Borden Ladner Gervais

How to Build a Strong Employee Equity Plan

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When planning for business success, it's imperative not to discount the role valued, loyal employees play in the bigger picture. Happy and engaged employees are typically more motivated and productive. This, in turn, leads to increased profitability and financial stability.

An employee equity compensation plan is an excellent way to achieve these objectives. While these plans can take different forms, they're essentially designed to give employees a stake in the business, including the risks and rewards that come with it. As such, they align the motivations of employees with those of a company's shareholders.

Yet, like all employment-related agreements, an employee equity compensation plan requires significant up-front design. In particular, senior leadership should consider the pros and cons of various types of plans before determining how to best structure employee agreements.

Cash-based vs. stock/share-based plans

When it comes time to determine an employee equity compensation plan structure, businesses have two primary options: a cash-based plan or, if the business is organized as a company or a mutual fund trust, a share/unit-based plan.

A cash-based plan provides employees with a cash bonus equal to the value of a financial metric, such as the value of a corporate share or EBITDA. Cash-based awards can align to existing value or be forward-looking, represented by the increase in value of the share (or other metric) from the date it's awarded to the date it vests.

With this plan, employees don't own actual shares or other equity in the business, and therefore have no voting or other ownership rights. Rather, their compensation is linked to the value of the business and their motivations align with shareholders' as a result. Cash-based plans are often a good alternative in closely-held family businesses, where actual share ownership is reserved for family members.

Stock/share-based plans, on the other hand, are designed to turn employees into owners. As such, they involve the issuance of actual shares. In Canada, stock option plans tend to be the most popular type of plan because they offer the most favourable tax treatment and flexibility with respect to vesting–but there are other types of plans that issue full shares as well. While share-based plans are common for both public and private companies, utilizing such plans in private companies involves special considerations.

What’s a stock option plan?

An employee stock option plan allows employees to purchase a company’s stock at a specified price (normally the fair market value at the time of the grant) for a set period of time. If the price of the stock goes up during that time, employees have the opportunity to purchase the stock at the specified price.

Setting the rules

While employee equity compensation plans can be incredibly useful to establish goodwill among employees, they can also pose challenges. To mitigate these risks–and avoid unnecessary conflict–it’s important to properly design the plan from the outset.

In the design, compliance with employment laws, taxation laws and corporate governance standards is of utmost importance. Additionally, a strong employee agreement is critical. Such an agreement should consider as many potential variables as possible–and address what will happen in the event of an employee death, termination, disability or if the employee quits or retires.

It is important to think about the possible situations in which the business may want to retain the right to cancel an employee’s options or buy back the employee’s shares. For instance, you need to decide if an employee’s estate will be allowed to exercise options or retain the employee’s shares from previously exercised options. You’ll also want to decide if there should be different rules surrounding when an employee quits, is fired for cause, retires or is fired without cause.

The company should also consider whether it will have the right or obligation to accelerate the vesting period for options in certain circumstances. The rules may differ depending on whether the company is public or private. For private companies, if an employee exercises options and becomes a shareholder, they should have a share ownership agreement governing their rights and obligations with respect to the other shareholders. For example, this may include provisions restricting the ability of the employee to pledge or transfer the shares, disclose financial information or vote against the majority shareholders on key matters.

A helping hand

Implementing a successful employee equity compensation plan can be a complex process, which is why you should make sure it’s properly structured from the outset.

Ideally, this means getting help to draft the compensation plan, option agreements, employment agreements and share ownership agreements. It also means getting advice on any pertinent securities issues, legal control issues, employment issues and tax issues that may arise.

To learn more about how BLG can help with your employee equity compensation plan, contact us.

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