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

Episode 6 - Founders' Stock: What if You Missed the Boat?

By Megan Monson, Christine Osvald-Mruz, and Chandra Shih

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Megan Monson: Welcome to the latest episode of Just Compensation. Today, we're going to talk about founders' stock and what to do if you miss the boat. I'm one of your hosts, Megan Monson, Counsel in Lowenstein Sandler's Employee Benefits and Executive Compensation Group.

Christine Osvald-Mruz: I'm Chris Osvald-Mruz, Partner in the same group as Megan.

Megan Monson: We're also joined by a special guest speaker today.

Chandra Shih: Hi everyone. I'm Chandra Shih, I'm a Partner in Lowenstein's Tech Group on the Deal Team. I work with emerging companies and venture funds and folks in the startup and tech space.

Christine Osvald-Mruz: So there's the classic startup vision, founders and early employees of a company get stocked when the company is new and has very little value. The ideal is to purchase or grant the shares when the value's low and in such a way that there's little tax to pay and then ride up on the value of the appreciation as the company becomes wildly successful.

Megan Monson: But the common problem that comes up is sometimes you just miss the boat. It could be because people join the company at a later point in time when the company has already increased value. Other times it comes up when founders promise early employees stock options or restricted stock, but for one reason or another, they don't get around to granting them until a later point in time, when the value of the company has since increased.

Christine Osvald-Mruz: We often get the question, what do we do now? Because of tax rules, you can't just go back in time. During this podcast, we'll talk about this in more detail, but this is one of those situations where I would say there's no perfect answer. Often we see companies and help companies do what I would just refer to as some form of rough justice here.

Megan Monson: So today's podcast is going to focus on this issue, but in the context of C corporations, while limited liability companies or LLCs may take it a different approach with the availability of profits interests and the ability to do catch up grants, that's a topic for another day. So to dive right in, we're going to kind of start on laying the foundation. What are the common types of founder equity that you see companies granting to visuals?

Chandra Shih: So I think from my perspective, typically for what I'll call "true founders," really, we see those folks coming in at the outset of the formation of the company. They are purchasing shares of common stock from the company at typically a nominal price in exchange for some small cash payment and also transfer of the initial assets related to the business. The business plan, if they have any other sort of soft or hard IP related to the idea. You sort of transfer all that over to the company in exchange for your initial shares.

Sometimes, we see other early folks incentivized with restricted stock grants. Shares of common stock that are granted to individuals typically in exchange for services where those folks are not paying out of pocket and instead are receiving the value of those shares as compensation. And then the other method we see used is sometimes stock options. Non-qualified stock options or incentive stock options used to give folks the right to buy shares at today's price, some point in the future.

Megan Monson: Are there some reasons why an individual might prefer one of these types of equity versus another?

Chandra Shih: Yeah, I think for sort of the true founder scenario, they are really benefiting from purchasing shares at the outset by paying a little bit of cash and contributing IP in order to get these shares today at today's value. The way that's usually set up is whatever the sort of value of the shares are, the fair market value, they are paying that today. And so what that means is the difference between what they've paid and what the fair market value is, is zero, meaning they're sort of zero tax hit to them. Assuming they're either receiving the shares fully vested, or if they're subject to vesting, they're filing an 83(b) election and choosing to sort of be taxed today. But that really gives them the benefit of no tax, very low purchase price on the shares, and they get to start their holding period for capital gains purposes and other things because they own the shares today.

Similarly, with the restricted stock grant, even if they may not be paying for the shares today, they are still receiving the shares today. And in theory, if it's early enough in the company's life cycle, the value of those shares is relatively low. And so even though they may have some type of tax hit related to it, in theory, it's a very low price point and it's worthwhile for them to do that.

Similar to the founders who are purchasing stock, when they're receiving those shares as a stock grant, they're actually a stockholder of the company, they're starting their holding periods for capital gains purposes and otherwise. Folks who are receiving stock options, the big benefit there is that you don't have a tax event when the options granted to you, but you don't actually own the shares. You're not a stockholder yet. You just have a right to buy them, when the vesting lapses or what other conditions are put on it. And so you don't have a tax event. You haven't come out of pocket at all yet. You can kind of wait and see if you want to become a stockholder and pay money, but you don't get to start your holding periods.

Megan Monson: That makes a lot of sense. From a company standpoint, I guess, putting aside the true founders who are really more likely going to get that stock purchase, is it more typical or more beneficial from the company's side, to issue restricted stock versus stock options or what you see be used more often?

Chandra Shih: Yeah, it's interesting because oftentimes it's driven by the recipient. Some folks are very, very focused on the way that the equity is being granted and have a really strong preference for either restricted stock or options. I do sort of see it both ways. I think big driving factors for the company are one, what does the employee or other service provider want? Two, do you want this person to be a stockholder or not?

Certainly when you give someone a stock option, assuming they vest through the option, they have the ability to become a stockholder, if they want to pay money to exercise the shares. Not everyone's willing to do that, and so one kind of interesting thing is that by giving someone a stock option, instead of shares of stock in a stock grant, you might actually end up with fewer stockholders at the end of the day, because people oftentimes don't choose the exercise, especially if they leave the company, it's still early, they may not have the cash to exercise or may not believe in the vision of the company and may not want to exercise. If you had given them a stock grant and they became a stockholder, they'd already own the shares. Typically, companies can repurchase those shares that are unvested, but whatever they vested through, they own and they walk away with, and they stay a stockholder on your cap table. That's kind of one interesting decision point, I sometimes see people think through

Megan Monson: In teeing up this conversation, we mentioned that sometimes you miss the boat, right? The value of the company has increased. You haven't yet granted stock options or restricted stock for one reason or another. Why can't you just go back in time and grant it with a retroactive, effective date?

Christine Osvald-Mruz: Let's take each type in turn, starting out with the stock purchase. The fair market value of the stock is much higher now. So purchasing at current fair market value may be too expensive. It may be cost prohibitive. If a company lets its service providers purchase stock at less than the current fair market value, the excess counts as compensation income and is taxable, and there's no cash to pay the taxes on that. And also if it's compensation to an employee, the company has a duty to withhold and pay taxes on that amount. If we turn to the stock grant kind of idea of restricted stock, subject to vesting, and here we are down the road, and again, the price has increased, the fair market value has increased, it's taxable as compensation, because it's a grant and again, without cash to pay the taxes.

And the recipient would be faced with the choice of, do you make an 83(b) election and pay tax now at this higher current fair market value, so higher taxes. Which you might do if you were expecting the value to increase, but then you're going to run the risk of losing that tax, if you end up forfeiting the stock or you could choose not to make that election, if you're the recipient of this kind of a grant and then you would have to pay tax on each vesting date, as it vests at the then current fair market value of the tranche that's vesting, which if the company is wildly successful, is going to get very expensive at various points in the future and where you're going to get the cash to pay the tax.

Chandra Shih: I also think from a practical perspective, it is very administratively burdensome for a company to try to help a stockholder figure out what the fair market value of their shares are, each time they vest. Really typical vesting schedule is something over four years, the first sort of 25% would vest after year one. And then after that, it's literally a monthly vesting event for the last three years. For non-public companies, you don't have a sort of market price or trading price that you can look at every day to come up with fair market value. So what that means is every month as shares are vesting, you as the company may have a withholding obligation and the employee or whoever holds the shares, will have this sort of tax event that's happening monthly and you have to together figure out what that actually translates to in real dollars. It's just not practical at all.

Christine Osvald-Mruz: That's such a great point, Chandra, it really is. And then just turning to the last type of equity grant that we talked about with this. So you're down the road, it's wildly successful. Now, if you get granted stock options, they have to be granted at current fair market value, which means there is a much higher exercise price than you would've had, you can't back date stock options as we started talking about. And so it's not as valuable of a grant at this particular point in the company's history and progress.

Megan Monson: Regarding back dating, why can't you back date these type of awards?

Christine Osvald-Mruz: I think it will probably make sense to run through them in turn again, like before. So with the stock purchase, you weren't an owner, you didn't get the stock, you didn't buy it back then. So in all of the company's tax and other records, you didn't make this purchase back then. So you really can't undo time. With this stock grant, the 83(b) election has to be filed within 30 days of the data grant, no exceptions. That's one of the few entirely inflexible things that there is in this world and that's very inflexible. So if you missed that, you missed it. But if you didn't make an 83(b) election, then as we were talking about, you have tax on each vesting date at current fair market value. With the stock options, if you put a below fair market value on date of grant exercise price on them, it's a violation of the deferred compensation holes under section 49(a) and the individual will have penalty taxes and the company will have reporting obligation and then it gets very ugly, very quickly.

Chandra Shih: And I think from a practical perspective, for each of these types of equity issuances, there is a formal board action that's required to be taken in order for the equity issuance to be effective. The board needs to have approved at a meeting or by written consent, the details of the issuance and that includes price and that approval has to be at a present date. And so from a practical perspective, you can't sort of go back in time and try to back date that board approval. It is effective as of whatever date the board actually formally approves it. And that's the date you're stuck with, and the price on that day, is the price that you're stuck with.

Megan Monson: That all makes a lot of sense. So I think we focused on why you can't go back in time, what the problems are with it, but what can you do to make up the value for employees when you've promised them something, but haven't gotten around to granting that equity and the value of the company has since increased. I'm curious what you guys see from a practical standpoint and what companies are doing to make people whole.

Christine Osvald-Mruz: There's a range of options, and I'm going to ask Chandra to do the really practical what she sees the companies doing, but I'll give you kind of a list of some things you could do. And then we can talk about what we're actually seeing people do. One is, you could grant extra options at the current fair market value. If you have room in your pool, because usually there's a pool set aside and granting a whole lot of extra options, you may run out of allotment to do that. If a company has cash and startups typically don't, so this is not very practical of an option, you could pay bonuses to cover taxes for a grant of restricted stock or a grant of unrestricted stock. But then the bonuses tax too. Companies can make loans to employees again, if they have cash. And sometimes I think Chandra, you can talk about this in more detail, but sometimes they'll do this in connection with early exercise options.

Another possibility is granting something called restricted stock units, which is a right to be paid in cash or shares on settlement, typically these are settled on vesting. The problem is that if RSUs are settled in shares, then the person has a tax hit when the shares get delivered, without necessarily having any cash to pay the taxes. There are some fancy alternative ways to structure RSUs that can involve both time vesting and liquidity vesting so that you wait till there would be liquidity, but this gets to be kind of a complicated and a long term approach for a startup that's trying to keep things simple and you can do a combination of these, but Chandra, I'd love your thoughts on this because I know you have direct experience with this probably daily.

Chandra Shih: Yes, we do see this problem come up a lot. And really the solution depends on the company and the folks who are entitled to this equity and haven't gotten it at the price they were expecting. Certainly if you've got one person who's a senior exec, that you're trying to get equity to now at a more expensive price, something like doing recourse promissory loan, to allow them to either pay the exercise price for the options or pay the purchase price to purchase shares, is something that we do see, and it's something that's potentially appropriate for someone who might be a more senior executive. Those loans, there are certain features that we expect to see in them. The person typically pledges the shares to secure the loan. The loan is decently long term and it is recourse, right?

So the person does have an obligation to pay it. They can't just forfeit the shares and have that sort of do away with the loan, right? That may not be the appropriate solution, if it's 30 employees who over the course of a couple of years, were promised options and they were never granted. Certainly the company's not going to go out and do this sort of promissory note thing with all of those folks. Instead, a lot of times we see either granting folks a little bit of extra equity to kind of say, "Oops, I'm sorry. Here's more." Which gives them honestly great upside. If the company sold, having that extra equity can mean a lot down the line, right? Or we see people go with the kind of cash payment, some type of a bonus or cash amount to sort of either try to make them whole, or give them a little bit of extra cash to compensate them.

Chandra Shih: Neither of them are perfect solutions because you just really can't solve for having gone back in time and giving them the benefit of a lower price. As Chris mentioned with the cash payment, that bonus payment, or however you want to structure it, is taxable itself, right? And so you can end up in this big circle of, do you try to true it up and how do you calculate it? And same with granting additional equity to folks, it's not usually a perfect solution. But really, employees appreciate that you're making an effort to try to write a wrong and it's usually a good opportunity for companies to go, "Wow, I'm never going to make that mistake again. I'm going to get a lot more serious about my equity granting practices, making sure we're doing it regularly and that we're paying attention to it," because it can be a costly thing to try to fix down the road, right? You're giving away real cash or real percentages of the company to folks that you otherwise sort of didn't have to, had you granted things earlier.

Megan Monson: No, that's a great point. And one thing I just want to mention and add on to that is if people are promised some sort of equity in writing in particular, and you're not granting it when it was promised and at a much later point in time. And so that there is an argument that they're entitled to something potentially more, it's good practice to try to get a release of claims from those people in connection, whether if it's a larger equity grant or a bonus, because you don't want to have any kind of open ended issues. Again, that's going to depend upon what your documents say, as well as the number of people involved. That's just something else to consider when kind of trying to correct and figure out the best way to navigate these issues.

So I think we've focused on a lot of great points today. Unfortunately, sometimes if you miss the boat, you just miss the boat. But in the case of founder stock and the tax rules do limit the options for making up for lost time and value. Although we've tried to highlight some of the common ways to give people rough justice in granting additional incentives while there's no perfect solution. Again, the goal is I think to get people as closely situated as possible as they would've been, if they were granted equity in the first instance.

Thank you so much, Chris and Chandra for joining us today and for our listeners joining us for this episode of Just Compensation. Hopefully you found the content helpful and we look forward to seeing you again next time.

Christine Osvald-Mruz: Thanks everyone.

Chandra Shih: Thank you all. Thanks for having me.

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