Employee Stock Options for the Participant

Part I: Elements of ESO's

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An important goal of every Board of Directors of a publicly traded company is to align the interests of the management and employees of the company with the interests of the shareholders. In principle, the maintenance of such an alignment will contribute to the maximization of the returns to the residual owners by reducing the ***agency problem***. By ***agency problem,*** we refer to the natural conflict of interest which exists when one group (agents or professional management) is engaged to make decisions in the best interests of another group (principals or shareholders). Since professional managers are motivated in their own self-interest, a conflict exists because the interests of the managers are not identical to the interests of the shareholders.

A common method of providing alignment of interests is equity compensation in the form of ***employee stock options or ESOs.*** Despite the widespread use of ESOs, we have observed that many recipients of these awards have little or no understanding of how ESOs work, how to determine their value, or how to manage them to meet their personal financial objectives. In an effort to educate and inform all interested parties as to the issues involved in awarding and owning equity compensation, we offer this series of ***White Papers*** which treats Employee Stock Options from the point of view of the recipient. In this first part, we cover the basic features common to all ESOs. We will walk through a number of examples to illustrate specific situations a recipient could encounter and to highlight the important decisions which must be made by an ESO owner.

In the second paper of this series, we will treat the ***valuation of ESOs*** and ***the risks and rewards*** of various scenarios which may be played out by a recipient. The differences between ESOs and exchange-traded equity options will be discussed. In the third paper we focus on the pros and cons of early exercise vs. holding the option until just before expiration and exercising at that time. This is a decision which must be made by every ESO owner in light of his or her own personal financial and tax situation. There are no hard and fast rules which apply.

Finally, we will take a brief look at some of the methods used to ***hedge a position in ESOs.*** There are techniques which may be used to mitigate the downside risks or avoid the loss of "time value." Hedging, although simple in concept, is complex in implementation, and a hedging program must be applied with full knowledge of the risks, rewards, and tax consequences.

ESO Basics

The specific conditions of an ESO award are spelled out in a company ***Stock Incentive Plan*** or ***Option Agreement***. An Employee Stock Option confers the right, but not the obligation, to purchase a specified number of shares of company stock at a specific price (the ***exercise price or strike price***) on or before some future date (the ***expiration date***). This type of option is known as a ***call option*** or simply a ***call***. The Options Agreement states whether the option is either a ***Non-Qualified Stock Option (NQSO)*** or an ***Incentive Stock Option (ISO)***. The agreement also states the number of shares and the strike price. Typically, the strike price of the ESO is the closing price of the company stock on the grant date. Also stated are the expiration date and a ***vesting period***. In most cases, the ESO cannot be exercised until sometime after the date of the grant. Once this time has passed, the ESO is said to have vested, or become available for exercise by the recipient. As an example, an ESO could be written to specify a grant date of January 30, 2013 with a three-year vesting period and a ten-year contractual period. Thus, the option could not be exercised until after January 30, 2016, and if not exercised, would expire and become worthless on January 30, 2023.

Vesting may take place all at once or in stages. For example, an ESO for 1,000 shares could vest completely after three years, or vest in increments of 25% per year for the next four years. In the latter case, the recipient could exercise 25% or 250 shares after one year, 50% or 500 shares after two years, and would have to wait for four years to exercise all 1,000 shares.

The difference between NQSOs and ISOs lies primarily in the rules which apply to their taxation. In this series, we shall concentrate on ***non-quals*** or NQSOs. The point here is that the recipient of any ESO award should read the options agreement carefully and know precisely what conditions apply to the award. The recipient should be aware of all the important dates specified in the award, as well as any restrictions on the ability to exercise or on the disposition of any stock purchased as a result of exercise.

An Example

Let's say you are an employee of ABC Company, and receive a grant of an ESO dated January 30, 2013. Here are the details which are stated in your Company Stock Plan or Options Agreement:

Date of Award:	January 30, 2013
Size of Award:	1,000 units (call option on 1,000 shares of ABC common stock)
Type of Award:	Non-Qualified Stock Option
Share Price on Award Date:	$40.00
Exercise Price:	$40.00 per share
Vesting Period:	Three years (No exercise is possible before January 31, 2016.)
Contractual Period:	Ten Years (Award expires and becomes worthless on January 30, 2023.)
Type of Vesting:	Cliff (All units vest at the same time)
Exercise Type:	Cash (This will be explained later.)
Tax Withholding:	Yes (This is very important. It will be explained later.)
Restrictions on Stock:	None

It is now mid-February and you are congratulating yourself on your good fortune and feeling great that your employer has selected you for an ESO award. If this is your first ESO award and you like your job and feel that your employer has a positive outlook for the future, you can probably look forward to additional awards in the years to come. You also have some work to do. In order to get the most benefit from your Employee Stock Options, you need to obtain some additional information about the award, have a financial plan going forward, and be prepared to make some decisions at certain dates in the future. Let's look at the details.

Before the Vesting Date

For the three years from the award date until the vesting date, you can't do anything with your ESO, but you should not forget that it is there. First, you should find out the ***fair value*** of the award on the grant date. This is the value of the award declared by your employer to both the SEC and the IRS. If your employer is a publicly traded corporation, domiciled in the United States, the corporation could deduct the value of this award (and all other similar awards) from its gross income as a compensation expense. ***You, the recipient, do not owe any Federal Income Tax on the award when it is granted.*** The fair value is important to you because it can help you in making the important decision of ***when best to exercise*** your options. The ***fair value*** of employee stock options is disclosed in the company ***annual report*** (SEC Form 10-K) or the ***Proxy Statement*** for the year of the award. The fair value is an estimate of what your ESOs would be worth if you could openly buy or sell them on an organized exchange, such as the Chicago Board Options Exchange (CBOE).

In addition to finding the fair value of your award, you should also familiarize yourself with the history and prospective outlook for your company stock. Look at the history of the stock price for the past ten years. Does the stock pay a dividend? How much? How often? Is the dividend fairly constant, growing, or erratic? You should also consider your overall financial situation. Do you have other investments in addition to stock in your employer? Are you saving for a major expense at some known future date? Do you have overall financial goals? Employee Stock Options, if well managed, can help you achieve your goals.

One more thing should be mentioned. If you leave your employer before the vesting date of your award (voluntarily or involuntarily) you will most likely ***forfeit*** your options. This also applies if you terminate your employment before you exercise your options, even though they may have previously vested. Keep this in mind if you are considering a move to a different employer.

Once Your Options Have Vested

After the vesting period has elapsed, you now hold options which you may exercise at any time before the expiration date. Let us assume that the stock of ABC Company has performed very well over the past three years, and is now trading at $60.00 per share. You are holding an option to buy 1,000 shares of ABC at $40.00 per share, which may be sold immediately at $60.00, thus earning a profit of $20.00 x 1,000 = $20,000. You decide to exercise immediately and sell your stock to take the profit in cash. Here is what happens.

You notify your employer of your intent to exercise. Since the award specified a ***cash exercise*** you need to come up with $40,000 cash to buy the 1,000 shares of ABC stock. That is not all. Your options have an ***intrinsic value*** of $20.00 per share. The intrinsic value is simply the difference between the market price of the stock and the exercise price of the option. An option which may be exercised at the current stock price or above has ***no intrinsic value, but is not worthless,*** as we shall see in the next paper of the series. Your intrinsic value at exercise is $20,000 x 1,000 = $20,000. If you sell the stock immediately, this is considered ordinary income, and is taxed at your marginal Federal rate. You also owe the 6.2% FICA and 1.45% Medicare taxes, since the $20,000 intrinsic value is considered as compensation. For simplicity, let us say that you owe 40% tax. We will not consider state or local taxes in this paper. Since your employer will withhold all taxes, the transaction looks like this:

Price of Stock:	$40,000
Taxes on Intrinsic Value:	$ 8,000
Value of Stock:	$60,000
Profit After Taxes:	$12,000

Some awards will specify a ***cashless exercise***, in which a cooperating broker immediately sells the stock and remits the excess after purchase price and tax to the recipient, thus requiring no up-front cash. A variation on this theme is the ***sell to cover exercise***, where the cooperating broker sells off enough stock to satisfy the exercise price of the option and taxes withheld, and then transfers the remaining stock to the recipient. In this case, the broker would receive 1,000 shares from ABC Company and immediately sell 800 shares to cover the $40,000 exercise price plus the $8,000 tax withholding. The recipient would receive 200 shares (assuming no brokerage fees are involved). Our recipient now has 200 shares of ABC, which may increase or decrease in price. The recipient bears the risk of a price decline, but will profit from a price increase. Of course, if the price increases further before the recipient sells the stock, additional taxes will be due.

Now we consider another case in which there is no tax withholding. In a cash exercise situation, our participant puts up $40,000 for 1,000 shares of stock with a current market value of $60,000. If he sells immediately, there is a $20,000 profit in cash and an $8,000 tax liability generated. Our participant should also recognize that holding the stock will not reduce his tax burden. The tax liability is incurred at the exercise of the option upon the intrinsic value. If he were to hold the stock for a year and a day after exercise, any additional profit over the intrinsic value at exercise would qualify for taxation as a long-term capital gain. Of course, there is a risk that the stock may decline in value over the subsequent holding period. If the stock declines, the ordinary income tax liability (including FICA and FUTA) from exercise does not change, but there may be a short or long-term capital loss.

Of course, our fictional recipient could have decided to simply hold on to his options once they have vested. He has a seven year window in which he can exercise them. If ABC stock is trading below $40.00 when the options vest, there is no point in considering exercise. The intrinsic value is zero. ***Our participant should not mistakenly assume that if his options have zero intrinsic value, then they are worthless.*** This is a serious mistake which can be avoided if one chooses to learn a bit more about the nature of option value. We proceed to the valuation of ESOs in the next paper of the series.

Disclaimer

The foregoing is intended for educational purposes only and is not to be regarded as investment advice. The examples are illustrative and do not represent actual employee stock options. The circumstances of every investor are unique. One should consult with licensed professionals before making any investment decision.

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