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

Episode 11
What Every Start Up Should Know About Stock Options

By Darren Goodman, Eric Weiner, Taryn E. Cannataro
MAY 2022

Kevin Iredell: Welcome to the Lowenstein Sandler podcast series. I'm Kevin Iredell, Chief Marketing Officer at Lowenstein Sandler. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts. Or find us on iTunes, Spotify, Pandora, Google podcast, and SoundCloud. Now let's take a listen.

Taryn Cannataro: Welcome to the latest edition of Just Compensation. I'm Taryn Cannataro, an Associate in the Executive Compensation and Employee Benefits Group. And I am joined today by Darren and Eric, who I will let introduce themselves.

Darren Goodman: Hi, I'm Darren Goodman. I'm a Partner in the firm's Executive Compensation Group.

Eric Weiner: Hi, I'm Eric Weiner, Partner in the Tech Group at the firm representing startup companies and venture capital funds.

Taryn Cannataro: Today, we'll be discussing some items that every private startup company that grants stock options or is considering granting stock options should know. The issues we will be discussing today could have long-ranging impacts that don't pop up until years down the line;for example, when the startup is contemplating an exit or sale and a buyer does due diligence. While we will only be discussing stock options today, there are, of course, other types of equity awards that a startup can issue. These, which come with their own set of considerations, will be discussed in other episodes of “Just Compensation.” Today, we'll be discussing issues that are very fact-and-circumstance specific. So please consult with counsel prior to granting any stock options or making changes to any stock options you've already granted.

Taryn Cannataro: Let's jump right in. What are the most important topics that a startup should be aware of when granting stock options?

Darren Goodman: There are two main areas to be aware of: proper documentation and approval of all stock option grants is the first one. Normally, companies have an equity incentive plan governing the terms of all of their options, and a form of grant agreement that has the terms specific to each person, such as their number of options, the type of options, their exercise price, et cetera. Each time the company grants options, proper approval is needed. Normally, that is a board or compensation committee approval. This is something that investors or acquirers will look at in diligence. Properly documenting grants at the time they are made can save a lot of time and expense later.

Eric Weiner: In fact, I would say that in my experience, this is diligence 101. It's one of the first things that lawyers in an EC/VC practice are trained to look for, something that's very easy to make a mistake on. And a mistake in granting options can have an impact not only on the sort of friction in the deal because you have to clean stuff up, but when you're thinking about negotiating an unallocated option pool, it can have an impact on the price of your deal.

Taryn Cannataro: So you mentioned two areas to be aware of. What's the second?

Darren Goodman: The second one is tax. So there are a surprising amount of tax implications to consider when you grant stock options. There are two different types of options. The first is incentive stock options, commonly called ISOs. And the second is non-qualified stock options, commonly called non-quals. The difference between the two is purely tax driven.

Darren Goodman: Whether you grant an ISO, an incentive stock option, or a non-qual, there is no tax when it's granted and there also is not any tax when it vests. The tax event is on exercise. When a non-qual is exercised, the gain, if any, is subject to ordinary income tax. When an incentive stock option is exercised, there's no ordinary income tax on the gain, but the gain could be subject to alternative minimum tax, which primarily impacts high earners.

Darren Goodman: There's a catch for the ISOs, in addition to the fact that there could be alternative minimum tax. In order to get the tax benefit, the person who holds the options has to exercise them and then hold the shares for at least two years from the date they're granted and one year from the date they are exercised. If you don't do that, you lose the ISO tax benefits. What often happens is that ISO holders don't exercise, the company sells, and there's never an opportunity to exercise and hold for one year.

Eric Weiner: Darren, that's exactly right. I would say in practice, even though a startup employee, if he or she's getting their first or second job at a startup company, if they looked at a blog, the blog would say an employee should get ISOs. We find that at the end of the day, about 95% of all ISO holders end up having non-qualified stock options because they don't exercise options until the actual sale event, so they don't meet the holding period requirements to have ISO treatment. So while it is market practice to issue ISOs, a company may want to talk to counsel about whether or not it makes the most sense to issue an NSO versus an ISO. Although, again, the market practice is to issue ISOs.

Taryn Cannataro: So aside from the holding period requirements, are there any other downsides to ISOs?

Darren Goodman: So ISOs can be a bit more complicated to administer than non-quals. So ISOs are governed by very specific regulations in the Internal Revenue Code. One of those regulations says that if you make a favorable change after the incentive stock option is granted, you convert that ISO into an NSO, as long as the ISOs in the money. One example would be normally people have 90 days post termination to exercise their options. Some companies want to give a longer period of time. If you go to a person who holds an ISO that's in the money and you say we want to extend that period, you can do it, but the consequence is that you'll convert the ISO into a non-qual.

Darren Goodman: Because of that, we would normally recommend going to the person who holds the ISO, giving them a short letter saying, "Here's what we'd like to do. Please agree or disagree with the extension." It's up to them. But it's a little bit of legal work involved in that, or potentially more legal work if you're doing this for a lot of people. And it's also important to think about those types of things upfront. You know, in my example, the company could have had a one-year exercise period at the time the company granted the option and they could have avoided that modification that they would later have if they wanted to extend 90 days to one year.

Eric Weiner: Darren, we see this all the time. I mean, the market was moving in a place where the post-termination exercise period was going to be greater than 90 days almost across the board. That has stopped. It's not the market anymore. But we are finding that clients routinely ask us about extending post-termination exercise period. This is one of those things I mentioned earlier. It's much, much, much easier to do it if the original grant was an NSO versus an ISO. So ISOs have their benefits and they have their burdens.

Darren Goodman: And there's other pitfalls to be aware of too. Incentive stock options can only be granted to employees. If you grant one to a consultant or a non-employee director, it's just not going to be an incentive stock option. If you're going to grant an incentive stock option to someone who's a 10% stockholder, such as a founder, the IRS regulations say that the exercise price has to be 110% of fair market value rather than the standard 100%. And the option can only have a five-year term to be exercised rather than the standard 10 years. So often, when 10% stockholders learn about that, they decide they'd rather have the non-qualified stock options than have those two limitations.

Taryn Cannataro: Given all of the complexities that you just mentioned, does that mean that you would recommend only granting NSOs?

Darren Goodman: It's certainly simpler from a legal perspective, but it's ultimately a judgment call. Many companies understand that ISOs are more complicated and they understand that at the end of the day employees may not get tax benefits from it. But they still view the potential benefit as worth the complexity.

Eric Weiner: And on top of that, I think if you're a startup company that's hiring, maybe you're hiring for the first time, because, like we mentioned, it's sort of market to issue ISOs, it could cause friction if you want to give your employees NSOs and they don't really understand why. And because this is so technical, it's kind of hard to explain. And you want to have your employee start at the company and be happy and not worry about these technical issues.

Darren Goodman: Absolutely.

Taryn Cannataro: Another item that you hear a lot about when discussing stock options is Section 409A. Can you explain what it is and why it applies to stock options?

Darren Goodman: So 409A is a provision of the Internal Revenue Code that's extraordinarily complicated and touches on all different sorts of compensation areas. In the stock option context, many people have heard of 409A valuations, but that's only the tip of the iceberg. In short, 409A has an exemption for stock options and almost all stock options are designed to fit into that exemption. One of the requirements of the exemption is that the exercise price of the option has to be at least 100% of fair market value on the date the option is granted.

Taryn Cannataro: Determining fair market value sounds pretty straightforward for public companies since there's a market price, but how does a private company determine fair market value?

Darren Goodman: So this is where the valuation comes in. The 409A regulations say that for a private company, fair market value has to be determined by the reasonable application of a reasonable method, which does not provide much practical guidance. However, if you get an independent third-party valuation, there's a presumption of accuracy that the IRS would have to show is grossly unreasonable. That presumption of accuracy lasts for up to 12 months from the day that the valuation is valuing the stock as of. But the valuation can become unreliable if there's a material event during that 12-month period. For example, receiving a term sheet.

Eric Weiner: Darren, this is an extremely important point. That's something that we discuss with our clients all of the time. If there's a number of pending options that the company has not yet granted, if it's waiting for a board meeting to grant options, but it knows it's potentially going to receive a term sheet from a VC or some other investor, maybe it's going to get an email with a valuation in it or a text with a valuation in it, it would be a very good idea for that company to issue those options before that happens so there's not a material event that occurs. And in that case, the pending option recipients will hopefully get the benefit of the current 409A valuation versus the later 409A valuation that would come to the business after that deal happens. So if you have pending options and a pending term sheet at the same time, that's another great time to call counsel and see what the right approach would be.

Darren Goodman: Absolutely. And it's something that an investor or an acquirer will scrutinize in diligence. And if a company gets it wrong, there can be a lot of work involved in cleaning it up. And that work could be avoided by calling counsel before granting the options.

Eric Weiner: Right. And it's not just a legal issue. It can be a relationship issue because if you grant an option to an employee at a lower price and then have to come back to them and say, "Oops," they may not be thrilled, right?

Taryn Cannataro: Why is there such a concern about 409A? What happens if there were a 409A issue with stock options?

Darren Goodman: So it's both a company problem and an employee problem. If there's a 409A violation for a stock option, it changes the tax treatment that I talked about earlier. The option starts to become taxable in the year that it vests based on the gain at the end of the year. So that gain is subject to income tax, plus there's a 20% penalty tax, plus interest accrues on that. Now, that's an employee problem. But from a company perspective, first, when the employee has income tax, the company has to withhold on that and it has to report that income tax. What often happens is the company doesn't realize there's a problem until years later. And not only does the employee have a problem, but now the company hasn't reported or withheld on taxes that it should have done that for.

Darren Goodman: As Eric pointed out, if an employee has a problem with a stock option, that employee is probably going to be unhappy and they might ask the company to gross them up or otherwise make them whole for the tax liability that they have. If there's risk around this, a buyer could seek a purchase price reduction or an escrow or additional indemnification protections. So really, all sides have a strong interest in making sure that stock options are done right.

Darren Goodman: I guess all I'd add is there's a limited ability to correct violations. If the price is set too low, that can generally be fixed in the calendar year the options are granted or the next year if the people who receive the options are not senior employees. The difficulty, as I said, is this might not be caught until years later.

Taryn Cannataro: Aside from making sure stock options are granted with an exercise price that's at least fair market value, are there other 409A issues that people should be aware of regarding stock options?

Darren Goodman: There's a number of issues, but an important one that many people aren't aware of relates to the 10-year expiration date for stock options. If the options are in the money, meaning the stock is worth more than the exercise price, extending that 10-year expiration date is an automatic 409A violation. Many of our clients were formed in the Great Recession era, so their earliest stock option grants are coming up against this 10-year deadline. And it makes a lot of sense to just extend that, but it's a 409A issue.

Eric Weiner: And as Darren mentioned, this is something we're seeing a lot nowadays. Private companies are staying private a lot longer. So even if it wasn't a company that started granting in 2010, companies forming today should be mindful that there's a clock on this and not to let that clock slip.

Taryn Cannataro: What can a company do if they find themselves in that situation?

Darren Goodman: There's not a perfect fix. Some companies choose to help their optionees exercise, for example by loaning them the exercise price. Others grant new compensation after the options expire, such as a sale bonus arrangement. Of course, a company can also choose to do nothing and take the view that the employee had 10 years to exercise and they chose not to. And at that point, the company could also decide to help some employees but not others. So it doesn't have to be a one-size-fits-all solution.

Taryn Cannataro: Thank you, Darren. The two key takeaways from today's discussion should be that you should always have proper documentation and approval of all stock option awards, and the importance of tax planning for both the employee and the employer in connection with stock options. Being aware of these issues from the outset, along with proper drafting and structuring of stock option documents can help you avoid many of the issues we discussed today.

Eric Weiner: And Taryn, I'd even take it one step further. In my experience, options are one of, if not the most technical matters that we deal with on a daily basis. They are very easy to do right, but they are very easy to do wrong. So even though it's something that a company is probably doing a lot of, it's important to always make sure you're talking to counsel when issuing equity, options or otherwise, but particularly options for the reasons discussed today. And we're obviously happy to talk to you when you're doing that.

Taryn Cannataro: That's exactly right. This session was intended to give you some high-level food for thought on a few issues that we see arise for startup companies that have or intend to issue stock options. But this was by no means a comprehensive discussion of all considerations that we see come up with respect to stock options. And these issues we discussed today may not apply to your particular situation.

Taryn Cannataro: If you have experienced any of the issues we discussed today or if you're planning to implement an equity plan or issue new stock option awards under an existing plan, we encourage you to consult with counsel to help you avoid some of the issues we discussed today.

Taryn Cannataro: Thank you very much for joining us today. We look forward to having you back for our next episode of “Just Compensation”.

Kevin Iredell: Thank you for listening to today's episode. Please subscribe to our podcast series at lowenstein.com/podcasts, or find us on iTunes, Spotify, Pandora, Google podcasts, and SoundCloud. Lowenstein Sandler podcast series is presented by Lowenstein Sandler and cannot be copied or rebroadcast without consent. The information provided is intended for a general audience. It is not legal advice or a substitute for the advice of counsel. Prior results do not guarantee a similar outcome. The content reflects the personal views and opinions of the participants. No attorney client relationship is being created by this podcast and all rights are reserved.