Cashing in Your Chips: Liquidity and Wealth Management Strategies for E-commerce Entrepreneurs

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Founders and executives of e-commerce companies can accumulate significant wealth with astonishing speed. In the internet economy, the time from company launch to IPO can be measured in months, not years. During this period, entrepreneurs work with total focus and a high level of passion to gain a first mover advantage in the market. At the same time, equity value rockets upward through successive rounds of financing. Given the speed at which e-business moves, it is not surprising that founders and managers sometimes fail to consider ways to optimize the value of their equity, and some leave significant money on the table as a result.

Successful e-commerce entrepreneurs spend most of their time and energy building their enterprises, both by inclination and necessity. Savvy entrepreneurs, however, understand the “money” issues associated with equity stakes in emerging companies, and take prompt action to create or preserve value at key points. The specific aspects of their strategies vary, but in general they include:

- Obtaining an equity stake early, when equity value (and hence grant prices and potential taxes) are low,
- Implementing techniques to assure that equity gains will be taxed at capital gains rates and not at ordinary income rates,
- Planning a path to liquidity before and not after a liquidity transaction,
- Implementing measures to prevent litigants from making claims against the wealth they have generated, and
- Organizing a coordinated team to manage the process of liquifying and diversifying their e-commerce wealth.

Planning at the initial stage should focus predominantly on the equity award. Regardless of its size, the upside of an equity award will be enhanced if it is structured to produce capital gains rather than ordinary income when the venture succeeds. The difference can be significant. Qualifying for capital gains treatment rather than ordinary income treatment will permit the entrepreneur to keep an additional 20¢ to 25¢ of every incremental dollar of equity returns generated by the venture. Standard option packages usually fall short in this regard. Restricted stock packages or profits interests, by contrast, will enable an entrepreneur to achieve capital gains treatment as long as they are properly structured, as will so-called West Coast option awards (which permit immediate exercise and thus are the functional equivalent of restricted stock). Although tax structure usually matters more than the other terms of the equity award, key provisions such as vesting upon a change of control also are important. Entrepreneurs need to be familiar with current market standards in this area, both when considering an emerging company opportunity and when recruiting others to join them.

A second aspect of the initial planning should involve consideration of estate planning opportunities. Admittedly, estate planning may not be high on the list of priorities for a 25-year old founder / CEO who barely has time for a significant other, let alone children. However, if children or other donees are in the picture, transferring equity to them before the value of the enterprise grows can be an effective strategy.

Understanding the path to liquidity in advance of a liquidity transaction is imperative. An initial public offering is viewed by many as the emblem of success, but can be problematic from a liquidity perspective due to legal, contractual and practical limitations on sales or hedging transactions by executives and founders of newly public companies. A strategic sale to a larger company before or after an IPO can provide more immediate liquidity, as long as the documentation contains favorable terms. Standard terms of sale have traditionally
included undertakings by the buyer to facilitate public sales through registered offerings at agreed upon times or at agreed upon intervals. Emerging terms of sale also include undertakings to facilitate hedging arrangements such as costless collars that permit an entrepreneur who has sold his or her company for stock to “lock in” the value of the proceeds. Given the potential volatility of many e-commerce and other emerging company stocks, failing to focus on diversification of a large equity position can lead to a substantial loss of value. An entrepreneur also must understand the different objectives and needs of his or her partners such as private equity or strategic investors when planning for liquidity, and should make sure that appropriate insurance and indemnity arrangements are in place in the event adversaries such as securities class action lawyers seek to claim a share of the wealth.

Entrepreneurs who build significant equity value face a number of management challenges. Diversifying and optimizing a portfolio consisting principally of the stock of a successful emerging company (whether $5 million, $50 million or $500 million) requires a coordinated team. The skill sets of the team members should include financial management, tax planning, securities and corporate law expertise, and estate planning. These skills generally are not offered in combination by a single vendor of services. Thus, it is important to assemble a team of experts who can work in a very focused and coordinated manner. Coordinating delivery of these experts’ skills is an art and requires a leader who will drive the process and minimize the clashing of egos. The entrepreneur functions as the “CEO” of this team, directing and animating the overall strategy but trusting the team to implement it in a creative and timely manner.

Conclusion

In The Big Heat, Gloria Grahame said, “I’ve been rich and I’ve been poor. Believe me, rich is better.” It is hard to disagree with this proposition, with the modification that being rich on a liquid, after tax basis is better than being rich on paper or before taxes. In the current business environment, where things move at internet speed, there are many opportunities to accumulate substantial wealth, but there are also many missed opportunities. By focusing the right issues at key points, an entrepreneur will be able, later in life, to look back on the dawn of the .com era with a portfolio of liquid assets and not just fond memories of an amazing time.