



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

**Episode 4 -
Early Exercise Stock Options**

By [Andrew Graw](#) and [Megan Monson](#)
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Andrew Graw: Welcome to the latest edition of Just Compensation. I'm Andrew Graw, I Chair Lowenstein Sandler's Employee Benefits & Executive Compensation Practice Group.

Megan Monson: And I'm Megan Monson, Counsel in Lowenstein Sandler's Employee Benefits & Executive Compensation Practice Group. And we're your hosts.

Andrew Graw: So with our podcast, Just Compensation, we focus on a number of topics that clients often come across. And today we're going to focus on a subject that often arises in the context of issuing stock options. Companies often consider whether to grant a stock option with the ability to exercise the option early. That means allowing the optionee to exercise and option before it has actually vested. In this podcast, Megan and I will explain what an early exercise right is, the pros and cons of issuing options with this feature, and some of the practical considerations around granting early exercise rights. So with that, let's start at the beginning with the basics. Megan, can you explain for us what an option with an early exercise feature is?

Megan Monson: Sure. And before I get into it, Andy, I just wanted to thank you for having me on today. It's a pleasure and I'm happy to be talking about this topic. So as you mentioned, options with an early exercise feature allow optionees to exercise their options before the options are actually vested. Most stock options are subject to a vesting schedule, which could involve annual, quarterly, monthly vesting. And the option generally cannot be exercised until it's in fact vested. But this is a way to work around that common scenario.

When you actually go and exercise the option, you're required to pay the fair market value for the exercise price, and then would subsequently become a shareholder in the company. By exercising options that have an early exercise feature, those share you receive on exercise are still going to be subject to vesting. Those shares will vest on the same schedule that apply to the original option grant. The shares that are purchased can also be subject to repurchase by the company at the exercise price if the vesting conditions aren't satisfied before you ultimately terminate employment by the company.

Andrew Graw: So, Megan, what is the optimal scenario for a situation where an option holder would want to exercise an option before it has vested?

Megan Monson: So the optimal scenario would be to grant an option with an early exercise feature and for somebody to early exercise immediately upon receipt of that option. The reason being is the option hasn't had time to appreciate in value between the date it was actually granted and the time that you're actually exercising the option.

Andrew Graw: And also it's giving the individual the opportunity to have the appreciation from exercise forward taxed at capital gains rates if the person becomes vested. And we'll get into why that is.

Megan Monson: That's exactly right, Andy. And that's really one of the benefits for granting stock options with an early exercise feature, is to start running the clock for long term capital gains treatment. Because ultimately the individuals would reduce the amount of taxes they've paid upon sale.

Andrew Graw: Right. And to put a fine point on that it's because option holders often only receive ordinary taxable income when they exercise either because the option is granted as a non-qualified stock option, so it's always taxable as ordinary income at exercise, or if it's granted as an incentive stock option or an ISO. Optionees often don't meet the holding period requirements in order to have capital gains treatment associated with those ISOs.

Megan Monson: And one point to just add on to that is, in order to take advantage of the long term capital gains treatment, the individual would have to file an 83(b) election within 30 days of the exercise of their option and the issuance of the underlying, we'll call, restricted shares that they receive. So that's an administrative step that both the company and the option holders need to be aware of in order to get the tax treatment that's advantageous.

Andrew Graw: Right. And that's really critical because the only reason for early exercising an option is so that the person can make an 83(b) election and start the clock running for capital gains treatment and also to set their basis as the fair market value of the stock received on exercise as the basis of the stock that they're receiving, less any amount that they've paid for it.

Megan Monson: And unfortunately the IRS is not all that forgiving. So there's really no flexibility if that 83(b) election isn't timely filed. So you have one shot to take advantage of it.

Andrew Graw: Right. You do have 30 days. But if you miss that 30 day period, you're just out of luck. And what you'll have is ordinary income when the stock vests in the future. So the ideal spot for somebody to early exercise where just like with restricted stock awards is that they're expecting the value of the stock to appreciate considerably so that they'll have capital gain stocks on the appreciation, but also they are recognizing relatively little income at the time that they're making the 83(b) election. Maybe you could expound on that a little bit.

Megan Monson: And that's exactly right, Andy. One of the benefits for early exercise stock options is the tax savings. And if the individual is exercising at the time that the option was granted or shortly after, there's not going to be any appreciation in the fair market value of the company. So in effect it would not really be a taxable event. One point that I wanted to touch on that related to what you've just mentioned Andy, in terms of restricted stock. A lot of companies may think about whether or not to grant options or restricted stock and what the differences are between options with an early exercise feature and restricted stock.

I think the benefit of granting options is that individuals still have to pay that exercise price. So they're still having to come out of pocket to take an ownership interest in the company. So it gives them a little bit of an additional incentive and head in the game versus with restricted stock, they're not required to come out of pocket for anything. And so they have a little bit different incentive in order to get that benefit.

Andrew Graw: Right. And I guess another aspect of it would be that when a company starts out granting options, they typically would grant more shares subject to an option because there is an exercise price, whereas restricted shares being considered full value shares because they provide for value from dollar one of the company you would normally grant fewer shares.

Megan Monson: Exactly. And I just wanted to make that point in that distinction, because I think that's something that we see come up often with clients who are weighing their alternatives in terms of what they're going to grant employees.

Andrew Graw: So tell us some of the downsides, I guess we've already touched on them. But maybe you could just take us through some of the downsides for granting early exercise options.

Megan Monson: Of course. So we've touched on a couple of the negatives. First and foremost is potential tax on exercise. That's really only going to come up if we're not in the scenario where somebody early exercise immediately or at the time of grant, when there's actually an appreciation and value from the time the option was granted and the time optionees actually exercise. There's also some risk that if an individual exercises the option and pays the exercise price, that stock in particular, because most of the time this is done in a private company context, those shares may never be liquid. And so there may never be an appreciation event. So you've paid money to take an ownership interest into equity, but you're never having an ultimate payout. So I'd say that's really one of the most significant risks with an early exercise option or in general exercising any stock options before a sale event.

Andrew Graw: Again, it comes back to whether or not the individual is exercising with the firm belief that the stock is going to go up in value. Certainly if somebody is an option holder in a company, the company wants to see the value of the company improve so that's a natural expectation for the option holder. And it's certainly right in line with the objective of granting the options in the first place.

Megan Monson: That, and they also want to be planning strategically for an exit event. So whether that's an ultimate sale of the company, a complete sale or sale of its assets, or an IPO, if that's the long term trajectory of the company and they ultimately have one of those events, the option holders would ultimately be paid out for those shares. But if that never occurs, that's a risk that you're taking that you're not getting a return on your investment.

Andrew Graw: Anything else in regards to potential downsides or pitfalls associated with early exercise options?

Megan Monson: Yeah. So a couple of other things I just want to mention is, again, there's the risk to fail to file the 83(b) election. Related to that there's also additional administration required with the early exercise options. The company has to monitor to make sure that the option holder files the 83(b) election so that they know how to treat it from a tax perspective. Also, from the company standpoint, you may prefer to have a limited number of stockholders. So this is a scenario where you're essentially encouraging people to become stockholders of the company at an earlier point in time.

Andrew Graw: Well, that brings us to a point about what happens when someone early exercises. So when they early exercise and become shareholders, in addition to executing a restricted stock agreement that contains the same vesting conditions as applied to the stock option, we also would want the individual to become a party to a stock restrictions agreement that limits the ability of the individual to take certain actions as a shareholder. Correct?

Megan Monson: That's exactly right.

Andrew Graw: Can you tell us about some of those?

Megan Monson: Sure. So I think as you said, you want to be limiting the ability for those stockholders to take certain action. So sometimes it'll come up that if there's an ultimate sale of the company, those individuals have limitations where they could be dragged along if they aren't voting a particular way in the transaction and other similar restrictions along those lines.

Andrew Graw: Right. So they would have, for example, be subject to an agreement that would provide for drag along rights, so that if there's a sale of the company they couldn't hold up the transaction as a minority shareholder and would have to vote along the same lines as the majority. They would also normally be subject to a right of first refusal, so that if they later on wanted to sell their shares, they would first have to offer the shares to the company to keep them within the company family rather than to some outside third party. And there would also typically be repurchase rates, where the company would be able to repurchase shares for fair market value, unless perhaps if the individual were terminated for cause. Are there any other repurchase situations, Megan?

Megan Monson: So some companies have actually taken the approach where they want there to be a punitive repurchase right. So not simply in the termination for cause scenario, but even if there's a resignation by the individual. They'll also treat that similar to, as you just mentioned, for cause, where there can be a

repurchase for the lesser of fair market value at the time of termination or the price the individual paid. And so, that's kind of a disincentive for individuals who are leaving the company to leave because they're not only getting their potential equity repurchased, but it could be at a cost that's less than what the equity is currently valued at. And there would be corresponding tax consequences to that.

Andrew Graw: Right. And I think it's safe to say that when we have early exercise option features, the most interesting part about those features is really the stock restrictions agreement that the person would be subject to once they early exercise in order to wrap them up, so to speak, as a shareholder and not be able to just sell or transfer their shares to anyone without the company's involvement.

Megan Monson: That's exactly right. And so companies tend to draft those in a way that are going to be more protective of the company and giving them more flexibility, whether it's limiting transfers, having company favorable repurchase rights, but they still want to have control to the extent they can over those underlying shares.

Andrew Graw: And if perhaps there's, for some reason, the individual was not already subject to employee covenants, such as noncompete, non solicit, non-disclosure, that would be an opportunity to condition their early exercise on them, agreeing to those kinds of covenants.

Megan Monson: Yeah. That's a great point. Because something that tends to come up is that you need additional consideration for getting existing employees to sign on to those type of covenants agreements. And by giving somebody an option with an early exercise feature that would cross that hurdle.

Andrew Graw: Megan can a company that has an equity plan that does not already have an early exercise feature modify it in order to include an early exercise feature and even amend outstanding options to allow for early exercise?

Megan Monson: Of course. So this can be done in a couple of different ways. The first step would be to amend the plan itself to allow for the granting of early exercise stock options. And creating a specific option award agreement that, again, allows for this early exercise feature and adds the requirement that those individuals will sign a corresponding doc restrictions agreement. With respect to the point about, can they offer this to individuals who already have outstanding options? The answer to that is also, yes. But with the caveat that, if it's done for outstanding options, it's typically going to require optionee consent.

Because most option plans and option award agreements allow the company to only make unilateral changes if they do not adversely impact the individual. And it becomes a question of whether this change could be viewed to adversely impact the individual option holder or not. In particular, if somebody was granted an incentive stock option, adding this type of feature would be considered a modification that would essentially reset the option grant unless their consent was received. And then it would otherwise convert the option into a non-qualified stock option for tax purposes. But that doesn't really

make a huge difference because of the tax benefits you're getting from having an early exercise stock option.

Andrew Graw: Good. Well, I think we've covered a lot of ground with respect to early exercise features for stock options. Is there anything else Megan, that you want to touch on before we wrap up this segment?

Megan Monson: So, I just want to point out that everything we've discussed, really the key to all of it is having proper documentation. So making sure that, not only your plan allows for granting options if you're going to grant them, but that you're keeping track of them appropriately and administering your plan in consistent with those options. Because as we mentioned, there are additional administrative hurdles and corresponding tax consequences. So we just want to make sure that you have somebody who's responsible for the oversight of the plan and it's administration.

Andrew Graw: Great. So clearly there are pluses and minuses to granting options with early exercise features for a brand new equity plan. Good idea to include an early exercise, a feature in the plan so that the plan doesn't need to be amended later on in order to allow for it should the company wish to make option grants with the feature. But of course it remains up to the company as to whether or not a particular option will be granted with an early exercise feature. I guess one more question, Megan. And that would be, do you typically see companies grant options on a broad base to employees with this feature or is it limited to select group?

Megan Monson: So, historically, I'd say it was offered on a one off basis to certain key executives because they really want to incentivize those folks in giving them something with an additional benefit. However, I've seen it become much more commonplace to, one, as you suggested, have plans that automatically allow for this. And two, to grant awards on a more wide scale basis with this feature. The downfall, as I said, is really the administration involved with these awards. So that's just something to be cognizant of. But I am seeing in the market a lot more companies granting these on a wider scale basis.

Andrew Graw: All right. So that's great. It certainly gives employers another tool in the toolbox in order to incentivize their key executives. So, in this podcast we've had an ability to go through the pros and cons of granting options with early exercise features. We certainly hope our listeners got a lot out of it. If there are any questions regarding early exercise features or equity plans in general, feel free to reach out to me or Megan with assistance in the future. We'll continue to bring our listeners podcasts on a variety of subjects, dealing in the employee benefits and executive compensation arena. We'll bring podcasts that deal with practical issues that our clients see on a regular basis. Thank you so much for joining us today. We look forward to having you back for our next episode of Just Compensation.

Megan Monson: Thanks for listening in. We hope you'll join us next time.

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