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Taking equity in your clients in exchange for providing PR services

Clients occasionally ask their public relations firms to take at least part of the PR firm's overall compensation in the form of equity. These instances tend to arise when the client is either a startup or a growth-stage company. There are yet other instances when PR firms are so convinced by the compelling business proposition of their client, especially clients involved in emerging technologies, that PR firms on their own accord want the opportunity to participate in the clients' future upside by taking some of their compensation in the form of equity.

This article discusses important factors PR firms should consider when deciding whether or not to take equity in their clients and what form to take.

DISADVANTAGES OF TAKING EQUITY

The equity may be capital stock of the client or other forms of equity such as stock options, restricted stock, warrants, or profit interests. Typically, the terms and conditions of the equity are embodied in various governing documents. In fact, the equity that the PR firm is acquiring may easily turn out to be worthless without a host of rights and protections if the PR firm does not exercise care and include key protections for the PR firm in the governing documents. Even then, the situation is fraught with difficulty for at least four reasons.

First, the PR firm will have to understand the ownership percentage of the equity being offered and be aware that this ownership percentage may likely be diluted in the future. The PR firm may seek to negotiate dilution rights, but those rights are usually reserved for the benefit of investors.

Second, the equity being offered to the PR firm may be subject to preference and priority rights of other classes of equity. Alternatively, the equity may be tied to vesting or forfeiture provisions, which could cause the PR firm to lose the equity if its relationship with the client were to be terminated.

Third, the equity documents can be complex and difficult to understand and subject to change when the client does additional financings rounds. These materials will need to be reviewed by experienced legal counsel. This, of course, would place an additional burden on the PR firm.

Fourth, there can be potential negative tax consequence to the PR firm in taking equity in exchange for services. Specifically, a PR firm may have to recognize as taxable income the fair market value of the equity even if the PR firm has not been able to "cash-in" on the equity. This means the agency would have to go out-of-pocket to pay the taxes and may never recoup that amount if the equity turns out to be worthless, for example if the client files for bankruptcy or never has an exit event.

THE ADVANTAGES OF CONTRACT EQUITY

There is a better solution. A PR firm interested in taking an equity stake in a client should consider obtaining "phantom equity" rights. This is a contractual right to receive certain equity-like benefits, as opposed to actual equity. By way of example, contract equity could be structured to pay a PR firm certain amounts upon the occurrence of certain events, such as a sale transaction or IPO of the client or a successful financing round by the client. Unlike equity documents, contract equity would be between the client and the PR firm only. This means that the PR firm could make certain that its rights were not subject to change for matters outside of its control. Further, contractual equity would not be subject to dilution or preference issues with respect to other classes of equity and should not be a taxable event until it is actually paid.

If done properly, contract equity provides not only many of the advantages to the PR firm of owning equity, but also fewer of the complexities and negative consequences. For example, the parties to a contract equity agreement have greater freedom to negotiate economic points as they see fit. These rights include the percentage of the proceeds to which the PR firm would be entitled, right to receive basic financial information and termination events, i.e., when the PR firm's contractual equity rights may terminate.

The main downside to the contract-equity structure is that the proceeds from any contract equity cannot receive capital gains treatment and will be subject to ordinary income tax. The difference in tax treatment could be material. Thus, the PR firm should consult experienced legal counsel to weigh the various advantages of using contract equity compared to taking actual equity in its clients to determine which form is more beneficial in a particular situation. ●

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