Cooley U:
Stock Options & Equity Compensation

Topics

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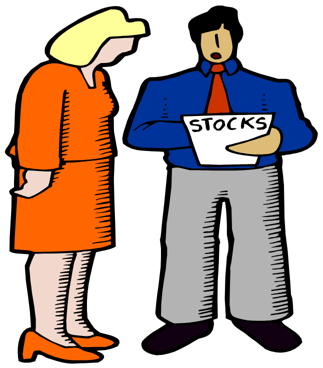
Overview: Incentive Compensation Matrix

FORM

TIMING		Cash	Stock
	Current	▪ Base salary ▪ Bonuses	▪ Stock Awards (fully vested)
	Deferred	▪ Retirement Plan ▪ Non-Qualified Deferred Compensation ▪ SARs (cash)	▪ Options ▪ SARs (stock) ▪ Stock Awards (with vesting) ▪ Restricted Stock Units

Equity Compensation Basics: What are the purposes of equity compensation?

- Creates **ownership culture**
  - Employees work to maximize value of company
  - Especially true if individual has a material impact on company performance
- Acts as a **substitute for cash** compensation
  - Company conserves cash
  - Employee may be willing to accept lower cash compensation in exchange for greater upside potential
- Vesting **encourages retention and/or performance**
- **Additional reward** (beyond cash) for services rendered



Equity Compensation Basics: What are the most common types of equity awards?

- **Stock Options**
  - the right to acquire (“exercise”) a fixed number of shares at a fixed price for a designated period of time
  - generally subject to vesting based on the recipient’s service to the company
- **Restricted Stock Awards (RSAs)**
  - the shares are issued on the date of grant
  - payment by the employee: an amount equal to the FMV of the stock for the shares (alternatively, may be granted as a bonus)
  - generally subject to vesting based on the recipient’s service to the company; while unvested, shares are held in escrow and subject to reacquisition by the company
- **Other types** (all uncommon for private companies):
  - restricted stock unit awards (RSUs), stock appreciation rights (SARs), “other stock awards” (catch-all for flexibility)

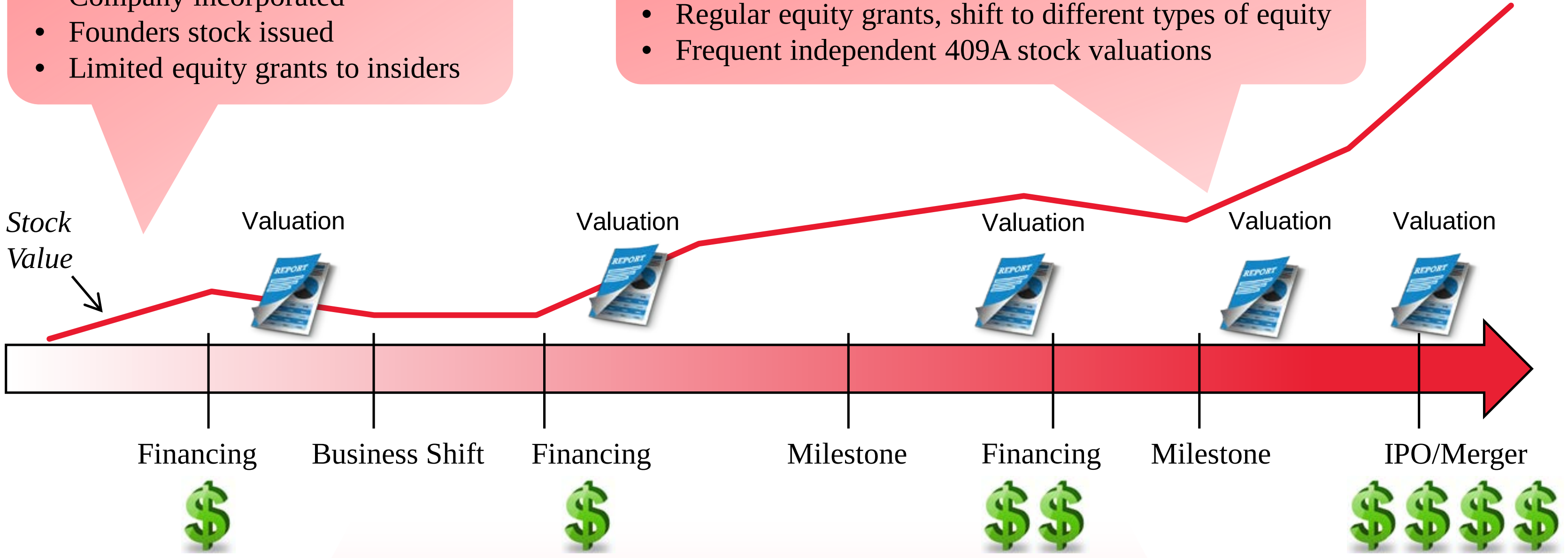
Sample Company Timeline

Founding Stage

- Company incorporated
- Founders stock issued
- Limited equity grants to insiders

After Expectation of Liquidity Event

- Regular equity grants, shift to different types of equity
- Frequent independent 409A stock valuations

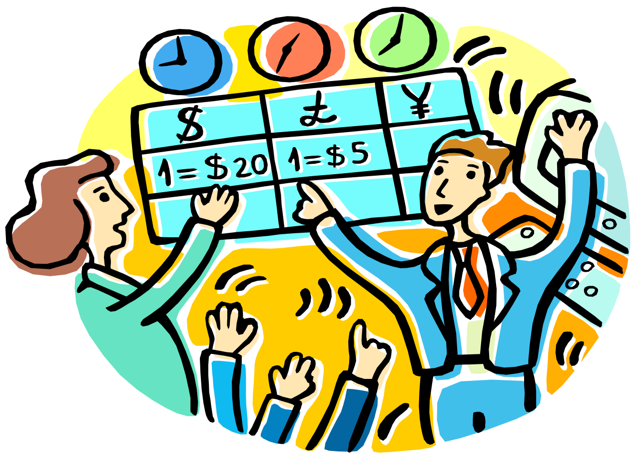


Post-Founding to Expectation of Liquidity Event

- Company develops assets and operations
- Establish equity plan, grant stock options to multiple employees
- Stock valuation becomes more formalized (e.g., 409A independent valuations)

Equity Compensation Basics: How to Choose the Right Vehicle

- **Consider the Employee's and the Company's Perspective**
  - **Investment Risk**
  - **Taxation**
  - **Cash outlay**
  - **Incentives created**



Founders Stock

Founder's Stock Awards: What is "founder's stock"?

- Founder's stock is the *ownership interest* the <u>founders of the company</u> acquire when they founded the company
- It is generally very, very, very cheap so that there is almost no cash investment
- IF the company is a huge success, the "founders" often reap an unimaginable financial reward
- On top of the potential for great financial reward, with proper planning, all of the gain on the "founder's stock" can generally qualify for long-term capital gains treatment

Founder’s Stock Awards: What is “founder’s stock”?

- While investors in the company are not looking to the founders to provide capital to the company, the investors do insist that the founders stay with the company to earn their stock with “**sweat equity**”
- Accordingly, the founder’s stock is subjected to vesting so that if a founder leaves the company for any reason before the stock vests, the company can repurchase the unvested stock for the lesser of the amount the founder paid for the stock or its then fair market value
- With some exceptions, if stock is subject to vesting when it is acquired, for tax purposes, the value of the stock when it vests is treated as compensation income (i.e., ordinary income) often referred to as “Section 83 income”
    - Ordinary income not long-term capital gains
    - Tax is owed on vesting not when the stock is sold

Founder's Stock Awards: 83(b) tax elections

- Fortunately for founders, Section 83(b) of the Internal Revenue Code permits a recipient of unvested stock to make an election (a "Section 83(b) election") within 30 days of the receipt of the property to recognize as ordinary income at the time of the receipt of the stock the excess of:
  - The fair market value of the stock without regard to the vesting restrictions over
  - The amount (if any) paid for the stock
- Because the value of the founder's stock is typically very low there is rarely any excess. Therefore, it is a "no brainer" to file the Section 83(b) election.

Because the deadline for a Section 83(b) election is based on the receipt of the stock and is a very short window (i.e., only 30 days), it is very easy for a Section 83(b) election to be missed. *Be hyper-vigilant*!

Stock Options & Stock Plans

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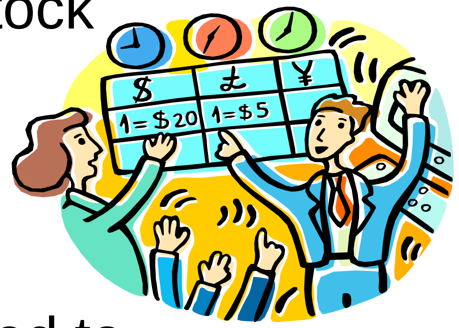
Why Stock Options Versus Restricted Stock?

- **Employee Perspective:**
  - No investment risk until exercise price is paid when the option is exercised
  - Greater control over timing of taxation
  - BUT restricted stock awards have greater potential for post-grant stock price appreciation to be taxed at lower capital gain rates



- **Employer Perspective:**
  - No cash outlay by the employer
  - Option has value only if stock price appreciates after grant date – tied to company performance
  - Employer often entitled to a tax deduction for the spread on the exercise of a stock option

Establishing a Stock Plan

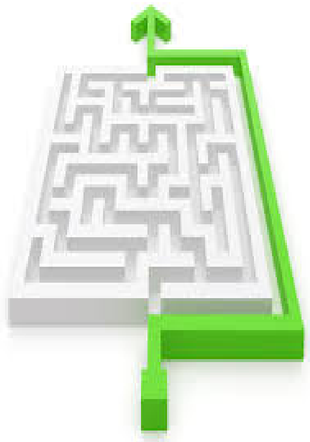
- A stock plan establishes a *pool of shares* that can be granted as stock options (or other stock awards) and contains a set of rules governing all awards; individual award terms can vary - set forth in individual option documents
- *Securities laws:* in order to be exempt from registration, a maximum number of shares must be approved by the board of directors (and, in CA, company stockholders) and only granted to service providers
  - Other securities rules permit grants to company insiders/sophisticated parties, allowing for limited grants prior to establishment of a plan (or outside of the plan)
- *Tax laws:* in order to grant tax-favored stock options (“incentive stock options”), stockholders must approve the plan
- Once the stock plan is approved by the board of directors and stockholders, the board of directors (or its designee) can approve individual stock options under the plan without needing stockholder approval again until the maximum shares are allocated

Establishing a Stock Plan

- Generally, a specific maximum number of shares must be set at the time of approval of the plan
  - May be increased any time with approval of board of directors and stockholders
- Different approaches to setting the number:
  - Amount necessary to accommodate expected grants over a period of time (e.g., 3-4 years)
  - Amount necessary for specific contemplated grants only
  - Amount established based on a percentage of outstanding company stock
- Is there "standard" practice? Short answer: No. Driven by specific company facts (growth, capitalization, employees) and stockholders' desire to "control" share usage
- ➢ Tips: formulate a strategy; be careful about promising certain grants to individuals; remember this is long-term compensation

Establishing a Stock Plan

- Major decision points:
  - Pool of shares
  - Plan administrative authority
  - Option duration
  - Vesting and exercise terms
  - Company's rights of repurchase and first refusal
  - Treatment upon a change in control
- California requires a notice filing
- Securities and tax rules impose certain parameters (e.g., 10 year term, service providers only)



Stock Option Basics

- A stock option is a contract that gives the recipient the right to buy up to a fixed number of shares at a predetermined price
  - The number of shares under an option, the exercise price and other terms are determined by the board of directors at the time of grant
  - Exercise price must be no less than current stock value, and remains fixed for the term of the option
- Stock options are not actual stock -- they provide the *opportunity* to purchase stock at a fixed price favorable price -- assuming value of the common stock increases
  - Until the recipient exercises the option and purchases stock, the recipient does not own stock and does not have voting rights
  - Options are a “leveraged” instrument – possibility for upside, no risk of loss until exercise
- Two types of stock options: “incentive stock options”(ISOs) and “nonstatutory stock options” (NSOs)
  - the only difference is (potentially) taxation; ISOs can only be granted to employees

Stock Option Vesting

- Generally the recipient “earns” the right to exercise the option and buy the shares based on the vesting schedule
  - Commonly, employees are granted an option with a *four-year vesting schedule* and a *ten-year term*.
  - Example: 1/4th of the shares vest on the one year anniversary of the grant date (or vesting commencement date) and the balance of the shares vest in a series of 36 monthly installments thereafter, **subject to continued services**
- And now, as translated:
  - If the employee is still employed on the 1st anniversary of the grant date, the employee has earned the right to exercise up to 25% of the shares under the option
  - Thereafter, the employee earns the right to exercise more shares on a monthly basis, until the entire option is vested on the 4th anniversary of the vesting commencement date, if the employee continues to be employed on each vesting date.

Accelerated Vesting

- Stock Plan will contain terms that apply to ALL options upon a change in control
  - Commonly, the plan gives the board of directors the *flexibility* to determine what happens at the time of the change in control (e.g., accelerate, cash out, terminate)
  - Sometimes, the plan provides that all options will accelerate if they aren't assumed by the buyer
- Some options are granted with additional special provisions that call for acceleration of vesting upon certain events. Most common accelerated vesting provisions:
  - **Single trigger** (less common) → vesting accelerates upon the occurrence of a change in control
  - **Double trigger** (more common) → vesting accelerates if employee is terminated (generally without "cause" or resigns for "good reason") within a certain time period before (e.g., 30 days) or after (e.g., 12 months) a change in control

Stock Option Exercise

- While private, an option can generally only be exercised by payment of cash or check
- Generally, an option can only be exercised after it has vested and before it expires
- However, some options allow for exercise prior to vesting – called "early exercisable" options
  - Unvested shares received on exercise are subject to a repurchase option in favor of the company (typically at termination of employment) at the lower of the original exercise price or the fair market value on the date of repurchase. This is just like a restricted stock award.
  - Shares are subject to tax as they vest UNLESS a section 83(b) election is filed within 30 days of exercise (then the shares are taxed upon exercise and not as they vest, and any future gain is capital gain)

When Does An Option Expire?

- Typically, upon the earliest of 10 years from the date of grant date

  OR

- Earlier on a termination of employment/service. Expiration rules vary, but are commonly:
  - 3 months after a regular termination
  - 12 months after termination due to disability
  - 18 months after an optionholder's death
  - Immediately upon a termination for "cause"
- Option grant documents can contain different terms, but beware of California securities requirements
- Some companies are providing for extended post-termination exercise periods (e.g., Pinterest); consult with counsel about various considerations

Granting Stock Options

- ***Who: employees***, ***directors*** or ***consultants*** who are providing *services* to the company or an *affiliate* of the company. Beware of the following:
  - option grant to an entity (e.g., VC firm, consulting company) presents securities challenges and should be discussed with counsel
  - employees cannot receive option grants prior to commencing employment
  - grants for a specific percentage of stock (rather than share number)
- **How:** board of director approval of stock option grant must include all terms of grant, including the fair market value (used to set exercise price)

Determining Fair Market Value

- Exercise price must be at least equal to **100% of FMV on date of grant** (110% for ISO grants to 10% holders)
- How do you know what the FMV of a private company's stock is on any given date? IRS: a value determined by the *reasonable application* of a *reasonable valuation method*, based on facts and circumstances. IRS valuation factors:
  - value of intangible and tangible assets
  - present value of future cash flows
  - private sale price/public trading price of comparable companies
  - recent transactions involving equity transfers/sales
  - control premiums and discounts for lack of marketability
  - all other 'available information'

- **Safest approach:**
  - Company can obtain valuation from 3rd party valuation firm (a "409A valuation")
  - IRS rules allow you to rely on the valuation **for up to 12 months** as long as nothing occurs that would materially affect the valuation (such as new financing round, new IP)

Determining Fair Market Value

- For very early stage companies, a 409A valuation is typically not done; board of directors determine the FMV in good faith based on general valuation factors
- Many VC firms/investors will require an independent 409A valuation
- What is the risk of not doing it?
  - Stock options granted below true market value
  - Significant tax consequences to employee and company
  - Most often arises in M&A, IPO, or can arise under an IRS audit

➢ Board should discuss with counsel when it makes sense to begin 409A valuations

Administration of Stock Plan and Option Grants

- Board of directors is ultimate administrator → interprets plan and award terms, approves grants and amendments
- Individual stock option paperwork can be prepared by company or outside counsel
- Important for company to maintain a stock option ledger with details of option grants, terms, exercises and track remaining “pool” in plan
- Some companies outsource paperwork and option ledger tracking to outside counsel or a third party administrator (companies/individual consultants)
  - Manual tracking often leads to error; online software applications can be very helpful
- However records are maintained, important to establish internal controls to ensure compliance