Will Traditional Stock Options Remain A Lure for Startup Employees?

Stock options have long been a staple for startups. Employees often work for a smaller salary at an emerging company in order to grow and develop the business for a potential pay day down the road when the company goes public or is acquired. However, recent under-performing IPOs serve as one cautionary tale for startup employees banking on a big IPO payout based solely on their stock options. It raises the question: is the promise of stock options going to be enough of a draw for emerging companies moving forward, or do startups need to be more creative in offering other arrangements to attract top talent?

There are some tech companies which have achieved great success with their IPOs and their employees have reaped the benefits. Celebrated stories about such successes keep stock options as the primary tool to attract, retain, and motivate startup employees. To their benefit, stock options allow employees to participate in the growth of a company without an immediate payment of cash, taxes, or risk of loss until they are exercised. With traditional stock options, it is only when an employee terminates employment that the employee will need to invest funds to pay the exercise price and applicable taxes in order to acquire shares. However, in the absence of liquidity for company shares, such investments can be so costly for many employees that they are effectively prevented from reaping rewards for their efforts.

While they remain a great benefit, every tech company does not make it to the big pay day, and now, with the poor performance of certain recent IPOs , employees could take a more careful look at whether traditional stock options deliver on their promise. As a result, startups should consider what other unique benefits they can offer that address some of the shortcomings of stock options and make them stand out from their competitors.

Traditional stock options typically have a maximum 10-year term, and provide employees with three months to exercise following termination of employment. Today's successful startup companies typically have such a long gestation period between their inception and a liquidity event—whether through acquisition or IPO—that they need to get creative to attract, retain, and motivate their employees.

Long Post-Employment Exercise Periods

Some companies provide long-serving employees with longer periods of time to exercise vested options following termination of employment. Rather than a mere three-month period, companies give long-term employees a period of years—including up to the maximum 10-year term of the option—to exercise following termination of employment. Such arrangements are one way to recognize the contributions of valuable, long-serving employees who may not necessarily have the skills to take a company to its next level of development.

Net Exercise Programs

Net exercise programs allow employees to tender stock subject to their options to satisfy payment of the exercise price and applicable taxes. Such arrangements allow employees to acquire a meaningful amount of company stock without the significant cash investment typically required to invest in a successful startup. These arrangements allow employees to capture the benefits of their efforts even when the company's stock is not liquid.

Promissory Notes

Promissory notes allow employees to exercise an option and pay the exercise price and applicable taxes by borrowing from the company or a third party. Promissory notes to acquire shares must come with at least some potential personal liability for the employee, although promissory notes to satisfy taxes need not have associated personal liability. Both arrangements are secured by the company shares being purchased. Because of their inherent legal and financial risks, such arrangements should be reviewed carefully with counsel before implementation.

Liquidity Assistance Programs

Some companies also offer liquidity assistance programs that allow employees to sell shares, including shares subject to stock options, to new or existing investors in a financing or through secondary sales. Such programs allow selected employees to become stockholders before an acquisition or IPO.

Restricted Stock Units

Restricted stock units (RSUs) represent the right to receive a payment based on the value of one share of company stock after vesting conditions have been satisfied. A common RSU arrangement vests upon the satisfaction of a time-based service requirement and a liquidity requirement, typically an acquisition or IPO. The advantage of such an arrangement is that employees do not need to invest funds to pay an exercise price, and taxes are generally deferred until the company has achieved liquidity. Moreover, RSUs are a "full value" award, meaning that the awards will have incentive and retention value even if the price of the company's stock falls.

As startup companies develop and mature, they should periodically review their equity incentive programs, and determine whether their current mix of incentives remains the optimal way to reward, retain and motivate their talented employees in a competitive labor market.