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PERSPECTIVE

Private companies and employees:

Calling your attention to equity call rights

By Thomas M. Asmar

Startups and other private companies often provide for the right to repurchase equity acquired by their employees (a call right) upon a termination of employment for a variety of reasons. Companies seeking to reward employees for their contributions during their employment through the use of equity awards may not want former employees continuing to participate in the upside value of the company or obtaining financial information of the company following a termination of their employment. Call rights also serve as a retention tool designed to incentivize employees to remain employed with the company. Call rights may also be used in combination with severance for a departing executive or key employee. This article provides an overview of issues to consider when designing and implementing a call right feature for equity held by employees.

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Repurchase Price. One of the key considerations in designing a call right is determining the repurchase price payable in different termination scenarios. Typically, the repurchase price is equal to the fair market value (FMV) of the underlying equity upon an involuntary termination of employment, including a termination by the company without cause or, if an employee has a contractual right to resign for good reason and receive severance (which right is typically afforded to a small group of executives or other key employees), a resignation for good reason (i.e. a good leaver). In the event of a termination by the company for cause (i.e. a bad leaver), the repurchase price is often equal to the *lesser* of (i) the cost to the employee of acquiring the equity (i.e. the exercise price for shares acquired upon exercise of a stock option) or (ii) the FMV of the equity. For a voluntary resignation by an employee (i.e. without good reason), the practice varies among companies with some setting the repurchase price to be equal to FMV, which is employee-friendly, or the lesser of cost or FMV, which would not provide the employee with any realization after working for the company; while this may seem harsh, companies may not wish to encourage or reward employees for a voluntary resignation, particularly if the employee subsequently works for a competitor. Some companies take a middle-of-the road approach with respect to this issue and provide for a below-FMV repurchase price that lapses over time, such as a scaling repurchase price equal to a percentage of FMV that increases after each year of completed service.

Employees may be surprised to learn that if their equity is subject to a below-FMV call right upon a voluntary resignation, then they may not receive the value they were expecting upon resignation, particularly if it appears that the underlying stock options, restricted stock units or other equity awards have "vested" pursuant to their terms. Companies should also exercise caution when providing for a below-FMV call right upon a voluntary resignation as one often overlooked issue is the tax consequence to the employee. A company's right to acquire equity held by an employee at below FMV upon a voluntary resignation is viewed as a substantial risk of forfeiture for federal income tax purposes. As a result, the employee is generally not taxed on the value of that equity until the substantial risk of forfeiture lapses, which may occur upon a liquidity event such as a sale of the company or an initial

public offering. When the substantial forfeiture lapses, this gives rise to ordinary income tax for federal income tax purposes, unless the employee previously made a valid election under Internal Revenue Code Section 83(b) within 30 days of the date of acquisition, pursuant to which the employee elects to pay tax on the value of the equity (ignoring the substantial risk of forfeiture) at the time it was acquired. If an employee makes a valid Section 83(b) election, then any gain resulting from disposition of the equity will be taxed at capital gains rates, instead of ordinary income rates. Applying these principles in the context of a sale of a company in which equity is cashed out for the deal consideration, if the equity is subject to a below FMV value call right upon a voluntary resignation, then the proceeds received for that equity should be subject to tax at ordinary income rates, rather than capital gains rates, unless the employee made a valid Section 83(b) election. Therefore, it is important to review the terms of any call rights and determine whether Section 83(b) elections were made in order to assess the tax consequences of equity held by employees in the event of a sale.

While not a legal issue, if a repurchase is at a price greater than FMV, there is a risk that this may trigger adverse financial accounting consequences. In addition, if a stock option or stock appreciation right award may be repurchased at a price greater than FMV, this could subject the employee to penalties and the company to tax reporting and withholding obligations for failure to comply with the deferred compensation rules of Internal Revenue Code Section 409A, which generally provide that the underlying stock may not be subject to a call right based on a measure other than the fair market value of the stock, except in very limited circumstances, including a separation from service for cause or a violation of a noncompetition or nondisclosure agreement, in which case, the price may be less than FMV.

Another issue to consider when determining the repurchase price is the type of equity that is subject to the call right. Equity purchased by an employee as an investment in the company is generally subject to repurchase at FMV only as this type of arrangement is not viewed as compensatory but rather as an investment similar to an investor purchasing stock in the open market. Stock options, restricted stock units and other compensatory equity awards are incentive-based, so that equity acquired pursuant to those awards are typically subject to a call right with a repurchase price that varies depending on the reason for termination of employment.

Determining Fair Market Value. The determination of fair market value is generally made by the company's board of directors which may take into account various factors in making that determination, such as the company's most recent valuation report, a pricing formula and/or business developments or other circumstances that may impact the value of the company. In the event of a dispute regarding fair market value, consideration should be given to providing the employee with an appraisal right which is occasionally afforded to high-level executives and individually negotiated.

Form of Payment. When a call right is exercised, the consideration payable for the repurchased equity is frequently paid in a single lump-sum cash payment. However, some companies may reserve the right to pay the consideration in the form of installments or a promissory note, particularly if liquidity is a concern for the company.

Duration of the Call Right. Call rights are likely to have a fixed duration providing the company with the opportunity to repurchase equity within a specified period of time following a termination of employment, which typically ranges from one to three years following termination. If the company does not exercise its call right within this period, then any future repurchase would need to be individually negotiated with the former employee.

Call rights typically expire upon the earlier to occur of a sale of the company or an initial public offering. In the case of a sale, the equity may be cashed out at closing or rolled over into a new equity program of the buyer, in which case, the buyer is likely to establish new terms or apply its existing terms to the equity in the post-closing company. In the event of an initial public offering, call rights are generally not needed because the equity is freely transferable in the public market.

Other Considerations. To avoid triggering adverse financial accounting consequences, repurchases generally should not occur prior to the 181st day following the later to occur of the date of the termination of employment or the date on which the equity was acquired. Also, companies may be limited in their ability to pay cash when exercising a call right pursuant to covenants in their debt or financing agreements or other corporate governing documents, in which case, the period during which the call right may be exercised may be tolled until those restrictions lapse.

If you are an employee who holds equity in a private company, you may wish to review the terms of any call rights on your equity to understand the circumstances in which your equity is subject to repurchase by the company upon a termination of employment. For private companies with call rights, it is important to understand their terms, particularly in the case of a departing employee who holds equity. Start-ups and other newly formed companies should consider putting in place a call right to appropriately protect the company and incentivize employees. ■

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