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**HR Network:
Stock Talk – The
Fundamentals of
Employee Equity
Compensation**

Why are we here?

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Why is equity compensation important to understand?

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- Key employee compensation and retention tool
- Central to employment/separation negotiations
- Common source of disputes
- Constant stressor for executives and HR professionals

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Stock talk agenda

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- Nuts and bolts
 - Stock options
 - Other types of equity awards
 - 409A valuations and tax treatment
- Everyday equity questions
- Common pitfalls

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What is a stock option and what are the different types of options?

Stock options

- Right to buy stock in the future at a fixed price (the “exercise price”)
- Exercise price is generally at least fair market value on the date of grant
- Typically subject to vesting and will be exercisable between vesting and expiration (unless granted as an “early exercise option”)
- Two types of options
 - Incentive stock options (**ISOs**)
 - Nonqualified stock options or (**NQOs** or **NSOs**)

Stock options (cont.)

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- Options will typically expire at the earliest of the following:
 - Unvested expire at termination of service
 - Vested expire 90 days/three months following termination of service under normal conditions (longer if due to death/disability)
 - Vested and unvested expire automatically upon a termination for “cause”
- To be exempt from Section 409A, underlying securities must be “service recipient stock” (most basic common stock will qualify)
- Typical exercise methods include cash (or equivalent), “net exercise,” same day sale arrangement (public companies only), promissory note

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Incentive stock options (ISOs)

- ISO plan requirements:
 - Specify maximum number of shares issuable as ISOs
 - Specify class(es) of employees eligible to receive ISOs
 - Maximum 10-year term
- ISO grant requirements:
 - Not designated as an NQO
 - Nontransferable
 - Exercised no later than the applicable post-termination exercise window
- Modification/changes may disqualify ISO status

Nonqualified stock options (NQOs or NSOs)

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- Employees, directors and consultants can receive NQOs
- An option grant that purports to be an ISO, but fails for any reason, becomes an NQO
- NQOs must be granted at fair market value to be exempt from 409A
- No limit on term, vesting or amounts vesting in any period or length of post-termination exercise period other than the expiration date

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What other types of equity awards are granted to employees?

Restricted stock awards (RSAs)

- Grants (or purchases) of stock, subject to risk of forfeiture
- Can be granted to employees, directors and consultants
- Restricted stock is not subject to 409A
- Generally subject to reacquisition/repurchase rights in favor of the issuer
- Shares are generally held in escrow until vesting, but holder will have all the rights of a stockholder (voting, dividends, etc.)
- Purchase may be facilitated through partial-recourse promissory notes secured by the stock
- Risk of forfeiture may be imposed after issuance in connection with a financing

Restricted stock units (RSUs)

- Contractual right to receive shares of stock in the future when vesting and settlement conditions are satisfied
- Like restricted stock, but shares are not issued until vesting or later (e.g., termination of employment, fixed date or 409A sale event) instead of at grant
- RSUs may also be settled in cash rather than in shares
- RSUs may be structured as deferred compensation subject to 409A if not settled upon vesting

How do RSAs and RSUs differ from stock options? Should I use different equity awards for different categories of employees?

RSUs versus stock options versus restricted stock

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- Grant of right to purchase shares versus promise to deliver shares versus actual shares of stock
- Value over time
- Taxation
- Different categories of employees
- Size/stage of company

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Market trends

- **The use of RSUs has increased as private company valuations have increased and companies remain private for longer**
 - RSUs are often introduced in the 12 to 24 months before an expected initial public offering (IPO)
 - A growing number of private companies grant “liquidity event” RSUs
 - RSUs do not completely replace options but are often used **in combination with** stock options
 - Companies often grant RSUs to a subset of employees (e.g., senior management) and then shift to broader use
 - Companies generally migrate to a “value-based” determination for the size of RSU awards

What about other flavors of equity (or equity-like) compensation awards?

Profits interests

- Rights to share in future appreciation in value of a partnership or LLC
- No value if partnership/LLC does not increase in value
- Actual equity interest in the LLC, and the holder is actually a member of the LLC
- Flexible class of equity interest (“catch ups,” rights to distributions, etc.)
- Impact on participation in company benefit plans

Other equity awards

- Phantom stock awards
- Management carve out plans
- Employee stock purchase plans
- Stock appreciation rights

What is a 409A valuation, and how does it impact equity grants?

Section 409A and determining fair market value (FMV)

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- Section 409A of the tax code is a comprehensive set of rules governing the taxation of nonqualified deferred compensation (defined broadly). Failure to be exempt from or comply with Section 409A results in a 20% penalty tax and income inclusion at vesting.
- Among other requirements, options and stock appreciation rights (SARs) must have an exercise price not less than FMV at grant to be exempt from Section 409A.
- Options with an exercise price less than FMV may be (very carefully) structured to comply with 409A.
- For options, noncompliance results in taxation upon vesting, whether exercised, and an additional 20% penalty tax (and additional 5% tax in California) on the employee plus interest. Tax, interest and penalties can escalate exponentially if not addressed.
- There is pressure on private companies to determine FMV, and the process for determining FMV becomes an issue in every financing and change in control transaction.

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Determining FMV

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- A valuation method is not considered reasonable if it:
 - Is more than 12 months old
 - Does not take into account all available information material to the determination of value as of the valuation date
 - Fails to take into account subsequent events, such as the resolution of material litigation or the issuance of a patent
- Valuation method should be consistently applied
- Grants close in time to a financing or change in control transaction

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409A best practices

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- **Founding stage**
 - Always resistance to seek independent appraisals
 - Relevant valuation factors
 - Possible use of restricted stock instead of options
- **Post-founding stage**
 - Independent appraisal or illiquid startup valuation
 - Don't rely on any kind of "rule of thumb" valuation
 - Consider retroactive appraisal (and correction if possible) following a financing
- **Established company with expectation of sale or IPO**
 - Independent appraisal
 - Restrict option grants/option grant dates

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How does tax treatment differ for the various forms of equity awards?

Tax consequences at grant date

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ISO	NQO	Restricted stock (sale)	Restricted stock (grant – 83(b))	Restricted stock (grant – no 83(b))	Profits interests	RSU
<p>None</p> <p>But adverse 409A consequences and loss of ISO status if exercise price is less than FMV</p>	<p>None</p> <p>But adverse 409A consequences if exercise price is less than FMV and NQO not structured to comply with 409A</p>	<p>None, if purchased at FMV</p> <p>File 83(b) election within 30 days of grant</p>	<p>Ordinary income equal to FMV of stock</p>	<p>None</p>	<p>None, because no value on grant date</p> <p>File protective 83(b) election</p>	<p>None</p>

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Basic tax treatment



- Tax consequences on vesting date(s)

ISO	NQO	Restricted stock (sale)	Restricted stock (grant – 83(b))	Restricted stock (grant – no 83(b))	Profits interests	RSU
None	None	None	None	<p>Ordinary income to grantee equal to FMV of newly vested shares</p> <p>Company receives a corresponding deduction</p> <p>Grantee's basis will be FMV at vesting</p>	None	<p>If settled at vesting, ordinary income to grantee equal to FMV of shares paid</p> <p>Company receives a corresponding deduction</p> <p>Grantee's basis will be FMV at vesting</p> <p>If settlement is deferred, Federal Insurance Contributions Act (FICA) taxes due upon vesting</p>

Basic tax treatment

- Tax consequences upon exercise

ISO	NQO	Restricted stock (sale)	Restricted stock (grant – 83(b))	Restricted stock (grant – no 83(b))	Profits interests	RSU
Spread subject to alternative minimum tax (AMT)	Ordinary income to grantee equal to the spread	N/A	N/A	N/A	N/A	N/A
No deduction to the company	Grantee's basis will be the FMV of shares at exercise Company receives a corresponding deduction					

Basic tax treatment



- Tax consequences at disposition

ISO	NQO	Restricted stock (sale)	Restricted stock (grant – 83(b))	Restricted stock (grant – no 83(b))	Profits interests	RSU
<p>Holding period met: Gain over exercise price subject to applicable capital gains tax</p> <p>Disqualifying disposition: Ordinary income equal to lesser of “spread” at exercise or at disposition</p> <p>Company receives a corresponding deduction</p> <p>Additional gain will be subject to applicable capital gains tax</p>	<p>No additional ordinary income to grantee</p> <p>Any additional gain/loss will be subject to applicable capital gains tax</p>	<p>Gain over purchase price subject to applicable capital gains tax</p>	<p>Gain over FMV on grant date subject to applicable capital gains tax</p>	<p>Gain over tax basis subject to applicable capital gains tax</p>	<p>Proceeds generally subject to applicable capital gains tax</p>	<p>Gain over tax basis subject to applicable capital gains tax</p>

Basic tax treatment

- Tax consequences upon company sale and cash-out of awards (options unexercised)

ISO	NQO	Restricted stock (sale)	Restricted stock (grant – 83(b))	Restricted stock (grant – no 83(b))	Profits interests	RSU
<p>Ordinary income equal to spread</p> <p>Corresponding deduction to the company</p> <p>If exercised, not subject to FICA and Medicare taxes (but taxed at full FMV of stock)</p>	<p>Ordinary income equal to spread</p> <p>Corresponding deduction to the company</p>	<p>Gain over purchase price subject to applicable capital gains tax</p>	<p>Gain over FMV on grant date subject to applicable capital gains tax</p>	<p>Payments for unvested shares subject to ordinary income tax</p> <p>Corresponding deduction to the company</p>	<p>Proceeds generally subject to applicable capital gains tax</p>	<p>Payments for unvested RSUs subject to ordinary income tax</p> <p>Corresponding deduction to the company</p>

Any special rules for equity grants
issued to employees outside the US?

Awarding equity outside the US.

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- Simple or complex depending on:
 - Where?
 - What?
 - Who?
- Company actions will depend on:
 - Tax advice
 - Required securities filings

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What is an 83(b) election, and why do I hear so much about it?

Section 83(b) elections

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- Election under the tax code to recognize as ordinary income at the time of receipt of stock (or other property) the FMV of the stock (without regard to vesting restrictions) over the amount (if any) paid for the stock
- Must be made within 30 days of transfer (no exceptions or do overs)
- Stock remains subject to vesting restrictions/risk of forfeiture (still investment risk)
- Additional gain in excess of FMV at transfer will be taxed at applicable capital gains tax rates

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What is a typical vesting schedule? Can we change vesting schedules for certain employees?

Vesting schedules

- Options usually are subject to vesting:
 - Earn the right to keep the option/shares over time
 - Unvested options expire when you leave the company
 - Vested options can usually be exercised for up to three months after you leave

Typical vesting schedule: Four-year vesting, one-year “cliff” (25%) and monthly for next three years

What to consider when extending an employee's post-termination exercise period (PTEP)?

Advantages of extending PTEP

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- A low-cost way of making options more valuable by not forcing a former employee to make an investment decision
- Viewed favorably by employees in a competitive market for talent
- Delays expense of purchase price and possible tax costs

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Things to consider when extending PTEP

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- Dilution
- Loss of ISO status
- Term of option expiration
- Logistical challenges in change in control (CIC)
- Disclosure burden
- Public company issues with blackout periods

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Why do employees choose NOT to exercise their stock options?

Exercise considerations

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- Unsure about investing in a company, especially a private one
- No funds to pay exercise price
- No funds to pay any taxes (AMT/income) that may result from exercising
- Prefer to wait to exercise until possible liquidity event (when there may be funds to pay for exercise price and taxes)
- Possible beneficial tax treatment not important
- Financially unable to bear risk of investment
- Option not close to expiring

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What is net exercise or cashless exercise? How can it help us?

Cashless/net exercise

- Cash outlay requirement may deter exercise
- Consider incentivization/alignment
- Taxes must be paid in cash
- Automatic versus discretion to permit

What types of equity issues arise in employee terminations?

Common negotiated items

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- Acceleration/forfeiture/continued vesting
 - Depends on plan and award terms, type of termination, anticipation of postemployment consulting relationship, other relevant circumstances
- PTEP extension
- Repurchase
 - Consider contractual rights, practicality of ongoing shareholder relationship

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Common employee equity pitfalls

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Failing to grant promised equity in offer letter

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Forgetting to add vesting schedule when granting equity awards

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Compensating employees with equity only

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Failing to clearly identify
post-termination exercise
period at time of
termination

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Failing to follow Rule 701

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Failing to comply with blue sky laws (and other securities law missteps)

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Forgetting about withholding

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Failing to consider blackout periods when calculating the PTEP for public company option holders

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Causing inadvertent break in service for postemployment engagements

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Too much equity – too little
time

Challenges with right-sizing equity
grants based on changes in
employee role and time
commitment

Thank you!

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Helen is a seasoned practitioner serving as a trusted advisor on her clients' most sensitive, complex and high-stakes matters daily, with a special emphasis on helping emerging companies build and develop their workforces and assisting public company boards in managing executive crises. She has an extensive counseling and disputes practice, representing companies at every stage of growth on a broad range of employment-related issues, including counseling, litigation and transactional matters. Every year, Helen assists hundreds of companies across numerous industries – such as government contracts, private equity, venture capital, fintech, edtech, adtech, insurtech, blockchain and tokenization technology, life sciences, sports, media and entertainment, consumer goods, and health and beauty – in navigating complex employment matters.

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Paula has more than 20 years' experience of executive compensation and equity incentives in the UK, the US and internationally. Companies turn to Paula for advice and transactional support throughout their life cycle as they build their businesses, expand internationally and plan their exits. Paula is skilled in advising multinationals, both public and private, on the incentive aspects of their most strategic transactions including M&As, with a focus on private equity, IPOs and SPACs. She also assists remuneration committees in their determinations relating to retention and incentive arrangements for board members and senior management.

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Ali is a trusted advisor to companies, management teams, venture capital, boards of directors and compensation committees on executive compensation and benefits issues arising in every stage of the corporate life cycle – ranging from emerging growth to blue-chip public. She also counsels companies through transformative events, such as mergers and acquisitions, initial public offerings (IPOs), venture capital and leveraged buyout transactions, spinoffs, restructurings and other transformative corporate events. With more than two decades of practice experience spanning many industries, her current practice focuses on cutting-edge technology and life sciences companies of all sizes, as well as clients within the private equity and real estate investment trust (REIT) sectors.

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