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

Episode 8 - Double Vesting Restricted Stock Units

By Megan Monson, Darren Goodman, Taryn E. Cannataro
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Megan Monson: Hi and welcome to the latest episode of Just Compensation. I'm one of your hosts today, Megan Monson, Partner in Lowenstein Sandler's Employee Benefits and Executive Compensation group, and I'm joined by two of my colleagues today who I'll turn it over to to introduce themselves.

Darren Goodman: Hi, I'm Darren Goodman. I'm a Partner in the firm's Executive Compensation group.

Taryn Cannataro: Hi, I'm Taryn Cannataro. I'm an Associate in the firm's Employee Benefits and Executive Compensation group.

Megan Monson: Thank you both so much for joining us today. Today's podcast is going to focus on a topic that is important for many companies, including leader stage startups, restricted stock units, and in particular, double vesting of RSUs. In this podcast, we plan to explain what a restricted stock unit or RSU is, the pros and cons of issuing restricted stock units to employees and other service providers, and the different types of terms that can apply to RSU.

Taryn Cannataro: Thanks, Megan. Let's start right at the beginning. What are restricted stock units?

Darren Goodman: A restricted stock unit is a right to receive a share of stock in the future. That's different than a restricted stock award. And this can often cause confusion. A restricted stock award, someone is granted stock on day one. With a restricted stock unit, they're not issued anything on day one. They're simply given a contract right to get shares at some point in the future. RSUs normally have a vesting schedule. For example, it can vest over time 25% on the first anniversary of the grant and monthly thereafter over the following three years is a pretty typical schedule. And often shares our issued when the RSUs vests or shortly after the time that they vest.

Megan Monson: I'll just add in that sometimes companies will set it up where RSUs can also be issued in the form of cash instead of a stock award. So that's one option that companies have when they're deciding to issue employees or other service providers RSUs, and that flexibility can typically be built into the plan document or an award agreement.

Darren Goodman: It's a great point. And there can be flexibility to pay out in either shares or cash in the company's discretion. In either case there's no tax event when the RSU is granted or when it vests. They're only subjects to ordinary income tax when the shares are issued or when the cash is paid out. Assuming the RSUs settle in shares they're subjects to ordinary income tax at the time the shares are issued. From that point on there's the potential for long term capital gain treatment. But from the time of grant, until time of issuance, all of the growth in the shares will be subject to ordinary income tax. There's not the opportunity for long term capital gain.

Megan Monson: And just one other point to add on is after the vesting occurs, most companies will typically have a period of time under their award agreement or plan in which to actually issue the shares or pay out the cash. That could be typically, within 30 days or by March 15th of the following year or some common structures.

Darren Goodman: Agreed.

Taryn Cannataro: So what are some reasons companies consider offering RSUs as opposed to other types of awards?

Darren Goodman: So a big reason is that an RSU is what is called a full value award. Another main type of equity award is a stock option. And for tax reasons, there's an exercise price that is usually set at fair market value when the option is granted. So if the company's value does not increase, the option is worthless. With a restricted stock unit, the recipient is getting a right to shares and those shares will be worth whatever the value of the stock is at the time the shares are issued. There's no exercise price. There's no way that the RSU will become worthless unless the shares themselves become worthless. It's particularly attractive for companies whose stock has significant value. If you grant an employee, a stock option with an exercise price that they can never afford to pay, it's less attractive to the employee.

Darren Goodman: For the RSU, the employee knows they'll get the shares and they won't have to pay the exercise price. Because they're full value awards, there's less dilution from RSUs. Companies will typically discount the number of RSUs that they grant compared to the number of stock options, because each RSU is more valuable than an option. Because the RSU award then is smaller, less dilution. Then for public companies, Megan mentioned the flexibility to issue the shares within a period of time after the vesting date occurs, public companies can use that window to make sure that they issue the shares after a blackout period ends, if the vesting date occurs during a blackout period.

Megan Monson: And in general, I tend to see RSUs used much more frequently in the public company context, or as Darren mentioned for later stage private companies. I also sometimes see even earlier stage private companies issue them to senior executives in particular, for the reason that Darren mentioned, they are full value awards and sometimes one reason or another executives are more familiar or more comfortable with RSUs. So they simply ask for that for the form of equity that it's being issued to them.

Darren Goodman: Agreed.

Taryn Cannataro: On the other hand, what are the potential downsides of issuing RSUs?

Darren Goodman: Well, a big one for private companies is the tax treatment. So if you have your standard restricted stock unit where you're issuing the shares on or shortly after vesting, if it's a private company, the employee has a tax bill and they can't sell those shares on a public market in order to fund their taxes. They're getting a benefit, but at the same time, they're also potentially coming out of pocket to pay a tax bill on a share that's private and they never know when they'll have liquidity on it.

Taryn Cannataro: Is there any way to delay that tax liability?

Darren Goodman: So what some companies have done is to grant something called a double vesting restricted stock unit. And there's a few different forms that this can take, but a typical one is to have two different vesting schedules. One is a standard time based vesting schedule that we discussed earlier, for example, vesting over four years, but that's not enough to cause the shares to be issued. There's a second vesting trigger, which normally is either a sale of the company or completion of an initial public offering. And the sale or IPO has to occur before a deadline such as seven years from the grant date. And the goal is to delay issuing the shares and the tax event until there is liquidity for those shares so the employees not caught in that tax trap of having tax, but no liquidity.

Taryn Cannataro: Are there any potential downsides to double vesting RSUs as opposed to RSUs that just have a time based vesting schedule?

Darren Goodman: The downside is that if the sale or IPO does not occur before that deadline, the RSUs are forfeited. So the executive has nothing. And oftentimes it can be difficult for people to get comfortable with that because they are taking a risk. In many cases, everyone expects a sale or IPO to occur before the deadline, but there's no guarantee that it will. So employees are taking a risk that there is no sale or IPO and they simply forfeit.

Megan Monson: I would just add on to that, even though they are taking a risk, they do have the benefit that they're not coming out of pocket to pay an exercise price as they would with a stock option. So at least economically they're not facing that type of loss if an IPO or change of control does not occur.

Darren Goodman: Absolutely.

Taryn Cannataro: Does there have to be a deadline? I know you mentioned seven years as an example. Could it be a different number of years?

Darren Goodman: So the deadline is tax driven and in order to comply with some complicated tax rules that can lead to some pretty stiff penalties for the people receiving the RSUs, if you're going to issue the shares, if there's a sale or an IPO, there needs to be a deadline that is short enough to create a substantial risk that the RSUs are forfeited. What the right deadline is, it's facts and circumstances, depending on the company. Many companies are comfortable that seven years is short enough to create that substantial risk of forfeiture. Some companies I've seen go as far as 10 years. Other companies have taken the view that a shorter deadline is more appropriate.

Megan Monson: And I think that's also just generally what other practitioners in this space have seen and agreed upon as well is that seven years is really the middle of the road, sweet spot, where most companies and practitioners are comfortable with that deadline, but you're going to certainly have outliers who are more or less conservative on that.

Darren Goodman: Right. There are other forms that this could take. What we're talking about is a structure where when employees satisfy the time vesting schedule, they could leave and they'll still get their shares if the sale or IPO occurs before the deadline. There are some companies that require employees to stay continually employed through the sale or IPO. And then you do have more flexibility on a deadline and what the exact trigger is, maybe something beyond a sale or IPO. It can vary depending on the company.

Megan Monson: But I think under both of those structures, really the goal is to delay taxation and vesting in issuance of the shares until there's a market for liquidity to pay the taxes that are owed.

Darren Goodman: Agreed.

Taryn Cannataro: So for somebody who wants to grant double vesting RSUs in their company, what steps would they need to take to do so?

Darren Goodman: So it's no different than any other type of equity award. So it will be granted under an equity incentive plan. Most companies that grant equity awards have omnibus plans that provide for restricted stock units to be granted. If a company doesn't have that, or if they have a plan that only allows for the grant of stock options, they either need to amend their option plan or put in place a new omnibus plan allowing for the grant of restricted stock units. There would be a restricted stock unit award agreement that would have the terms of the award, and it would lay out both vesting schedules and it would include the expiration date that applies to the restricted stock units. And then just like any other equity award, board, or compensation committee, approval would normally be needed in order for that grant to be approved.

Megan Monson: And similar to any other type of equity award that the company issues, you would want to keep track of these awards in your cap table or other purposes. So you know how many awards have been issued and you can keep track of when they vest and when shares would need to be issued.

Taryn Cannataro: Are there any other considerations or items to think about with respect to RSUs?

Darren Goodman: I think those are the main items. We encourage companies who stock is increasing in value and stock options just aren't a sufficient incentive to consider restricted stock units. Many of our clients, particularly late stage tech clients are in that position. And they've found that these double vesting RSUs are a good way to incentivize their employees once stock options lose their attractiveness.

Megan Monson: And I would just add in that if it's an earlier stage company and they're adopting an omnibus equity plan, it's a good idea to have the plan allow for granting RSUs, even if they're not intending to do so in the early stages of growth, but they may want that flexibility later on and therefore they wouldn't need to amend their plan for that purpose. And they could simply adopt an award agreement at that later time. Well, thanks everybody so much for joining us today on this episode of Just Compensation. We hope that this episode provided some helpful guidance surrounding restricted stock units, as well as the pros and cons of granting such awards and the benefits of issuing them with a double trigger vesting schedule. Thank you so much, Darren and Taryn for joining today. We look forward to having you back for our next episode of Just Compensation.

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