Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 22 -
"In-the-Money" or Discounted Stock Options: The Pros, Cons, and How to Avoid 409A Violations

By Andrew E. Graw, Megan Monson, Taryn E. Cannataro

MARCH 2023

Kevin Iredell: Welcome to the Lowenstein Sandler podcast series. I'm Kevin Iredell, Chief Marketing Officer at Lowenstein Sandler. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts. Or find us on iTunes, Spotify, Pandora, Google podcast, and SoundCloud. Now let's take a listen.

Andrew Graw: Welcome to the latest edition of Just Compensation. I'm Andrew Graw. I chair Lowenstein Sandler's Employee Benefits and Executive Compensation practice group. I'm joined today by Megan Monson, a partner in the group, and Taryn Cannataro, an associate in the group. Today's discussion will focus on "in-the-money," or also called discounted stock options. Typically, for tax and other reasons, stock options are granted with an exercise price that is at least equal to fair market value at the time of grant. However, there are times when companies find themselves in positions where they will want to grant stock options with an exercise price that is less than fair market value. Today we're going to discuss how companies may grant these in the money stock options and some high-level considerations to be aware of if you're thinking about granting them. Of course, this is not intended to be an exhaustive discussion and as always we urge you to consult with your legal counsel. So Taryn, tell us, when are "in-the-money" options typically used?

Taryn Cannataro: This often comes up when a company promises an employee an option grant and the fair market value of the company's stock increases before the grant's made. This could be due to an inadvertent delay or if the company can't grant the options at the time for business reasons. Another reason we see company grant "in-the-money" stock options is if it wants to replace an expiring option but keep the economics of the award the same. For a discussion on what other options a company may have for expiring stock options, you can see our previous episode of Just Compensation on expiring stock options.

Megan Monson: So the biggest impediment that we see companies encounter when you're granting "in-the-money" stock options is Code Section 409A. Section 409A is a section of the Internal Revenue Code that governs non-qualified deferred compensation. And under 409A, stock options are generally treated as deferred compensation unless they meet certain requirements, as traditional stock options typically do, one of which is the exercise price must be no less than the fair market value on the date of grant. However, kind of for some of the reasons that Taryn mentioned, there are other ways to grant "in-the-money" options that will not violate 409A, which is really going to be the focus of our discussion today.

It's critical to avoid a 409A violation because of the negative tax implications. There's immediate income inclusion if the option is vested or it would be immediate inclusion upon vesting. And there's also a 20% excise tax on the option holder, and there's also an additional 5% excise tax on top of that if the option holder is in California, plus penalties and interest on the underpayment of taxes. So really having a 409A violation is particularly harsh outcomes for the option holder.

Andrew Graw: So Megan, how can an “in-the-money” option be granted so that it doesn't violate 409A?

Megan Monson: Yeah, so that's a great question, Andy. So there's two different ways that an “in-the-money” stock option can be structured. One is to comply with 409A, and we'll get into that piece of it in a minute. The other more common way is to meet a different exemption from 409A, aside from granting an option with an exercise price of the fair market value. So I'll talk a little bit about how the option can be structured to meet a different 409A exemption and then Taryn will get into the details about how an option can comply with 409A.

Most often we see clients structuring “in-the-money” stock options to be exempt from 409A by utilizing what's commonly referred to as the short-term deferral exception combined with vesting upon the lapse of a substantial risk of forfeiture such as continued employment through a particular date. The short-term deferral means that the options are only exercisable for up to two and a half months following the end of the employer's taxable year in which the vesting occurs. So for most taxpayers, that's the calendar year. So March 15th of the following year is when options would need to be exercised by. From a company standpoint, structuring options to be exempt from 409A provides much greater flexibility in that you can accelerate vesting without violating 409A.

So let's walk through an example of an option that's structured to meet another exemption of 409A. Somebody's granted an option on January 1st. The option's scheduled to vest on 12/31. Once that option vests, they have until March 15th of the following year during which the option can be exercised or it would otherwise be forfeited. So setting the option up that way that it has that limited period of time following the vesting date is one way to set it up to be exempt from 409A that we commonly see.

Taryn Cannataro: Thanks, Megan. And as you mentioned, “in-the-money” options can also be structured to comply with 409A, although we do see this less frequently than options that are intended to be exempt from 409A as a short-term deferral. Companies can structure options to be compliant with 409A by restricting the ability to exercise until a permitted payment event under Section 409A occurs. The most common permitted payment events or here events that trigger exercise that we see used are either a fixed date or a change in control. And it's important to note that those permitted payment events each have very specific definitions under Section 409A.

409A compliant options must specify at the time of grant the event that will trigger exercise and the period during which the options can be exercised. Similar to options that are structured to be exempt from 409A as a short-term deferral, options that comply with 409A also must be exercised within an allotted window. Often this window is the same as the short-term deferral window that Megan just mentioned, and if the options are not exercised within the allotted window, they'll be forfeited.

An example of an option that complies with 409A would be if an employee is granted an option to purchase a thousand shares of common stock with an exercise price of a dollar at a time when the fair market value is 10 and the options only vest and become exercisable upon the sale of the company. The sale of the company must meet the Section 409A definition for a change in control and then the options must be exercised or cashed out upon the change in control or within a very limited time thereafter.

Andrew Graw: Seems like there's some overlap between the requirements for complying with the short-term deferral exception under 409A and or actually complying with the deferred compensation requirements of 409A. So Megan, can you comment on that?

Megan Monson: Yeah, so that's a really great point, Andy. So you are correct that there is certainly some overlap. So for example, it's possible that an option is structured to be exercisable only upon a change of control, and that could be both excluded from 409A under the short-term deferral exception, but also comply with 409A because it's a 409A permissible payment event. And so in order to be 409A compliant, care must be taken to make sure the definition of change of control complies with 409A. What we see in practice is sometimes crafting an option to be both compliant with and exempt from 409A can be really helpful against a fail-safe, potentially having an inadvertent violation of 409A. So even if you're intending to utilize the short-term deferral exception, you're still using the proper 409A definition of change of control to really make sure that you are kind of protected on both fronts.

Andrew Graw: Thanks, Megan. So Taryn, what are some of the downsides to issuing “in-the-money” options?

Taryn Cannataro: As we touched on earlier in the episode, “in-the-money” options have a limited flexibility regarding the timing of exercise. Normally, stock options can be exercised once they're vested until the option expires. “In-the-money” options have limitations on the timing of exercise and typically the window which they can be exercised is shortened. This means that if the options are not exercised during that window, they'll be forfeited or the employee could be required to exercise the options at a time when there's no liquidity to do so. There's also kind of the downfall if you're structuring the option to comply with 409A in that there's limited flexibility to change the time and form of payment. Another thing to be aware of is “in-the-money” stock options cannot be granted as ISOs as a result of the requirements for granting incentive stock options. So they will be structured as non-qualified stock options.

Andrew Graw: Right. Incentive stock options have to be granted at fair market value, so by definition, a discounted or “in-the-money” option just would not qualify.

Taryn Cannataro: Exactly.

Andrew Graw: Any other points to raise for those considering granting “in-the-money” options, Megan?

Megan Monson: So many equity plans that we see are not set up to allow for granting “in-the-money” options, and so a plan may need to be amended in order to permit such awards. You would also typically need a specific award agreement that's structured to be either compliant with or exempt from 409A. In the public company space we don't see this done often, although they can grant “in-the-money” options. But some other considerations we tend to see, again for our public company clients, are potential accounting issues, concerns about negative shareholder reactions, and reporting requirements. So those are some of the reasons why we don't see this as frequently in that space. And while not inherently problematic, granting “in-the-money” options just may raise additional questions from investors or by a buyer in the course of a diligence exercise if the company's being sold.

Andrew Graw: Well, that was great. Thanks, Megan and Taryn for explaining “in-the-money” options to us. Thank you very much for joining us today. We hope you found this discussion useful and provided some food for thought if you have a situation where “in-the-money” stock options may be a good fit. Please also check out the materials that are presented with this podcast that go through the examples that were discussed. We look forward to having you back for our next episode of Just Compensation.

Kevin Iredell: Thank you for listening to today's episode. Please subscribe to our podcast series at lowenstein.com/podcasts, or find us on iTunes, Spotify, Pandora, Google podcasts, and SoundCloud. Lowenstein Sandler podcast series is presented by Lowenstein Sandler and cannot be copied or rebroadcast without consent. The information provided is intended for a general audience. It is not legal advice or a substitute for the advice of counsel. Prior results do not guarantee a similar outcome. The content reflects the personal views and opinions of the participants. No attorney client relationship is being created by this podcast and all rights are reserved.