

Case Study #3: The importance of understanding your stock option vesting schedule. Are you leaving money on the table?

Solution: Saved client from leaving \$350,000 on the table.

Background:

Client reached out wanting to understand their stock options. They were an early stage employee at a start up, that was later acquired by a large publicly traded company, a leader in the industry. The start up was acquired in a majority stock for stock transaction, with some cash consideration paid. How will this affect your taxes?

Let's walk through the year by year mechanics of the situation. This situation is specific enough to be useful, but generic enough to apply to many tech employees with a similar situation.

Year 1: Company acquired → You will receive some stock in the publicly traded company and some cash. You will have to pay tax on the cash paid (sometimes called the “boot”). For the stock options that had vested as of acquisition date, these stock options will be exercised at time of acquisition and transitioned to stock (likely in the form of RSUs) in the acquiring company.

Year 2: The public company now offers this employee RSUs. This specific case involved two parallel tracked vesting schedules: stock options in subsidiary company, and RSUs (restricted stock units) in the public company. As time passes, the stock options vest and are exercised if “in the money”. “In the money” meaning, the exercise price (fair market value, aka selling price of the shares) is above the strike price (the price agreed upon at the grant date).

So in this situation, the employee was faced with the tough decision to keep working at their current job or to leave and pursue their dream job –

Client: “My stock option account shows that I have \$700k in stock options value in my portfolio. I think I am in a good position to move on. What does this total value mean? How does this work if I leave the company?”

Response: Since you have only worked 2 years out of the 4 year original vesting schedule for your stock options, you only have \$350k in liquid stock that has vested. The remaining stock is unvested. Meaning, you have to stay at the company another 2 years in order to complete this vesting schedule. Your opportunity cost of leaving will be \$175k per year for the next 2 years. If you do leave, you will only be able to take what has vested. Unvested shares go back to the company! In short, it is not necessarily a bad idea to leave, but you should understand the economic costs of leaving for your specific situation.

Solution:

Wound up saving the client \$350,000 in stock on the table, which went on to be worth even more. Rumors were strong in the industry that the client's company may be acquired. In fact, it was, within the next 12 months. Client wound up staying long enough to fully exercise all \$350,000 in options when the company was acquired. All options fully vested at acquisition date, with no out of pocket cash on stock options. Showed client how to use RSU sales to cover options exercise that did not have cashless exercise choice. Rest (or work) and vest, you are set!
