods provided under Sections 422 (incentive stock option plans) and 423 (qualified employee stock purchase plans) of the Internal Revenue Code of 1986, as amended (the "Code"). It also discusses restricted stock concepts as they relate to such direct stock purchases, and it briefly addresses bonuses of company stock to employees. The direct purchase of company stock by an employee is typically based on the discounted and/or book value of a company's capital stock. This concept will be examined from the following fundamental perspectives: (1) valuation, (2) design and structure, (3) tax implications to the sponsoring company and its employees, (4) financing and/or funding, and (5) securities laws. Please note that although this chapter focuses on stock-based programs, the same concepts generally apply to limited liability companies in which membership interests are granted in lieu of company stock.

5.1 Direct Stock Purchase Programs

Direct stock purchase programs generally permit executives and other key employees to purchase company stock at a purchase price that is discounted for minority interest and lack of marketability purposes. This should not be taken to mean that such stock purchase programs provide for the bargain purchase of company stock, since this could result in

unintended tax consequences to the employees making the purchases. Many company stock purchases are properly discounted for minority interest and lack of marketability purposes, and such discounted value correctly constitutes fair market value with respect to the purchasers. Some employers also use book value for purposes of establishing the purchase price for company stock under such a direct stock purchase program. These types of direct stock purchase programs are most popular with closely held companies. While these programs are most often made available to executives or other key employees, they can be made available more broadly. The broader use of such plans, however, may entail more complex planning, documentation, and consideration and satisfaction of applicable securities law requirements.

5.1.1 Valuation Considerations

Establishing an appropriate purchase price for shares of company stock is one of the most important decisions that a company will make about a direct stock purchase program. This decision requires thorough analysis and advice.

5.1.1.1 Enterprise Value

In this approach, the company must first establish the purchase price for the entire enterprise, including all cash and assets minus debt and preferred stock (the "enterprise value"). The starting point for establishing the purchase price is typically the company's enterprise value, as based upon an appraisal by an independent valuation firm or a pre-established formula (most commonly a multiple of earnings or sales). This value indicates what the company would be worth if it were sold in its entirety to a single purchaser. When divided by the number of outstanding shares of company stock, a per-share price is established.

Next, the per-share price of the company stock must be discounted to address the negative impact that a minority interest or a lack of marketability has on company stock value. When one or more parties owns less than 50% of the shares of stock in a company, the value of his or her ownership may be reduced for (1) not having a controlling interest (the "minority discount"), or (2) not having a ready market for the shares of company stock due to the company's status as a closely held company (the "marketability discount"). These discounts can be substantial, often ranging from 20% to 50% of the purchase price for one share of company stock if it had both control rights (the ability to direct the use of company assets) and marketability (the ability to sell at any time at an undiscounted price).

5.1.1.2 Book Value

Book value as established by a company's audited, reviewed, or compiled financial statements can be used to establish the purchase price for a direct stock purchase program. Book value is set at a company's common stock equity, i.e., total assets minus liabilities, preferred stock, and intangible assets such as goodwill. The book value method is commonly used to value closely held companies that are expected to grow and generate profits. Book value is readily determinable and provides price stability (which may not be present under formula prices based on earnings multiples or comparisons with prices of comparable publicly traded companies). Employees can be educated to understand that if the company performs well, the value of his or her shares of company stock will increase in an amount equal to the company's earnings per share less dividends, providing a direct link between performance and "payoff" to the employee who decides to purchase company stock. On the other hand, a book value direct stock purchase plan may provide employees with an incentive not to increase, or possibly even to reduce, dividends in order to increase the company's book value.

Book value usually understates the real value of a company because it is, by definition, a less than fair market measure of accumulated net assets, whereas the real value of a company is driven more by its potential for future earnings. A growing company, therefore, is almost always worth more, and often considerably more, than book value. The danger in this relationship is that it could motivate an executive to be more conservative in managing assets to assure high current net asset book value rather than taking risks on investments for future growth. There also is a concern that if book value is used for purposes of a stock purchase program, the Internal Revenue Service (IRS) may conclude that an executive will be purchasing company stock at less than fair market value and that the difference between fair market value and the actual purchase price could constitute ordinary compensation income and be subject

to taxation to the executive. Please see the discussions of tax consequences in sections 5.1.2 and 5.1.3 below, as this may not always be cause for concern.

5.1.1.3 Fair Market Value for ESOP Purposes

Where an employee stock ownership plan (ESOP) owns capital stock of a closely held company, the fair market value of the company must be established on an annual basis by an independent, outside appraisal. This independent appraisal will almost always include a lack of marketability discount (albeit a lesser lack of marketability discount than the discount that would be applicable for a minority interest in the company). If the price of an ESOP company's capital stock is established on a marketable-minority interest basis (i.e., the ESOP does not own a controlling interest but a price can be set by reference to actual public market pricing for stock in companies comparable to the closely held company without the need to adjust the price for the lack of an active market in the subject company's stock), an additional discount for minority interest purposes is necessary. If the company does not maintain an ESOP; the minority interest discount, plus a typically larger discount for lack of marketability than the discount used for ESOP purposes, can be applied to fair market value to establish the purchase price for a direct stock purchase of company stock. A company should focus on the fairness of the stock purchase price in such a stock purchase program relative to the ESOP fair market value so as to be fair to the ESOP from a financial perspective. It also is generally advisable for a company that establishes a stock purchase program to engage an executive compensation consultant to provide an opinion as to the reasonableness of compensation contemplated by a particular stock purchase program design as it applies to the executives of the company, if the stock purchase program has the potential to significantly dilute the ownership interests of the ESOP.

5.1.1.4 EBITDA Value

Where an ESOP does not exist, a closely held company's board of directors can determine its earnings before income, taxes, depreciation, and amortization (EBITDA) and then apply a multiple to the EBITDA for purposes of establishing the overall fair market value of its capital stock. Discounts for minority interest and lack of marketability purposes can then be applied to establish the purchase price for purposes of a direct stock purchase of company stock. The appropriate multiples of earnings and discounts for minority interest and lack of marketability should be obtained either from an independent appraiser and/or from empirical data. Furthermore, outstanding long-term debt and excess cash also should be considered in establishing the purchase price for company stock in a direct stock purchase program. This applies under all circumstances. Ultimately, from an "independence" perspective, it is advisable to obtain an independent appraisal of company stock; however, this may not be financially feasible in every case.

Regardless of how a company establishes the purchase price of company stock for purposes of a direct stock purchase program, the company should apply the purchase price determination formula consistently from year to year. Further, the company should carefully and repeatedly communicate the formula in simple terms to the employees who participate in making the direct stock purchases.

5.1.2 Purchase and Sale of Company Stock

Shares of company stock under a direct stock purchase program may be purchased for cash or with secured and/or unsecured promissory notes (preferably recourse as opposed to non-recourse debt for tax purposes), or they may be issued as stock bonuses. As with other types of equity incentive plans, the employer generally will impose vesting, transfer, repurchase, and/or other restrictions on the company stock that an employee purchases. For example, an employer may retain the right to repurchase the company stock at the initial purchase price paid for the stock in the event of termination of employment before a specified date, the employee's voluntary termination of employment with the company without "good reason" (as defined in the stock purchase agreement, a form of which appears as an appendix to this book) or termination by the company with "cause" (as defined in the stock purchase agreement). One common reason that a company might impose a repurchase requirement upon the employee's termination of employment is to minimize complications that may arise (e.g., shareholder disputes) if the employee leaves the company to work for a competitor or sets up a competing business upon termination of employment. Regardless of whether a company imposes restrictions on the company stock that an employee purchases, companies should attempt to require

employees to sign noncompete agreements specifying these terms if the jurisdiction allows such agreements. Because the requirements for and enforceability of these agreements vary from state to state, noncompetition agreements, as well as the definitive stock purchase agreement, should be drafted only with the advice and review of qualified legal counsel. Companies that allow employees to purchase company stock pursuant to a direct stock purchase program also should require them to sign proprietary rights, confidentiality, and non-disclosure agreements to protect against competitors who may later hire such employees (again, as allowed by the applicable jurisdiction).

Direct stock purchase programs for company stock that are subject to a non-lapse restriction for income tax purposes are typically referred to as formula price or "delta" stock purchase programs. A non-lapse restriction normally requires the employee to resell the company stock back to the company at the stock's formula price or book value upon termination of employment or at other times that are specified in the stock purchase agreement, and it prohibits any other transfer of the company stock by the employee. Such a restriction generally reduces the fair market value of the company stock to its formula price or book value (as opposed to whatever market value the stock might obtain) for income tax purposes. Upon the sale of the company as a result of a change in control, however, the sale price is typically adjusted to be consistent with the (usually higher) purchase price established by the terms of the sale to the third party. The employer also has the discretion to design the direct stock purchase program to provide dividend and voting rights to and/or withhold such rights from the employee purchaser.

Direct stock purchases of company stock other than common stock can be structured so that the stock may be convertible into regular common stock of the company at a conversion ratio equal to the original purchase price per share of the company stock divided by the fair market value per share of the regular common stock on the date that the company stock was purchased by the employee. Although this also can be accomplished with the change in control feature described above, this conversion feature allows the employee to participate in the future appreciation of the company's common stock with minimal downside economic risk. This is because the typical structure of such preferred stock would provide that the employer would repurchase the stock from the employee at either the initial purchase price or a formula or book price unless the stock is converted to common stock. This conversion feature may create income tax problems for the employee if economic value is created without cost to the employee upon conversion of the company stock. This potential taxation is discussed under the heading "Non-Lapse Restriction Considerations" below.

5.1.3 Tax Considerations

5.1.3.1 Restricted Stock Issues

Restricted stock is stock that is purchased by or granted to an employee that is subject to specified restrictions, such as a vesting schedule or meeting performance targets. Generally, restricted shares of company stock, whether purchased or granted as a bonus through a direct stock purchase or bonus program and whether or not subject to a non-lapse restriction (i.e., a permanent formula or book value repurchase formula), constitute "property" subject to the rules of Section 83 of the Code. The purchase of company stock by an employee, or grant by an employer, should in most cases constitute a transfer for purposes of Section 83 of the Code. Section 83(a) of the Code provides that an employee receiving properly restricted stock under a direct stock purchase or stock bonus program will realize no income for Federal income tax purposes at the time of the purchase or bonus (unless he or she files an election pursuant to Section 83(b) of the Code). Rather, the employee will realize income when the restriction or forfeiture provisions lapse. Tthe income realized will be in an amount equal to the then per share fair market value multiplied by the applicable number of shares of company stock.[1] The company issuing the shares of capital stock will be entitled to a compensation deduction at that time equal to the amount taken into income by the employee to the extent that the amount constitutes reasonable compensation to the employee. Upon the employee's subsequent sale of the shares of capital stock to the company, the employee also will realize gain or loss, as the case may be.

Because Section 83 of the Code generally applies to the purchase or bonus of restricted company stock under a direct stock purchase or bonus program, the excess, if any, of the fair market value of the company stock purchased

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1. Section 83 of the Code, and the technical requirements applicable to restricted stock plans, including the pros and cons of making an election under Section 83(b) of the Code, are more fully described in the chapter "Restricted Stock Plans" elsewhere in this book.

pursuant to such a program (i.e., the formula or book value price if a non-lapse restriction is used) over the purchase price paid by the employee will be compensation, and thus, ordinary income to the employee upon receipt of the company stock. This assumes the stock is vested (see below for a discussion of vesting) at the time of purchase or a Section 83(b) election is filed with the IRS. The ultimate sale of the company stock should result in a capital gain (taxed at the maximum rate for ordinary income thereafter) or loss measured by the difference between the sale proceeds and the original value of the company stock at the time of the initial purchase by the employee. The employee can usually avoid this ordinary income tax treatment on the subsequent sale of the company by making an election under Section 83(b) of the Code to close the ordinary income tax element of the transaction at the time of the initial purchase.

In a Section 83(b) election, the employee elects to pay taxes at the time of purchase or grant of the company stock. In that case, the employee would pay ordinary income tax on the difference between the purchase price (if any) and the fair market value of the shares of company stock. No further taxes would be due until the shares of company stock are sold (not, as without a Section 83(b) election, when the restrictions lapse), and then the tax would be capital gains, not ordinary income tax. If the restrictions do not lapse (such as where the employee leaves before vesting), then the employee cannot claim any credit for taxes previously paid.

Vesting typically refers to certain restrictions on the company stock purchased or granted pursuant to a direct stock purchase or bonus program. Such restrictions may serve to make the company stock subject to a substantial risk of forfeiture upon certain conditions and establish other restrictions upon an individual's or entity's ability to freely transfer the company stock to other parties. If the forfeiture and nontransferability conditions are fully enforced, the employee may not receive anything as a result of the initial purchase of company stock, even if there is a difference between the fair market value of such company stock and the initial purchase price. This probably will not be present in a properly constructed direct stock purchase program (i.e., one in which the company stock is repurchased at the formula or book value purchase price upon a subsequent triggering event). Therefore, if the risk of forfeiture is substantial, and the company stock is not freely transferable, taxes are generally not imposed upon the direct purchase of company stock. Only when the restrictions on the company stock lapse at a later date will tax consequences ensue.

Under a direct stock purchase or bonus program, an employee may purchase or be granted shares of capital stock of the issuing company that are subject to a substantial risk of forfeiture and transfer restrictions that will lapse only if he or she remains in the employ of the company for a specified period after such receipt and/or if certain corporate or individual performance objectives have been achieved. If the employee terminates employment before the expiration of the restriction period or before satisfaction of any performance objectives, he or she may forfeit the shares of company stock to the company and will receive only the original purchase price (if any) back at such time. If the employee remains employed by the company until the end of the restriction period, the forfeiture provisions will lapse and the employee will own the company stock, assuming required performance objectives have been achieved.

5.1.3.2 Non-Lapse Restriction Considerations

If the company stock purchased under a direct stock purchase program is subject to a non-lapse restriction that sets a price for the resale of the stock in advance (i.e., the repurchase of the company stock at a formula price or book value) and the sponsoring company at some time later cancels the restriction, the employee will realize ordinary income upon such cancellation equal to the excess of (1) the fair market value of the regular common stock at that time over (2) the book value of the company stock immediately before the cancellation, unless the employee can prove that the cancellation is not compensatory and that the company will treat it as noncompensatory by not taking a deduction that it would be entitled to if the cancellation were compensatory. (Non-lapse provisions would typically not apply to bonus shares of company stock.)

Whether a cancellation is compensatory depends on the facts and circumstances of each case and is covered in detail in applicable Treasury Regulations under Section 83 of the Code. Ordinarily, if an employee is required to perform additional services or if the employee's salary is adjusted to take the cancellation into account, then the cancellation has a compensatory purpose. An example of a noncompensatory cancellation is if the cancellation is made solely because the original purpose of the restriction no longer exists. The regulations indicate that a cancellation in connection with a public offering of company stock generally may be noncompensatory and, therefore, will be tax-free to the employee. It is not clear, however, whether a direct stock purchase program may provide in advance for automatic cancellation of the formula or book value repurchase restriction upon a public offering or another change in control. In theory, at least, the

time at which the restriction is lifted (i.e., whether in advance by the terms of the stock purchase agreement or by a decision made concurrently with the public offering or change in control) should be immaterial if in fact the motive for the cancellation is noncompensatory (i.e., to remove the restriction that was originally imposed to create a market for capital stock rather than to increase or defer compensation).

The tax consequences of adding a conversion feature to the terms of the direct stock purchase program (i.e., giving the holder of the restricted company stock the right to convert that stock into regular common stock) are uncertain. First, the conversion privilege adds value to the restricted company stock at the outset, and the employee may have to pay more than the formula price or book value for the company stock to avoid recognizing compensation income upon the purchase of the company stock. Second, unlike the case of a convertible debenture, it is not clear that the actual conversion into regular common stock will be tax-free to the employee. There is little or no regulatory and/or case law authority with respect to this issue. In the case of restricted company stock subject to a non-lapse restriction, the IRS may assert that the conversion is in fact a compensatory cancellation of the company's right to repurchase the company stock for the formula price or at book value, resulting in ordinary income to the employee at the time of conversion. Alternatively, the existence of the conversion feature may turn the non-lapse restriction into a lapse restriction from the outset because the conversion feature negates the permanent nature of the formula price and/or book value repurchase restriction. Under these circumstances, the employee will be liable for tax on the excess of (1) the fair market value of the regular common stock over (2) the purchase price for the company stock at the time of the original purchase. Any subsequent conversion into regular common stock should then be tax-free.

Although the IRS has considered this issue only in a publicly traded company context, a brief discussion of one such ruling may be instructive here. The IRS has concluded that in a formula price direct stock purchase plan where a publicly traded company discounted its stock from the fair market value by 60%, a non-lapse restriction was not present because upon an executive's termination of employment he was obligated for only five days to sell the company stock back to the employer at the discounted formula price. Following the five-day period, the executive could sell the company stock to anyone at full fair market value. The IRS stated that the executive's five-day right of first refusal was not a permanent restriction as required by applicable U.S. Treasury regulations. The IRS also pointed out that the purpose of the non-lapse restriction is to provide a method for valuing the company stock of a closely held company where it is difficult to establish fair market value. (Without a non-lapse restriction, the fair market value of the company stock on the date of purchase less the purchase price is typically ordinary income to the employee.) It is unclear whether this IRS guidance means that the non-lapse restrictions will not work for formula price direct stock purchase plans of publicly traded companies or that they will work for both closely held and publicly traded companies where the valuation procedure is not an arbitrary discount from fair market value and the right of first refusal period is extended.

5.1.3.3 Section 409A Considerations

Finally, it is worth noting that Section 409A of the Code applies only to nonqualified deferred compensation plans. Direct stock purchase programs are excepted from Section 409A if the stock purchase is not deferred and the exercise price per share is at least equal to the fair market value per share of the stock as of the grant date.

Section 409A is complex and it is impossible to give a broad overview of the statute and applicable regulations, but following is a summary of the rules and regulations.

Section 409A of the Code provides that all amounts deferred under a nonqualified deferred compensation plan (which generally means amounts deferred beyond March 15 of the year following the date of grant of the deferred compensation for companies whose taxable year is the calendar year) must be currently included in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income unless certain requirements are met:

- Compensation may not be distributed earlier than the participant's separation from service, disability, death, or a change in control of the company, or an unforeseeable emergency causing severe financial hardship to the participant.
- The receipt of benefits may not be accelerated beyond the time or schedule of payments set forth in the plan unless allowed by government regulation.

- A participant must make his or her initial decision to defer compensation before the end of the preceding taxable year or as provided by regulation. In the case of performance-based compensation based on services performed over 12 months or more, the participant's election must be made at least 6 months before the end of the period.
- Any changes in time and form of distribution (to the extent permissible under government regulations) must not become effective until at least 12 months after the date the election is made.
- Any election to change the time and form of distribution made for reasons other than death, permanent disability, or an unforeseeable emergency must be deferred for at least five years from the date the payment would otherwise have been made.
- An election related to a payment made at a time specified under the plan must be made at least 12 months before the date of the first scheduled payment under the plan.
- Any payment of deferred compensation to a "Specified Employee", if made pursuant to an agreed upon schedule of payments, must be deferred until the earlier of the six-month anniversary of the employee's termination of service or the employee's death. For purposes of Section 409A, a "Specified Employee" is an employee of a publicly traded company that is either a 5% owner, a 1% owner with compensation in excess of $150,000, or an officer with compensation in excess of $145,000 who is a member of the group of employees comprised of the lesser of 50 employees, or the greater of three employees or 10% of the employees.

The U.S. Treasury Department published the final Section 409A regulations on April 14, 2007, with the effective date of such regulations being delayed until January 1, 2009. The U.S. Treasury Department established a corrections program for nonqualified deferred compensation plans that fail to satisfy the requirements of Section 409A of the Code and the applicable Treasury Regulations (the "IRS Section 409A Correction Program"). See IRS Notice 2008-113 (making Notice 2007-100 obsolete), 2008-115, and 2010-6 (modifying several provisions of Notices 2008-113 and 2008-115). Relief under the IRS Section 409A Correction Program is not available for (1) companies and employees who are currently "under examination" (i.e., who are subject to a current IRS examination or audit) and (2) intentional failures or transactions that the IRS has listed as abusive transactions. Correction of a Section 409A failure may require, for example, modification of a payment schedule, the inclusion of income of a portion of the deferred compensation in the employee's current income, and/or the payment of penalty taxes by the employee. Given the restrictions on eligibility and potentially onerous correction requirements (albeit less burdensome that the statutory penalties), companies that intend to adopt a non-qualified direct stock purchase program should consult with counsel to ensure that the plan is compliant before adoption.

5.1.4 Comparison of Direct Stock Purchase Programs to Stock Option Plans

Under a direct stock purchase plan, an employee generally must pay (or obligate himself or herself to pay) full formula price or book value for the shares of company stock that he or she purchases. In a stock option plan, an employee is not obligated to expend funds until a gain on his or her investment is reasonably assured. Furthermore, under a direct stock purchase plan, the employee's upside potential for gain on the appreciation of the market value of the company's common stock is limited by a formula price or by book value, except possibly in the case of a cancellation of the formula price or book value repurchase restrictions in connection with the public offering, a conversion of the shares of company stock to regular common stock, or a change in control. Stock options could have these features built in as well; however, other than a change-in-control provision, they normally do not; the option usually is simply for the purchase of common stock.

The principal disadvantages of a direct stock purchase program as compared to a stock option plan, however, are the uncertain federal income tax consequences involved with the use of non-lapse restrictions and the possible adverse tax treatment for programs with conversion features. When a company changes the price of an employee stock option or otherwise alters the option terms so as to increase the intrinsic value of the stock option, the company is required to recognize any difference in fair market value between the option immediately before and after the change. The accounting rules ameliorate the impact of this change by permitting companies to increase the value placed on the

"before" option, thereby providing more replacement value to employees without incurring an additional earnings charge.

5.1.5 Loans to Employees

In some cases, companies may want to loan employees the money or extend credit to employees to fund the purchase of shares of company stock. The IRS will be concerned that such loans should be considered a form of disguised compensation. These loans are subject to the same rules as with any loan to an employee. If the loan interest terms are more favorable than an equivalent arms-length transaction, Section 7872 of the Code provides that the difference in interest charged and the interest that would accrue under the applicable federal rate ("imputed interest income") is generally taxable to the employee and is treated as part of the employee's gross income. Loan programs, therefore, need to be established with appropriate legal, tax, and accounting advice. Loans between employer and employee that do not, in the aggregate, exceed $10,000 are generally exempt from imputed interest under a de minimis exception; however, if one of the principal purposes of the loan is to avoid paying tax, then the de minimis exception does not apply. For various tax purposes (e.g., in order to qualify an employee for tax-deferral under Section 1042 of the Code), recourse loans are advisable as compared to non-recourse loans.

In addition, personal loans to officers and directors of publicly traded companies are banned under the Sarbanes-Oxley Act of 2002. Personal loans made by closely held companies are not subject to the Sarbanes-Oxley Act; therefore, this restriction does not apply.

5.2 Stock Bonus Plans

Under a stock bonus plan, an employee's bonus is typically contingent upon the issuing company's earnings exceeding a stated level for a specified period, although this is not a requirement. Companies could simply issue shares of company stock to employees as a bonus regardless of company or individual performance. If the company stock is given as a bonus to employees, companies would typically require the shares of company stock to be forfeited if not fully vested before termination of employment. A stock bonus plan allows a company great flexibility and creativity in compensating its employees. For example, such a plan can provide that if the company's earnings rise above a certain minimum level, the bonus amounts also will increase. This type of incentive provides the company's employees who receive these stock bonuses with an incentive to achieve maximum earnings. The bonuses may be paid in the form of the company's capital stock or cash or a combination of both. Again, if a company chooses to fund the benefit that is earned with respect to the grant of stock bonuses by distributing company stock to employees, the stock that is distributed may be restricted so that it may be sold only to the company, the company has a right of first refusal with respect to the future sale and purchase of such stock, and/or the stock must be sold to the company when the employee's employment terminates, at a price equal to the fair market value per share at the time of the sale.

An employee receiving shares of capital stock under a stock bonus plan does not realize income for federal income tax purposes until the amount of his or her stock bonus is determined and issued. At that point, he or she will realize ordinary income in an amount equal to the fair market value per share multiplied by the number of shares of company stock that he or she receives plus the amount of any cash that he or she receives. The sponsoring company is entitled to a compensation deduction equal to the amount that the employee(s) recognize as ordinary income to the extent that such amount constitutes reasonable compensation to the employee(s). When the employee sells the capital stock back to the company, he or she realizes gain or loss, as the case may be.

Stock bonus plans may be more appropriate when a company wants to provide stock to a broad group of employees, rather than just key executives. In most (but certainly not all) companies, employees generally do not have the discretionary income, or risk tolerance, to buy shares of company stock. It is important to recognize, however, that when employees are given company stock, they typically incur a tax obligation even though they only have pieces of paper that cannot be sold for some time. In some cases, this may be demotivating to employees unless the company also provides a cash bonus to pay the taxes.

5.3 Providing a Market for the Company Stock

Whatever kind of plan a company establishes, it is essential that consideration be given to how the shares of company stock can be sold. In too many cases, the plan is simply that the shares of company stock will have value when the company goes public or is sold in a sale to a third party. While the dramatic stock market decline at the turn of the 21st century dampened enthusiasm for going public, even at its boom, very few relatively small closely held companies succeeded in completing an initial public offering (IPO). At most, there were only about 800 IPOs in a year, and 200–300 was more typical before the economic recession that occurred in 2008. Many of these were spin-offs of larger companies or large closely held companies that decided to go public. In 1999, Inc. magazine found that 109 of the fastest growing closely held companies planned to go public that year; only 9 succeeded. According to available statistics, in 2007, 282 companies went public; however, the number dropped substantially in 2008 to just 51 companies. According to PricewaterhouseCoopers LLP's US IPO Watch, IPO activity started to recover in 2010, with 168 offerings in that year, 134 in 2011, 146 in 2012, 238 in 2013, and 228 in the first three quarters of 2014.[2]

Selling to another company or an investor group is more common; however, here too expectations many times may outrun reality. Merger and acquisitions markets run hot and cold, however, and finding the right buyer, even in good times, can be difficult.

There are other alternatives, however. Companies can repurchase the stock directly (note that such repurchases are not deductible) or set up an ESOP (employee stock ownership plan) to do so (in which case they are deductible and, in certain cases, may allow the selling employee to defer taxes if the selling employee makes a proper election under Code Section 1042). They can also informally connect employees who want to buy additional shares of company stock with employees willing to sell. Finally, companies may be able to attract outside investors to buy stock, although this may be the most difficult of any of the alternatives described here. Whatever approach is taken, there needs to be a "Plan A" and a backup plan. Allowing employees to purchase company stock, or even just giving them company stock, with no realistic liquidity process in mind is substituting wishful thinking for solid business planning.

5.4 Securities Law Considerations

Securities laws exist at the state and federal level. Each state has its own rules, although there are broad similarities among states. Securities law is a large and complex subject; however, the two key elements are registration and disclosure. Registration means the filing of documents with the state and/or federal securities agencies concerning the employer whose stock is being sold. There are registration procedures for small offerings of company stock (under $1 million or $5 million, depending on the procedure) that can be accomplished for relatively small legal fees; however, larger offerings require a lot of complex paperwork, and fees often exceed $100,000. Registration requires the filing of audited financial statements and continuing reporting obligations to the Securities and Exchange Commission (SEC) and appropriate state agencies.

Disclosure refers to providing information to purchasers about what they are getting, similar to but frequently less detailed than what would be included in a prospectus. At times, there are specific state and federal rules about what needs to be included in these documents (i.e., objective discussions of risks, the financial condition of the company, officers' and directors' salaries, and other information). In the absence of requirements for the registration of the securities, disclosure is intended to satisfy the antifraud requirements of federal and state securities laws.

5.4.1 Federal Securities Law

5.4.1.1 Registration and Disclosure

Generally, offers to sell securities (stocks, bonds, etc.) require registration of those securities unless there is a specific exemption. Direct stock purchases of company stock would fall under this definition. Furthermore, while not necessarily applicable to the direct stock purchase programs maintained by closely held companies that this chapter addresses,

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[2] PricewaterhouseCoopers, "PwC IPO Watch Finds Q3 IPO Market Proceeds Raise $38.1 Billion," http://www.pwc.com/us/en/press-releases/2014/q3-2014-ipo-watch-press-release.jhtml.

companies with 2,000 or more shareholders (or 500 or more shareholders who are nonaccredited investors) and more than $10 million in assets are considered publicly traded companies under federal law and must comply with the reporting requirements of the Securities Exchange Act of 1934 (the "1934 Act") even if they do not have to register under the Securities Act of 1933 (the "1933 Act"). Additionally, the Jumpstart Our Business Startups Act of 2012 (JOBS Act) updated and added to the definition of "company" by creating the new category of "emerging growth company," which is defined as a private company or newly public company that has not registered shares on or before December 8, 2011, and that has total gross revenues of less than $1 billion during its most recently completed fiscal year. An emerging growth company must follow the registration requirements of the 1934 Act but is not subject to all of the disclosure requirements imposed on all other public companies.

There are a number of exemptions from these rules listed below. These are exemptions from registration; any time company stock is offered for sale, it should include appropriate financial disclosure to satisfy antifraud rules. The principal exemptions under federal law are:

- Offers to a company's employees, directors, general partners, trustees, officers, or consultants can be made under a written compensation agreement. Under SEC Rule 701, the maximum dollar amount of stock that may be sold to these people in a year without registration is the greatest of: (1) $1 million, (2) 15% of the issuer's total assets, or (3) 15% of the issuer's outstanding class of stock being sold. The 15% ceiling would not apply if the offering is under $1 million. The offer itself does not count for purposes of the available exempted amount. If more than $5 million of securities are being sold, however, the issuer is required to disclose risk factors to potential buyers and deliver financial statements in accordance with Form 1-A of Regulation A.
- Another exemption is available under Section 4(2) of the Securities Act of 1933, which has been interpreted to allow for exemptions from federal registrations of offerings of stock to a limited number of investors who have access to the same information normally provided in a public offering and who are accredited investors or sophisticated enough both to assess and to bear the risks. This exemption has been interpreted in different ways by the courts. Whether it allows such approaches as offering stock to more than just a company's key employees is unclear. It does probably work for many direct stock purchase programs to selected management employees.
- Another set of exemptions is available under the SEC's Regulation D, which provides three exemptions for small offerings, Rules 504, 505, and 506. Rule 504 exempts offerings up to $1 million to an unlimited number of people, with no limits of their being sophisticated or accredited. Rule 505 provides an exemption for offerings of up to a total of $5 million to as many as 35 nonaccredited investors and an unlimited number of accredited investors in any 12-month period. Rule 506 exempts offerings of any size made to as many as 35 sophisticated investors and an unlimited number of accredited investors.

  "Accredited investors" include directors, partners, or executives of the issuing company; anyone with a net worth (including that of their spouses) of over $1 million; and anyone with an income over $200,000 (or whose joint income with a spouse is more than $300,000) who has made that amount for the preceding two years and is likely to continue to make it; and financial institutions, business development companies, or other companies with total assets exceeding $5 million. "Sophisticated investors" are people who, on their own or with the aid of a representative such as an accountant, are able to judge the risks, merits, and disadvantages of a particular investment.
- Offerings that are made only to residents of the state in which the offering is made are generally exempt if the offeror has its principal office in that state, gets 80% of its gross revenue from business conducted in the state, and has 80% of its assets in the state.

5.4.1.2 Antifraud Provisions

To comply with the antifraud provisions of federal securities laws, disclosure of certain corporate information to employees under a direct stock plan is advisable. The disclosure standard for registration statements filed under the 1933 Act may be used as a guideline for the type of information that needs to be disclosed. The following is a list of information that generally must be disclosed in registration statements:

- Description of business.

- Description of property.
- Description of any legal proceedings.
- Market price of and dividends on the company's shares.
- Recent financial statements.
- Other pertinent financial data.
- Management's discussion and analysis of financial condition and results of operations.
- Changes in and disagreements with accountants on accounting and financial disclosure.
- Names of directors and executive officers.
- Executive compensation.
- Security ownership of certain beneficial owners and management.
- Certain relationships and related transactions.
- General plans for the company's future.

It is important to note that meeting the disclosure standard for registration statements filed under the 1933 Act is not a requirement for closely held companies that implement a stock option plan; rather, the disclosure would be helpful in responding to antifraud claims by the employees against the company and its board of directors for transactions arising under a stock option plan.

5.4.2 State Securities Laws: The California Example[3]

State laws generally require that any offer or sale of securities in the state by an issuer must either be qualified by the department of corporations or secretary of state or be exempt from such qualification requirements. In this respect, the California securities laws will be used as an example. California law requires that any offer or sale of securities in the state by an issuer must either be qualified by the California Department of Corporations or be exempt from the qualification requirements. Company stock purchased by an employee pursuant to a direct stock purchase program is a security and an employer issuing company stock is considered an issuer. Thus, an employer's direct stock purchase program must comply with California securities laws in addition to any federal requirements that must be met. Given the considerable effort and expense involved in qualifying securities issuable under a direct stock purchase program, finding an exemption to the qualification requirement can be important.

5.4.2.1 Exemptions from Qualification

If an employer offers direct stock purchases only to key employees, it may rely on the exemption found in Section 25102(f) of the California Corporations Code. The exemption is generally limited to sales to no more than 35 people (excluding officers, directors, and managers as well as affiliates and banks) who have a preexisting personal or business relationship with the offeror or its directors, officers and managers. Alternatively, an employer may sell stock to unaffiliated purchasers who, either through their own business or financial expertise or the expertise of their independent advisors, could "be reasonably assumed to have the capacity to protect their own interests in connection with the transaction," while still respecting the 35-person limit on such exempted sales. If an employer wants to expand the direct stock purchase program to reach other than key employees and savvy outsiders, it may find that the 35-person limit is unduly restrictive.

Recognizing this, the California legislature enacted an exemption to the qualification requirements in 1996. Section 25102(o) of the California Corporations Code exempts offers and sales of securities in connection with stock

3. For a broader discussion of this issue, see Gene Hwang, "State Securities Law Considerations for Equity Compensation Plans," in the NCEO's book *Selected Issues in Equity Compensation.*

purchase or stock option plans or agreements without limiting the number of persons eligible, where the securities involved are exempt from federal registration requirements under Rule 701 of the 1933 Act. The transaction must, however, meet several other requirements promulgated by the state Corporations Commissioner that were amended as of July 9, 2007. Those include:

- A plan must specify the number of shares available for issuance and the persons eligible to receive options or purchase stock.
- The options or purchase rights are not transferable except by will or the laws of descent.
- The plan must be approved by the company's stockholders within 12 months of the later of the adoption of the plan or first issuance of the option or security in California and the authority to grant options or purchase rights terminates no later than 10 years after the date of adoption or stockholder approval, whichever is earlier.
- The options must have an exercise period of no more than 120 months from the date the option is granted. The right to exercise in the event of termination of employment, to the extent the optionee is entitled to exercise on the date of termination, must continue for at least (1) six months from the date of termination of a termination not for cause other than by death or disability and (2) 30 days from the date of termination not caused by death or disability. The plan may allow for an issuer's repurchase upon termination.

Additionally, while the exercise price of options is not restricted by current California state law, issuers should keep in mind the restrictive provisions of the federal securities and tax laws discussed in this chapter if an exercise price below the fair value at the time of grant is contemplated.

5.5 Closing Remarks

Direct stock purchase programs, and even stock bonus plans (other than tax-qualified stock bonus plans, not described here) typically are not designed to provide equity incentives on a broad basis to all or a large number of a closely held company's employees. They typically work best to motivate certain key employees to improve a company's productivity and profitability and, in turn, the company's fair market value. A direct stock purchase program or stock bonus program is an excellent supplement to a broad-based stock option plan and/or an ESOP. One important exception to this is for very small companies with just a few or several regular employees. These companies may find direct stock purchase or bonus programs the only practical way to share company stock with most or all of their employees, although, as this article makes clear, there still will be significant legal, tax, financial and securities laws issues to consider. A handful of larger companies may want to use these approaches for broader plans as well, although the tax and securities law advantages of the kinds of qualified plans or stock option plans described in the penultimate chapter of this book, such as ESOPs and 401(k) plans, make them more appealing to most companies in such circumstances.

If a direct stock purchase program or stock bonus program is created and used together with the design, implementation, and continued maintenance of an appropriate ownership and participation program and a broad-based employee stock ownership plan and/or equity incentive plan, empirical evidence and years of experience have demonstrated that the sponsoring employer should achieve enhanced productivity and profitability and that, ultimately, the fair market value of its capital stock should increase over time.