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

Episode 7 - Common Equity Plan Pitfalls

By [Megan Monson](), [Taryn E. Cannataro]()
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Megan Monson: Hi and welcome to the latest episode of Just Compensation. I'm one of your hosts today, Megan Monson, Partner in Lowenstein Sandler's Employee Benefits and Executive Compensation group, and I'm joined by my co-host...

Taryn Cannataro: Taryn Cannataro. I'm an Associate in Lowenstein's Employee Benefit and Executive Compensation group.

Megan Monson: Thanks so much again for joining us today. We're going to focus on a topic that affects many companies that are taxed as C corporations and could have long ranging tax impacts, impacts on employee retention, finance, and corporate governance across the board which is, common pitfalls in equity incentive plans.

Our focus today is going to be talking about typical snags and pitfalls that we see arising in private companies' equity incentive plans. We're going to discuss these common pain points that we typically see with the hopes of helping you to avoid these issues in your own plans going forward. Of course, with any topic, we're not going to be able to cover all issues that arise and that affect equity plans in today's podcasts. But again, our goal is to focus on some that we see the most frequently and that may be burdensome to fix. This might be helpful from your standpoint in terms of strategic planning if you're considering either adopting a new equity incentive plan or issuing equity awards from an existing plan. As mentioned, Taryn and I are going to touch on some of these items for your consideration. So getting right into it, Taryn, what's a common pitfall that comes up on a regular basis with respect to equity incentive plans?

Taryn Cannataro: Megan, while it's hard to single out just one issue is the most common, I'd say one issue we see frequently, which could have a number of undesirable repercussions is a failure to grant stock options at or above fair market value or a failure to document the methodology for determining fair market value or exercise price. While we will discuss in further detail on a future podcast, there are few items to note here. Section 409A of the internal revenue code is a complex section of the tax code that regulates non-qualified deferred compensation. 409A could impose significant penalties on stock options that are granted with an exercise price that is less than fair market value as of the date of grant. For non-public companies, this is often due to a failure to obtain an independent valuation at least every 12 months. For non-public companies, fair market value must be determined by a reasonable application of a reasonable valuation method. In practice, many companies choose to obtain a 409A evaluation from a third party appraiser to determine fair market value, which generally provides a rebuttable presumption of accuracy for up to 12 months.

Megan Monson: Yeah, that's a really good point about the 409A evaluation. I mean, in general, you're right, that they are presumed to be valid for a 12 month period of time. But one thing I'll point out is that they can become reliable if there's a material event within that 12 month period that could impact the value of the company such as entering into a term sheet, having a financing round, having a sale of the company, launching a new product, entering into material contracts, and things of that nature. So it's really important to kind of keep that in mind when relying upon a 409A valuation to make sure that equity is being granted at fair market value. I think it's also important to note that if a company incurs one of these material events, that's a common scenario where we see options granted at an exercise price less than fair market value, so it's something that's really important for companies to be diligent about. Is there a reason that kind of this issue doesn't come up in the context of public companies?

Taryn Cannataro: Yes. So public companies typically can rely on their trading value to issue stock options. So it's easier to value the fair market value for the public companies.

Megan Monson: That makes a lot of sense, appreciate that. Are there some other kind of typical pitfalls that you see coming up on a really regular basis?

Taryn Cannataro: Another issue that arises frequently is the failure to properly and timely document grants and also to follow corporate procedures, but treating the awards as approved. So for example, there may not be a board consent or the award agreement may be incorrect, but the individual employee believes that they were properly granted the stock options and the companies treating it as such.

Megan Monson: That's actually a really helpful point because I feel like that comes up where it raises questions of whether or not awards were actually granted and if they were at fair market value. And so in the context of, again, a financing or a change in control and somebody's looking at these documents in hindsight, that could be a really big area where there could be a disconnect and you want to make sure all of your documentation lines up.

Taryn Cannataro: Exactly. Relatedly, it's also common for there to be a delay in obtaining board approval of equity grants promised to employees. This could result in an increase in fair market value and therefore the exercise price, which could create issues with employees who are expecting an exercise price that is lower. Sometimes companies will promise option grants to prospective employees in an offer letter. One of the most important points to remember here is that any proposed option grants that are detailed in an offer letter or employment agreement should remain subject to board approval. In addition, another concern is when the value of the company increases before the option is granted. Most companies do not want to grant options at less than fair market value. An option will not be able to do so by the terms of their plan, because the plans will need to comply with 409A.

Megan Monson: Another point on the corporate governance issues that you've been talking about that I see come up fairly frequently is that a company fails to keep track of the number of options being granted against their pool of options that are authorized under the plan. So that can have a host of implications. One being, if you grant options in excess of what the plan allows, you're now no longer able to rely upon the plans securities exemption for granting those options. And then it becomes a question of what can be done to correct it. So it's really important to keep track of your cap table and making sure that you're not granting options in excess of your pool. It's a pretty simple matter to increase your pool, it just requires board approval and if you want to grant incentive stock options stockholder approval. So most often when you're dealing with at least relatively small C corporations, it's not an issue to get the necessary approval.

Taryn Cannataro: Exactly. And often when you want to make employees whole, and you can't issue options under the plan, you may be required to provide a cash bonus in lieu of options or find some other way to compensate them or make them whole, which is not necessarily the intended outcome of the option grant.

Megan Monson: Yeah, that's a really great point. And I think across the board, it's just really helpful to keep in mind that all of these implications that Taryn and I've just mentioned are going to not only have potential tax implications, but there are also again, corporate governance considerations that could be relevant down the line and you have to think of things from the employee retention perspective as well.

And so any of these issues that impact employees can potentially sour the employee relationship unless you do, as Taryn suggested, and trying to make employees whole in one way or another. There's a couple of other issues that we haven't touched on yet that I've seen a lot of companies ask me about, I'd say on at least weekly, if not more frequently basis. And one of those is making sure that your equity plan allows for a lot of flexibility in the event of a change in control. Part of that is you're not going to know what's going to need to be accounted for at the time of a sale and so you want to make sure that you can treat options and other outstanding equity awards however you need at that later point in time.

Taryn Cannataro: Exactly, Megan. And I would say that one important point that we would want to see in most equity plans is that the company has the unilateral ability to cancel awards. So for example, one provision that we often find missing from documents is the ability to cancel vested awards in exchange for payment equal to any gain without option holder consent, or the ability to cancel unvested awards or underwater options without payment of consideration.

Megan Monson: Yeah, that's a great point because I see that come up very frequently as well. And companies will tend to ask if their plan doesn't allow for that, what are the alternatives? And one of the things they can do is seek an option cancellation agreement from individuals and get their consent to the cancellation, but that can be administratively burdensome depending upon the number of option holders they have and the deal timing. So it is best practice to kind of have that hardwired into your plan to provide yourself that flexibility up front. And related to that, I think it's just in general good practice to make sure that the company has the ability to take any actions unilaterally without the consent of the equity award holder. Because again, that just reduces any sort of administrative burdens and paperwork, whether it's in the context of a change in control or more generally in terms of administering the plan. So since we've been focusing on some of these administrative hurdles, is there anything else that a company can do to be proactive and try to avoid these issues?

Taryn Cannataro: Yes. So I think the easiest and quickest way to avoid a lot of the issues we've been discussing today is to adopt a standardized state of the art form of award agreement. Similarly, avoiding any variations in award agreements and side deals. This helps to just streamline the grant process and it helps companies avoid the administrative burden of coming up with individualized award agreements and also helps companies to maybe keep their costs down when granting awards. Another recommendation would be to make sure the plan provides a company with enough flexibility to make important determinations in its so discretion, as Megan said earlier. And that should be not only in the plan document, but also in the individual award agreements.

Megan Monson: Those are all really great points. Something else that I've been suggesting to clients on a going forward basis, because I've found that it does help, especially if they are doing a lot of the administration internally is providing them with a checklist for when they're granting equity incentive awards. So it goes through what are some I think typical considerations and issues that they would face, helps them get the documentation done properly, and it also highlights some of the pitfall areas that we've mentioned so far so that they know if those are things that come up or they're doing something kind of off of the norm, those are scenarios to give their attorneys a call to again, make sure that they are granting awards properly and also treating awards properly as people exercise or leave the company.

It's also helpful if they have somebody who's dedicated to administering the equity plan, whether it's somebody internally or they have an external third party provider. But again, it's just helpful to have somebody not only maintaining the cap table, but keeping track of all of the relevant documentation making sure there's executed board consent, award agreements, things of that nature. So we've been focusing on a lot of common equity issues that arise throughout the normal life cycle and course of administering an equity plan. But what about when employees are leaving the company? Are there typical issues in that context that companies should be aware of?

Taryn Cannataro: One issue we see come up frequently is a company attempting to extend the post termination exercise period for incentive stock options. Because of the rules of incentive stock options, the post-termination exercise period cannot be longer than 90 days. So while you can extend the post-termination exercise period for incentive stock options, it would convert those incentive stock options to non-qualified stock options. So the company should make sure that that's the intended result and make sure that the employee is clear on the fact that they will be holding non-qualified stock options after the post-termination exercise period is extended.

Megan Monson: And just to note quickly on that, that's going to typically require not only board approval, but also approval from the individual option holder. So again, it's just really important to make sure that you're having the proper documentation in place to affect that.

Taryn Cannataro: Exactly. And sometimes this conversion from incentive stock options to non-qualified stock options could happen unintentionally if the offer to extend the post-termination exercise period is left open for more than 29 days. So any offer to an employee to extend the post-termination exercise period should be kept open for 29 days or less.

Megan Monson: That's a great point. And it is I think a footfall that a lot of companies don't realize and could inadvertently trip up over.

Taryn Cannataro: Another issue that we see arise is when a company wants to accelerate vesting for departing employees. In the event that you want to accelerate vesting for an employee or service provider, it's important to review the plan document and corresponding award agreement to determine when their unvested awards are forfeited. It's very common for unvested awards before fitted upon a termination of service. Therefore, any acceleration of vesting would require necessary approval prior to the termination date. So proactive planning is key here if we want to accelerate vesting for any departing employees to avoid last minute scrambles.

Megan Monson: That makes sense. And again, that's something else that would require board approval typically. So it's just really important to be thoughtful in terms of the timing involved. Another common issue that we see is individuals who transition from an employee to a consultant while they're holding incentive stock options. And I see this question come up time and time again. While you would have to look at the underlying documents applicable to this individual, it would generally involve any stock options that have vested would remain incentive stock options, and anything that would vest during their time as a consultant would be converted to non-qualified stock options, whether or not those vested stock options must be exercised within a certain period of time following the transition to a consultant in order to remain incentive stock options is going to be dependent upon the plan document and the individual award agreement.

So it's important to be not only reviewing those documents to understand what the treatment is, but also to be able to answer employee questions, because a lot of people when they do face that transition want to understand how that impacts them.

Taryn Cannataro: Exactly. And I think that's just another example of where proactive planning can help avoid some issues.

Megan Monson: So throughout this podcast today, our goal was to give you some high level food for thought on again, just some frequent issues that we see in equity plans, but it's by no means intended to be exhaustive, and it may not apply to your particular situation. It's always important to not only review things as they arise against your plan documents and award agreements, but we hope that by highlighting some of these issues, they're things that you can become aware of and try to mitigate against on a going forward basis.

Two key takeaways I just want to reiterate that we've been talking about throughout are, you should always have proper documentation and approval of all equity awards because that's not something that can always be fixed after the fact, and it can help mitigate against a lot of these issues we identified. And it's also really important from a tax planning perspective for both the employee and employer in terms of issuing equity awards. So that just kind of highlights, and again, another reason to make sure that you have not only proper documentation, but you're following the terms of the plan granting awards when they're promised, granting it no less than fair market value and all of these other things that we've mentioned. Proper drafting and structuring of the equity plans upfront can also help avoid a lot of these issues. So again, it's really important to make sure that you are being proactive as Taryn mentioned throughout this process.

We're hopeful that you haven't yet experienced any of the issues we've discussed today. However, if you have, or if you're planning to implement an equity plan or issue new equity under an existing plan in the future, as always, we'd encourage you to consult with council to help avoid these issues or figure out how to best navigate and fix any issues that have arisen going forward. Thank you so much for joining us today. We look forward to having you back for our next episode of Just Compensation. Thanks for tuning in.

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