UC Law Business Journal

Volume 20 | Number 2 Article 4

7-2024

Stock-Based Compensation in Startups: Employee Implications & Potential Solutions

Alec Galustian

Stock-Based Compensation in Startups: Employee Implications & Potential Solutions

*Alec Galustian**

ABSTRACT

Stock-based compensation remains prevalent in the United States private market, particularly among high-growth private companies, yet concerns persist regarding its potential drawbacks. This paper focuses on stock-based compensation in startup companies, delving into the legal frameworks behind the practice and identifying regulatory gaps. It examines well-known advantages of stock-based compensation, common misconceptions, and highlights its many disadvantages, primarily from the perspective of a startup employee. These drawbacks stem from the lack of private company disclosure obligations, illiquidity and lock-in concerns, and regulatory changes favoring the private market. This paper also explores a trend in the SEC's tone toward increased regulation of private companies, evaluates strategies taken by a few private firms to mitigate associated risks, as well as potential solutions, including improved disclosure, repricing programs, secondary market sales, and strategic adjustment of RSU liquidity event conditions.

TABLE OF CONTENTS

*J.D., University of California College of the Law, San Francisco, 2024; B.A., Communication Studies, Loyola Marymount University, 2019. Thank you to Professor Evan Epstein for his support, guidance, and corporate governance expertise throughout the writing process.

I. INTRODUCTION

Stock-based compensation is an equity-based compensation practice that continues to dominate the private market in the United States. While providing numerous benefits to companies, employees, and shareholders, there remains a major concern that high levels of stock-based compensation may actually be disadvantageous to companies, employees, and shareholders. This is especially true for private companies considered to be "high-growth."[1] Thus, for the purposes of this paper, I will focus on stock-based compensation in startup companies.

Private companies typically offer stock-based compensation in two ways: either by granting employees stock options or restricted share units ("RSU").[2] The common theme among private companies is to offer stock options, typically in the form of non-statutory (or non-qualified) stock options ("NSO") or incentive stock options ("ISO").[3] The primary difference between ISOs and NSOs lies in who may receive these stock options, the tax treatment that accompanies such options, and the requirements connected to ISOs.[4] Private companies also offer RSUs, but they are less frequent compared to stock options and are typically reserved for later stages of growth.[5] This paper will

1. *How Do You Know if You Have a High Growth Startup*, FASTER CAPITAL (Mar. 6, 2023), https://fastercapital.com/content/How-do-you-know-if-you-have-a-high-growth-startup.html (describing what makes a startup "high-growth").

2. Brian Misamore, *Understanding Stock-Based Compensation*, HARV. BUS. SCH. ONLINE BUS. INSIGHTS BLOG (June 16, 2016), https://online.hbs.edu/blog/post/understanding-the-linkedin-sale-and-stock-based-compensation.

3. Anat Alon-Beck, *Unicorn Stock Options-Golden Goose or Trojan Horse?,* 2019 COLUM. BUS. L. REV. 107, 130 (2019).

4. *Id.*

5. *RSU v. Stock options: What's The Difference?*, EMPOWER: THE CURRENCY (Aug. 2, 2022), https://www.empower.com/the-currency/money/stock-options-vs-rsu.

explore the implementation process of stock-based compensation plans, alongside an examination of the legal frameworks, including instances where regulations may be lacking.

This paper examines the evident advantages of stock-based based compensation and the goals that private companies seek to achieve by instituting such programs. The principal advantages and goals of interest alignment, employee retention, cash preservation, and favorable tax treatment are highly valuable for startups. This paper also seeks to debunk misconceptions associated with these common goals and illustrate the disadvantages of traditional stock-based compensation programs. For instance, in a startup company, those most affected by stock-based compensation practices are employees and other common shareholders because they are the equity investors who face illiquidity and capital lock-in obstacles.[6] In the current economic climate, private companies face declining valuations, expiring or underwater options, and have no choice but to let those options expire without value. Moreover, in the current regulatory environment, companies are increasingly deciding to stay private to avoid the safeguards common to the public market as a result of years of deregulation.[7] Consequently, employees end up being the primary stakeholders who end up paying the price. This paper also evaluates some actions that a few notable private companies pursued to counteract these problems, and whether companies in similar stages in their life cycles, with similar stock-based compensation programs, may be able to implement those potential solutions as a means of dealing with the stock-based compensation problem.

This paper will also examine current trends within the Securities and Exchange Commission ("SEC"), the private market, and potential solutions to stock-based compensation that may mitigate the risks and drawbacks noted above, while acknowledging the difficulties associated with their implementation. The solutions that seem most capable of addressing these risks, include implementing an improved disclosure regime, extending the expiration date of or repricing stock options, incorporating programs for employees to sell their shares to outside investors, and in the context of expiring RSUs, strategically adjusting liquidity event conditions.

II. STARTUP CHARACTERISTICS

Startups distinguish themselves from public corporations through their focus on technology, innovation, and high-growth.[8] A company becomes a public company by virtue of "making a public offering of securities, listing

6. Alon-Beck, *supra* note 3 at 117.

7. Caroline A. Crenshaw, *Big "Issues" in the Small Business Safe Harbor: Remarks at the 50th Annual Securities Regulation Institute*, SEC: SPEECHES AND STATEMENTS (Jan. 30, 2023), https://www.sec.gov/news/speech/crenshaw-remarks-securities-regulation-institute-013023

8. Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 159 (2019).

securities on a national exchange, or by reaching a certain asset size, and number of shareholders of record."[9] A public company, unlike a startup, is subject to various governance requirements imposed by federal statutes and securities exchanges, including the necessity of having a majority of independent directors on the board and non-binding shareholder votes on executive compensation.[10] In contrast, private companies, including startups, operate within a less defined regulatory framework.[11] As a result, startups are exempt from many of the disclosure and reporting obligations imposed on public companies.[12] Typically initiated by entrepreneurs and initially funded by a small group of investors such as friends, family, and angel investors, startups aspire to secure additional funding from venture capital ("VC") firms.[13] The ultimate objectives for a startup revolve around innovation, high-growth, and eventual exit strategies, often through an acquisition or initial public offering ("IPO").[14] In essence, startups are subject to general corporate law principles but may otherwise govern their affairs in private.[15]

The startup investment model involves high levels of risk, but also the potential for significant returns. Startups aim to grow rapidly, and it is this aspect which appeals to the investment model of angel and VC investment.[16] Angel investors are those persons who are accredited investors with "at least $1 million in wealth or $200,000 in annual income" and invest their own capital.[17] VC investors are institutional asset managers who create funds in which institutional investors may invest.[18] These funds are subsequently utilized to acquire equity in startup companies.[19] Like angel investment, venture fund investment allows only "qualified purchasers"—individuals owning at least $5 million in investments or funds owning at least $25 million in investments—to invest in VC funds.[20] Given the eight-to-twelve-year life spans of VC funds, they must invest rapidly.[21] The fundraising cycle is also a multi-step process through which startups raise capital during different periods.[22] VC

9. *Id.* at 163.

10. *Id.*

11. *Id.*

12. Evan Tarvier, *Are Private Companies Required to Publish Financial Statements?*, INVESTOPEDIA (Oct. 30, 2022), https://www.investopedia.com/ask/answers/062415/private-company-required-disclose-financial-information-public.

13. SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 21, 27 (2019).

14. *Id.*

15. Pollman, *supra* note 8, at 165.

16. Seth C. Oranburg, *Bridgefunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 CORNELL J.L. & PUB. POL. 397, 405 (2015).

17. 17 C.F.R. § 230.501(a)(5)-(6) (2013).

18. Oranburg, *supra* note 16, at 408.

19. *Id.*

20. 15 U.S.C. § 80a-2(51)(A) (2012).

21. Allen Wagner, *The Venture Capital Lifecycle*, PITCHBOOK (May 14, 2014), https://pitchbook.com/the-venture-capital-lifecycle/.

22. Oranburg, *supra* note 16, at 410.

funds tend to focus on high-growth investments; for example, the software sector accounted for 31% of total deal value in 2020, 37% in 2021, and 40% in 2022.[23] Today, startups have also been able to attract various other institutional investors, such as mutual funds.[24]

New institutional investors have clearly had an impact—or better and for worse—on these companies.[25] Consequently, such companies are able to stay private for longer, which founders typically prefer so they can continue to maintain control over their companies and increase innovation.[26] On the other hand, by staying private longer, employees today increasingly face problems with respect to their stock-based compensation plans. Unfortunately, many companies lack any form of recourse.

III. STOCK-BASED COMPENSATION IN STARTUPS

A. Processes for Offering Stock-Based Compensation Plans

Stock-based compensation is extremely popular among both private and public companies in the United States, but the process through which stock-based compensation is offered differs in fundamental respects for startups.[27] As a preliminary matter, the process of offering stock-based compensation lacks transparency in the private market, as the United States' securities regulations do not require that private issuers disclose information regarding their capital structure or fair market value to their employees.[28] Rule 701 of the Securities Exchange Act of 1933 ("Securities Act") also provides an exemption for private company offerings, with recent revisions over the last three decades that have resulted in minimal regulatory oversight of stock-based compensation programs in the private market.[29] As a result, financial disclosure requirements only apply to private issuers issuing more than $10 million worth of stock-based compensation within a twelve-month period.[30] Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") also mandates corporations with a certain number of shareholders to assume the disclosure and governance responsibilities of publicly listed corporations.[31] However, to further shield private companies from regulatory scrutiny, the Jumpstart Our Business Startups Act of 2012 ("JOBS Act") amended Section 12(g) of the Exchange Act.[32] The amendment eliminated restrictions on the

23. NVCA YEARBOOK 2021; NVCA YEARBOOK 2022; NVCA YEARBOOK 2023.
24. Alon-Beck, *supra*, note 3 at 120.
25. *Id.* at 150.
26. *Id.*
27. *Id.* at 126.
28. Yifat Aran & Raviv Murciano-Goroff, *Equity Illusions*, J.L, ECON., & ORG. 1 (2023).
29. *Id.* at 29.
30. *Id.*
31. Abraham Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 615, 626 (2017).
32. *Id.* at 627.

number of employees and service providers that such companies may compensate using stock-based compensation while remaining private, making the disclosure threshold even harder for these companies to meet.[33]

The governance structure of a startup is radically different from that of a public company. When investing in startups, venture capitalists often negotiate terms to obtain board seats as part of their investment, allowing them to access critical information, monitor opportunistic behavior, and provide them with a voice over significant decisions such as financing or exit strategies.[34] Startups typically adopt a stock-based compensation plan, establishing a pool of stock options to incentivize employees with ownership stakes.[35] Like the board of directors of publicly traded companies, the board of directors of private companies is typically responsible for the implementation and execution of stock-based compensation plans, but in some cases, may have a compensation committee or a specific individual, like a CFO, responsible for overseeing stock-based compensation plans.[36] Moreover, depending on the type of plan, shareholder approval may be required, as is the case with ISOs.[37]

Startups typically award two classes of stock: common and preferred.[38] Common stock is the typical stock of a corporation, without priority over any other shareholders.[39] Common stock represents ownership and typically includes voting rights, whereas preferred stock contains dividend payments and liquidation priorities.[40] Preferred stock is typically issued to VCs after each round of financing, while common stock is given to employees, angel investors, and other early investors.[41] Today, founders and very early stage employees increasingly receive preferential stock treatment, while the rest of the company's employees remain at the bottom of the waterfall.[42] This is one of the reasons for controversial lawsuits, like *Trados*, which will be discussed later.[43] Preferred stock is more valuable as its holders have priority over common stockholders in the payment of dividends and in the case of

33. *Id.*

34. *See* Brian Broughman & Jessie M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319, 1329 (2013).

35. *Pollman, supra* note 8, at 171.

36. *See* Joe Brennan, *The CFO's Guide to Employee Equity & Ownership*, SPENDESK (Oct. 26, 2021), https://www.spendesk.com/blog/employee-equity-ownership/.

37. Paul Swegle, *Avoid These Ten Equity Compensation Mistakes*, STARTUPGC (Sept. 7, 2020), https://www.startupgc.us/post/ten-common-equity-plan-mistakes.

38. Aran & Murciano-Goroff, *supra* note 28, at 2.

39. 18 C.J.S. *Corporations* § 215 (2023).

40. James Chen, *Common Stock: What It Is, Different Types, vs. Preferred Stock*, INVESTOPEDIA (Sept. 19, 2023), https://www.investopedia.com/terms/c/commonstock.asp.

41. Alon-Beck, *supra* note 3, at 134.

42. Steve Blank, *How to Make Startup Stock Options a Better Deal for Employees*, HARV. BUS. REV., (Apr. 3, 2019), https://hbr.org/2019/04/how-to-make-startup-stock-options-a-better-deal-for-employees.

43. See, e.g., In re *Trados Inc. S'holder. Litig.*, 73 A.3d 17 (Del. Ch. 2013) (concerning common shareholder breach of fiduciary claims brought against a startup board for failing to receive anything from a merger transaction).

liquidation or sale.[44] Even though most employees hope for an IPO, VCs tend to pursue a sale as the most common form of exit to quickly gain from their investment and provide liquidity to the fund's investors.[45] For more mature startups, like Stripe or Foursquare, going public is still the ultimate goal but they may need to remain private for several more years due to current economic conditions and declining valuations. As a result, employees of later stage startups who receive compensation in the form of stock options or RSUs may often be on the losing end of such a decision.[46]

B. Traditional Forms of Stock-Based Compensation in Startups

i. Stock Options

Stock options serve as contractual agreements between a company and its employees and are the same with respect to both startups and publicly traded companies.[47] Stock options are governed by the Internal Revenue Code ("IRC"). The two most prevalent types of stock options are ISOs, used mostly by private companies, and NSOs, more commonly employed in public companies.[48] Both types of stock options will be discussed in more detail below. Stock options are used in private companies to incentivize employees to take part in a company's growth.[49] With stock options, the holder of an option is granted the right to purchase a specific number of shares at a predetermined strike price, usually fixed at the fair market value at the time of the options grant.[50] The option can be exercised within a fixed period (usually ten years); however, companies impose vesting restrictions that limit employees' ability to exercise the options for a specified period of time, typically four years, during which the employee must remain employed by the company.[51] The most prevalent vesting schedule is known as "cliff-vesting," where one-fourth of options become available at the end of the first year, and the remainder becomes exercisable monthly over the next three years.[52] Stock options are particularly valuable when the stock option agreement is designed for a long period of time, but the option agreement usually allows employees

---

44. Alon-Beck, *supra* note 3, at 134.

45. D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 316 (2005).

46. *See* Alfred Lee, *Foursquare Lets Employees Swap Out Underwater Options*, THE INFORMATION (Jan. 19, 2016), https://www.theinformation.com/articles/foursquare-lets-employees-swap-out-underwater-options.

47. Saul Levmore, *Puzzling Stock Options and Compensation Norms,* 149 U. PA. L. REV. 1901, 1901 (2001).

48. CONSTANCE E. BAGLEY & DIANE W. SAVAGE, MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY 521 (Cengage Learning, 6th ed. 2009).

49. Elvis Picardo, *Employee Stock Options (ESOs): A Complete Guide*, INVESTOPEDIA (Oct. 12, 2022), https://www.investopedia.com/terms/e/eso.asp.

50. Alon-Beck, *supra* note 3, at 127.

51. *See* BAGLEY & SAVAGE, *supra* note 47, at 519.

52. Alon-Beck, *supra* note 3, at 127.

only ninety days to exercise any vested options if they leave the firm.[53] When a company goes public, employees benefit from vested options as they can purchase and sell their stock, and in turn, realize the value they created or contributed to.[54] However, many startups today are deciding to remain private for longer periods.[55]

1. Incentive Stock Options (ISOs)

Incentive stock options or ISOs, are most commonly used by private companies.[56]

While ISOs are only granted to employees and receive beneficial tax treatment compared to NSOs, employees may only take advantage of these benefits provided certain conditions are fulfilled.[57] To grant ISOs, both the board of directors and shareholders must approve a written plan, and the exercise price of the options cannot be priced lower than the fair market value of the stock on the date of the grant.[58] ISOs also cannot be transferred, except upon death.[59] In terms of timing, employees must exercise the ISOs within ten years from the date of grant or within ninety days of their termination.[60] Due to their beneficial tax treatment, the value of ISOs exercised by employees cannot exceed $100,000 in any one calendar year; otherwise they will not be treated as ISOs and lose their favorable tax treatment.[61] Lastly, ISOs contain a holding requirement that states that employees must retain their shares for at least two years after the date of the grant and one year after exercising the option.[62] Provided that all requirements are met, the employee will not incur any tax liability at the time of grant or upon exercise.[63] However, once the stock acquired through exercising the options is sold, any gain or loss resulting from the sale will be taxed as a long-term capital gain or loss.[64] If the holding requirements are not satisfied, then any sale is void, and the ISOs are treated as NSOs.[65] In summary, the appeal of ISOs stems from their preferential tax treatment, which can be especially valuable for startup employees.[66]

53. *See, e.g.*, Adrian Facini, *What is the 90-Day PTE Window?*, CARTA: EQUITY EDUCATION (Apr. 18, 2023), https://carta.com/blog/pte-90-day-window/.

54. *See* BAGLEY & SAVAGE, supra note 47, at 347.

55. Alon-Beck, *supra* note 3, at 128–129.

56. BAGLEY & SAVAGE, *supra* note 47, at 521.

57. Alon-Beck, *supra* note 3, at 130.

58. *See generally* 26 U.S.C. § 422.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. Shelby Skoczylas, *How Stock Options Are Taxed*, CARTA: EDUCATIONAL ESSENTIALS (Jan. 2, 2023), https://carta.com/blog/equity-101-exercising-and-taxes/.

64. *Id.*

65. *Id.*

66. Boxion Kolb & Amanda Tan, Incentive Stock Option Accounting and Strategy Considerations, EQUITYMETHODS (Aug. 3, 2021), https://www.equitymethods.com/articles/incentive-stock-option-accounting-and-strategy-considerations/.

2. Nonstatutory Stock Options (NSOs)

Nonstatutory stock options or NSOs, are another form of stock options and work the same as ISOs—otwithstanding tax implications.[67] Similar to ISOs, NSO plans are usually written with a requirement that the exercise price of the option cannot be lower than the fair market value of the stock on the date of grant.[68] However, unlike ISOs, NSOs are not limited to only employees and have fewer restrictions.[69] Although there is no requirement that the board of directors or shareholders approve the plan, there will often be an agreement approved by the board.[70] The tax treatment of NSOs is different in that NSO holders are taxed at the time of exercise.[71] In addition, the tax owed is generally based on the difference between the fair market value of the underlying security at the time of exercise and the price at which the NSOs are exercised, which is treated as ordinary income.[72] Furthermore, there is no time period within which an employee must exercise an option, nor an annual limitation on the amount of stock underlying NSOs that becomes exercisable in any as is the case with ISOs.[73] Despite being less burdensome, the severe tax consequences of NSOs make them the less favorable option in the startup context.[74]

i. Restricted Share Units (RSUs)

Restricted stock units or RSUs, are an alternative form of stock-based compensation typically offered to employees and executives of a company when a company reaches maturity and stability in valuation.[75] Like stock options, RSUs represent a contract between a company and its employees.[76] RSUs are essentially a commitment by a company to provide employees with a certain number of shares at a future date.[77] As RSUs are more common for

67. BAGLEY & SAVAGE, *supra* note 48, at 519.

68. Alon-Beck, *supra* note 3, at 131.

69. *Id.*

70. *Incentive Stock Options: Everything You Need to Know*, UPCOUNSEL (Feb. 1, 2023), https://www.upcounsel.com/incentive-stock-options.

71. Skoczylas, *supra* note 63.

72. *Id.*

73. Amy Hwang, *Differences Between Incentive Stock Options and Nonqualified Stock Options*, DAVIS WRIGHT TREMAINE LLP: STARTUP L. BLOG (Jul. 23, 2020), https://www.dwt.com/blogs/startup-law-blog/2020/07/differences-between-iso-nso.

74. Natty, *Comparing Startup Equity Compensation Flavors, ISOs, NSOs, and RSUS*, SUBSTACK: SEMI-STRUCTURED CAPITAL MANAGEMENT (Mar. 24, 2021), https://semistructured.substack.com/p/comparing-startup-equity-iso-nso-rsu.

75. Josh Steinfeld, *What is a Compensation Plan?*, CARTA: COMPENSATION (July 7, 2022), https://carta.com/blog/compensation-plan/.

76. *Id.*

77. *Restricted Stock Units (RSUs) vs. Stock Options: Which Is Better?*, PULLEY (May 5, 2023), https://pulley.com/guides/rsu-vs-stock-options.

companies in their later stages, it also serves as a retention tool, specifically to incentivize valuable employees who have been with the company since its early stages to remain at the company until their shares vest.[78] Moreover, employees are able to hold on to their RSUs after they leave the company, unlike stock options.[79]

RSUs can be structured similar to options as well, where they become available to employees over time, subject to certain conditions being met.[80] Unlike stock options, however, RSUs provide employees with downside protection due to the lack of an exercise price.[81] Regardless of when RSUs are granted, they will always be equivalent to the stock price.[82] In addition, for the purposes of taxation, RSUs are governed by Section 409A of the IRC, which states that when vesting conditions are met, RSUs are treated as ordinary income and are taxed immediately (like NSOs).[83] A drawback of RSUs, however, is their potential for minimal upside since employees may receive fewer RSUs.[84] This is because of their ability to have value regardless of how well a company is performing after the grant.[85] In addition, startups structure their RSUs around a time-based and liquidity event (e.g., IPO or acquisition) based vesting schedule, meaning both targets have to be met in order for the RSUs to vest.[86] If those targets are not met within the allotted time, the RSUs expire, and employees are unable to reap the benefits of the equity compensation they expected unless their employer extends the expiration date or finds an alternative solution.[87] Furthermore, RSUs allow companies to postpone their issuance of new shares until the vesting schedule has concluded, which defers share dilution.[88] Although RSUs are beneficial to employees due to their reliability and downside protection, they may still pose problems to employees in companies remaining private for extended periods.

78. Alvin Carlos, *The Complete Guide to Restricted Stock Units (RSUs) for 2023*, DISTRICT CAPITAL MGMT. (Mar. 9, 2023), https://districtcapitalmanagement.com/rsu/#:~:text=RSUs%20also%20serve%20as%20a,gets%20to%20take%20them%20back.

79. Alon-Beck, *supra* note 3, at 170

80. *Id.* at 169.

81. *Id.*

82. *Id.*

83. *See generally* I.R.C § 409A.

84. Alon-Beck, *supra* note 3, at 170.

85. *Id.*

86. Heather Brookfield et al., *Part I: What Are "Double-Vest" RSUs and Why Are They Making Headlines?*, GOODWIN LAW (Feb. 16, 2023), https://www.goodwinlaw.com/en/insights/publications/2023/02/02_16-what-are-doublevest-rsus.

87. *See* Dan Primack, *Payments Giant Stripe Raises $6.5 Billion at a $50 Billion Valuation*, AXIOS: ECON. & BUS. (Mar. 15, 2023), https://www.axios.com/2023/03/15/stripe-50-billion.

88. Roger Wohlner, *How Do Restricted Stock Units Work?*, INVESTOPEDIA (Apr. 18, 2023), https://www.investopedia.com/articles/financial-advisors/110915/restricted-stock-units-what-know.asp.

IV. STOCK-BASED COMPENSATION ADVANTAGES AND GOALS

Stock-based compensation is popular among private companies in the United States due to the goals it seeks to accomplish and the advantages it seeks to provide.[89] This practice is widespread among both early-stage and later stage startups. Stock-based compensation is also not exclusive to high-level executives because mid-level employees receive a significant portion of it.[90] This form of compensation is an effective way for companies to recruit and retain employees, especially in the technology sector, where the CEO and other high-level executives play crucial roles in innovation and piloting the company's trajectory in an environment that is rapidly changing.[91] Moreover, this approach is an effective way to encourage employees to remain with the company, especially because of the valuable experience employees possess which would be expensive to transfer to another company.[92]

By offering stock-based compensation, employees do not have to have to incur capital risks nor the income tax consequences associated with offering additional cash compensation.[93] As startups tend to be more focused on a single product or service, as well as growth, they may see an increase in employee effort corresponding with the use of stock-based compensation.[94] Stock-based compensation is particularly important in the startup context because it enables these companies to compete for talent without increasing cash compensation due to the cash saved through stock-based compensation.[95] Stock options may also induce employees to save in anticipation of exercising their options, creating a capital pool for new business ventures or expansion.[96] By focusing on an exit strategy in the startup context, companies are also compelled to plan for liquidity by focusing on growth in order to maximize the company's value prior to an exit.[97]

A common explanation for stock-based compensation is that it incentivizes employees and aligns their interests with those of the company's founders and shareholders.[98] This, in turn, motivates employees to increase productivity and improve firm performance.[99] This is especially true for startups, where free-riding problems common to public corporations are less

89. *See* Alon-Beck, *supra* note 3, at 125.

90. Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1426 (2007).

91. Jeongchui Ha, Executive Compensation and Firm Performance: Domestic and Multinational Firms 3 (Jan. 31, 2000) (Ph.D. dissertation, Temple University) (ProQuest).

92. *Id.*

93. Alon-Beck, *supra* note 3, at 122.

94. Richard A. Booth, *Give Me Equity or Give Me Death - the Role of Competition and Compensation in Silicon Valley*, 1 ENTREPRENEURIAL BUS. L.J. 265, 273 (2006).

95. *Id.* at 275.

96. *Id.*

97. *Id.* at 274.

98. Hannes, *supra* note 89, at 1439.

99. *Id.* at 1434

likely.[100] This practice has the effect of turning employees into owners and may create a sense of community within the company.[101] Stock options may also enhance employees' performance by tying the value of the options to the company's stock price exceeding the exercise price.[102] Stock-based compensation plans can also beneficial to startups in terms of tax obligations.

Some stock-based compensation plans are tax deductible.[103] With the exception of ISOs, companies can obtain tax deductions when offering NSOs and RSUs.[104] Congress drafted tax breaks to encourage stock-based compensation, as evidenced by Section 162(m) of the IRC.[105] As stock-based compensation plans are for the most part performance based, companies offering such plans are eligible for a tax deduction under Section 162(m).[106] This is important because tax deductions are cash flow positive and the taxes that would otherwise have to be paid are instead retained by the company.[107]

Even though stock-based compensation plans will continue to thrive and are considered to be a pillar of the private market, they have their disadvantages and companies should adjust or rethink their plans accordingly, especially in light of current economic concerns.

V. PROBLEMS ASSOCIATED WITH INCREASED LEVELS OF STOCK-BASED COMPENSATION IN STARTUPS

A. Lack of Investor Sophistication & Disclosure

While stock-based compensation indeed offers numerous advantages and can fulfill many of the goals outlined above, its drawbacks become apparent when considering its potential impact on startup employees. Startup employees, especially entry-level employees, do not have a sufficient understanding of what drives startup equity or how stock-based compensation plans work, which is one of the most common criticisms of the high levels of stock-based compensation in startups.[108] Studies indicate that employees tend to view stock-based compensation as an investment, but may not appreciate

100. Aran & Murciano-Goroff, *supra* note 28, at 4.

101. Hannes, *supra* note 90, at 1434.

102. Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 38 (2000)

103. Bruce Dravis, *Dilution, Disclosure, Equity Compensation, and Buybacks*, 74 BUS. LAW. 631, 636 (2019).

104. PWC, *17.4 Income tax accounting for incentive stock options*, PWC: VIEWPOINT (Dec. 31, 2022), https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/income_taxes/income_taxes__16_US/chapter_17_income_ta_US/174_income_tax_accou_US.html#pwc-topic.dita_1709274509221137.

105. I.R.C. § 162(m).

106. *Id.*

107. Rhea Alleyne, *Capitalizing on an Employee Stock Option Plan*, SPRING BLOG (Mar. 30, 2018), https://spring.is/blog/capitalizing-on-an-employee-stock-option-plan/.

108. Aran & Murciano-Goroff, *supra* note 28, at 2.

the associated risks.[109] The lack of disclosure, lock-in, and illiquidity concerns associated with stock options are among the chief concerns that employees may not appreciate when deciding to make such an investment through exercising their options grants.[110] Given the absence of disclosure obligations, employees in startups lack essential information about the condition of their companies and their entitlements, leaving them largely uninformed.[111]

At the federal level, the Economic Growth, Regulatory Relief, and Consumer Protection Act ("Economic Growth Act"), which was signed into law by President Trump in 2018, mandated the SEC to amend Rule 701 of the Securities Act to increase the cap on the amount of securities that may be sold or issued from $5 million to $10 million.[112] This allowed eligible private companies to offer or sell more securities to employees for compensatory purposes without the need to register the securities with the SEC or provide financial and investment risk disclosures.[113] Indeed, the amendment encouraged employees to own stakes in larger companies, but it also limited disclosure requirements.[114]

At the state level, Delaware and California are among the only states that have private company financial disclosure requirements codified in their respective corporations codes.[115] Although Section 220 of the Delaware General Corporations Law provides a mechanism for stockholders to inspect company books and records, including financial statements and stockholder lists, the inspection right is almost impracticable.[116] Most private company stock option agreements now incorporate a contractual waiver of Section 220 shareholder inspection rights, preventing employees from obtaining information about the financial condition of the company and the value of their shares.[117] The increase in the use of these waivers arises from a concern of protecting proprietary information about the firm.[118] The National Venture Capital Association has also recently amended its model financing documents, specifically its model Investors' Rights Agreement, to include the waiver clause.[119] Similarly, Section 1501 of the California Corporations Code, requires

---

109. *Id.* at 3.

110. *See* Alon-Beck, *supra* note 3, at 139.

111. *See* Aran & Murciano-Goroff, *supra note 28,* at 2.

112. 17 C.F.R. § 230.701 (2018).

113. *Id.*

114. Alon-Beck, *supra* note 3, at 182.

115. Rolfe Winkler, *Own Startup Shares? Know Your Rights to Company Financials*, WALL ST. J. (May 24, 2016), https://www.wsj.com/articles/own-startup-shares-know-your-rights-to-company-financials-1464082203.

116. *See Id.*

117. Anat Alon-Beck, *Bargaining Inequality: Employee Golden Handcuffs and Asymmetric Information*, 81 MD. L. REV. 1165, 1168 (2022).

118. *See id.* at 1199.

119. Cameron R. Kates et al., *Modeling the Market: The National Venture Capital Association Revises Its Model Documents*, TROUTMAN PEPPER (Sept. 16, 2020), https://www.troutman.com/insights/modeling-the-market-the-national-venture-capital-association-revises-its-model-documents.html.

privately held startups to disclose financial information to shareholders and applies to all companies headquartered in California, despite being incorporated in other states such as Delaware.[120] Section 1501 requires a company's board to provide an annual report, containing "a balance sheet as of the end of the fiscal year, and an income statement and a statement of cashflows for that fiscal year," . . . unless the company has less than 100 shareholders who expressly waived the requirement in the bylaws.[121] In reality, most companies ignore the law since penalties for violating the law are capped at $1,500.[122]

Although laws do exist imposing disclosure obligations on companies meeting certain requirements, the large federal threshold and state law loopholes make them easy to circumvent. Plus, if employees try to bargain away from or avoid this practice, they would be unable to receive their stock-based compensation plans.[123] Section 220 contractual waivers are a relatively new practice and it's unclear whether the waivers will be enforceable in court, but the use of these waivers are increasing, and employees continue to be left in the dark. Due to this lack of disclosure, startup employees continue to face challenges in making informed decisions about whether to purchase illiquid stock by exercising their options.[124]

B. Lock-in, Illiquidity, & Lack of Downside Protection

Lock-in refers to the situation where investors cannot withdraw their capital contributions or compel the corporation to either purchase their shares or distribute assets.[125] The lock-in phenomenon is also known as "golden handcuffs" and can prevent employees from departing a startup until either a sale or an IPO.[126] This practice may seem beneficial in that it ensures stability due to the inability to withdraw, but lock-in and illiquidity may pose a problem for employees who must choose between either foregoing their expiring options or exercising them for shares that may turn out to be worth less than the price at which they exercised their options.[127] Employees also face this problem when holding underwater options, meaning the price at which they have to exercise the option is greater than the fair market value of the shares.[128] Without a repricing program, employees face difficult choices: paying a premium for their options, risking the possibility of the stock becoming

120. Winkler, *supra* note 113.
121. Cal. Corp. Code § 1501 (2024).
122. Winkler, *supra* note 113.
123. Alon-Beck, *supra* note 115, at 1207–1208.
124. *See id.*
125. Alon-Beck, *supra* note 3, at 141.
126. Aran & Murciano-Goroff, *supra* note 28, at 4.
127. Alon-Beck, *supra* note 3, at 117.
128. John D. Martini et al., *Addressing Underwater Stock Options*, HOLLAND & KNIGHT (Sept. 28, 2022), https://www.hklaw.com/en/insights/publications/2022/09/addressing-underwater-stock-options.

worthless, or allowing the options to expire, thereby potentially forfeiting any profits should the company succeed.[129]

Most startup employees also do not have downside protection due to their status as common shareholders when exercising their options.[130] For instance, in the event of a sale, common shares are the last to get paid due to the priority given to preferred shareholders, who in the context of startups, are generally VCs.[131] The most common form of exit for a VC-backed startup is a sale, which can end up disadvantaging common shareholders. In such a case, the preferred shareholders receive a sum that corresponds with their liquidation preference.[132] Recent controversial lawsuits like *Trados* illustrate this point, where the common shareholders sued for breach of fiduciary duty after failing to receive anything from the company's sale.[133] Though the court deemed the transaction fair to the common shareholders because of the company's poor prospects, it also criticized the VC-run board of directors for not primarily serving the interests of the common shareholders.[134]

As startups increasingly decide to remain private, employees are required to pay significant amounts of money from their own pockets to exercise stock options and pay taxes on potential profits that may never come to fruition.[135] There have even been instances where employees took out loans to exercise their stock options due to being last in priority during the sale of the company, which in effect resulted in them paying money to work for the company and never profiting from their options.[136] This can be seen in the situation involving a former unicorn by the name of Good Technology ("Good"), where the company's board decided to sell the company at half its value after initially declining an acquisition offer because of their goal of going public.[137] Some of the employees even purchased additional shares on the open market because they believed the company would be successful, despite their lack of knowledge about the company's financial status.[138] Good is one of many examples of the negative consequences common employee shareholders face due to the lack of downside protection and the disclosure issues discussed above.

129. *See id.*
130. Alon-Beck, *supra* note 3, at 142.
131. *See Id.*
132. *Id.* at 135.
133. *Id.*
134. Abraham Cable, *Does Trados Matter?*, 45 J. CORP. L. 102, 104 (2019).
135. Alon-Beck, *supra* note 3, at 128–129.
136. *Id.* at 143.
137. *Id.*
138. *See* Matt Levine, *Good Technology Wasn't So Good for Employees*, BLOOMBERG (Dec. 23, 2015), https://www.bloomberg.com/opinion/articles/2015-12-23/good-technology-wasn-t-so-good-for-employees.

C. The Problem of Staying Private: Foursquare vs. Stripe

Stock options in the context of startups are based on the principle that a company will go public in a determined number of years, but today, these companies are staying private longer and employees are facing the consequences. As companies choose to stay private for longer periods, employees' stock-based equity may face dilutionary effects.[139] For instance, as new money continues to flow into these companies from VCs, this, in turn, dilutes the value of employee stock option grants.[140] VCs end up gaining the upside of startups remaining private because unlike employees, VCs typically have the benefit of keeping their ownership percentage intact through pro-rata rights.[141] Furthermore, the logic behind stock options starts to fade when a startup extends beyond its original exit horizon, and employees become less incentivized to stay beyond their initial vesting date.[142]

Although I mentioned that the use of RSUs offer a compelling and safer alternative to stock options, they may also have their own disadvantages, especially in this context. RSUs eventually expire if a company does not exit within the specified timeframe and do not vest unless the company achieves a liquidity event.[143] Take for example, Foursquare, the geolocation technology startup, who in 2016 allowed employees to exchange their expiring stock options for RSUs.[144] Fast forward to 2023, many of those same employees who exchanged their stock options for the "safer" alternative are now left with nothing due to the expiration of those RSUs.[145] This is because under United States federal tax laws, the expiration date or term likely cannot be extended.[146] However, there are companies, like Stripe, who have been able to get around this hurdle through alternative mitigation strategies.[147]

Stripe, the financial technology decacorn that had plans of going public, has decided to remain private due to declining technology valuations.[148] Stripe had also previously issued RSUs to employees for retention purposes, which

---

139. Blank, *supra* note 42.
140. *Id.*
141. *Id.*
142. *Id.*
143. *Liquidity for RSUs*, ESO FUND, https://www.esofund.com/liquidity-for-rsus#:~:text=RSUs%20expire%20if%20a%20company,after%205%20to%207%20years (last visited Mar. 5, 2023).
144. *See* Lee, *supra* note 46.
145. *Id.*
146. Brookfield et al., *Part III: What Primary Mitigation Strategies Exist for Companies with Double-Vest RSUs That May Be Expiring?*, JD SUPRA: GOODWIN LAW (Mar. 6, 2023), https://www.jdsupra.com/legalnews/part-iii-what-primary-mitigation-7890660/.
147. *See* Marina Temkin, *No Way Out: Stripe's Share Rescue Plan Not an Option for Most Startups*, PITCHBOOK (Mar. 2, 2023), https://pitchbook.com/news/articles/stripe-ipo-down-round-tax-restricted-stock-unit (explaining Stripe's plan of waiving the liquidity event condition and securing Series I funding to pay for the tax obligations associated with the vested RSU shares).
148. *Id.*

were expected to expire in 2023 unless it went public.[149] In response, Stripe took a novel step in the right direction for its employees by waiving the liquidity event condition and having the shares vest immediately.[150] When the RSUs vest, however, employees are faced with a massive tax bill mandated by Section 1244 of the IRC and will unlikely be able to pay for it.[151] As a result, and not by any means necessary, Stripe raised nearly $7 billion in Series I funding to help these employees cover their tax bill in the form of a loan or buying back a portion of their vested RSUs.[152] Moreover, the funding round was non-dilutive because the liquidity provided to employees would end up offsetting the new shares issued during the latest funding round.[153] The question then is, will other private companies be able to follow Stripes lead? Stripe is uniquely situated, on the brink of an IPO, and has substantial demand for its stock. Thus, the unfortunate reality is that most private companies likely will not have this luxury and probably will not be able to attract enough capital to modify their grants, leaving them no choice but to let RSUs expire.[154]

There is neither a one-size fits all solution for startups offering stock-based compensation programs nor for employees dealing with challenges associated with the implementation of these programs. Therefore, it is prudent to take into account the concerns outlined above, consider the trajectory of our regulatory framework, and explore potential company-based mitigation strategies as a proactive approach to addressing such issues.

VI. POTENTIAL SOLUTIONS TO STOCK-BASED COMPENSATION PROBLEMS

Startups will likely continue their practices of offering traditional stock-based compensation programs, but they also may be able to mitigate the risks associated with these programs. Startups can create their own disclosure regime, set up programs allowing employees to sell on secondary market platforms or to outside investors, reprice or extend underwater options, and engage in mitigation strategies similar to Stripe's. These solutions are not perfect and may be impracticable for many companies, but they are worthy of a startup board's consideration.

---

149. Alex McMurray, *Stripe: The Top Paying Fintech is Rethinking Compensation*, EFINANCIALCAREERS (Mar. 6, 2023), https://www.efinancialcareers.com/news/2023/03/jobs-at-stripe-compensation.

150. *Id.*

151. Tanay Jaipuria, *Understanding Stripe's Latest $6.5B Fundraise*, SUBSTACK: TANAY'S NEWSLETTER (Mar. 20, 2023), https://tanay.substack.com/p/understanding-stripes-latest-65b; *see also* 26 U.S.C. § 1244.

152. Rohan Goswami, *Stripe Slashes Valuation to $50 billion in New $6.5 Billion Funding Round*, CNBC (Mar. 15, 2023), https://www.cnbc.com/2023/03/15/stripe-raises-series-i-billion-at-sharply-reduced-50-billion-valuation.html.

153. *Id.*

154. Temkin, *supra* note 147.

A. Improved Disclosure Regime

Without access to reliable information regarding a company's actual worth, employees may take on higher levels of risk than anticipated and could face significant tax liabilities on potential profits that may never result.[155] Moreover, the value of a unicorn's common stock may decrease below the option's strike price, resulting in employees essentially "paying to work for their company when their stock option profits do not materialize."[156] The lack of clear and accurate information about a company's valuation poses a significant challenge for employees, impeding their ability to assess the value of their stock options and make well-informed investment decisions.[157]

Currently, private companies do not have disclosure obligations unless they meet certain requirements and these obligations may be avoided through contractual waivers.[158] In light of recent cases involving companies like Theranos Inc. and FTX, the SEC has begun displaying promising signs of improving disclosure obligations.[159] Concerns have emerged that existing regulations incentivize companies to stay private, thereby allowing them to avoid registration requirements, and as a result, disclosure.[160] Over the past 10 years, the amount of companies classified as unicorns has grown exponentially.[161] In 2023, there were roughly 1,200 unicorns, compared to about 40 in 2013.[162] The SEC has also listed potential private company disclosure rulemaking as one of its key priorities in 2024.[163] As a result, the SEC's evolving stance toward reform, prompted by the rapid expansion of the private market, warrants close attention.

Without action by the SEC or a rule (or amendments to existing rules) mandating new disclosure requirements for private companies, or clarity by the Delaware Court of Chancery regarding the legality of contractual waivers in stock option agreements, employees will likely continue to lack essential information concerning their investments. A solution may be to revert the Rule 701 threshold back to $5 million, but the SEC would not have the power to do so since the threshold was set by Congress.[164] Additionally, there is always a possibility that the threshold may be further increased under a Republican-dominant Congress. The SEC, however, may be able to create triggers based on other metrics, like company revenue and valuation to name a few.[165] In fact,

155. Alon-Beck, *supra* note 117, at 1187.
156. *Id.* at 1187.
157. *Id.* at 1191.
158. See Aran & Murciano-Goroff, *supra* note 28, at 29. *See also* Alon-Beck, *supra* note 117, at 1168.
159. Crenshaw, *supra* note 7.
160. *Id.*
161. *Id.*
162. *Id.*
163. Bridget Neill et al., *Five key SEC priorities in 2024*, EY (Feb. 13, 2024), https://www.ey.com/en_us/public-policy/sec-top-five.
164. *See* Economic Growth Act, *supra* note 112.
165. *See* Section 12(g) of the Securities Exchange Act: Issue Brief, CARTA (Mar. 31, 2023), https://carta.com/blog/issue-brief-12g/.

in 2021, the SEC released a proposed revision to Rule 701, which would give startups hitting the $10 million threshold the option of disclosing a valuation report, as opposed to financial statements.[166] The new proposal is a promising development, but its implementation remains uncertain.

Nevertheless, startups companies may have the capacity to implement their own disclosure regime. While the benefits of remaining private are closely linked to the need not to disclose, private companies will create a more transparent environment for employees by disclosing a few key pieces of information. For example, Professor Anat Alon-Beck, whose research on corporate governance is extensive, has recommended that companies could disclose outstanding debt, compensation practices, how much stock or debt they have issued or plan to issue, as well as provide employees with the assistance of an "independent purchaser representative."[167] The independent purchaser representative can be especially helpful for unsophisticated employees purchasing shares. Without essential financial information, there is a possibility that employees may start turning to the courts for remedies, especially in light of the recent standardization of contractual waivers in stock option agreements.[168] While the success of these potential lawsuits is unclear, the risk of litigation may create a sense of urgency for startup company boards.

B. Options Repricing & The Secondary Market

Due to the problems associated with underwater and expiring options, as well as lock-in and illiquidity, company boards should consider implementing repricing programs, extending the expiration of stock option grants, or implementing a program to sell to outside investors. As employees face the risk of missing out on gains by letting their options expire, or paying a significant premium for options, both the company and its employees are on the losing end of this situation.[169] For instance, if stock-based compensation plans are planned around retention, then underwater or expiring options may defeat that purpose and lead employees to seek better compensation elsewhere.[170] In addition, employees may end up being dissatisfied with management, which may lead to a loss of motivation, a decline in overall company performance, and as a result, decreased investor confidence.[171] Thus,

166. Yifat Aran, *The SEC should do more to make startup equity compensation transparent*, TECHCRUNCH (Apr. 24, 2021), https://techcrunch.com/2021/04/24/the-sec-should-do-more-to-make-startup-equity-compensation-transparent/.

167. *See* Alon-Beck, *supra* note 3, at 185.

168. *See supra* Section IV.A.

169. *See supra* Section IV.B.

170. *See* Tim Johnson, *The Real Problem with Tech Professionals: High Turnover*, FORBES (June 29, 2018), https://www.forbes.com/sites/forbesbusinessdevelopmentcouncil/2018/06/29/the-real-problem-with-tech-professionals-high-turnover/#37ddb3164201 (explaining high turnover rates in the technology industry due to mistreatment of minority employees and non-competitive salaries).

171. *See* Alon-Beck, *supra* note 3, at 141.

company boards may want to consider repricing or extending the exercise period for these options.

Repricing simply refers to reducing the price at which the option may be exercised.[172] If a company's stock options are significantly below the fair market value of the stock, then a board can decide to reduce the exercise price to that value.[173] The pre-existing options can either be cancelled and replaced with the issuance of new options or amended with a lower exercise price.[174] There are also no tax implications to this method if the new exercise price is equal to the fair market value.[175] While this may resolve the problem of paying a premium or losing out on the chance to obtain value, there still remains a concern of lock-in, due to vesting schedules,[176] illiquidity, and insufficient access to a secondary market. Moreover, employees still lack information regarding the inherent value of their stock, and in the case of unicorn stock, they still would likely have to pay a prohibitively expensive premium.

As discussed above, in the case of Good, employees made the unfortunate decision of purchasing additional shares in the open market, instead of using it as an exit vehicle.[177] With the advancements in secondary markets, like the Nasdaq Private Market, Forge Global, or EquityZen, startup employees—if permitted by their employers—may be able to sell their shares in the open market.[178] However, this may be more appropriate for more mature startups, like Stripe, SpaceX, or Databricks, who have significant demand for their shares.[179] Companies have also started to use their rights of first refusal and even block sales, due to the potential adverse effects such sales can have on company valuations.[180] There remains a concern that companies permitting such activities risk forfeiting their status as private companies due to section 12(g) of the Exchange Act.[181] Importantly, while the JOBS Act made it easier for companies to avoid registration, it also made it easier for shares to be traded on secondary markets, by increasing the 12(g) registration trigger to

172. Monica Patel & Malhar Naik, *Private Companies: Time To Consider Repricing Underwater Stock Options?*, GOODWIN LAW (Sept. 19, 2022), https://www.goodwinlaw.com/en/insights/publications/2022/09/09_19-whats-next-a-path-forward-in-uncertain-times.

173. Martini, *supra* note 128.

174. *Id.*

175. *Id.*

176. *See* Kris Snodgrass, *A Guide to Repricing Underwater Options*, NORWEST: BLOG (Feb. 27, 2023), https://www.nvp.com/blog/a-guide-to-repricing-underwater-options/.

177. Levine, *supra* note 138.

178. *See* Alon-Beck note 3, at 173; *see also* FORGEGLOBAL, https://forgeglobal.com/; *see also* EQUITYZEN, https://equityzen.com/.

179. *See* John Divine, *10 of the Most Valuable Private Companies*, US NEWS (Nov. 2, 2023), https://money.usnews.com/investing/articles/most-valuable-private-companies.

180. Rosie Bradbury, *Investors deal out tough love to founders at secondary auctions*, PITCHBOOK (Aug. 10, 2023), https://pitchbook.com/news/articles/secondary-share-sales-founders-cap-table-down-rounds-valuations-fundraising-weekend-pitch.

181. Cable, *supra* note 31.

2,000 shareholders.[182] Although there is a registration risk, the threshold is rarely ever met under the current regulatory framework.[183] This is because 12(g) allows shares to be owned in "street name," meaning securities can be held in the name of a brokerage firm or other nominee, rather than in the name of the actual owner.[184] Even if there are thousands of individuals who own shares, they are counted as a single shareholder for the purposes of determining whether the threshold has been met.[185] Despite private company status forfeiture concerns and companies preventing trades due to decreased valuation concerns, the relaxed 12(g) threshold seems to have sparked an increase in employee access to the secondary market.[186]

The recent increase in the 12(g) registration threshold has indeed provided increased secondary trading opportunities for startup employees but companies remain fearful of losing their status as a private company.[187] Another increase in the threshold may further boost secondary trading volume and ease status forfeiture fears from a company perspective, but valuation concerns persist, particularly due to employees selling discounted shares on such platforms.[188] While a startup may have the ability to contractually regulate the prices at which employees decide to sell, the full potential and impact of such measures remain speculative. Moreover, employees forfeit their eligibility for Section 83(i) tax deferral under the Tax and Jobs Act of 2018 when engaging in secondary market trading.[189] Consequently, employees may face the dilemma of either pursuing liquidity opportunities, albeit accompanied by substantial tax liabilities, or retaining their stock to benefit from the deferral provision.

A company concerned with maintaining private company status may also consider instituting a plan to sell to a single institutional purchaser. This is known as a tender offer, which occurs when a single investor offers to buy shares from shareholders.[190] Uber (pre-IPO) is a great example of this, as it allowed its employees, as well as other shareholders, to liquidate their shares to Japanese multinational holding company, Softbank.[191] It is worth noting

182. *See id.*

183. Paul Kiernan, *SEC Pushes for More Transparency From Private Companies*, WALL ST. J. (Jan. 10, 2022), https://www.wsj.com/articles/sec-pushes-for-more-transparency-from-private-companies-11641752489.

184. *Id.*

185. *See id.*

186. Marc Vartabedian, *Stalled IPO Market Leaves Startup Employees, Individuals Eager to Unload Shares*, WALL ST. J. PRO: PRIVATE EQUITY (Feb. 12, 2024), https://www.wsj.com/articles/stalled-ipo-market-leaves-startup-employees-individuals-eager-to-unload-shares-b53b0c41.

187. Cable, *supra* note 31.

188. Sophie Shulman, *High-tech startups blocking secondary deals to save face and valuation*, CALCALIST: CTECH (Jan. 31, 2023), https://www.calcalistech.com/ctechnews/article/spsr0b7l0.

189. *See* Alon-Beck, *supra* note 3 at 189.

190. Adam Hayes, *Tender Offer Definition: How it Works, With Example*, INVESTOPEDIA (Apr. 15, 2022), https://www.investopedia.com/terms/t/tenderoffer.asp.

191. Anita Balakrishnan, *SoftBank Agrees to Buy Stake in Uber*, CNBC (Dec. 28, 2017), https://www.cnbc.com/2017/12/28/softbank-uber-investment-tender-offer-announced.html.

though, that those who reaped the most benefits were the earlier investors and employees, as opposed to later-joining employees who remained locked-in.[192] Recently, OpenAI, the widely popular artificial intelligence and research company, was the latest to provide an alternative liquidity opportunity to employees by striking a tender offer with Thrive Capital, a notable VC firm focused on technology investments.[193] Tender offers can help solve significant issues for both companies and their early employees, but Uber and OpenAI are unique examples where investment demand was substantial.

C. RSU Liquidity Event Condition Waiver

In the context of private companies with an RSU focused compensation program, these companies may be able waive the liquidity event condition and allow those shares to vest after having satisfied the time condition.[194] Most startups likely will not have the same opportunity as Stripe to engage in another round of funding to cover the tax consequences associated with those vested shares, but waiving the liquidity event condition may be a better strategy than letting those potentially valuable shares expire with no value. Since employees likely will not be able to pay for that tax burden, companies can also permit the obligation to be satisfied by withholding a portion of their stock to cover their tax liability.[195] However, for companies in cash preservation mode, this likely would not be a viable option, as they would end up withholding a percentage of the shares and using their own cash to cover employees' tax liability.[196] Moreover, a waiver might also jeopardize the beneficial tax position of other yet to expire RSUs.[197] This is a potential solution to allowing RSUs to expire worthless, but again, taking this step is highly dependent on a company's positional strength.

CONCLUSION

Stock-based compensation plans have become a prevalent and widespread practice among startup companies in the United States. These plans, in the form of stock-options and RSUs, provide advantages to startups as an effective way to attract and retain talent, align employee interests with those of founders and other shareholders, encourage employees to save, and

192. *See id.*; *see also* Alison Griswold, *Former Uber employees have gone into debt to hang onto shares they still can't sell*, QUARTZ (Dec. 10, 2017), https://qz.com/1149381/uber-softbank-shares-debt.

193. Hannah Miller, *OpenAI Deal Lets Employees Sell Shares at $86 Billion Valuation*, CNBC (Feb. 16, 2024), https://www.bloomberg.com/news/articles/2024-02-17/openai-deal-lets-employees-sell-shares-at-86-billion-valuation?embedded-checkout=true.

194. *See* Brookfield, *supra* note 146.

195. *Id.*

196. *Id.*

197. *Id.*

create a sense of belonging within a company.[198] However, while stock-based compensation plans provide unquestionable benefits, startup employees bear the brunt of many of the disadvantages associated with these programs.

Illiquidity and lock-in concerns remain a significant issue for startup employees, especially for those at later stage startups because they are unable to easily withdraw their equity holdings or market their shares to outside investors.[199] Many startup employees also lack investment sophistication, which may lead to uninformed and costly investment decisions.[200] In addition, the lack of access to critical financial information prevents employees from making informed investment decisions.[201] Ultimately, this lack of information keeps employees in the dark regarding the value of their equity grants. Considering the increased usage of contractual waivers in startup stock option agreements and companies remaining private for prolonged periods, employees are also prevented from inquiring into the financial information of their employers.[202] As a result, the Delaware Court of Chancery may see an increase in books and records cases, and until a decision on the legality of these waivers or a new (or amended) rule by the SEC, employees will continue to remain uninformed. Although the SEC seems to be trending toward heightened disclosure obligations for private companies, startup boards may be able to—and should—implement their own disclosure framework, all the while ensuring they balance valid concerns of safeguarding the proprietary interests of their companies.[203]

Despite these challenges, RSUs remain a better option for startup employees, due to providing more certainty and downside protection.[204] Indeed, RSUs are not without their flaws, as demonstrated by cases like Foursquare, where employee RSUs were permitted to expire worthless.[205] This highlights a concerning trend: as companies choose to remain private for extended periods, RSUs increasingly face the risk of expiring worthless.[206] However, companies have the opportunity to mitigate this risk by waiving the liquidity event condition or exploring innovative solutions like Stripe, depending on the circumstances of the company.[207]

As liquidity concerns become more prevalent among employees, startup boards must weigh the benefits and drawbacks of their stock-based compensation plans. Repricing options or extending their exercise periods may prove to be viable for underwater or expiring options, even though this does not address the liquidity problems associated with many stock-based

198. *See supra* Section III.C.
199. *See* Alon-Beck, *supra* note 3, at 117.
200. *See supra* Section IV.A.
201. See Alon-Beck, supra note 3, at 182.
202. *See* Alon-Beck, *supra* note 115, at 1182.
203. *See* Neill et al., *supra* note 163; Alon-Beck, *supra* note 3, at 185
204. Alon Beck, *supra* note 3, at 169.
205. *See* Lee, *supra* note 46.
206. *Id.*
207. *See* McMurray, *supra* note 146.

compensation programs.[208] On the other hand, despite registration and valuation concerns, allowing shares to be sold on secondary platforms—with company-set sale price policies—may be able to provide employees with greater liquidity, despite the negative tax implications associated with this practice.[209] An argument can also be made that registration risk is moot due to the "street name" loophole in 12(g) of the Exchange Act.[210] Moreover, engaging in a tender offer may be a suitable option.[211] Both options provide effective ways of creating liquidity, but are highly dependent on demand.

While stock-based compensation plans have become an integral part of private companies' compensation strategies, it is important for companies to consider the potential drawbacks that their employees may face and address these concerns accordingly. Based on my analysis and depending on the stage of a company's life cycle, companies should consider the following: adjusting their current informational structure; engaging in repricing or extending stock-options; implementing programs allowing employees to sell their locked-in shares to outside investors; and adjusting RSU liquidity event conditions sparingly when companies decide to remain private for extended periods. By addressing the potential drawbacks of stock-based compensation and tailoring strategies to accommodate employee needs, startups can cultivate transparency and create opportunities for employees while also mitigating corporate risks.

208. *See* Snodgrass, *supra* note 176.
209. *See* Alon-Beck, *supra* note 3, at 189.
210. *See* Kiernan, supra note 183.
211. *See supra* Section IV.B.