Stock Options: Key Considerations for Startups Hiring Talent

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Stock options are a form of equity compensation that, when granted, give the optionee the ability to purchase shares of stock in a company at a predetermined price per share, known as the exercise price or strike price. At the time of grant, stock options do not represent current stock ownership; rather, they provide the opportunity to become a stockholder after the options have vested and are exercised.

Stock options can be a valuable tool for startups seeking to recruit, incentivize, and retain skilled talent. They can help make compensation packages more competitive by giving employees an opportunity to participate in the company's future growth, particularly where a startup may not be able to offer larger cash salaries. In addition, stock options are frequently used to align the company and employee's goals by having the stock options act as a retention tool that may encourage employees to stay and grow with the company. They encourage employees to be invested in the company's long-term success by providing them with a potential stock ownership stake in the company.

While stock options can be fully vested upon the date of grant, more often than not, companies will want to issue stock options with a vesting schedule. Vesting schedules are typically time-based, although they may also be milestone-based and tied to the achievement of specified targets or other performance objectives established by the company. The length of vesting provisions can vary, but a typical time-based vesting schedule for employee stock option grants is four-year vesting with a one-year cliff. This means that the stock options would vest over four years' time, but during the first year, no options will vest until the optionee reaches the one-year anniversary (commonly referred to as a cliff). At that time, 25% of the stock option will vest, and thereafter, over the remaining three years, the other 75% will vest in either substantially equal monthly or quarterly installments. Vesting structures (whether time-based or milestone-based) can encourage employees to remain with the company over the full vesting period in order to vest in, and have the opportunity to exercise, the full number of shares subject to the option.

Key Considerations when Granting Stock Options

- Incentive stock options may be granted only to employees and can qualify for favorable federal tax treatment if applicable statutory requirements are satisfied. If stock options are being issued to an advisor, consultant, or director who is not an employee, the option generally should be structured as a nonqualified stock option (also referred to as a nonstatutory stock option), rather than an incentive stock option.

- The exercise price per share should be at least equal to the fair market value of the underlying shares on the date of grant. The board of directors should review, carefully consider, discuss, and determine the fair market value used for stock option grants and approve the grants at a board meeting or by written consent. One common way for boards to support their fair market value determination is to obtain an independent valuation under Section 409A of the Internal

Revenue Code.

- If you are the recipient of a stock option grant, the option will typically stop vesting when your employment or other service relationship with the company terminates. The applicable equity incentive plan and option agreement will determine how long vested options remain exercisable after termination. A 90-day post-termination exercise period is common, particularly for employee grants, but it is not a universal rule. In addition, an incentive stock option generally must be exercised within three months after termination of employment to retain its incentive stock option status, subject to certain exceptions. If an incentive stock option remains exercisable for a longer period, it may lose its incentive stock option tax treatment even if the option itself remains exercisable.

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