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Equity compensation trend: extending the time to exercise vested stock options

Employee Benefits Alert

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A number of high-profile technology companies recently adjusted their equity compensation programs in a manner they hope will help attract employee talent by providing an extended period to exercise vested stock options after termination of employment. In particular, Pinterest and Quora adjusted their stock options to allow employees with at least two years of service to exercise their vested stock options for up to seven years after they terminate. Other emerging growth and startup technology companies may be considering similar adjustments to their stock options.

Providing an extended period to exercise vested stock options is not a new idea. In the past, employers have considered this approach, typically on a case-by-case basis, if the employee was in good standing and unique circumstances were present upon termination or if the employee has some degree of leverage in negotiating his or her departure. What is new is the trending consideration to provide an extended post-termination exercise period to employee option holders generally.

BACKGROUND

Due to certain tax and securities laws, as well as accounting rules, it is very common for stock options issued by private companies have a term of up to ten years from the date of grant. Many companies, however, follow the standard rules set forth in the Internal Revenue Code for incentive stock options by providing a standard three month period to exercise a vested stock option after termination of employment, which has the effect of shortening the term of the option for those who leave the company before the option's expiration date. [1]

Recognizing that there is flexibility in how long a stock option can remain outstanding following termination of employment, some technology companies have considered providing a longer post-termination exercise period. This Alert outlines some advantages and disadvantages of providing an extended exercise period. The considerations for both employer and employee are slightly different if the extended exercise period is added by amendment rather than included in the original award.

EMPLOYER CONSIDERATIONS FOR NEW OPTION GRANTS

Advantages

1. Employee recruiting: Current employees and future hires may view an extended post-termination exercise period as highly favorable because the decision of choosing to exercise and pay the purchase price for their vested stock options can be delayed if the employee leaves the employer before the option has expired.

2. Less pressure on the employer to gain liquidity: In the current economic and capital markets environment, many private companies are delaying their IPOs until much later in their business lifecycle and considering mergers and acquisitions. Providing an extended period to exercise allows an employee to terminate and still potentially enjoy the liquidity of a later IPO or sale of the company.

3. Less complexity: There may be less administration involving stock option exercises when employees terminate employment because questions regarding deadlines to exercise, loans and secondary sales to third parties to facilitate financing the exercise of stock options may be avoided or postponed.

Disadvantages

1. Shareholder dilution: When an employee terminates and fails to exercise vested options, the forfeited shares can be used to replenish the equity plan's share reserve pool for future new hire or refresh grants (including the individual who will be replacing the departed employee). However, if a terminated employee is able to retain vested stock options for an extended period, the underlying shares will necessarily continue to be reserved for a potential future exercise and more shares will be needed to grant awards to new hires or for refresh grants. As a result, common stockholders will face added dilution from a larger number of outstanding equity awards.

2. Unearned gain: An employee who is allowed to retain an option right for an extended period after ceasing to contribute to the employer's future growth and value appreciation may be viewed as being unjustly enriched by the future contributions of employees who do remain with, or subsequently join, the employer, while avoiding the capital commitment of a real investor.

3. Accounting impact: Stock options with a longer exercise periods after termination result in greater non-cash compensation expense, and more complex valuation methods may have to be used by the employer to expense the stock options on their financial statements.

4. Increasing the likelihood of employee terminations: Employees who cannot pay the exercise price for their vested stock options will not feel financially handcuffed to their employer out of fear of forfeiting vested stock options immediately after termination.

5. Incentive stock option limits will still apply: Incentive stock options (ISOs) generally convert to nonstatutory stock options (NSOs) three months and one day after an employee terminates his or her employment (except in the case of death or a disability). As a result, an employee who wants to keep his or her ISO status for tax purposes would not benefit from an extended exercise period.

6. Likely higher employment tax expense for the employer and the employee: The exercise of NSOs requires both employee and employer to pay Social Security and Medicare taxes, as well as income tax withholding. ISOs do not trigger these taxes. As a result, by extending the period by which stock options may be exercised, the employer likely increases the chances that many of its vested stock options will not be ISOs and will therefore result in greater employer Social Security and Medicare tax liability.

7. Income tax withholding obligations increase: The exercise of NSOs requires the employer withhold income tax from employees and former employees. ISOs do not trigger income tax withholding upon exercise. Delayed exercise of options by former employees will increase the employer's payroll administration burden.

8. Fewer "carrots": An extended post-termination exercise period is one of the benefits an employer may offer a terminating employee in exchange for a separation agreement and release of claims. If stock option agreements already provide for an prolonged post-termination exercise period, employers will need to find other carrots to entice employees to sign release of claims agreements.

EMPLOYER CONSIDERATIONS FOR AMENDING EXISTING OPTION GRANTS

If an outstanding stock option is amended to extend the post-termination exercise period, a few additional considerations apply:

1. Advance corporate approvals: An extension of the exercise period will likely require approval of this amendment by the equity plan administrator (*e.g.,* the board of directors) in advance of the original option post-termination expiration date.

2. ISO and optionholder consent issues: The modification to extend the post termination exercise period for ISOs that are "in the money" will cause them to immediately become NSOs. ISOs that are "underwater" or "at the money" on the date of an extension amendment will remain ISOs (assuming the option otherwise meets the other requirements for ISOs on the amendment date). However, the ISO holding period for capital gain purposes will restart. Due to these negative tax effects, most employers may need to obtain the individual's consent in advance of approving for the extension amendment.

3. Accounting impact: An amendment to an existing stock option to extend the exercise period likely will be considered a modification for accounting purposes and may lead to an additional non-cash compensation charge on the employer's financial statements.

4. Deferred compensation limitations: To avoid adverse employee tax treatment under Section 409A of the Internal Revenue Code (governing certain deferred compensation), the term of otherwise exempt options may not be amended to exceed the ten year anniversary of the original date of grant or the original expiration date of the stock option, whichever comes first.

If you are considering an adjustment to your stock option program to provide for extended exercise period generally or to an individual stock option holder, please contact William Hoffman, Cisco Palao-Ricketts or any member of our Employee Benefits and Executive Compensation group.

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[1] In the case of death or disability, the period to exercise is often six or twelve months.

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