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Negotiating And Structuring Your Stock Compensation (Part 3): Equity Grants When You Terminate Employment

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Many executives and employees are unpleasantly surprised to find a gap between what they expect from the equity compensation they negotiated at hire and what they ultimately receive when they lose their job. The fact of termination, in and of itself, will always have an impact on your ability to retain (or exercise) previously granted equity rights. But what that impact will be depends on your specific agreements, the company's overall plans and policies, and—in many cases—the reason for the termination.

Termination will always have an impact on your ability to retain (or exercise) equity rights.

Part 1 of this series looked at the way that conflicting or inconsistent provisions between different equity documents may interact to produce surprising results. Part 2 considered which existing documents and rules non-founder executives must take into account when negotiating for equity compensation at early-stage companies. Part 3 reviews the steps that an executive must take to preserve her equity rights at (or prior to) the time when employment terminates, and in any severance agreement. Termination may occur for many reasons, including those stemming from a change in control of the employer company. For purposes of this article, "equity rights" refers to all kinds of grants: stock options, restricted stock units, performance units, restricted stock, etc.

Know What You've Got Before You Lose It

Regardless of the reason for an employment termination, for most employees the experience of leaving a job is highly stressful. In my practice, I regularly counsel individuals who are taken aback by their own emotional responses to the process of disentangling themselves from their employer. Deeply felt reactions may cause a terminated employee to throw up his hands and walk away without fully considering rights, including equity rights, that are already on the table. In most cases, equity rights (e.g. stock options, stock appreciation rights) must be exercised prior to, or within a short period after, the termination date.

Decisions at termination will need to be made quickly, if not immediately, so understand your plan documents and get informed answers.

Cool-Headed Analysis Needed

Decisions about handling cash flow, taxes, and investment strategy will need to be made quickly, if not immediately, during a period that is already stressful. It's fine to decide that your equity rights are not worth pursuing, and walk away from them after a cool-headed analysis. Deciding by not deciding, however, raises the odds that you will later regret having forfeited otherwise vested rights.

Your Documents

As I discussed in my earlier articles, the key to a successful equity compensation negotiation is to have a full understanding of the underlying documents. That understanding will hold you in good stead when your job comes to an end. In the best of all worlds, you will already know what is in your agreements when you make (or are informed of) the termination decision. But whether it is early or late in the process, be sure to know—and have the documents handy to support—your informed answers to the following questions *as of any particular date*:

- *What percentage of my equity rights is vested?* Note that you should not be relying on the company to provide you with this information—you should be keeping track of it yourself. If you wait until your termination date to request this information, you may find yourself greatly disadvantaged by administrative or political recalcitrance (especially if there are disagreements between you and your employer regarding the reasons for termination).
- *Am I entitled to receive accelerated rights in connection with certain kinds of terminations?* If you have an individually negotiated agreement, you may have rights to accelerated vesting on certain non-cause terminations, such as termination due to job elimination, or resignation for "good reason" (e.g. a change in your position or responsibilities without your consent). Even if your agreement is standard, your rights may be subject to acceleration at the time of a corporate transaction (such as a change in control or initial public offering).

Rights to acceleration may appear in several different documents. You need to know what (if any) rights you have and which documents control such rights. In addition, not all accelerations are automatic. If acceleration is treated as a component of your severance, you may be required to execute a "release of claims" against the company as a condition to receiving additional equity. This requirement (if any) will also be set out in your equity documents.

- *What would it take to perfect my rights?* That is, do some rights require an exercise using cash? Is it sufficient to simply deliver a notice of exercise? Whom is the notice directed to? Can you use email delivery, or must it be delivered by a particular method? Is something else required? If you have already purchased stock with a note, does it need to be paid off at the time of termination?
- *How much time do I have to perfect my rights?* Don't assume that you will have plenty of time after

termination to analyze and make decisions regarding your equity position. Some plans provide that equity rights terminate *on the date of termination*. Others provide for a post-termination exercise period—typically between 30 and 90 days, but sometimes more and sometimes less, depending on the flexibility of the plan documents governing the grant (see a related FAQ with survey data on post-termination exercise periods). Moreover, your own grant documents will govern your post-termination exercise period. Your documents may provide for a shorter (or longer) period than the default under the employer's plan, so read carefully.

- *Will there be limits on my post-employment equity ownership?* In a privately held company, you may be required to sell back your already-vested rights at the current value or (alternatively) hold onto your equity indefinitely, until a liquidity event. In a public company, there may be insider trading or Section 409A restrictions on your ability to make immediate plans with respect to your holdings. In certain situations, you may be subject to forfeiture or clawback provisions related to post-employment noncompetition or securities law requirements.

Don't Forget The Practical Issues

Another key consideration is the financial reality of buying (or keeping) your equity rights. Stock may be less (or more) valuable to you personally once you are no longer an employee of the issuer. You need to think about the following practical considerations in advance:

- *What information will I need at the time of termination to make an informed decision about my equity investment?* As with any other equity investment, buying (or retaining) equity in your former employer is a decision that must follow your personal investment philosophy and portfolio. The needs that inform this decision are the same as those in any other investment decision. If your employer is public, you are entitled to (and can easily obtain) all information that is available to the general public for securities law purposes. This includes annual (and quarterly) reports, current trading information, press releases, and other disclosures filed with the SEC. Public companies are required to post these documents (or links to them) on their websites, often in the "Investor Relations" section. You can also download them directly from www.sec.gov using the EDGAR search system.

  If your employer is private, you have a more difficult task. Depending on state law requirements, your employer may (or may not) be required to provide holders of equity rights with financial and/or other disclosure information. Without such requirements, the decision of whether to invest in your former employer will probably be based on your personal knowledge of the company's business, its finances, and its likelihood of success—particularly on your sense of whether there is a meaningful liquidity event in the company's future.

- *What are the cash-flow consequences of exercising or retaining rights?* Exercising equity rights, particularly at the time of employment termination, can be expensive. In public companies, the available liquidity for easily selling shares may provide the cushion you need to get you to your next job, or to give you some time off. In a privately held company, it may be too risky to tie up your cash in untradable shares of a company that you no longer influence (unless you know exactly what is coming next). As at any stage of the game, your decision must be based on your big-picture assessment of the investment. The timing of the decision may add to the urgency, but the underlying considerations remain the same.

- *Will there be tax consequences to exercising or retaining equity rights on termination?* There are different tax consequences to each kind of equity award. If you intend to hold onto vested stock, or if vesting accelerates in restricted stock for which you have already filed an 83(b) election, there may be no immediate tax consequences to you at termination. A public company same-day sale, a private company nonstatutory stock option exercise, or the vesting of restricted stock may result in ordinary income tax (and payroll tax withholding). Similarly, RSUs and SARs may be subject to ordinary income tax at the time of exercise or vesting. Always consult a tax advisor prior to exercise to avoid surprises.

Know The Impact Of Special Circumstances On Your Equity Rights

Although any termination of employment will have an impact on your equity rights, not all termination events ("triggers") are equal. The company's stock plan may provide for a certain amount of across-the-board acceleration on a change in control or specific type of corporate transaction. Broad-based reductions in force (RIFs) or early retirement offers may include their own equity sweeteners. These accelerators are generally easy to track; the company is likely to advise all employees on the timing and impact of such transactions.

On the other hand, as noted above, you may have individually negotiated special treatment for certain types of involuntary terminations, or those that occur after a specific trigger, such as a change in control or a "good reason resignation."

> **Alert:** Particularly in the event of a contested termination, you should not expect the company to explain your rights to you.

Be prepared to promptly assert those rights in any communications and negotiations with the company. If you think you are going to have a dispute on your hands, make sure to get legal advice on how to address the issues without compromising your position.

Know The Value Of Equity To A Severance Package

Many of my clients are able to negotiate their severance packages at the time of termination. (The ability to do this will, of course, depend on the reasons for termination.) If you find yourself in this situation, don't overlook the opportunity to use equity as a component of your severance. Particularly in privately held companies, employers may be more willing to enhance existing equity grants than to pay additional cash. A partial list of negotiable possibilities includes accelerated vesting, post-termination consulting agreements that support vesting, forgiveness of outstanding promissory notes related to the stock, and extended post-termination exercise periods. Although your company may initially take the position that it cannot change the terms of your grants, or that doing so would cause accounting problems, very few plans actually prohibit these types of enhancements. It all depends on your bargaining power (and persuasiveness!).

You should expect to sign a "waiver and release of claims" in consideration of any severance, including enhanced equity compensation, that has been negotiated at the time of termination. It goes without saying—though I'm going to say it anyway—that you should never sign a release (or any legally binding document related to your employment rights) without reviewing it carefully with counsel.

Courts Impose Strict Interpretations

Don't assume a court will order an employer to restore equity rights that expired unexercised. The case law abounds with sad tales of former employees who relied on erroneous beliefs.

It's a grave error to assume a court will order an employer to restore equity rights that expired unexercised. This is exactly what happened in *Deal v. Consumer Programs Inc.*, 470 F.3d 1225, 1229 (8th Cir. 2006). In that case, the executive (Deal) had a dispute with her former employer over severance pay. Deal sent letters to the company saying that she wanted to exercise her options, but did not tender the purchase price because she intended to exercise with the cash she was owed for severance. The company did not honor the exercise, and the post-termination exercise period expired. Although the court ultimately agreed that Deal should receive the severance pay, the fact that she had not properly exercised her options barred her from recovering her equity (or its value). Had Deal exercised properly but been denied the stock by the company, she probably would have recovered the full amount.

Similarly, in *Donaldson v. Digital General Systems*, 168 S.W.3d 909 (Tex. App. 2005), Donaldson's failure to submit a written exercise notice—even though he had been told by the option administrator that the company would not honor the exercise—doomed his subsequent claim to the stock.

Don't Wait To Exercise

If you intend to own stock in the company, and you suspect that your employment may be coming to an end, it's always best to exercise earlier rather than later. Under many plans, a company can take the position that an employee has been terminated for cause and deprive him of his ability to exercise vested stock options at termination. Even if the cause determination is subsequently overturned, it may no longer be possible to get the full benefit of the equity award.

On a related point, if you have negotiated up front for an unusually long post-termination exercise period and wish to take advantage of it, I strongly encourage you to consult with a lawyer before the standard post-termination exercise period expires. You may need to take steps to confirm the length of the period with the company, and—if necessary—exercise quickly anyway.

> **Alert:** The case law abounds with sad tales of former employees who relied on their (erroneous) beliefs that they had extra months or years to exercise their options.

In one court case, an executive believed he had negotiated a 10-year post-termination exercise period based on an ambiguous general memorandum describing the plan, although his grant documents set out a 90-day period. Six years later, he tried to exercise and ended up in court, where he lost (notwithstanding a finding that the company was negligent in its representations to him). See *First Marblehead Corp v. House*, 473 F.3d 1 (1st Cir. 2006), affirming 401 F. Supp. 2d 152 (D. Mass. 2005). Donaldson, above, had similar facts and the same result (in Donaldson, with a one-year post-termination exercise period).

Act Promptly With Your Equity Rights

Armed with all of the above information, you should be ready to make informed, timely decisions about your equity in a termination of employment. Even if you believe you have grounds for a legal action against your former employer, don't dawdle when it comes to your stock. If you think you are entitled to any equity compensation as of the date of termination, act quickly to assert your rights to it. In the case of unexercised options, this means getting in all of your paperwork *along with the exercise price or same-day-sale authorization* before the post-termination exercise period expires. You should do this even if you are confident that the employer will not honor your exercise, or if your calculation of vested shares is different than that asserted by your employer. Follow the rules set out in your equity agreements to the letter to ensure that you stake out your claim.

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