STOCK OPTION LIQUIDITY: A GUIDE FOR PRIVATE COMPANY EMPLOYEES

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Introduction

For many companies, stock options are a well-established way to compensate and incentivize employees. Stock options can align employees, create a culture of ownership, and provide long-term financial upside.

The valuation and exercise mechanics of public company stock options are relatively straightforward. However, there are many complexities associated with private company options, which have increasingly come into focus as companies remain private longer.

Historically, private company shareholders (and option holders) have been expected to hold their stock until a company liquidity event, whether IPO or acquisition. Post-IPO, employees could exercise their options and sell the resulting shares, subject to lock-up periods, blackout dates, and other trading restrictions. However, over the past decade, private companies have been staying private longer, prompted by the increasing availability of private capital, rising private valuations, periods of public market volatility, and the desire to avoid certain regulatory and compliance requirements. This not only delays the timeframe for employees to realize liquidity, but may also present challenges related to option exercise and tax optimization.

In many cases, the employee's desire for liquidity is driven by individual milestones (i.e., buying a home, paying a child's tuition, tax planning, or other personal needs) or job change (i.e., departed employees with incentive stock options, as outlined below). Additionally, the costs associated with exercising an option grant (strike price plus applicable taxes) can be cost prohibitive, leading to an employee to forgo the exercise entirely.

As a result, employees are increasingly turning to the secondary market to seek liquidity for their options. The overall secondary market for private company shares has continued to grow in recent years and was projected to reach $100 billion in 2021.[1] Realizing liquidity for options entails additional complexity compared to the typical secondary stock sale; an option holder must understand the specific exercise mechanics, timing restrictions, and tax implications associated with each option grant. An option holder may seek a dedicated secondary partner who can provide specialized guidance and optimized pricing for the resulting shares.

Overview of Stock Options

Stock options are the right to buy a set number of company shares at a fixed price, typically called a strike price or grant price. This price is determined by a company's fair market value ("FMV") – the strike price typically being equal to the FMV of the company's stock on the day of the option grant. As the value of the company's shares increase over time, so does the inherent value of the stock options, resulting in financial upside for the employee.

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In This White Paper:

Why Seek Liquidity for Private Company Options?

- Generate near-term cash for personal needs
- Lock in gains
- Cover exercise costs (including strike price and associated taxes)
- Provide asset diversification
- Avoid public stock trading restrictions (lock-up periods, blackout dates, executive restrictions, etc.)

[1] Wall Street Journal, "Secondary Transactions on Pace to Reach $100 Billion This Year." November 1, 2021

Private companies typically use an independent 409A valuation provider to determine the FMV of its common stock. As the company's valuation increases through additional rounds of raised capital, the difference between the FMV and the options' strike price is known as "the spread." When this spread is positive, the options are considered to be "in-the-money."

Often, companies will assign a vesting schedule to an option grant, which means that an employee will only be allowed to exercise a certain number of their total options per month, quarter, or year. Companies use vesting schedules to incentivize employees to stay with the company over a longer period of time.

Options will also have an expiration date. Typically, most options expire 10 years from the grant date. However, an employee grant can also expire after an employee leaves the company; in many cases, an employee may only have a short window of time to exercise their options after they leave, often 90 days or less.

All of this information, including the type of shares and number are outlined in an employee's grant document.

Ways to Exercise Options

1. **Pay cash (exercise and hold):** An employee may use their own money to exercise options, paying the strike price to purchase and hold the resulting shares. This is typically the riskiest method, given the stock remains illiquid after exercising the option, and the employee is not guaranteed to make a profit (or even get their money back). Plus, their money is tied up in their shares until they sell.

2. **Cashless (exercise and sell to cover):** If a company is public or offering a tender, it may allow employees to simultaneously exercise their options and sell enough shares to cover the purchase price and applicable fees and taxes. The employee may then elect to hold or sell the remaining shares.

3. **Cashless (exercise and sell):** If a company is public or offering a tender, it may allow employees to exercise and sell all their options in one transaction. A portion of the proceeds from the sale will cover the purchase price plus applicable fees and taxes, while the employee pockets the remainder.

Key Considerations

When evaluating a potential exercise and sale of options, it is important to consider the timing restrictions, mechanics, and tax implications associated with each individual grant. The first, and perhaps most important, issue to understand is whether an option is an incentive stock option (ISO) or non-qualified stock options (NSO)

ISOs vs. NSOs. From an employee's perspective, incentive stock options (ISOs) and non-qualified stock options (NSOs) primarily differ in taxation and expiration. ISOs may qualify for favorable tax treatment if they are exercised and held (instead of sold) for a minimum period of time, specifically:

- An employee must hold the options (and/or resulting shares) for at least two years after the initial grant date of the ISOs
- After exercising the options, the employee must hold the resulting shares for at least one-year

Additionally, ISOs must be exercised within 90 days after terminating employment to retain the favorable tax treatment – otherwise they'll be taxed as if they were issued as NSOs.

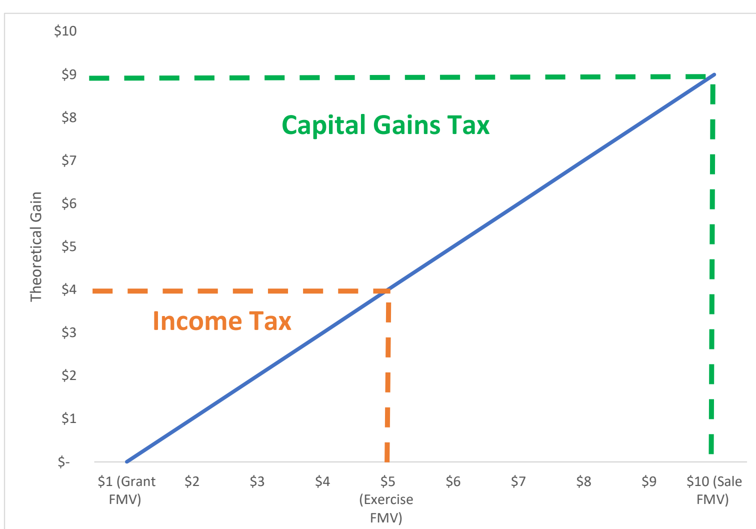
If these holding period and exercise requirements are met for an ISO grant, the entire gain from the option exercise and sale may be taxed at the capital gains rate (instead of the higher ordinary income tax rate).

ISOs vs. NSOs – a Summary	
ISOs	**NSOs**

• Qualify for special tax treatment where only the capital gains tax needs to be paid on the total gain between Sale FMV and Grant FMV
• Tax does not need to be paid until the holder sells the resulting shares
• Holding Period requirements must be met to qualify for this treatment:
    ○ Hold underlying options (and/or resulting shares) at least two years from the initial grant date
    ○ Hold resulting shares at least one year following exercise
• Upon the termination of employment, ISOs must be exercised within 90 days to qualify for ISO treatment
	• There is no special tax treatment
	• An employee needs to pay income tax on the initial gain between the exercise FMV and the grant FMV, due on exercise
	• An employee then needs to pay capital gains tax on the secondary gain between the sale FMV and the exercise FMV, due on sale
	• There are no holding period requirements
	• Upon the termination of employment, an employee will have a set amount of time to exercise options, which is detailed in their initial grant document

Calculating Tax Liability for NSOs. The initial gain (the difference between the FMV of stock when an employee exercises their options, and the grant price of those options) is taxed as ordinary income. On top of that, an employee will pay capital gains tax on any increase between the FMV when the shares are exercised and when the shares are sold (because the stock is owned after the option is exercised, any gain made when sold is taxed as profit).

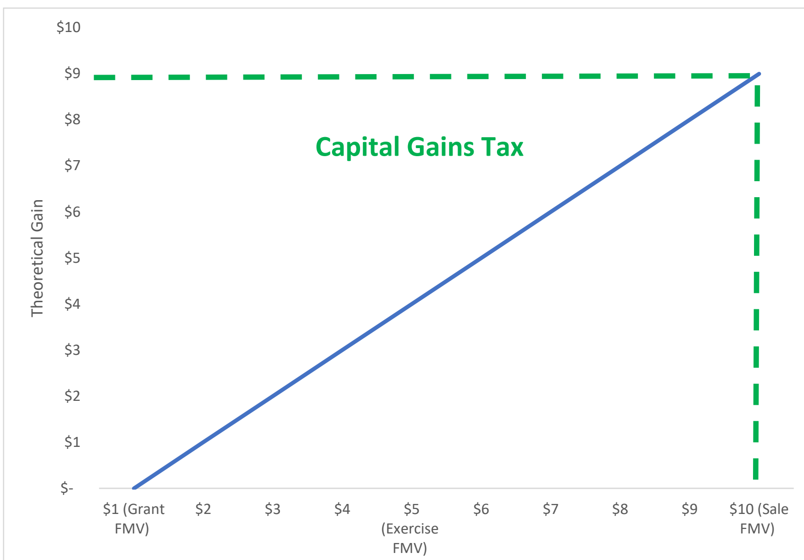
For example, let's say an employee is granted options at a $1 grant price. They go on to exercise their shares when the FMV is $5/share, creating an initial gain of $4/share (Exercise FMV less Grant FMV). Eventually, they sell their shares at $10/share, which creates an additional gain of $5/share (Sale FMV less Exercise FMV). The employee in this example would pay an ordinary income tax rate on the initial gain of $4/share, and a capital gains tax rate on the secondary gain of $5/share.



Since the ordinary income tax rate is higher than the capital gains tax rate, it is in the employee's best interest to minimize their initial gain between the Exercise FMV and Grant FMV. In the example above, the employee would pay less income tax if they chose to exercise their options closer to their grant price of $1/share. While their secondary gain would increase, it would be subject to the capital gains tax rate, which could result in fewer taxes paid overall:

	$5 Exercise FMV	$3 Exercise FMV (lower)
Grant FMV	$1	$1
Exercise FMV	$5	$3
Initial Gain	*$4*	*$2*
Income Tax (assume 37% rate)	**$1.48**	**$0.74**
Sale FMV	$10	$10
Secondary Gain	*$5*	*$7*
Capital Gains Tax (assume 22% rate)	**$1.10**	**$1.54**
Total Tax Paid	**$2.58**	**$2.28**
Difference	$0.30	

Calculating Tax Liability for ISOs. Continuing the example above, if an employee is granted options at $1/share, and those options are ISOs and the two holding requirements are met, they would pay a capital gains rate (assumed to be 22% for illustrations purposes) on the total gain between the sale price and the grant price. In this illustration, the capital gains rate results in tax of $1.98/share, which demonstrates the benefit of ISOs versus NSOs:



	ISO	NSO
Grant FMV	$1	$1
Exercise FMV	$5	$5
Initial Gain	*$0*	*$4*
Income Tax (assume 37% rate)	**$0**	**$1.48**
Sale FMV	$10	$10
Secondary Gain	*$9*	*$5*
Capital Gains Tax (assume 22% rate)	**$1.98**	**$1.10**
Total Tax Paid	**$1.98**	**$2.58**
Difference	$0.60	

Therefore, if an employee owns ISOs, they must consider the holding periods to qualify for special tax treatment. If an employee owns NSOs, they may want to consider early exercising options to minimize the income tax paid between the exercise FMV and grant FMV.

Early Exercising. Some companies will allow the exercise of options before they have fully vested (referred to as "early exercising"), oftentimes as early as the initial option grant date. The benefit of doing this is to minimize the initial gain between Exercise FMV and the Grant FMV, which could limit an employee's exposure to taxes in the case of NSOs. If an employee chooses to exercise the options early, they must file an 83(b) election to take advantage of the beneficial tax treatment, which must be filed within 30 days with the IRS.

Alternative Minimum Tax (AMT). If ISOs are exercised, and the underlying shares aren't sold within the same year (i.e., the holding period requirements are met), employees may also need to calculate the alternative minimum tax. AMT is calculated by including more things as taxable income, including the spread between the price paid to exercise ISOs and the FMV at the time of exercise. If an employee's taxable income is more than the AMT exemption amount, an employee would need to calculate their tax obligation both ways and pay the greater of the two calculations. As such, it is important to talk to a tax professional to learn how to plan for a potential AMT liability.

Secondary Market for Employee Options

As companies stay private longer, employees holding options may want to consider selling their options to create personal liquidity for various life milestones. An employee may find a buyer for their options directly or use one of the platforms previously mentioned. Alternatively, in some cases the company will coordinate the sale of options for multiple employees. This is often referred to as a tender process. A broad tender occurs when the company identifies several employees who wish to sell, negotiates a set price, and coordinates the sale with a previously selected buyer. For more information on running a tender process, please see our whitepaper, here.

An individual can sell their options in one of two ways:

1) A potential seller can seek out a broker group such as Forge, Nasdaq, etc. to solicit potential bids for the purchase of their options. The benefit of this approach is that the seller will likely be introduced to multiple parties that may yield multiple offers. However, the main drawbacks to using this strategy include the payment of broker fees that increases the costs to the seller, as well as working with a wide range of counterparties who may not be able to accurately value the company. Any potential buyer will likely want additional information on the company before transacting, but the company may not want to provide information to a wide range of potential sellers, as this can be distracting from running the business. Therefore, the price coming from these broad processes may not be optimized to meet an employee's needs.

2) Alternatively, a potential seller can negotiate directly with a single secondary investor that has sector expertise within the company's focus area. This type of investor may be better able to provide fair pricing even if information is limited, given their deeper knowledge of the market and comparable companies. The company may also be willing to share more information with a single, knowledgeable party rather than a broad range of generalist, thus optimizing the price paid to the employee. Once an agreed upon price and structure are reached, the investor will reach out to the company as a future shareholder to begin the share transfer process.

Pricing for secondary shares is highly specific and may be presented as a discount or premium to the company's last round. A secondary partner will typically utilize a market value approach, performing an independent valuation of the company, accounting for its core business model, market dynamics, and IP, among other factors. There may be different pricing for different share classes (i.e., common vs. preferred) based on liquidation preferences, dividends, and other shareholder rights.

The company can support the valuation process through information disclosure, though isn't always likely to do so. Common diligence requests include the corporate presentation, financial statements, overview of key regulatory and commercial milestones, current capitalization table, and key corporate documents. Access to information and alignment between the entity purchasing the employee's shares and the company will maximize the price that investors are willing to pay.

Finding the Right Secondary Partner

Whether considering the sale of options or shares, employees should seek a dedicated partner with the sector expertise, transaction experience, and financial wherewithal to optimally complete a transaction.

From the company's perspective, the secondary buyer should serve as a long-term partner, supporting the company operationally and financially, as well as provide ongoing liquidity for shareholders (including future secondary purchases). As the median time to exit for private companies remains high, a secondary partner can play a vital role for both the company and its shareholders.

Sector expertise. A secondary partner with specific sector expertise can contribute to a smoother due diligence process and optimized pricing for the shares, based on an understanding of the specific regulatory, commercial, and legal dynamics issues faced by a company. As mentioned previously, a knowledgeable investor is especially valuable when information access is limited.

Transaction experience. Option exercises are typically more complex than primary investments, given the unique structuring, legal, and tax considerations of the process. An experienced secondary partner can help the option holder navigate these considerations, ensuring a smooth process and expeditious closing.

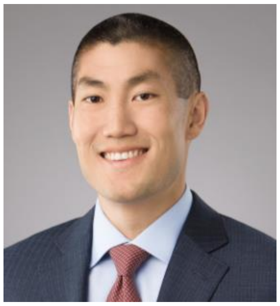
Dedicated Capital. A well-capitalized partner, with a dedicated capital pool, can ensure an expeditious closing. Moreover, a well-capitalized investor can provide future support for the company, including capital reserves to participate in follow-on financings, as well as the ability to execute additional secondary transactions for shareholders.

Overview of Revelation Partners

Revelation Partners is a dedicated secondary investor, providing flexible capital solutions to the healthcare ecosystem. We specialize in shareholder liquidity, GP solutions, and growth capital with a customized and long-term approach.

With a 14-year track record, deep sector expertise, an extensive industry network, and over $900 million of committed capital, Revelation Partners is a trusted partner to healthcare companies, investors, founders, and funds.

About the Authors



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