THE TAKEAWAYS

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RSU's vs Options – What are the facts?

Stock options/equity comp have been granted to employees for many years – generally considered the third leg of employee comp alongside salary, and bonus. The basic premise of granting equity is twofold :

1) Align the employee's interests with overall corporate success/investors

2) Create a retention vehicle as the typical four year vesting period requires employees to stay around in order to collect the full value of the award.

Equity comp is a complex issue – new tools for cap table management like Carta have eased some of the burden, however there is a lot of effort required to get this right. Specifically – this needs to be a joint effort between legal, hr and finance – given the issues in each of those areas. Too often, in a young company, one of those departments runs the cap table and oversees employee equity grants. Lack of coordination amongst all three groups – which is common -- can result in any/all of the following issues:

- Employees believing they will be awarded a grant based on a price quoted by a hiring manager or recruiter, vs the day the option is granted – and the 409a value on that date (which will be changed at least once per year). There can be an unwelcome surprise when an employee receives paperwork with a different price than they were promised.

- Granting options to an employee before they start work – BOD's may be asked to approve a grant for an employee who has accepted an offer, but not yet started. This has the same effect as backdating and the equity grant will end up being cancelled as invalid.

- Cap tables with improper share counts if cancelled options are not properly handled – this can result in option pools being increased unnecessarily.

- Equity plans that allow for broad transferability, which may not be desired.

- A commitment to extended option exercise periods – without understanding the ramifications from a cost (accounting), dilution, or broader employee perspective (ISO's become NSO's after 90 days)

- Accounting treatment for all of the above which can result in significant accounting charges down the road (beyond cheap stock)

- Creation of an unforeseen tax liability (409A) for an employee

The specific advantages of granting stock options vs RSU's have traditionally been around the different accounting treatments, in addition to shareholders' desire to reward employees for driving value above the price of the award, and not paying for the value created prior to the employees service. Additionally, until FAS123, options did not create any expense (P&L) impact for the company, nor are there any tax implications to the employee for the issuance or vesting of a stock option (taxes are only incurred at the time of settlement of the option – when the employee exercises their option and busy the shares, and again when the employee sell their shares).

Public companies started awarding RSU's more broadly after the dot com bust, as employees found themselves underwater on their stock options (when the stock price drops below the option grant price) – thereby resulting in zero retentive value and encouraging employees to join new companies, where they could restart their stock awards at the then current lower prices. This was exacerbated by the accounting rules that made repricing or replacing stock options very expensive for the company (variable accounting treatment). RSU's insulated employees from the volatility of the stock market, as the awards always held some value as they mirrored the performance of owning a share of stock in the company (RSU's are never underwater).

That said – the challenge was that companies had to record an expense when granting RSU's to the employee, and similarly, the employee had to recognize income (and incur a tax liability) as the RSU's vest.

This was in contrast to options where there was no company expense and employees only incurred a tax liability upon 'cashing out' of their option. In 2006, accounting treatments changed (FAS123R), which required expensing of option grants – thereby minimizing the difference to the company's P&L of issuing options vs RSU's – thereby further encouraging the use of RSU's by public companies. However, that same accounting change, now allowed companies to re-price options without such harsh accounting treatment (variable expense) – however the rise of shareholder metrics (Glass Lewis) strongly discouraged companies from repricing options after stock drops, as public shareholders were suffering losses and felt employees should not be granted a do-over at their expense.

What is important to note here is the difference in employee tax treatment for an option vs an RSU. Without getting into the nuances of ISO's vs NSO's, an option has no tax impact on the employee until settled.

Keeps things simple.

RSU's result in a taxable event upon vesting – so that an employee will incur income equal to the value of the shares on the day they vest – whether they sell the stock or choose to hold. Companies have solved this dilemma by doing a share withholding concurrent with a vesting event (can have vesting be time based coupled with a liquidity event) – whereby if an employee were to vest in 100 shares of stock, the company will issue only 70 shares to the employee, retiring the other 30 shares (essentially buying them back) in order to satisfy the tax withholding liability incurred by the employee. This does require a cash outlay from the company, to pay the govt the required withholding taxes, which ultimately show as taxes paid by the employee for the compensation they received (shares issued). Side note here – the one anomaly we have found here is around granting RSU's to non-employees – specifically the company's BOD.

As they are not company employees, directors are 1099 -- not W2 employees, making it impossible for the company to do share withholding. As such directors are incurring a significant tax liability upon vesting and must come up with the cash to pay their taxes on their 'earnings' from the RSU grant – if they do not have the excess cash on hand, they then need to sell stock in the open market – creating the need to file SEC docs reflecting an insider sale – which can have a negative impact on investors (why are insiders selling?). There are some complex remedies here that companies can implement and should (10b-5 plans for directors), as if share prices fall between vesting and sale, directors can find themselves owing more in taxes than the total value of the shares that vested – requiring the sale of up to 100% of their grant.

Again – this is a subject that has been frequently overlooked over the last 10 years, as even though RSU utilization has increased, the bull market has driven this to be a non-issue that will only become relevant if/when share prices start to drop.

Now – what about the use of RSU's at private companies? This has become a subject of interest as companies stay private longer and valuations skyrocket. We have seen companies go public at prices lower than their latest preferred value, potentially placing the last round of stock options underwater – thereby encouraging companies to explore the use of RSU's while private – before they do an IPO. There has been resistance from companies in moving in this direction for several reasons:

- Preferred shareholders are reluctant to provide built in gains to employees that are not helping to drive the value up from the date they join the company.

- Employees incur a tax liability upon vesting – this requires the company to spend a fair amount of cash buying back employee shares to settle tax liabilities upon vesting (share settlement)

- Employees become common shareholders upon vesting – yet their shares are illiquid – meaning there is no ready market to sell their shares (although secondary markets are becoming more active here).

Additionally, market volatility does impact private companies that are staying private for longer. With common share valuations trading at such high levels, there is continued risk of employees being underwater post-IPO – markets can drive shares up or down regardless of company performance and insulating employees from being underwater post-IPO can be beneficial to morale.

Much of the concern around granting RSU's in private companies can be overcome simply by implementing a double trigger vest for RSU's so they only vest subsequent to a liquidity event (six months past IPO or after a CIC). This way share settlements can be used to settle employee tax liabilities covered based on their time-based vested amounts. Note that the accounting treatment on double trigger options is different -- rather than an upfront fixed charge, there is no accounting charge until the second trigger, at which point there is a charge for the fully vested shares at the THEN CURRENT stock price.

The other question is around employee departures prior to the liquidity event --- what happens to their vested RSU's? Some companies have chosen to terminate RSU grants within 30-90 days of employee departure (similar to options if not exercised). Alternatively, companies can allow employees to 'take' their vested RSU's with them, as long as the plan defines a specific time frame upon which RSU's would ultimately expire. Again, variable accounting on these grants could cause some shareholder discomfort.

No doubt that RSU's are a more complex instrument than options – given the tax effect on employees (caveat – tax treatment outside the US can vary country by country). That said, few employees understand how a stock option works, how equity capital markets operate let alone the tax consequences around these capital gains. In all instances, companies need to educate employees – most specifically when moving from options to RSU's it is important for employees to understand why they are getting fewer shares as well as how they will be taxed on these shares.

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