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Executive Compensation: New Rules Are in Place for Technology Companies To Follow

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ATLANTA - There are a new set of rules and standards for compensating executives and employees of technology companies. The traditional ways of compensating executives – options and bonus plans – are undergoing radical change. As a result, private and public technology companies must reconsider their compensation programs, option plans and incentive-based packages.

Traditional Package:

For years, stock options have been the centerpiece of executive compensation. The options were usually incentive stock options (ISOs), providing tax benefits – generally no tax on the grant or exercise of the option (unless an alternative minimum tax applied in a rare circumstance). Options traditional include standard terms:

- An exercise price equal to fair market value of a share of common stock.
- Vesting annually and equally over a three or four year time period during employment.
- A term of ten years in which to exercise the option.

Reasons for Change:

In the past two years, several reasons have emerged for changing compensation for executives. Many of these reasons are unrelated to technology companies and actually harm entrepreneurial businesses in their efforts to attract executives and retain talented employees. The key drivers of change have been:

- Accounting Uncertainty - The Financial Accounting Standards Board (FASB) and other accounting regulatory bodies have reexamined the accounting treatment for stock options. Under soon-to-be proposed rules, stock options may impose a substantial expense charge to earnings, thereby making options less desirable. A big concern is the uncertainty regarding the magnitude of this expense hit and negative impact on a company's financial statements.

- Shareholder Dissatisfaction – Shareholder dissatisfaction has been fueled by concerns over excessive compensation for certain corporate executives. In reality, the abuses have not been widespread in the technology area. On the contrary, tech companies are in the greatest need of creative forms of equity compensation, since most start-ups have limited amounts of cash.

- Management Financial Commitment – In recent years, Compensation Committees of Boards and compensation consultants have focused on the importance of management making a financial commitment to the long-term future of the business. Stock options provide limited value in this regard, since the executive does not have to pay money to exercise the option until a later date. Critics have taken the position that management should be required to place some money at risk.

- Overhang Concerns – Option grants create "overhang" issues. An overhang is a term used to describe the potential shareholder dilution caused by unexercised options. Shareholders are more concerned about these effects than ever before and are examining the impact of these options on the capitalization tables of public and private companies.

Microsoft's Impact:

Microsoft Corporation has led the way in changing the perspective of many technology companies on executive compensation. However, the Microsoft arrangement is unique in many respects – most notably that Microsoft is a public company with a very liquid stock.

Microsoft's compensation program has shifted from options to restricted stock units (also called deferred stock grants). The program involves finding an independent third party who is willing to purchase outstanding options (even those that are "under water" meaning that their exercise price is above the current stock price). There are few public companies for which such a third party option purchaser can be found, and such an alternative is not really available for private companies given securities laws.

As a result of these changes and issues with options, companies are planning to reduce the number of option grants to executives. Also, many companies are considering reducing the employees eligible to participate in option programs. Others are simply waiting to see what further changes will occur in the immediate future. This uncertainty is a major area of concern for executives who are worried that their sweat equity may never translate into real compensation.

New Alternatives: Several new alternatives for incentive compensation are currently being considered by technology companies.

- Time Vested Restricted Stock Units – This type of arrangement, also known as a deferred stock grant, involves a promise to grant stock at a later date based on continued service as a recipient. The recipient is generally taxed at the time the stock is actually received.

- Time Vested Restricted Stock – This program involves a current grant of stock with restrictions that will lapse based on continued service of the recipient. The party receiving the stock may make a tax election (a so-called Section 83(b) election) and pay tax currently on the value of the stock received. The tax is then paid, with the hope that the stock will appreciate in value.

- Performance Vested Restricted Stock – This involves a promise to grant stock at a later date, or a current grant of stock with restrictions that will lapse, based on meeting certain objective performance criteria. Again, a tax election may be made in order to pay the tax now, rather than in the future (when the stock may have appreciated in value resulting in a higher tax). Note that performance-based equity grants may have detrimental accounting implications.

- Cash Based Performance Plans – Under these plans, a promise of future cash bonuses is based upon meeting certain objective performance criteria. The main disadvantage is that cash bonuses do not give employees the feel of "ownership" that equity based alternatives may provide.

- Change of Control Bonus Plans – These plans have become prevalent with technology companies, especially those with significant liquidation preferences as a result of venture capital infusions over multiple rounds of financing. A promise is made to pay a certain bonus amount (in cash or property) upon a "change of control" of a company. A change of control usually involves a transfer of a majority of the stock of the company or sale of substantial assets in the business. A significant detriment for these plans is that the bonuses paid may be "golden parachute payments" with attendant harsh tax consequences, depending upon the size of the bonuses and whether the recipients are classified as "disqualified individuals."

Technology companies need to continue monitoring developments in the executive compensation, accounting and tax areas. It may be years before a new standard of executive compensation is established for tech companies. In the meantime, tech companies should work with their Compensation Committee and advisors to come up with arrangements that are acceptable to company executives and the rank and file.

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