

# A CHECKLIST DEVELOPING EMPLOYEE STOCK OPTION PLANS IN PRIVATE COMPANIES

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Please note that this checklist has been written from the perspective of the owner/manager of a private business in Ontario.

This Checklist was written as an introduction only to a complex strategic, human resource, tax and legal issue. Generalizations can never be applied to any specific situation, and appropriate tax, legal and human resource advisors should be consulted before any specific employee stock option plan is implement.

<p><b>1. The Development Team</b></p> <p>Who will be on your team?</p>	<ul style="list-style-type: none"> <li>• Consider issues related to stakeholders: owners, investors, bankers, senior management, employee representation</li> <li>• Consider third party advisors: legal, tax, accounting, corporate finance, investor relations, human resources, business valuator</li> </ul>
<p><b>2. Strategic Issues: Employer Benefits</b></p> <p>Why are you doing this?          What do you hope to accomplish?          What are your objectives?          How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<p>Employer Considerations include:</p> <ul style="list-style-type: none"> <li>• Profit sharing.</li> <li>• Reward for past services.</li> <li>• Improve company value over time.</li> <li>• Share improvements in company value – past, future or both.</li> <li>• Improved company financial performance</li> <li>• Attract key people – all or some.</li> <li>• Improved employee performance—all or some.</li> <li>• Increased employee commitment to the company – all or some.</li> <li>• Increased access to employee ideas for improving the business.</li> <li>• Reduced labour/management conflict – all or some.</li> <li>• Reduced salary and benefit demands – all or some.</li> <li>• Source of investment capital.</li> <li>• Sell shares to use up capital gains exemption.</li> </ul>

	<ul style="list-style-type: none"> <li>• Get liquidity for some of owner’s share capital.</li> <li>• Potential retirement strategy.</li> <li>• Other?</li> </ul>
<p><b>3. Strategic Issues: Employer Pitfalls To Avoid</b></p> <p>What are your key worries or concerns that the plan must address? How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<p>Employer Considerations Include:</p> <ul style="list-style-type: none"> <li>• Having to provide financial disclosure.</li> <li>• ESOP employees seeking a say in how the business is run.</li> <li>• The complexity, cost and time required to design, implement and maintain an ESOP.</li> <li>• Having to consider minority shareholder rights.</li> <li>• Being subject to greater employee scrutiny.</li> <li>• Having your company subject to greater employee scrutiny.</li> <li>• Being accountable to employee/partners.</li> <li>• The plan being so anemic that it does not meet its objectives.</li> <li>• Other?</li> </ul>
<p><b>4. Strategic Issues: Employee Benefits</b></p> <p>What benefits are you trying to offer the plan participants? How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<p>Employee Considerations include:</p> <ul style="list-style-type: none"> <li>• Greater access to information about the company.</li> <li>• An opportunity to have a say in how things are done.</li> <li>• Greater job security.</li> <li>• An opportunity to participate in company profits and increase company value.</li> <li>• Reduced labour/management conflict.</li> <li>• Access to investment opportunity.</li> <li>• Access to tax deferred or tax sheltered investment opportunity.</li> <li>• Increased personal wealth.</li> <li>• Other?</li> </ul>

<p><b>5. Strategic Issues: Employee Pitfalls To Avoid</b></p> <p>What employee concerns do you anticipate having to satisfy? How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<p>Employee Considerations include:</p> <ul style="list-style-type: none"> <li>• Never really getting the chance to have an impact on the business.</li> <li>• Hitching your star to a vehicle that never takes off, leaving you worse off if the company does not grow in value while you are accepting lower than usual personal compensation.</li> <li>• Investing hard earned money in a high risk venture that does not pay off.</li> <li>• Not achieving the vesting requirements.</li> <li>• Not having the resources to buy the shares.</li> <li>• Not being able to sell out when you want to</li> <li>• Other?</li> </ul>
<p><b>6. Valuation</b></p> <p>What is the present value of your business? How do you know that? What are the key factors in your business value? How can you build that into the plan so it becomes a learned and applied approach to the business? How will changes in value impact the plan? How will you determine value in the future, if necessary? How will you manage private owner issues and their impact on those values? (e.g. bonusing down) How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<p>Considerations include:</p> <ul style="list-style-type: none"> <li>• using business valuator now</li> <li>• using a formula</li> <li>• using outside valuation from time to time as arises</li> <li>• leaving all valuation issues to be determined by board of directors</li> </ul>
<p><b>7. Investment Opportunity</b></p> <p>Are you doing this to raise money? To what extent is the plan being presented as an investment opportunity to employees? How will that be reflected in the plan, or how you present the plan?</p>	<p>Considerations include:</p> <ul style="list-style-type: none"> <li>• pricing</li> <li>• building in a “closing door” in the timing</li> <li>• securities law issues</li> <li>• impact of poor “investment” performance</li> </ul>

<p><b>8. Who Will Sell the Shares?</b></p> <p>The existing owner? The company from treasury?</p>	<ul style="list-style-type: none"> <li>depends on strategic purposes and tax planning considerations for the owner</li> </ul>
<p><b>9. Who Will Participate in the Plan?</b></p> <p>A few key people already on staff? A few key people to come on board in the future? A few key people by position? The staff as a whole? Some combination of that? Will they hold their shares directly, or through a trustee, or some other mechanism? How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>depends a great deal on the strategic objectives</li> <li>you can be very flexible and imaginative (e.g. can be in discretion of directors)</li> <li>can be key employees or all employees as a whole</li> </ul>
<p><b>10. Number, Type and Attributes of Participating Shares</b></p> <p>What percentage of the company will be offered – as a group, by individuals? Will those percentages be guaranteed? (see anti-dilution issues below) What types of shares will be offered? How many? Voting or non-voting? Dividends? Management bonuses? Seats on board? Other attributes? How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>you can be very imaginative and creative in this area</li> <li>consider how these shares interact with other shares and future share issues</li> </ul>
<p><b>11. Granting of Options</b></p> <p>Who will get them? How many? When? Will grants be conditional upon performance/milestones being achieved?</p>	<ul style="list-style-type: none"> <li>you can be very flexible and imaginative in this area</li> </ul>

<p>What if they are not met?  Who will determine these things?  When and how?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	
<p><b>12. Option Price</b></p> <p>What price will employees have to pay?  Fixed at the beginning or determined at time of grant or some other time?  Who will determine price?  When and how?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• depends on your strategic objectives</li> <li>• can be flexible and imaginative</li> <li>• can leave it to the board at the time the grants are made</li> </ul>
<p><b>13. Vesting</b></p> <p>So the grants have been made; when can the employee exercise them?  Will vesting be conditional upon performance/milestones being met?  What if they are not met?  Who will determine these things?  When and how?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• depends on your strategic objectives</li> <li>• can be flexible and imaginative</li> <li>• can leave it to the board at the time the grants are made</li> </ul>
<p><b>14. Exercise of Options</b></p> <p>How will employee exercise options?  What will mechanics be?  Will they have to execute a shareholders' agreement?  If yes, under what terms?  How will the employee fund payment for shares?  Will the company provide financial assistance?  Use of bonuses to do this? Mandatory or optional?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• can avoid a shareholders' agreement by relying on the company's Articles and the provisions of the <i>Business Corporation's Act</i></li> <li>• company can loan money or take back promissory note, although are taxable benefit and other issues to consider</li> </ul>

<p><b>15. Termination of Unexercised Options</b></p> <p>How long after vesting does “use them or lose them” kick in?  What about quitting?  Being fired for cause?  Being fired without cause?  Death?  Disability?  Sale of the business?  IPO?  Failure to use bonus money to buy vested shares?  How will that be determined?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• depends to some extent on strategic objectives</li> <li>• normally dealt with at time options are granted</li> <li>• three to ten year range is fairly typical</li> </ul>
<p><b>16. Acceleration of Unvested Options</b></p> <p>What will happen to unvested options on an IPO or sale of the business or similar event?  Will accelerated vesting be permitted?  When and how?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• most plans permit acceleration of pro rata portion or some percentage of unvested options on a major company liquidity event as an added benefit to employees, and let employees use the proceeds of the sale to fund exercise</li> </ul>
<p><b>17. Drag-Along Provisions</b></p> <p>Can owner force a sale of the business?  On what terms?  How impact options?  What about IPO?  What about death or disability of the owner?  What if sale/IPO price is less than option price?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• owners usually retain right to sell, IPO etc., including right to force option holders to accelerate and/or sell on same terms, using funding from transaction to fund exercise of options</li> <li>• ties into acceleration issue</li> <li>• consideration must be made to owner forcing sale at less than what employee paid for shares</li> </ul>

<p><b>18. Anti-Dilution Provisions</b></p> <p>How are employee percentages at time of grant “guaranteed”?  What if owner bringing in new investor or needs other form of capitalization?  How will this be reflected in plan?</p>	<ul style="list-style-type: none"> <li>• usually owners can not force dilution of option holders except to the extent owner is being diluted on an equivalent basis</li> </ul>
<p><b>19. Liquidity and Repurchase Issues</b></p> <p>How will employees pay for their shares?  Use of their money?  Financial assistance from company or owner?  Use of bonuses to pay?</p> <p>When and how will employees get to cash in their shares?  Do they have to wait for a liquidity event?  What if it does not happen in the expected time frame?  Will the company or the owner guarantee a buyback?  If yes, under what circumstances and what price, and without buy back being a burden?  How to prevent a “run on the bank”?</p> <p>What about employee death, disability?  Termination for cause?  Termination without cause?  Retirement?  Resignation?  Illness?  Use of insurance?</p> <p>How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• complex issue that gathers in many previous decisions including price, termination, bonus and acceleration provisions</li> <li>• is absolutely critical to success of plan</li> <li>• depends on strategic objectives</li> <li>• can be imaginative and flexible</li> </ul>

<p><b>20. Tax Planning</b></p> <p>What are tax implications to owner, company and employee at each stage?  When will capital gains or losses be recognized for tax purposes?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• a complex issue that is a moving target</li> <li>• expert professional advice is mandatory</li> <li>• the business terms can be assembled as a “wish list” before tax advice is obtained</li> <li>• must be included in communication strategy</li> </ul>
<p><b>21. Profit Sharing</b></p> <p>How will options tie into to bonuses and other profit sharing arrangements?  Must employees use profit share to pay for vested shares? What if they don’t?  What about bonusing down for small business deduction?  Loaned back to company?  Impact on dividends?  Dilution of share value?  How will all this be reflected in the ESOP? In the plan or in the policies?</p>	<ul style="list-style-type: none"> <li>• important issue to integrate</li> <li>• depends on strategic objectives</li> <li>• exercised options participate pro rata with owner in dividends etc.</li> <li>• do not usually give big bonuses and attractive options, unless mandatory that the bonuses be used to exercise vested options</li> <li>• small business deduction bonuses usually pro rata for exercised option holders and loaned back on same terms as owner</li> </ul>
<p><b>22. Access to Information</b></p> <p>What information will option or ESOP shareholders get that they do not get already?  How will it be kept confidential?  Will a permanent waiver be required for audited statements?  Are there other informational issues?</p>	<ul style="list-style-type: none"> <li>• As a general rule you must assume that plan participants will need or will legally be required to obtain copies of the company annual financial statements</li> <li>• There may be more informational issues if there are vesting conditions etc. they have to meet</li> </ul>
<p><b>23. Business Protection Agreements</b></p> <p>What sort of non-competition agreements and non-solicitation agreements will plan participants have to sign on for?  More onerous than regular employees?</p>	

<p><b>24. Decision Making</b></p> <p>Will plan participants have any say or even a greater say in how things are done than regular employees?  Will they be entitled to seats on the board, or a board representative, or to attend board meetings, or get copies of board minutes or resolutions?</p>	
<p><b>25. Financing Obligations</b></p> <p>Will plan participants be required to support Company financing with personal guarantees, indemnities, surities, mortgages etc.?</p>	
<p><b>26. Employee Compensation</b></p> <p>How will options tie into regular compensation programs?  Salary, commissions, termination packages, perqs?  How will this be reflected in the plan or policies or in the employee contracts?</p>	<ul style="list-style-type: none"> <li>• depends on strategic objectives</li> <li>• can be imaginative and flexible</li> </ul>
<p><b>27. Securities Law</b></p> <p>Does plan comply with current legislation?  Must the plan be designed to survive and IPO?  If yes, what stock exchange rules need to be reflected in the plan?</p>	<ul style="list-style-type: none"> <li>• professional expertise will be required in this area</li> </ul>

<p><b>28. Plan Documents</b></p> <p>Discuss contents of:  Plan Document  Policy Statements  Form of Grant  Employee Information Package  Articles of Amendment, if required  Shareholders' Resolutions  Directors' Resolutions  Employment Contracts  Other documents, as required</p>	
<p><b>29. Plan Management</b></p> <p>Who will administer the plan?  How will grants, vesting, exercise etc. be documented?  For management, employee, company accountant and company lawyer?  What will go in company minute book, and when?</p>	<ul style="list-style-type: none"> <li>• usually all done through board of directors and CFO with appropriate resolutions inserted into company minute book</li> <li>• some group plans use a trustee to participate in administration on behalf of participating employees</li> </ul>
<p><b>30. Communication Strategies</b></p> <p>How will plan be communicated to the participating employees in a manner which is simple, clear, convincing and motivating?  What will be communicated?  Who will do it?  How will plan be used as a motivator after the initial glow wears off?</p>	
<p><b>31. A Final Review</b></p> <p>Have we outlined a plan that is legal, fair and represents good business?</p>	