Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 20 - Expiring Stock Options: What Can the Employer Do?

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Taryn Cannataro: Welcome to the latest edition of Just Compensation. I'm Taryn Cannataro, an associate in the Executive Compensation & Employee Benefits Group. And I'll turn it over to my colleagues to introduce themselves.

Darren Goodman: Darren Goodman, a partner in the firm's Employee Benefits & Executive Compensation Group.

Megan Monson: And I'm Megan Monson, a partner in the same practice group as Darren and Taryn.

Taryn Cannataro: Today's discussion will be focused on stock options that are approaching their expiration date and how to deal with this. Typically, stock options expire if they're not exercised within 10 years from when they're granted. Many companies have an exit within 10 years or go public. However, some companies are staying private for longer, particularly in the current economic climate. As a result, early employees may have outstanding stock options that are nearing their expiration date. We frequently get asked what can or should companies do in this situation, which we will discuss today. What is the standard term for a stock option?

Darren Goodman: So Taryn, as you said, in general, it's 10 years for an option, that's an incentive stock option. The 10-year deadline is required by the Internal Revenue Code. It's actually a five-year deadline to grant an incentive stock option to someone who's a 10% stockholder. For non-qualified stock options, 10 years is not required by the Internal Revenue Code, but it's almost universally the maximum term that you see. And the longer term could present bad optics for investors because often when investors are making an investment in the company, they're expecting to have a liquidity event within less than 10 years. And if you have a term that's more than that, you're signaling that the investor could be waiting a long time to get liquidity for their shares.

Taryn Cannataro: So what happens at the end of the term if the options are not exercised?

Megan Monson: The options would expire pursuant to the terms of the underlying option agreement. And typically, any expired options would return to the pool of shares available under the company's equity plan. Although we would suggest checking the terms of your option plan to make sure that's how it works.

Taryn Cannataro: Can you extend the term of an existing stock option?

Darren Goodman: So this is a question that we get all of the time, and the answer is normally no, you cannot. And the reason for that is that under Section 409A of the Internal Revenue Code, if you extend the expiration date for a stock option, if that option is in the money, meaning the stock is now worth more than the exercise price, which is almost always the case for an option that's been outstanding for almost 10 years, if the option's in the money, extending the 10-year expiration date automatically triggers a 409A violation, which means that the option becomes taxable even though it hasn't been exercised. And not only is it taxable, but the option holder faces a 20% penalty tax plus interest. So a very terrible outcome for the option holder. There's a very narrow exception to those rules when an exercise would be prohibited by law. It almost never is the case that that exception applies.

Taryn Cannataro: That does sound terrible. It seems like this should come up all the time.

Megan Monson: It's really less common than you would think. As Darren mentioned earlier, most companies are going to have an exit within that 10-year period or go public. And so for this situation to arise, one, the company would've had to not have been sold for at least 10 years and an employee would have to stick around and still be with the same company through that period of time. So you're having to reach an alignment of all of those factually for this to even be an issue. Also, when employees terminate employment, they typically have a 90-day post-termination exercise period during which to exercise their options. And if they fail to do so, those options would expire.

So again, that's another scenario where options are going to be expiring for a short period of time after somebody leaves. If a company does undergo a sale, this doesn't come up because options are typically cashed out or canceled. And if the company goes the IPO route, it's non-issue because the employee can exercise, and then sell shares to pay the taxes. That said, most of the time this doesn't come up just again for the factual reasons I mentioned. It does come up from time to time, and so companies should be aware of what happens and what their options are when this arises.

Taryn Cannataro: So what can a company do with respect to expiring stock options?

Darren Goodman: There's no silver bullet here. The first thing is that a company can do nothing. They can take the view that 10 years is an awfully long time to decide whether or not you want to exercise. And if someone has elected not to exercise, that's their decision. Sometimes it's just not practical as a business matter. The options might be held by a key employee, for example. And often this issue arises for the earliest employees who often are key employees. If a company does want to do something, they can make it easier for someone to exercise. For example, allowing a net exercise where the person doesn't have to pay the exercise price and the company simply issues shares with a value equal to the spread on the options. It's easier to exercise that way because the person only has to come out-of-pocket for the tax bill rather than the exercise price.

A company could loan the option holder the money to pay the exercise price or even to pay the taxes as well. If someone has incentive stock options, a company needs to be careful because a modification of those options will convert it from an incentive stock option to a non-qualified stock option. So depending on the situation, you could be increasing the tax burden there. It's a case-by-case analysis to decide are you better off having someone exercise an incentive stock option or helping them exercise and converting it to a non-qualified stock option. Another option would be if a company has a lot of people in this situation, a range for cashing out these options. A company itself, if it has a lot of cash, could offer to cancel options in exchange for cash payments. An outside investor could make the same offer if it's making an investment in the company. In the current market, I'm not seeing that much, but it is something that we do see, especially over the past couple of years before the downturn in the tech markets.

Taryn Cannataro: What tools are available should a company want to try to make an employee whole for an expired option?

Megan Monson: So as Darren mentioned, companies are not under any obligation to do anything. But that said, there could be a number of business reasons that a company may choose to try to make somebody whole. In particular, if it's somebody who's been with a company for a long period of time or who is really a key employee that they want to continue to incentivize and compensate them for the expired equity. So there's not going to be any perfect fit or fix. That said, there are some alternatives companies can consider in an effort to give somebody something in lieu of the option that expired. As Darren mentioned, there could be some secondary offering, and they're being paid some value for the options that were otherwise expired.

If the equity plan allows for it or if the company chooses to amend it to allow for it, the company can grant restricted stock units usually with some double trigger vesting and whereby they're given vesting credit for any time-based vesting, but that would also only ultimately vest if there's a subsequent sale of the company. Another alternative would be granting in the money stock options. And that can be a little bit complicated from a tax perspective as you're required to comply with the 409A rules related to that. But that's something that you can utilize as a tool if you're trying to give somebody a new option with an exercise price that's less than the current fair market value. Another alternative would be to grant new options at today's fair market value. But again, they're losing out on the benefit of the value that the company has grown over the past number of years. And another alternative that I tend to see companies utilize is also offering some cash bonus or phantom equity arrangement that intends to mimic the economics that a stock option would've had.

Taryn Cannataro: Are there any other considerations?

Darren Goodman: So one thing to keep in mind is if a company helps one person, it could set a precedent where a company may feel that it should help others as well. And people talk, right? If an employee hears that someone else was helped out if their options were about to expire or there was something done for them, as Megan just talked about, after their options did expire, it can create an expectation that everyone will be treated the same way. It's a complicated topic, and there's no one size fits all answer here. If an employee learns about this, they may decide, "You know what? I want to exercise before the 10 years." Depending on the situation, one of the solutions that we were talking about may make sense. But in general, I'd say it's important for companies to be consulting with outside counsel when this question comes up and for option holders to be consulting with their own tax advisors as to what makes sense for them.

Taryn Cannataro: Thank you very much for joining us today. We hope you found this discussion useful and provided some food for thought as it relates to stock options approaching their expiration date. We look forward to having you back for our next episode of Just Compensation.

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