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Assessing Risks Under Tech Start-Up Stock Incentive Plans – When Time Doesn't Cure All!

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Depending on a tech start-up company's initial financial condition, many tech start-ups are sometimes not able to pay market rates for talented engineers or computer programmers. Most tech start-up companies usually establish some form of incentive compensation plan ("Plan") to entice talented employees to join their business in exchange for a mix of cash compensation and a piece of the business' upside in lieu of a higher base salary. However, accepting compensation awards through a Plan have certain inherent risks that may cause an employee to "miss out" or a company to encounter substantial tax consequences.

Recently, Airbnb has acknowledged that employees participating in the company's incentive compensation plan may be at risk of missing out on receiving benefits under their Restricted Stock Unit ("RSUs") awards. Typically, Plans that issue RSUs allow an employee to convert their RSUs into the company's stock upon the company going public. Airbnb issued a substantial amount of RSUs to certain employees in 2014 and these awards have an expiration date set for early 2021. In the event the company (i) delays its IPO until after 2021, (ii) opts not to buy back their employee's RSUs, or (iii) does not arrange for an outside investor to buy such RSUs, the employees will not be able to cash in on their awards. To avoid these distressing situations, a company or an employee should each independently evaluate/plan around some of the suggestions listed below.

When a company is evaluating their Plan, a company should provide proper realistic incentives while accounting for risks associated with (i) various tax consequences and tax recognition events, (ii) U.S. Securities and Exchange reporting requirements (especially in relation to Section 12(g) of the Exchange Act), (iii) cost/maintenance of the plan (lawyers' fees and regular valuation assessments under 409A), (iv) connecting overall benefits of incentives with company strategy and timing, and (v) de-incentivizing employees by setting unrealistic goals rather than goals that employees are able to understand and achieve without swinging for the fences.

When an employee is evaluating whether or not to accept an award in lieu of compensation, under a Plan, the employee should consider (i) whether the company is providing for an appropriate mix between fixed compensation and incentive compensation, (ii) whether short term or long term performance metrics are achievable and reasonable as may be applicable to either the employee or company, (iii) whether the performance metric may be accurately captured or measured, (iv) the mechanics of the award and rights or consequences that come along with the award (i.e. vesting schedules, creation of any ownership/voting rights in the company, or the nature of any tax consequences), and (v) the overall future prospects of the company achieving future success.

Given the complexity of these plans and awards, companies and employees should have sophisticated legal counsel review these plans and award agreements prior to their implementation or execution.

For additional information contact Edward Grattan.