

January 2007

**In this issue: SMEs and Employee Equity
Passports to be required from Canada to the US**

HENKE BARTRAM PLLC

Legal power for startups to mid-size enterprises (SMEs).

We help in the following areas:

- Business Formation and Succession
- Business Sales and Acquisitions
- Copyright/Trademark Protection and Licensing
- Employment
- Business Capitalization and Financing
- Marketing, Sales and Contracts
- Real Estate
- Business Operations
- Commercial Dispute Resolution
- Start Ups

SMEs and Employee Equity *First in a series*

By Dirk Bartram

This article explains the advantages and challenges of employee equity ownership in small and mid-size enterprises (SMEs). (SMEs are closely held companies with up to 250 employees.)

Articles in future editions of *Biz Law* will take a look at the types of equity that can be transferred by SMEs to employees and how it's typically done.

The Advantages

Many SME executives think, or at least suspect, that employee ownership results in productivity gains. It may well, but we were unable to locate a study which tests that hypothesis. One study by researchers at Rutgers University does suggest that broad-based stock option plans in *public* companies improved employee productivity and slightly improved the return on assets, but did not improve overall shareholder return. Whether the same holds true in SMEs remains to be seen. Another study suggests that employee ownership in public companies results in higher productivity only when the company employs a highly participative management style.

Of course, potential gains in productivity are not the only reason to offer employee ownership. Employees in many sectors are beginning to expect equity because more employers are offering it. We were unable to find a survey or study showing the percentage of SMEs offering employee ownership. We did locate a study that shows that over 61% of venture backed SME *software* companies in the study offered broad-based stock options. Employment at these companies was primarily in the 20 to 100 employee range and most companies who participated in the study were located on the West Coast.

The Challenges

HENKE BARTRAM PLLC
1001 Fourth Avenue, Suite 3200
Seattle, WA 98154
Dirk Bartram 206 624 4788
dbartram@henkebartram.com
Danferd Henke 206 624 4787
dhenke@henkebartram.com
www.henkebartram.com



Danferd Henke

*Dirk
Bartram*

Employee ownership can create challenges for management. SMEs often decide to go forward despite these challenges, *but management should not offer employee ownership without a plan to address them.*

Fiduciary Duties. In Washington, directors and controlling shareholders owe a fiduciary duty to the corporation and all of the shareholders. This duty requires directors and controlling shareholders to always deal with the corporation and other shareholders fairly and in good faith. Thus after shares are issued to employees, the founders can no longer unilaterally take corporate actions that may benefit them at the expense of the corporation or other shareholders. Examples of such actions are taking unusually large salaries, charging the company excessive amounts for the use of the founder's intellectual property or taking a business opportunity that could have been taken by the company.

Shareholder Rights. Employee shareholders are entitled to vote on many amendments of the corporation's articles of incorporation, the sale or merger of the company, plans of share exchange and certain company reorganizations. Thus many fundamental corporate decisions can no longer be made only by the founders. Of course, the founders might retain enough stock to control the outcome of the vote, but a full shareholder vote will still be required after full disclosure to all shareholders regarding the proposed corporate action. In addition, shareholders who vote against certain proposals have the right to force the company to appraise and repurchase their shares (known as "dissenters' rights"). Finally, employee shareholders have the right to inspect certain books and records of the company.

Departing Employees. When employees leave the company, their interests are no longer aligned with the company's. Thus SMEs typically don't want departing employees to keep their shares. That means the company must purchase the shares back upon the employee's termination, which can cause a cash drain.

Securities Laws. Federal and state securities laws apply to the issuance of equity to employees. This means that the company must secure an exemption from securities registration requirements. It also means that the company must fully and accurately disclose all material information regarding the company and its business prior to offering equity to its employees.

Lack of Employee Understanding. Many employees lack a proper understanding of employee ownership. Here's a list of facts they often don't know:

- Some forms of equity compensation will trigger employee income tax liability without the cash to pay it. Equity compensation in LLCs may also trigger self-employment tax for the employee.
- There is no market for the employee's shares. Thus she

can't realize on the shares unless she departs the company or the company has a liquidity event. Moreover, dividend payments on the shares are unlikely, since the company needs cash to grow.

- Certain forms of equity compensation require the employee to make a significant cash investment.
- After becoming a shareholder, the employee will still likely have no real say in company affairs.
- Additional equity can be issued by the company to other people, which results in the dilution of the employee's ownership percentage of the company.

The company should inform employees about such issues before offering equity to them.

Next issue: Ways to transfer equity to employees in corporations: stock options, restricted stock and stock purchases.

* * * * *

Passports to be required from Canada to US.

Here's an important announcement for Washington SMEs, since their executives and employees frequently travel to Vancouver BC and other points Canadian.

Beginning **January 23, 2007**, all persons, *including U.S. citizens*, traveling by **air** between the United States and Canada, Mexico, Central and South America, the Caribbean, and Bermuda will be required to present a valid passport, Air NEXUS card, or U.S. Coast Guard Merchant Mariner Document, or an Alien Registration Card, Form I-551, if applicable.

As early as **January 1, 2008**, all persons, *including U.S. citizens*, traveling between the U.S. and Canada, Mexico, Central and South America, the Caribbean, and Bermuda by **land** or **sea** (including ferries), may be required to present a valid passport or other documents as determined by the Department of Homeland Security. While recent legislative changes permit a later deadline, the Departments of State and Homeland Security are working to meet all requirements as soon as possible. Ample advance notice will be provided to enable the public to obtain passports or passport cards for land/sea

© 2007 Henke Bartram PLLC

All articles are intended for general information purposes only and should not be construed as legal advice. You should contact your attorney to obtain advice on any particular issue or situation.

