Equity Incentive Compensation Plans for Start-Ups

A Practical Guidance® Practice Note by
Matthew A. Secrist, Taft Stettinius and Hollister LLP

Matthew A. Secrist
Taft Stettinius and Hollister LLP

This practice note identifies and discusses the most common types of equity and equity-based incentive compensation awards issued to a start-up company's founders and key employees, among other individuals. The practice note will also examine the equity incentive compensation plans to which such awards are subject and provide practical guidance and advice for drafting such plans.

By doing so, this practice note will address the following questions:

- What are the basic elements of these awards/plans?
- What are the tax considerations that impact the exercise of a grantee's rights under these awards/plans?
- What is required to ensure that a particular award or plan grant complies with both federal and state securities laws?

The following major headings are addressed in this practice note:

- Equity Compensation in General
- Types of Equity Compensation Awards
- Equity Incentive Compensation Plan Drafting
- The Impact of the Securities Laws on Grants of Equity Incentive Compensation

For related discussions, see the following, Taxation of Executive Compensation § 7.02, "Designing a Stock Program," Executive Stock Options and Stock Appreciation Rights § 1.03, Executive Stock Options and Stock Appreciation Rights § 1.04, Taxation of Executive Compensation § 7.08, "Impact of Taxation Under Section 83," and Start-Up & Emerging Companies § 14.02. For a discussion regarding equity as an element of total executive compensation, see Current Legal Forms with Tax Analysis § 12.30, "Executive Compensation Arrangements."

Equity Compensation in General

There are several types of equity incentive compensation arrangements for a start-up's employees, including its founders, and in many cases, its directors, officers, and outside contractors as well. Awards are generally subject to vesting schedules, meaning that the recipient of such start-up equity has to "earn" those awards over time by continuing to work for the company before the award fully vests.

Initial equity grants to the founders of a start-up company are given to motivate, retain, and reward them when they have met agreed-upon company goals. Occasionally, founders are granted some equity that vests immediately, which means that the founders receive such shares outright and unencumbered by restrictions. Generally, however, founders are granted restricted equity that is subject to significant restrictions (relating to transfer rights, etc.) that encumber ownership of the equity until one or more (typically time-dependent) conditions are satisfied.

Similar to the conditions placed on founders' restricted equity grants, with respect to founders' stock options, the ability to exercise such options are dependent on:

- The founder(s) continuing to remain employed by the start-up until a pre-agreed-upon vesting period has lapsed –and/or–
- The founder(s) being able to cause the start-up to achieve certain performance milestones (e.g., the start-up's drug product passing clinical trials with the Food and Drug Administration or the start-up reaching certain revenue targets) based on a previously established timetable.

Subsequent equity grants, whether given to founders, key employees, or other grantees, are given in part to incentivize them, but also because in a start-up's early stages, cash is generally scarce, and the start-up usually cannot afford to pay market-rate salaries. However, the start-up still needs to attract and keep talent to move its business forward. Thus, equity grants are the easiest and most logical way to accomplish the start-up's personnel goals. In fact, in many industries, it is expected that an interest in the start-up's equity will be a part of each employee's (or, at a minimum, each key employee's) compensation package.

Conventional wisdom holds that compensation tied to an increase in the perceived or demonstrated value of the start-up's stock (or, in the case of certain equity incentive compensation plans, in the perceived value of the start-up itself) is said to align the founder or other grantee's interests with the interests of the start-up's investors. As such, this (at least in theory) incentivizes grantees to do everything reasonably possible to enhance the start-up's performance. However, such alignment of interests only works when the ability to secure the benefits of what is offered is tied to a verifiable way to measure the actual progress of the start-up's business (such as the growth of the company's market share, the amount of investment by later stage investors, revenues, and profits).

With these factors in mind, it is crucial to craft a plan that makes sense to all parties involved (i.e., the grantees, the start-up, and any future investors to the company). A primary objective is to draft a plan where a grantee's ability to secure the incentive compensation is linked directly to progress toward the start-up's avowed goal, which must be able to be objectively measured. This will quell any objections that founders, other grantees, and investors may have regarding the plan being defectively designed or biased in favor of one of their respective interests.

While equity incentive compensation plans come in all shapes and sizes, with enormous variability even within a single type of plan, it is important to determine which form is appropriate for the particular start-up based on an examination of the start-up's incentive goals and specific needs. In some cases, it may make sense to consider adopting more than one type of plan and to tailor each plan to the specific circumstances and the prospective pool of grant recipients.

Keep in mind that issuances of securities to employees, like securities issuances to any other person, are subject to federal and state securities regulations. Consequently, neither an issuer nor an employee may sell unregistered securities without either registering the security or qualifying under an exemption. See the section The Impact of the Securities Laws on Grants of Equity Incentive Compensation below for a further discussion.

Types of Equity Compensation Awards

Equity compensation granted to start-up founders, directors, officers, employees, consultants, and other service providers frequently consist of:

- Restricted stock
- Restricted stock units (RSUs)
- Stock options (either (1) incentive stock options (ISOs) (tax-qualified or statutory) or (2) nonstatutory stock options (NSOs) (nontax-qualified))
- Stock appreciation rights (SARs)
- Capital interests and profits interests for LLCs taxed as partnerships –and–
- Phantom plans

Below is a discussion of the basic elements and the tax considerations pertinent to each of the foregoing. For an additional discussion, see Equity Compensation Types and Tax Treatment.

Restricted Stock

Restricted Stock General Elements

Restricted stock involves the issuance of stock (normally common stock) pursuant to a restricted stock purchase agreement that is generally only entered into by founders of a start-up. For more information about the issuance of restricted stock to a start-up founder and the purchase agreement used in connection with the issuance of such

stock, see the practice note Founder Equity Purchase Agreements and Issuances of Corporations: Drafting Considerations.

The terms of a restricted stock purchase agreement establish the conditions that must be satisfied by the founder in order for the individual to secure unrestricted ownership of the stock in the future. For example, unlike the situation with stock purchase agreements signed with outside investors or venture capitalists (where the stock sold is unrestricted), under restricted stock purchase agreements, the start-up is generally given the right to reacquire any unvested stock (typically at the price paid by the recipient for the shares) upon the occurrence of a specific event. An example of a specific event would be the termination of a founder's employment with the start-up prior to the expiration of the full vesting period pursuant to the founder's restricted stock purchase agreement. When this happens, the founder typically receives no financial benefit from the founder's prior ownership of the founder's unvested stock since, generally, the founder was prohibited from pledging such shares until the stock's ownership restrictions lapsed.

The vesting schedule is not cast in stone and, depending on the terms of the equity incentive compensation plan under which the grant is made, as well as the relative bargaining strength of each of the parties, it may be varied by negotiation. In addition, sometimes a black-out period (or cliff) is imposed on vesting so that no shares will start the vesting clock ticking until the black-out period expires (which is typically the first 12 months of employment).

The purchase price for shares purchased pursuant to a restricted stock purchase agreement is typically payable in cash or by a full recourse promissory note in favor of the start-up, although other forms of payment are also permissible. See the forms Founder Stock Purchase Agreement (Vesting), Founder Stock Purchase Agreement (No Vesting), and Promissory Note Secured by Pledge of Stock.

Restricted Stock Tax Considerations

The tax treatment accorded restricted stock is complex and requires the parties to pay careful attention to the following Internal Revenue Code (IRC) tax considerations:

- The tax treatment that will be accorded upon the subsequent vesting of those shares (where the shares are subject to vesting) –and–
- The tax treatment that will be accorded upon the ultimate sale of those shares

In both cases, such treatment depends on whether or not the recipient of the grant timely files an election under I.R.C. Section 83(b) (83(b) Election). See I.R.C. § 83. By properly making an 83(b) Election, the recipient will be subject to income and employment tax on the current value of restricted stock on the grant date (minus) any amount paid by the recipient. Thereafter, any appreciation in the value of the shares after the grant date will not be subject to taxation until such time as the shares are sold, and then solely under the rules applicable to capital gains. See the forms Section 83(b) Election Form (Restricted Stock) and 83(b) Election Client Memorandum. For additional guidance regarding the application of Section 83 to property such as restricted stock, see Tax Risks of Equity-Based Compensation, Taxation of Executive Compensation § 7.08, "Impact of Taxation under Section 83," Taxation of Executive Compensation § 7.09, "Impact of Section 83: When Compensation Income Must Be Recognized," Taxation of Executive Compensation § 7.10, "Impact of Section 83: Election to Include Forfeitable Property in Income," and Taxation of Executive Compensation § 7.11, "Impact of Section 83: Nonlapse Restrictions Affecting the Amount of Recognized Compensation."

Absent an 83(b) Election, the recipient will have income and employment tax obligations in each year in which any shares vest. The amount that must be included for income and employment tax purposes is equal to the excess of the fair market value of the vested shares on the vesting date over the amount paid for such shares.

In addition, the recipient (and the start-up) are required to satisfy income and employment tax obligations through tax withholding at the time of the 83(b) Election or vesting (absent an 83(b) Election), which may require an immediate cash outlay by the recipient. While founders often have the ability to secure cash to satisfy such an obligation, non-founder and non-key employees may be faced with a catastrophic event to satisfy such withholding obligations, especially if the employee is unable to sell any of the shares to offset the tax obligations. Under the IRC and the rules promulgated by the Internal Revenue Service (IRS) interpreting this provision, an 83(b) Election must be made no later than 30 days after the date of grant of the shares to the recipient.

You should also note that the start-up will be entitled to a federal income tax deduction equal to the amount of compensation income recognized by the grant recipient at the time such ordinary compensation income is deemed to have been received. This date is either at the time of the 83(b) Election or the vesting date (absent an 83(b) Election).

The form 83(b) Election Client Memorandum can be used to communicate, in summary, the substance of the Section 83(b) Election rules. Recipients of the grant should also be urged to consult with their own tax counsel regarding making an 83(b) Election.

For a treatise discussion regarding the use of restricted stock, see Executive Compensation § 5.04, "Restricted Stock."

Restricted Stock Units (RSUs)

RSU General Elements

A restricted stock unit (RSU) represents a promise by the company to transfer a share of the company's stock or a cash payment equal to the value of a share of the company's stock at a specific time in the future. RSUs are not actual ownership interests in the underlying shares, which means that holders of RSUs are not the beneficial owners of the shares. As such, holders of RSUs are not entitled to vote, receive dividends, or exercise other stockholder rights until the RSUs vest and the shares are transferred to them. For more information about RSUs, see Start-Up & Emerging Companies § 14.02, at paragraph [10].

RSUs may vest based on the passage of time (time vesting), the achievement of company or individual performance goals (performance vesting), or the occurrence of a liquidity event (e.g., the sale of a company). A combination of factors may be required for RSUs to vest, and it is not uncommon for start-ups to require both time vesting and a liquidity event for a holder's RSUs to vest.

RSU Tax Considerations

An RSU holder does not pay taxes when the RSU is granted. For employment tax purposes, both stock-settled and cash-settled RSUs are taxed on the fair market value of the underlying shares when the award is no longer subject to a substantial risk of forfeiture. For income tax purposes, stock-settled RSUs are taxed at ordinary income tax rates on the fair market value of the underlying shares at the time the award is settled, while cash-settled RSUs are taxed at ordinary income tax rates on the amount of cash paid in settlement of the award (typically the fair market value of the underlying shares at the time the award is settled).

In addition, a holder of RSUs may be eligible to make an I.R.C. Section 83(i) (83(i) Election). An 83(i) Election allows eligible, private corporations to offer "qualified employees" the opportunity to make an election to defer the recognition of income on illiquid company stock acquired through the settlement of RSUs for up to five years after the RSUs vest. A qualified employee must make an 83(i) Election within 30 days of the earlier of (1) the date on which the stock becomes transferable or (2) the date such stock is no longer subject to a substantial risk of forfeiture. For a further discussion regarding the impact of Section 83(i), see Lexis Explanation IRC Sec. 83(i)

Stock Options

A stock option gives the optionee the right, but not the obligation, to purchase shares at the exercise price. There are two kinds of options: incentive stock options, which are statutory and set forth in I.R.C. Section 422, and nonstatutory stock options. Both types of options are described below.

Incentive Stock Options (ISOs)

Incentive Stock Option General Elements

ISOs are options that satisfy the requirements of I.R.C. Section 422 (Section 422), which provides special tax treatment (as discussed below) in connection with the exercise of the option and the disposition of the shares subject to the option. Key requirements of Section 422 are (1) ISOs must be granted only to employees of the start-up or its parent or subsidiary, and (2) the exercise price of an ISO must be no less than the fair market value of the stock on the date of grant. (Note: In the case of 10% shareholders, the exercise price of an ISO must be no less than 110% of the fair market value of the stock on the date of grant). See the forms Stock Option Plan and Stock Option Agreement.

Incentive Stock Option Tax Considerations

There are no federal income tax consequences upon the grant or vesting of an ISO. Upon exercise, the employee incurs no tax liability unless the employee is subject to the alternative minimum tax (AMT) under I.R.C. Section 55. The start-up will not be entitled to a federal income tax deduction either. Upon sale of the shares (assuming that the sale does not occur (1) within one year after the date of exercise or (2) within two years after the date of grant), any gain is taxed to the employee as long-term capital gain, which means that the gain is not considered wages for income and employment tax purposes.

If the shares are disposed of (which includes gifts and certain other transfers) within one year after the date of exercise or within two years from the date of grant, then the difference between the fair market value of the shares on exercise (minus) the exercise price is considered compensation income to the employee. The start-up is not required to withhold on the compensation income, and the start-up may claim a federal income tax deduction for the

income piece. Any gain recognized on the sale over the fair market value of the shares on exercise is subject to short- or long-term capital gains tax depending on how long the employee held the shares.

For a further discussion of ISOs, see Start-Up & Emerging Companies § 14.02, at paragraph [3][a] and the Equity Incentive Plan Resource Kit.

Nonstatutory Stock Options

Nonstatutory options (NSOs) are stock options provided to employees (and sometimes directors or consultants) that do not comply with the statutory rules that apply to ISOs under I.R.C. Section 422. NSO are also often referred to as nonqualified stock options.

Nonstatutory Stock Options General Elements

NSOs are stock options that do not satisfy the requirements of Section 422 and are not eligible for special tax treatment. Unlike ISOs, NSOs may be issued to nonemployees, such as consultants, as well as employees. Start-ups may also grant NSOs to key employees (including founders) to whom the start-up wishes to grant options containing terms not permitted by I.R.C. Sections 422 and 423. See the forms Stock Option Plan and Stock Option Agreement.

In general, an employer will want to ensure that the NSO satisfies the requirements of I.R.C. Section 409A (Section 409A) because a violation of Section 409A results in a 20% excise tax penalty and interest penalties that are imposed against the service provider (i.e., the employee or consultant). An NSO will generally comply with Section 409A if the exercise price of the NSO is at least equal to the fair market value of the stock on the date the option is granted. The IRS Treasury Regulations set forth factors that must be applied in determining fair market value. Due to the potential penalties, most private companies will engage a third-party valuation firm to calculate fair market value.

For an additional discussion regarding NSOs, see Start-Up & Emerging Companies § 14.02, at paragraph [3][c].

Nonstatutory Stock Options Tax Considerations

In most cases, there are no federal income tax consequences upon the grant or vesting of an NSO. At the time of exercise, the recipient will recognize compensation income equal to the excess, if any, of the fair market value of the option shares at the time of exercise of the option over the exercise price of the option. The compensation income is subject to income and employment taxes.

If the optionee is an employee, then the start-up will be required to withhold income and employment taxes from the compensation income. Such withholding can be satisfied either from the current earnings paid to the employee, by an out-of-pocket direct payment to the start-up, or through other means determined by the start-up. Upon sale of the shares after exercise of the option (and recognition of whatever compensation income is required to be exercised), the employee will recognize capital gain or loss in an amount equal to the difference between the sale price and the fair market value of the shares on the date of the option's exercise. If the shares have been held for more than one year prior to being sold, the gain or loss will be treated as long-term capital gain or loss to the optionee.

If the optionee is a 1099 service provider (such as a consultant), then the start-up will not be required to withhold income and employment taxes from the compensation income. Instead, the 1099 service provider will have a self-employment tax obligation for the compensation income piece.

The start-up is entitled to a federal income tax deduction to the extent of the income recognized by the optionee upon exercise of the NSO.

Similar to RSUs, the holder of an NSO may be eligible to make an 83(i) Election in order to defer the recognition of income. For more information about the 83(i) Election rules, see Section 83(i) Elections for Qualified Stock Grants.

Stock Appreciation Rights (SARs)

SARs General Elements

A stock appreciation right (SAR) award provides the recipient with the right to receive cash or stock equal to the appreciation in value of a share of employer stock above the SAR exercise price on the grant date. A SAR is similar to an option except that an option holder receives stock equal to the fair market value of the stock on exercise whereas a SAR recipient will only receive stock or cash equal to the difference between the exercise price and the fair market value of a share on the date of exercise. When exercised, SARs are customarily settled in cash, but may also be settled in stock. Similar to NSOs, SARs must set forth an exercise price that complies with Section 409A.

For more information about SARs, see Start-Up & Emerging Companies § 14.02, at paragraph [7][b].

Tax Treatment of SARs

SARs are generally subject to tax in the same manner as NSOs. One exception though is that SARs are typically

settled in cash so in many cases there are generally no capital gains tax considerations in the case of a SAR.

Capital Interests and Profits Interests for LLCS Taxed as Partnerships

Many start-ups are initially formed as an LLC that is treated as a partnership for tax purposes. Equity interests in partnerships usually fall within one of two categories: (1) capital interests and (2) profits interests.

For additional discussions about capital interests and profits interests, see the practice notes Profits Interests as Incentive Compensation and Profits Interest Plans and Employee Equity Compensation (LLC).

Capital Interest – General Elements

A capital interest is an interest in the LLC that provides the holder with a share of the LLC's assets if the LLC was sold immediately after the interest was granted. Capital interests are typically granted outright or in a manner similar to restricted stock or an NSO.

Capital Interest – Tax Treatment

A capital interest granted as a restricted capital interest is taxed in the same manner as a restricted stock grant, and a capital interest granted in the form of an option similar to an NSO is generally taxed in the same manner as an NSO. One key difference is that the individual is treated as a partner (not an employee) once the individual holds the capital interest. This means that the individual will no longer be treated as a W-2 employee. Instead, the individual will be subject to self-employment tax and the individual may no longer pay for common employee benefits, such as medical insurance, with pretax dollars. Given the change in tax status from employee to partner, some employees may not find that the grant of a capital interest that motivating.

Profits Interest

Profit interests are the more common form of partnership equity interests granted in start-ups. A profits interest entitles the holder to a share of future partnership profits but not in the existing capital of the LLC. Thus, unlike a capital interest, a profits interest holder will not be entitled to a share of the LLC's assets if the LLC was immediately liquidated after the interest was granted. Instead, the recipient is entitled to share in future profits after the grant. While a holder of profits interest may be granted voting rights, the partnership may make the interest a nonvoting one.

Profits Interest – Tax Treatment

If the following "safe harbors" are met, then the grant of a profits interest is a nontaxable event to both the recipient and the partnership:

- The recipient receives the profits interest in exchange for the provision of services to or for the benefit of the partnership granting the interest.
- The interest must not relate to a substantially certain and predictable stream of income from partnership assets.
- The recipient must not dispose of the profits interest within two years after receipt. –and–
- The profits interest must not be a limited partnership interest in a publicly traded partnership.

Similar to a capital interest, once the individual holds a profits interest, the individual is treated as a partner (not an employee). The change in status might not be looked on as favorable to the recipient so the start-up should consider this change in status before granting a profits interest.

Note: In order to maintain employee status, a start-up may consider establishing a multiple entity structure so that the individual is treated as employed by one entity (thereby retaining W-2 status) and owning a partnership interest in a separate entity (thereby being a self-employed individual in the other entity).

Phantom Plans

Phantom Plans General Elements

After considering all of the various options above, a start-up may decide that it does not want to grant any equity but still wants to make employees feel like owners. An alternative to granting real equity is to grant phantom equity, which represents an unsecured and unfunded promise to make a cash payment to a service provider at a specified time in the future equal to the value of a specified number of company shares or LLC units. Essentially, a phantom plan provides a cash bonus that tracks the growth in the value of the start-up.

One of the main considerations of a phantom plan is liquidity. A start-up considering the adoption of a phantom plan must determine when the phantom plan grants are payable, which typically requires some liquidity type event (e.g., a sale of the company). In this regard, many phantom plans are structured so that the award recipient will forfeit the award if the individual terminates employment or services prior to the liquidity event. This forfeiture provision acts as both a retention tool and helps to manage the liquidity concerns.

Tax Treatment of Phantom Plans

Phantom plan awards typically only provide for vesting and payment upon a liquidity event. Once the liquidity event occurs and a cash payment is paid, the recipient will have compensation income subject to income and employment taxes. The start-up will also be entitled to a tax deduction for the amount of the cash payment.

In addition, a start-up must be mindful of Section 409A when establishing vesting and payment terms. As discussed above, a violation of Section 409A can result in substantial penalties payable by the recipient. In order to be exempt from Section 409A, many phantom plans are structured to provide payment no later than March 15th of the year following the year of vesting, which allows the phantom plan to be exempt from Section 409A under the short-term deferral exception.

Equity Incentive Compensation Plan Drafting

A well-drafted start-up equity incentive compensation plan will address all of the following issues (but note that some of these issues may be reflected in the underlying award agreement as well).

Type of Equity Awards

The plan should indicate the type of equity award(s) to be issued under the plan (e.g., restricted stock, ISOs, and/or NSOs).

Equity Subject to the Plan

The plan should indicate the maximum aggregate number and types of shares or units that the plan may issue.

Change in Control

Many plans permit accelerated vesting of a grantee's equity award(s) upon a change in control at the start-up (i.e., a sale or merger of the company). Accelerated vesting is activated by either a single trigger (the act of the change in control alone) or a double trigger (the act of the change in control, plus an employee's termination without cause or resignation for good reason). Depending on the terms of the plan, a change in control could cause any previously unvested awards of a founder or employee to (either fully or partially) vest immediately.

A departed employee's receipt of accelerated equity compensation due to a change in control may be classified as an "excess parachute payment" by the IRS and subject to a 20% excise tax (I.R.C. Sections 280G and 4999). An extended discussion of such IRC sections and the subject of excess parachute payments is beyond the scope of this practice note. See Section 280G Resource Kit for more information regarding I.R.C. Sections 280G and 4999 including Golden Parachute Rules Video.

For a discussion on change in control agreements and drafting considerations, see the "Change in Control" titles within the Corporate Transactions EBEC Resource Kit.

Designation regarding Plan Participants

The plan should clearly indicate the classes of individuals or entities that will be permitted to participate in the plan. Remember that only employees can participate in tax-qualified stock options (such as ISOs). Be sure that the plan is not drafted in a way that will risk the tax-qualified nature of the plan if favorable tax treatment for grantees under the plan is what the start-up is seeking. For example, in crafting the plan, it must be made clear that any ISO granted to a 10% shareholder must be priced in an amount at least equal to 110% of the fair market value of the stock at the time of grant; otherwise, the plan's tax-qualified nature will be compromised. See Incentive Stock Option Checklist.

Administration of the Plan

The plan should specify the governing body within the start-up (or where administration is delegated to a third-party fiduciary, outside of the start-up) that will be charged with administering the plan, making all decisions impacting the plan, and any participation under it. Make sure the grant of authority to the particular administrative entity, whether (as is typical) it is the start-up's board of directors or some compensation committee to which the board of directors has delegated authority, is very broad so as to empower them (or it) to decide unanticipated issues as they arise.

Plan Provisions for Certain Corporate Events

The plan should be drafted in a manner to provide for an adjustment in the number of shares or units to which the equity incentive grant relates in the event of any merger, consolidation, reorganization under the federal bankruptcy laws, recapitalization, reincorporation, stock dividend, spin-off, dividend in property other than cash, stock split, liquidating dividend, combination of shares, exchange of shares, change in corporate structure, or other reorganization of the start-up. Failure to include an adjustment provision will leave the grantees under the plan subject to unfair dilution with respect to any of these types of events. In each case, the adjustment to be made should be determined by the start-up's board of directors or other entity assigned the task of administering the plan.

Moreover, the plan should include procedures for the treatment of awards in the event of a sale. Many purchasers will require the start-up to address existing awards as part of the sale agreement. As an example, it may be desired to have terms stating that vested awards will be satisfied with a cash payment and unvested awards will be forfeited upon a sale of the start-up.

Authority to Amend or Terminate the Plan

Be sure to reserve to the board of directors (or other administering entity) the absolute discretion to amend the plan in any way it deems to be in the best interests of the start-up, even to the extent of terminating the plan itself. Bear in mind that such grant of authority cannot adversely affect the interests of any plan participant who has already received grants under the plan, at least with respect to those past grants.

Restrictions on Transfer and Rights of First Offer / First Refusal

It is common for stock or units issuable under an equity incentive compensation plan to be subject to various restrictions on transfer since the purpose of such plan is to provide an incentive for grantees to think like owners, putting the interests of owners (and themselves) first. Allowing freely, transferable equity to be issued under the plan would thus defeat this purpose. Consequently, it is customary to include right of first offer and/or first refusal obligations in equity incentive compensation plans.

In the context of an equity incentive arrangement, a right of first offer requires any grantee under the plan who becomes an equity holder and who, subject to the plan restrictions, proposes to sell their equity to offer the equity to the start-up or other non-selling equity holders before offering them to a third party. If the start-up and the non-selling equity holders opt not to buy the equity, the selling equity holder is permitted, usually for a limited period of time, to sell the equity to a third party. The third-party sale cannot have terms more favorable to the third-party buyer than the terms offered to the start-up and the existing non-selling equity holders, including pricing terms.

A right of first refusal requires any selling equity holder, if that individual receives a bona fide third-party offer to purchase some or all of that individual's equity and wants to accept the offer, to offer to sell such equity to the start-up or the non-selling equity holders. The offer to the start-up and the non-selling equity holders must be made on terms similar to those offered by the third party, including pricing terms. If the start-up and the non-selling equity holders opt not to buy the equity, the selling equity holder is permitted to sell the equity to the third party, typically for a limited period of time.

Repurchase and Put Rights

Repurchase rights are generally granted to a start-up under restricted stock plans (or under stock option plans having an early exercise feature) where the shares (or the right to acquire shares) have not yet fully vested. When such repurchases occur, those repurchases typically occur at the price originally paid for the shares. In contrast, put rights provide the grantee with an option to sell their shares back to the start-up at a price that will be determined in accordance with a formula built into the plan at the time of the plan drafting. Similar rights are also typically provided in grants of restricted LLC interests.

Drag-Along Rights and Tag-Along Rights

Under a drag-along rights provision in the plan documents, upon a change in control, the start-up has the right (the drag-along right), but not the obligation, to force the grantee to tender their shares for purchase by the acquirer, in the same proportion, for the same consideration, at the same price and on the same terms and conditions as apply to the start-up's other holders of the same class of shares for which the drag-along right provision is being triggered. More often than not, the plan provides that the start-up's drag-along right terminates upon the start-up's initial public offering (IPO).

Tag-along rights are essentially the opposite of the start-up's drag-along rights in that the holder of the rights (presumably a grantee of shares received under the terms of an equity incentive compensation plan) has the right to demand to be treated like other sellers of shares in certain corporate sale transactions.

Similar rights are also typically provided in grants of restricted LLC interests.

Lock-Up

Under a lock-up provision, awards and the underlying shares granted under an equity incentive compensation plan generally may not be sold or otherwise transferred for an indefinite period of time, which most commonly lapses anywhere from six months to two years after an IPO.

Clawbacks

Under a clawback provision, any and all awards granted under the plan are subject to recoupment in accordance with any clawback policy that:

- The start-up may be required to adopt pursuant to the listing standards of any national securities exchange or association on which the start-up's securities end up being listed –or–
- That may otherwise be required due to the Dodd-Frank Wall Street Reform and Consumer Protection Act or other applicable law

In addition, in many cases, as part of this provision, the board of directors (or other governing entity) will reserve to itself the right to impose such other clawback, recovery, or recoupment provisions in an award grant as it may determine is necessary or appropriate, including but not limited to a reacquisition right in respect of already acquired shares (or other cash or property) upon the occurrence of an event constituting "cause" as that term may be defined, either in the plan itself or in the grantee's employment or consulting agreement.

For a discussion regarding clawbacks, see Clawback Policy Design and Tax Issues and Sexual Harassment and Executive Compensation.

The Impact of the Securities Laws on Grants of Equity Incentive Compensation

Publicly held companies that issue equity to employees and independent contractors and directors must conform to existing securities laws regarding issuance of securities. This section discusses those laws in part. For a broader discussion, see the Executive Compensation Disclosure and Governance Resource Kit. Start-ups commonly are privately held, and often rely on Rule 701 of the Securities Act to grant equity-based compensation to their employees without registering these securities with the Securities and Exchange Commission.

Federal Regulation and Registration of Securities

The offer and sale of securities (the definition of which includes stock options, and most other forms of equity participation) is regulated at both the federal and state levels. Since equity incentive compensation arrangements and plans are regulated under federal and state securities laws, it is important for you, as counsel, to know what is required to ensure compliance. Accordingly, below is a brief description of federal and state securities law considerations you should be aware of, which specifically highlights the registration exemptions that permit the use of stock options and other forms of equity participation to provide additional compensation to those individuals who render essential services to a start-up and who neither qualify as accredited investors under Regulation D of the federal securities acts nor possess the level of investment sophistication required to satisfy the *Ralston* test (as discussed below). For a more in-depth discussion of relevant federal and state securities laws, see the practice note Start-Up Capital Raising: Federal and State Securities Laws Considerations.

For start-ups that are not investment companies, there are two primary sets of federal securities laws that affect the start-up offering and selling its securities, including stock options and other forms of equity participation in the start-up, to their employees and certain other qualified individuals:

- The Securities Act of 1933, as amended (Securities Act) –and–
- The Securities Exchange Act of 1934, as amended (Exchange Act)

This practice note will focus primarily on those issues arising under the Securities Act since it is that statute that deals with the initial issuance of securities by a start-up. For a discussion on both laws, see U.S. Securities Laws.

The Securities Act and Its Section 5 Registration Requirement

Subject to certain exemptions (due either to the nature of the offering or the nature of the security being offered), Section 5 of the Securities Act generally requires a start-up to file a registration statement with the federal agency, the Securities and Exchange Commission (SEC) containing information about itself and the securities it is offering before being allowed to offer or sell those securities to members of the general public (a group to which most of the individuals in the start-up's employee pool typically belong). Section 5 accomplishes this by prohibiting the use of the instrumentalities of interstate commerce (i.e., the mails, the telephone, the internet, etc.) in any such offering unless a registration statement, complying with the SEC's rules, is filed. The reference to the instrumentalities of interstate commerce provides the jurisdictional predicate to enable the SEC, as a matter of law, to regulate in this area.

Available Exemptions from Federal Registration—Stock Options and Other Equity Incentives

There are a number of statutory and rule exemptions to the requirement that a start-up must register with the SEC under Section 5 of the Securities Act before offering

or selling stock or other securities. While most of these are used to avoid registration where the offering is being made to traditional investors (i.e., private placements), several of the exemptions appear, at least on their face, to be available to offerings made to non-investors, such as grants of restricted stock, stock options, and other forms of equity compensation to officers, directors, employees, and consultants. Some of these exemptions, to the extent that they appear to have application to the granting of equity incentive compensation to directors, employees, and consultants, are set forth below.

Section 4(a)(2) under the Securities Act

Section 4(a)(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." Upon first examination, it appears that, given the closed circle and private nature of equity compensation grants by start-ups to their own directors, employees, and consultants, that the exemption would be available for that purpose.

However, as far back as 1953, in the case of Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953) (Ralston), the Supreme Court rejected that notion. In *Ralston*, the issue before the Court was whether Section 4(2) (now Section 4(a)(2)) of the Securities Act provided an exemption from registration for a stock offering being made supposedly to key employees only.

During its deliberations, the Court touched upon the following points:

> . . . the applicability of [Section 4(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."
>
> . . . [Thus,], the "exemption question turns on the knowledge of the offerees . . . . The focus of inquiry should be on the need of the offerees for the protections afforded by registration."

Thus, according to the Court, investors (including employees) in a qualified private offering need to be sophisticated investors. If this requirement is met, then the investors have access to information about the offering, and the start-up meets the Section 4(a)(2) exemption.

However, by contrast, in the *Ralston* case, the employees who were offered stock options were rank-and-file employees. The employees were not shown to have access to the kind of information that the registration statement required for a public offering would disclose. Therefore, the offering was found to be a public offering, which did not allow Ralston Purina to use the registration exemption. The Court added that with respect to the offering, every single offeree must satisfy the conditions of the exemption for the exemption to apply.

So, under the *Ralston* case, along with subsequent court cases and SEC rulings and administrative interpretations affirming the original *Ralston* standard for availability of the exemption, it is clear that at least with respect to rank-and-file employees and other persons who do not meet the sophistication test, a start-up cannot rely on the exemption available under Section 4(a)(2) to avoid registration under Section 5 of the Securities Act. For a law review discussion of the *Ralston* case and its impact, see ARTICLE: RED, YELLOW, OR GREEN LIGHT?: ASSESSING THE PAST, PRESENT, AND FUTURE IMPLICATIONS OF THE ACCREDITED INVESTOR DEFINITION IN EXEMPT SECURITIES OFFERINGS, 14 Va. L. & Bus. Rev. 329.

Regulation D

Regulation D is a series of substantive and procedural rules, numbered 501 through 508, that provide two main transaction exemptions (Rules 504 and 506) for private offerings. Regulation D is the SEC's attempt to provide precise guidelines that, if followed, will assure issuers of the availability of an exemption from the federal registration requirements. Securities issued in reliance on one of the Regulation D exemptions are subject to certain restrictions on resale.

Rule 701

Rule 701 is the principal exemption upon which start-ups rely in granting equity incentive compensation to non-founders and individuals who neither meet the sophistication and access to information requirements of the Ralston holding, nor qualify as accredited investors under Regulation D.

Rule 701 under the Securities Act provides an exemption from registration for issuances of securities to employees, directors, general partners, trustees (where the start-up is structured as a business trust), officers, consultants, and advisors (provided they render bona fide services and that such services are not in connection with the offer and sale of securities in a capital-raising transaction), and family members of any of the foregoing individuals (who acquired the securities through gifts or domestic relations orders) if the offers and sales of the securities meet various conditions, including the following:

- The issuance of securities under Rule 701 must only be made to the category of individuals specified in

Rule 701 and in connection exclusively with employee-like equity compensation, and not with capital raising transactions.

- The amount of securities that can be sold during any consecutive 12-month period in reliance upon Rule 701 may not exceed the greater of:
  - $1 million
  - 15% of the start-up's total assets, measured at the end of the start-up's most recently completed fiscal year –or–
  - 15% of the outstanding class of securities being offered
- The start-up must furnish to every person to whom equity incentive compensation is granted under the exemption afforded by Rule 701, disclosure adequate to satisfy the antifraud provisions of the federal securities laws (note that start-ups who fail to do so risk enforcement action by the SEC). With respect to the required level of disclosure, if companies do not want to disclose extensive information to their employees and others and are willing to keep the amount sold below $10 million in a 12-month period, they would need to provide only the disclosure necessary to satisfy the antifraud provisions of the law (i.e., no misrepresentation of a material fact and no omission to state a material fact). However, if companies wish to exceed the $10 million limitation (which was raised from $5 million as of July 24, 2018), then disclosure must consist of the following:
  - A copy of the compensatory benefit plan or contract
  - A copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 (ERISA) or, if the plan is not subject to ERISA, a summary of the plan's material terms
  - Risk factors associated with investment in the securities under the plan or agreement –and–
  - The financial statements required in an offering statement on Form 1-A under Regulation A
- The start-up must deliver to each grantee of equity incentive compensation under Rule 701 a copy of the written compensatory benefit plan before the date of sale. –and–
- The start-up must not be a reporting company (i.e., subject to the reporting requirements under Section 13 or 15(d) of the Exchange Act) or an investment company registered or required to be registered under the Investment Company Act of 1940.

Unlike offerings under Rule 506 of Regulation D, offerings under Rule 701 are not exempted from state registration. Some states in which employees reside may require filings and advance clearances before offerings pursuant to an equity incentive compensation plan may be made to employees in those states.

As interpreted by court cases and SEC administrative rulings and staff interpretations of the rule, the actual specifics of Rule 701 are exceedingly complex. Therefore, prior to recommending to your client that they proceed with the granting of equity incentive compensation to employees and others in reliance on the exemption from registration afforded by Rule 701, you should consult, and attempt to thoroughly understand, both the case law, administrative interpretations of the rule, and state law where applicable. For more information about Rule 701 and its specifics, see 17 C.F.R. § 230.701—Exemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation, the practice note Employee Incentive Compensation and Rule 701, and the SEC "no action" letters and other administrative interpretations and guidance issued in connection with this rule.

State Regulation of Securities

In addition to federal regulation under the watchful eye of the SEC, the offer and sale of securities by a start-up is also subject to regulation by state authorities under their own statutes and regulations (commonly referred to as "Blue Sky" Laws).

Fortunately, many Blue Sky Laws include a statutory transactional equivalent (i.e., good for the initial sale but not for resales) that mirrors Rule 701 or provide another exemption afforded either by Section 4(a)(2) of the Securities Act or Regulation D. Variations among these various Blue Sky Laws include such things as:

- A limitation on the aggregate offering amount or sales of the securities, including securities sold outside of the state
- Numerical limitations on offeree outreach (i.e., a limit on the number of potential investors who can be invited to purchase), both with respect to offerees within the state, as well as the total number of offerees in general
- Limitations on the allowable number of purchasers in any 12-month period, which can include both in-state and out-of-state purchasers
- A requirement that the start-up file with the state securities administrator whatever they file with the

federal regulators, as well as in some cases, additional, or different documentation than what is required by the SEC

- Limitations on commissions that may be paid to licensed broker-dealers
- Limitations on who may assist the start-up in selling securities (e.g., widespread restrictions on who may participate in selling the offering), other than licensed broker-dealers, most of whom are indifferent to pleas by start-ups for assistance due to the relatively small aggregate commissions that may become due
- Prohibitions against general solicitation and advertising –and–
- Restrictions on the manner in which the offering may be made

One area where some states are actually more permissive than the SEC in allowing offers and sales without having to jump through the normal regulatory hoops is when the transactions are considered isolated (i.e., a small number of sales over a specified period). In many cases, the start-up can avail itself of the exemption without having to make any filing with the state securities administrator. While not all states provide such an exemption (California is one very notable exception), where the exemption exists, it can be a boon for both you, as counsel, and your client. Most notably, if you couple such a state exemption with an available federal exemption, there may be no need to make any filings at all; thus, relieving you and the client of at least one regulatory burden.

For a discussion regarding the application of Blue Sky Laws, see Blue Sky Law Compliance in Securities Offerings, Limited Offerings under Blue Sky Laws, and Securities and Transaction Exemptions under Blue Sky Laws.

California's Exemption as an Example

California's securities regulatory system is unique among the states. Viewed by many as perhaps the toughest, and most burdensome system among the states, California regulates all offers and sales of securities in California, even among founders and even where a secondary sale is involved (i.e., sales and transfers among shareholders and third parties in which the issuer is not involved). In every case, the offers and sales must be qualified with California's Department of Financial Protection and Innovation (Department), unless the security itself is considered exempt (e.g., bank notes) or the transaction is exempt under the California Securities Law of 1968 (CSL) or the regulations promulgated thereunder.

California provides an exemption for issuances pursuant to an equity incentive compensation plan outlined in CSL Section 25102(o) (Section 25102(o)). Section 25102(o) provides that with respect to the issuance of securities pursuant to stock purchase and stock option plans and agreements, such issuances are exempt from registration under California law provided that the issuances of such securities are exempt from federal registration pursuant to Rule 701 and that the terms of the plan or agreement conform to certain Department regulations. The filing requirements of Section 25102(o) require that a Section 25102(o) form be filed with the Department of Corporations (along with payment of a fee) within 30 days of the first issuance of any security under the plan. Additionally, an issuer (other than a California corporation) must file a consent to service of process with the Department.

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- Equity and Incentive Compensation Arrangements for Start-Up Companies
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- Equity Incentive Plan Resource Kit
- Equity and Incentive Compensation Arrangements for Start-Up Companies
- Tax Risks of Equity-Based Compensation
- Start-Up Company Employment Law, Benefits, and Executive Compensation Resource Kit
- Start-Up Resource Kit

Templates

- Founder Stock Purchase Agreement (Vesting)
- Founder Stock Purchase Agreement (No Vesting)
- Stock Option Plan
- Incentive Stock Option Award
- Nonqualified Stock Option Award (Employee)

Matthew A. Secrist, Partner, Taft Stettinius and Hollister LLP

Matthew focuses his practice on employee benefits and executive compensation matters. He is experienced in a wide range of employee benefits matters, including tax qualified retirement plans, nonqualified deferred compensation plans and arrangements, welfare benefit plans, COBRA, HIPAA, and Affordable Care Act issues. Matthew also advises clients regarding compliance with Internal Revenue Code Sections 280G and 409A. His executive compensation experience includes employee fringe benefit plans, stock option plans, supplemental executive retirement plans (SERPs), employment agreements, severance plans, and various other forms of incentive compensation arrangements.

In addition to assisting employers with day-to-day employee benefits-related matters, Matthew has guided employers through cases where the employer participated in a distressed multiple employer welfare arrangement (MEWA) where a court appoints a receiver/independent fiduciary to oversee plan liquidation and payment of employee medical claims. Matthew also counsels clients on employee benefit matters in employer bankruptcies.

Matthew advises tax-exempt entities from formation to termination, and represents clients in controversy proceedings before the IRS and the Department of Labor.

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