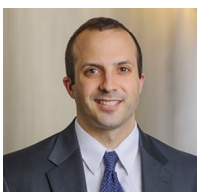


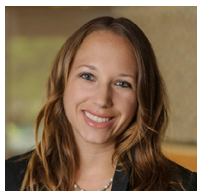
# Should You Offer RSUs? Restricted Stock Units as an Attractive Executive Compensation Option

A Practical Guidance® Article by

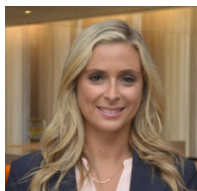
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Top level talent remains in high demand, and many employers are seeking innovative ways to lure and retain executives. That can pose a challenge for many employers, in particular later stage start-ups, for whom stock option grants (traditionally a significant element of compensation) may be insufficient to recruit or retain employees.

In this situation, one potential solution is to grant Restricted Stock Units (RSUs).

## What is an RSU?

An RSU is a contractual right to receive shares of stock in the future. Unlike a restricted stock award, where the employee is actually transferred stock on the date of grant, a person who is granted an RSU is not a stockholder on the date of grant.

RSUs, as with any other equity award, are normally issued under an equity incentive plan, and require approval by a company's board of directors or compensation committee, as well as execution of an award agreement by the recipient of the RSUs.

The terms of RSUs are determined at the time of grant, and, among other things, RSUs are normally subject to a vesting schedule. For example, a typical time-vesting schedule would provide that 25% of the RSUs vest on the first anniversary of the date of grant, and the balance vest in equal monthly installments over the three-year period thereafter (subject to continued employment with the company through the applicable vesting date).

Alternatively, an RSU could vest upon achievement of company-wide or executive-specific performance targets (such as the achievement of company revenue targets), again subject to continued employment through the date the targets are achieved.

In each case, the shares underlying RSUs often "settle" (in other words, are issued) on or shortly after vesting.

RSUs are "full value awards," meaning that, unlike stock options, RSUs do not have any exercise price or purchase price. This can make RSUs more attractive than stock options, for multiple reasons.

First, with stock options, the exercise price per share is normally equal to the fair market value per share at the time of grant. For a late-stage start-up whose shares have significant value, that means that employees could perceive stock options as having limited additional upside.

In addition, it may be cost-prohibitive for employees to exercise options with significant exercise prices, plus, if the value of the company's stock declines after the stock options are granted, the options would be "underwater," i.e., have no value unless the stock subsequently increases in value above the original exercise price.

RSUs, on the other hand, can never be underwater because they do not have an exercise price. From a Company perspective, since RSUs are full value awards, companies typically issue less RSUs than options, resulting in less dilution.

## What is the Tax Impact of an RSU Award?

Generally, the shares issued in settlement of an RSU are subject to ordinary income tax when the shares are issued, based on the fair market value of the shares at that time; there is no ordinary income tax event at grant or vesting (although employment taxes could apply at the time of vesting). Any increase in the value of the shares between issuance and a sale of the shares may be eligible for long-term capital gain treatment, depending on how long the shares are held.

For a private company, this presents a conundrum. Recipients could have a significant tax liability, without being able to sell their shares to satisfy that liability.

## Double Vesting RSUs

In order to delay the tax liability for RSU recipients of privately held companies, some companies choose to grant what is often referred to as "double vesting RSUs" or "double trigger RSUs." This means that the RSUs will only vest if two vesting conditions are satisfied: (i) a time-based vesting schedule, and (ii) a performance-vesting requirement that is satisfied only if there is: (A) a sale of the company, or (B) an initial public offering ("IPO") within a certain number of years after the date of grant. This approach is intended to delay issuance of the shares—and the taxable event — until there is liquidity for those shares.

Recipients of RSUs are typically required to continue employment through the applicable time-vesting date. After termination of employment, recipients typically retain RSUs that time-vested prior to the date of termination (unless termination is for "cause"), and those time-vested RSUs remain eligible to vest if the performance-vesting requirement is satisfied.

To be exempt from Section 409A of the Internal Revenue Code of 1986, as amended, the deadline for the sale or IPO to occur must be short enough to create a substantial risk that no sale or IPO occurs before the deadline, and the RSUs are forfeited if that deadline is not met.

The appropriate deadline varies based on the facts and circumstances at the time the RSUs are granted, but many companies are comfortable with a seven-year time limit. A shorter deadline may be appropriate for a company that is anticipating sale or IPO in the near-term. On the other hand, the facts and circumstances at the time of grant may support a longer deadline.

## Are RSUs Right for You?

Companies for whom stock options may not provide sufficient incentives (or who anticipate that the company will reach a point when stock options may not provide sufficient incentives) should consider granting RSUs. Double vesting RSUs, in particular, may be an especially effective way to incentivize employees of late-stage startups.

Most public and later stage private companies already have an omnibus equity plan in place that provides for RSU grants, and if not, the existing equity plan can usually be amended to allow for the grant of RSUs. However, introducing a new form of incentive compensation normally requires advance discussion with key stakeholders, and it is not unusual for a customized form of award agreement to be prepared.

Therefore, companies that wish to switch to RSUs should be sure to plan in advance to ensure a smooth rollout.

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### **Darren Goodman, Partner, Lowenstein Sandler LLP**

Clients turn to Darren for responsive service and sound counsel that advance their goals. He regularly provides legal guidance on the employee benefit aspects of mergers, acquisitions, and other business transactions, including negotiation of employment terms and application of the golden parachute payment provisions of the Internal Revenue Code.

Darren also advises corporate and individual clients on executive compensation matters, such as Section 409A compliance; design and administration of equity compensation plans; and employment, equity, change-in-control, and separation agreements. In addition, he counsels clients on retirement plans and welfare benefit plans, including compliance with the Patient Protection and Affordable Care Act.

Before joining the firm, Darren served as law clerk to the Honorable Stuart Rabner, Chief Justice of the New Jersey Supreme Court, and intern to the Honorable Robert B. Kugler, United States District Judge, District of New Jersey.

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With a focus on ensuring compliance and minimizing cost, Megan advises businesses and C-suite executives on a wide variety of employee benefits and executive compensation matters. She represents an array of public and private businesses of varying sizes and across multiple industries.

Megan's experience ranges from plan design, implementation, and ongoing administration and compliance through termination. She provides legal counsel pertaining to tax qualified plans, welfare plans, and Affordable Care Act issues, as well as on deferred compensation and equity arrangements intended to attract and retain employees.

Megan also assists in the negotiation of employment and separation agreements and applies honed skills in both company and executive representation. Due to her exposure to analyzing the issues from both perspectives, Megan is able to effectively negotiate, identify, and advise on potential problems before progress can be obstructed.

Moreover, she provides counsel on the employee benefits and executive compensation aspects of business transactions. This includes assisting with the transition of employee benefits arrangements; implementing new benefits arrangements such as retention bonuses, management incentives, and equity plans; complex 280G analyses and completion of shareholder votes; and negotiating the terms of benefits deal documents.

Prior to joining the firm, Megan worked as a tax consultant for Deloitte Tax LLP. While attending law school, she served as a judicial intern for the Hon. Freda L. Wolfson of the U.S. District Court for the District of New Jersey.

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Taryn provides employee benefits and executive compensation counsel and advice to corporate executives as well as public and private companies from a broad array of industries.

She assists with all aspects of plan design and compliance related to tax-qualified plans, welfare plans, and deferred compensation plans and arrangements, including equity and other incentive compensation plans. Taryn also advises on compensation and benefits aspects of corporate transactions, including complex 280G issues and negotiating employment terms.

Her practice includes counseling companies and executives on the design, drafting, and negotiation of executive compensation arrangements, such as employment, equity, change in control and separation agreements.

Prior to joining the firm, Taryn worked as a tax manager in Deloitte Tax LLP's Global Employer Services practice group, where she assisted a wide variety of public and private companies with U.S. and international employee benefits and ERISA tax issues.

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