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

Episode 55

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Taryn Cannataro: Welcome to the latest episode of *Just Compensation*. I'm joined today by two of my colleagues, Megan Monson, partner in the Executive Compensation Employment and Employee Benefits Practice Group.

Megan Monson: Hi, very nice to be here.

Taryn Cannataro: And Jessica Stewart, associate in our practice group as well.

Jessica Stewart: Nice to be here too.

Taryn Cannataro: In today's episode, we're going to discuss a question that C corporation sellers often must consider when undergoing a corporate transaction. What happens to the outstanding stock options or other equity awards in connection with the deal? We will discuss some common treatments for outstanding stock options or other outstanding equity awards in a transaction, including what these different approaches mean for employees, sellers, and buyers. We'll also discuss different tax implications of the various treatments and employee incentivization considerations that could drive negotiations. As always, this is not intended to be an exhaustive discussion. We encourage you to consult with legal counsel with specific questions. Before a seller starts a deal process, what are considerations to keep in mind with respect to outstanding equity awards, Megan?

Megan Monson: That's a great question. So, equity awards are typically granted pursuant to an equity plan and an individual award agreement. Options are the most commonly used, so we're going to focus largely on those in terms of our discussion today. So, the equity plan and the individual award agreement are going to be the documents that provide the awardee with terms of their award, including the exercise price of an option, the vesting terms, including any sort of acceleration, what constitutes a change of control, and what happens to unvested or outstanding awards in connection with a change of control. So, since these documents also dictate what the seller's choices are with respect to any sort of outstanding equity awards in connection with a transaction, it's really important to understand what they say. And the documents, usually the plan will enumerate the various choices that the company has in terms of how it's going to treat outstanding equity awards in connection with the sale.

The documents can also give very broad discretion to the company to treat outstanding equity or, in particular, stock options, however they see fit. So, really, I think the biggest key takeaway is knowing what is or is not permitted under the plan documents going into a sale process to know what your alternatives are. Another thing to think about is depending upon what those documents say, whether or not you're going to need approval from equity holders in connection with the treatment of outstanding equity awards in the transaction is another important consideration. And that can have an impact on deal timing, especially if there's a large number of option holders and can be difficult or unwieldy to handle at the eleventh hour in a deal.

Something that we see come up fairly frequently is signing option cancellation agreements. That would typically require option holder consent, or if you want to have an option holder agree to something that's not expressly permitted in a plan document or their award agreement, again, that's another situation where you would need their consent to approve of that treatment. So, in general, also when you're thinking about outstanding equity awards, it's important not to negotiate the treatment of that in a vacuum and think of it in the larger deal context, but also with the, call it gatekeeping, parameters of what the plan documents do or don't allow.

Taryn Cannataro: Some common terminology that we hear when we talk about the treatment of options is vested versus unvested or in the money versus out of the money or underwater. Jessica, can you help explain the differences and why they matter?

Jessica Stewart: Sure. So, vested options mean that all of the restrictions, including any time-based or performance-based conditions, have lapsed or been achieved, and the options are now exercisable by the option holders. Unvested options are those options that are still subject to these restrictions, and the option holder cannot exercise the options yet. This assumes that they are not early exercise options, which we won't get into in this discussion. Typically, the treatment invested in unvested options differs in a transaction. Whether or not to accelerate any unvested options is often an unnegotiated deal point.

An “in the money” option means that the current fair market value of a share of the company's stock is greater than the options exercise price. This means the shares the option holder receives by exercising the option will have value to the option holder as they will be receiving shares worth more than what they paid for them. For example, an option that has an exercise price at 50 cents and the per share price in the deal is a dollar, they will have a gain. An “out of the money” or “underwater” option has an exercise price that is greater than the stock's current fair market value, which means that the option holder will pay more to exercise the shares than the shares are actually worth.

Taryn Cannataro: What are some common ways to treat options that are outstanding in a transaction?

Megan Monson: Well, one, as I mentioned, you have to know what is or is not permitted by the plan and the option agreement. And the other thing to think about is whether the treatment is going to differ and the answer is most likely whether the options are vested or unvested and whether they are in the money or underwater. In most transactions, there's a few common ways to treat vested in the money options. First, it is an assumption or substitution by the buyer. Second is a cash-out, meaning they're cancelled in exchange for a cash payment related to the value of those options and backing out any sort of exercise price that would be owed. The third is a cancellation without payment of any consideration, although I'll say that is less common with respect to vested in the money options. And the fourth thing that we often will see is rolling over the equity awards.

So, an assumption or substitution means the buyer steps into the seller's shoes in terms of the seller's plan, or it could be swapping out the existing options for new options under the buyer's plan. And all terms and conditions of those options remain the same other than the exercise price, which is proportionally adjusted. And this can be common when the buyer wants continuity and the seller's options aren't underwater. However, any sort of assumption or substitution would need to be reviewed for compliance with the tax code and may have considerations with respect to section 280G of the code that we've talked about in prior episodes. A cash out, as I mentioned, is sometimes referred to as a cancellation for consideration, and that's really the most straightforward path. Vested options are paid out in cash based on the consideration the option holder would be entitled to receive in connection with the deal had they exercised their vested options, less the aggregate exercise price.

If there are unvested options, they can be accelerated and paid out similar to if they had been vested, depending upon what the equity plan or award agreement says in terms of acceleration and/or what the deal terms are. If there is acceleration, that may be something that requires board approval and coordination with buyer on as well. It can be common in cash heavy transactions where the buyer doesn't want legacy equity from the seller to have outstanding equity cashed out for consideration. Cancellation without consideration is really often used when the options are either underwater or out of the money or the parties don't wish to accelerate unvested options. So, you kind of think of it as two buckets. You have out of the money options or unvested equity that is not going to be accelerated. So, those are kind of two common scenarios where the outstanding equity will be cancelled without consideration, again, presuming that your plan allows for that.

In terms of a rollover, that involves option holders taking a portion of the sale proceeds that they would receive with respect to their vested equity and instead getting a portion of equity in the go forward company. This comes up most frequently in private equity deals just with respect to senior management, as it means to incentivize those key employees to continue an employment with the buyer. Another thing to think about is you're kind of considering all of the alternatives in terms of how outstanding awards or options are treated is depending upon what path is taken, do you want to then terminate the existing equity plan or a buyer may require termination of the plan and understanding what those termination provisions and approvals would look like?

Taryn Cannataro: Jessica, how are other awards like RSUs or restricted stock typically treated in transactions?

Jessica Stewart: RSUs are often treated similarly to options, meaning they can be cashed out, cancelled, or rolled over. Restricted stock can likewise be treated like RSUs or options, but holders of vested restricted stock are often treated like common stockholders. Any Section 83B elections that a restricted stockholder may have made does not have an effect on the transactional treatment of restricted stock. As with options, the treatment of RSUs and restricted stock will depend on the terms of the applicable equity incentive plan and award agreements. But unlike options, RSUs and restricted stock are full value awards, meaning they don't have an exercise price, so they don't have the same considerations with respect to being in the money or out of the money. So, deal mechanics and whether the deal is cash heavy may play a greater role in determining the treatment of RSUs and restricted stock.

Taryn Cannataro: Can the seller unilaterally decide how to treat outstanding awards in the transaction?

Megan Monson: That's a great question, Taryn. I'll start with the overarching thing, again, that I've emphasized a few different times is understanding what the plan permits and whether the company has broad discretion in terms of how outstanding awards are treated. That said, many equity plans and award agreements prohibit a company from making adverse changes to an equity award after it's already been granted without the award recipient's consent. So, if you're looking to do something that's above and beyond, again, the broad strokes, discretion that the company has or may not have, depending on how the plan document's drafted, you may require consent from the award recipient. And one common thing that comes up often is that sellers ask equity holders to sign agreements cancelling their outstanding equity award, and consent is typically obtained for that even if it's not required by the terms of the equity plan or award agreement, because you're often seeking a release of claims in connection with the cancellation.

On that point, sellers should really be mindful of whether they have the right pursuant to the plan to require the equity holders to sign that document. And if not, do they need to provide some sort of additional consideration to option holders or equity holders to incentivize them to sign it and or to get a valid release of claims? These kind of cancellation agreements are often structured to not only provide the award recipients about information and how their outstanding awards are being treated in connection with the transaction, but also as an opportunity to get consent for that treatment to the extent that it's needed.

And as I briefly touched on that, these cancellation agreements usually include certain key terms, one of which is a release of claims. That's often something that we would suggest or see in those documents. Also, reps and warranties with respect to the outstanding awards, such as that the award recipient solely owns the equity, there's no liens, no undisclosed side agreements to really be sure that the equity will be cancelled and they're able to agree to that free and clear. And those cancellation agreements will often also include just general information about tax withholding and reporting and also reminding the equity holders to consult with their individual tax advisors for individual advice as well.

Taryn Cannataro: Is whether the deal a stock deal or an asset deal important to decide how to trade outstanding awards?

Jessica Stewart: Absolutely. It's important to first look at the equity plan to see if the deal meets the definition of a change in control. A minority investment or a small asset sale might not necessarily trigger the plan's change and control obligations. In asset deals, if the company is not continuing in operation, employees may experience the termination of employment with the seller, which adds another layer of consideration regarding the treatment of equity awards. For example, the post-termination exercise period may start to run. Practically speaking, if employees continue to hold awards in a non-operational company, there would not be a benefit to exercise and the seller may decide to terminate the plan.

Taryn Cannataro: How does the difference between whether outstanding options or ISOs or NSOs impact how to treat outstanding equity in a transaction?

Megan Monson: Yeah, so that's a great question, Taryn. One item to consider is whether there could be a disqualifying disposition of ISOs, which occurs when shares that are acquired upon exercising in ISO are disposed of before satisfying the statutory holding periods, which are two years from the date of grant or less than one year from the date of exercise. So, if an ISO holder exercises one month before closing and then sells the shares obtained upon exercise of that ISO in connection with the closing, there would be a disqualifying disposition and those ISOs would lose their tax favorable treatment, meaning that a portion of the shares would be taxed at ordinary income rates instead of favorable capital gains treatment. Another item to consider is the ISO spread and exchange rule preservation rules. If an ISO is being assumed or substituted by the buyer or rolled over to the buyer, the spread with the seller, meaning the difference between the exercise price and the fair market value of the seller's stock has to be identical to the spread of the buyer, meaning the difference between the exercise price and the FMV of the buyer stock.

The tax regulations provide guidance on how to calculate the exchange ratio needed to ensure that the spread stays the same, but if the spread changes or additional benefits are given that weren't provided under the old equity plan, the assumption does not qualify under the ISO rules and the assumption would be treated as a modification and ISO status can be lost. So, it's really critical to make sure any assumption is done in a way that complies with the tax code. One other item to mention is to consider the ISO's terms. The terms of the ISO can't be modified, which at a high level is defined as any change in the terms that provides the ISO holder with additional benefits, but regardless of whether the ISO holder actually benefits from that change, it can become a rather elaborate and time-consuming inquiry to make sure that the ISO's terms with buyer are identical to the ISO terms with the seller to the extent that there are ISOs that are being assumed or substituted in connection with a transaction.

Taryn Cannataro: Jessica, post-closing, can option holders participate in an earn-out?

Jessica Stewart: Part of the deal negotiation will include discussing whether option holders should share in any earnouts. This can be a particularly important discussion when options are underwater but are being cashed out in the deal, essentially meaning that option holders get their options canceled in exchange for nothing. However, the parties could choose to treat the options like shares for purposes of earn-out participation, allowing option holders to receive some value for their options.

Taryn Cannataro: Determining how to treat outstanding equity awards in a transaction is often where compensation and company culture meet. The parties in a transaction will have to consider both the economics of the deal and the incentives to employees. Employers should also pay special attention to existing documentation of equity awards and the tax implications of the option treatment. Thank you for joining us today. If you enjoy today's discussion, please subscribe, leave us a review, and share this episode with your colleagues. You can also reach out to us via email if you have questions or ideas for future topics. We look forward to having you back on the next episode of *Just Compensation*.

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