

Employee Memorandum: Explanation of NQSO Grant (Private Company)

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Summary

This form memorandum from a company granting a nonqualified stock option (NQSO) award explains the terms and consequences of the award to the recipient employee or service provider. This form includes practical guidance, drafting notes, and alternate clauses.

This form is drafted assuming that the entity granting the nonqualified stock option is a private company. It is intended to supplement a separate NQSO award agreement that governs the issuance of the options.

For more LPA resources relating to NQSOs, see [Equity Compensation Types and Tax Treatment](#), [Equity Award Drafting Checklist \(Section 409A Compliance\)](#), and [Stock Option Plan \(Nonqualified and Incentive Stock Options\)](#).

Date: [date]

To: [recipient name]

From: [company name]

Re: Grant of Nonqualified Stock Options

Introduction

This memorandum provides a brief overview of your grant of nonqualified stock options (“NQSOs”) from [company name] (the “Company”) under the [equity plan name] (the “Plan”). This memorandum does not comprise a complete and exhaustive legal analysis on this subject and you are advised to consult your legal and/or tax advisor(s) about the implications of your grant of NQSOs. For additional details, please refer to your [name of award agreement] (“NQSO Agreement”) dated [date] and the Plan. The Company does not guarantee the tax treatment of any NQSO grant.

Overview of NQSOs

As part of your compensation package with the Company or its affiliate, you will receive a stock option grant, which is an equity-based award that has the potential to provide you with an ownership interest in the Company. Your option grant will provide you with the right to purchase the number of shares of Company stock set forth in your award agreement at a pre-established price, called the “exercise” or “strike” price until your award terminates or expires. You may decide to exercise only a portion of your option or not to exercise your option at all.

Stock options are treated as either nonqualified stock options or incentive stock options (“ISOs”) The stock options being awarded to you are intended to be treated as NQSOs and are not intended to meet the requirements set forth in Section 422 of the Internal Revenue Code (the “Code”) applicable to ISOs.

This memorandum outlines key information regarding your NQSO grant. However, we recommend that you carefully review the terms of the Plan and your NQSO Agreement for a full understanding of your option award.

Grant

Your NQSOs are being granted to you in connection with the services you provide to [the Company OR related entity]. The specific terms and conditions of your NQSOs are set forth in the Plan and your NQSO Agreement, including any vesting conditions.

In order to accept your NQSO grant, you must sign the NQSO Agreement and return a copy of it to [Company representative and contact information]. Acceptance of your NQSO grant is your acknowledgement of the terms of the NQSO Agreement and the Plan and does not mean that you must exercise your NQSOs in the future.

Drafting Note to “Grant” Section Second Paragraph

If there is an alternative method for accepting the grant (e.g., via e-sign), add a description to this paragraph.

You should be sure to keep a copy of your NQSO Agreement and the Plan for your records.

Vesting

Your grant of NQSOs may be unvested on the date of grant and may be subject to certain time- and/or performance-based vesting conditions, subject to your continuous employment with or provision of continuous service to the Company or its affiliates through the applicable vesting date(s). Please see your NQSO Agreement for the vesting terms that apply to your NQSOs.

Drafting Note to “Vesting” Section First Paragraph

Option awards are commonly subject to time-based vesting, performance-based vesting, or both. If the grant is fully vested upon grant, this section can be revised to provide instead that the option award is fully vested as of the grant date. If the Company typically imposes the same conditions for all optionees or if you want to tailor the memorandum to each optionee’s vesting conditions, you can use the Alternate “Vesting” Section First Paragraph, which will need to be modified as applicable.

Alternate “Vesting” Section First Paragraph:

Your grant of NQSOs are unvested on the date of grant and may be subject to certain time- and/or performance-based vesting conditions, subject to your continuous employment with the Company or its affiliates through the applicable vesting date(s). The vesting terms for your NQSO grant are as follows:

- [percentage]% of the options granted under the NQSO Agreement named above are time-vesting NQSOs, subject to the following [cliff OR graded] vesting period: [time-vesting schedule].
- [percentage]% of the options granted under the NQSO Agreement named above are performance-vesting NQSOs, subject to the achievement of the following performance goals: [performance-vesting terms].

Please see your NQSO Agreement for details regarding the vesting terms that apply to your NQSOs.

Drafting Note to Alternate “Vesting” Section First Paragraph

Tailor this paragraph to describe the optionee’s vesting conditions. For generic language that refers the optionee to their award agreement, see the default “Vesting” Section First Paragraph.

You are not required to exercise your NQSOs, in whole or in part, when they vest. [Upon your termination of employment from, or of the services you provide to, the Company and any of its affiliates, any unvested portion of your NQSOs will be automatically forfeited.] Depending on the circumstances of your termination, but in any event prior to the NQSO’s expiration date, you will have at least [period, e.g., three months] to exercise any vested portion of your NQSOs. *For further details on exercising your options upon termination, see the following section.*

Drafting Note to “Vesting” Last Paragraph

Although it is typical for grantees to forfeit unvested NQSOs upon termination, it is not required. Modify the bracketed text if forfeiture does not apply. Additionally, a 90-day exercise period for vested NQSOs upon a grantee’s termination of employment (or termination of a nonemployee’s services) is typical for private companies and tracks the requirements of ISOs; however, it is not required as there are no analogous rules for NQSOs.

Note that, although the nonqualified deferred compensation rules under I.R.C. § 409A treat certain modifications and extensions of outstanding option awards as resulting in the grant of a new option or the adoption of an additional deferral feature (potentially resulting in Section 409A penalties), it is generally permissible for a company to extend the exercise period of an option to a date which is no later than the earlier of (1) the latest-possible expiration date under any circumstances as provided in the NQSO Agreement and (2) the 10th anniversary of the grant date. 26 C.F.R. § 1.409A-1(b)(5)(v).

The Company may also consider including a provision that delays the termination of the NQSOs if the optionee is unable to exercise the NQSOs during the limited post-termination window without violating applicable laws (including registration requirements under state or federal securities laws). The Section 409A rules also permit such extensions so long as the tolling period ends no later than 30 days following the period during which the exercise is prohibited by law. 26 C.F.R. § 1.409A-1(b)(5)(v)(C).

Exercise

You may elect to exercise your NQSOs after they satisfy the vesting requirements applicable to your option grant, at the exercise price set forth in your NQSO Agreement. The exercise price of your NQSOs is set forth in your NQSO Agreement and is equal to at least 100% of the fair market value of the Company's stock on the date of grant. Should you elect to exercise your NQSOs, you may exercise all or only a portion of the NQSOs that are then vested.

Your options will expire on [expiration date], which is [the tenth anniversary of your grant date OR shorter period]. Any vested portion of your NQSOs that you do not exercise prior to the expiration date will be forfeited automatically.

Your NQSOs will be granted to you in connection with your [employment with OR services provided to] the Company or its affiliate, and therefore you must remain an [employee OR at the service] of the Company (or a related entity) at all times during the option period, beginning on the grant date. Generally, you will have [period, e.g., three months] from the date of your termination to exercise your vested NQSOs (or until your NQSOs expire, whichever occurs sooner). If you suffer a termination due to disability, you will have [period, e.g., one year] from the date of your termination due to disability to exercise your vested NQSOs (unless your NQSOs expire sooner). If you die at a time when you are eligible to exercise vested NQSOs, your estate will be permitted to exercise the vested NQSOs [period, e.g., one year] from the date of your termination due to death (unless your NQSOs expire sooner).

Drafting Note to "Exercise" Section Third Paragraph

While it is not mandatory for plans to allow post-employment exercise, most do so to the extent permitted. Similarly, if the optionee dies during their period of employment or within a post-employment exercise period, the optionee's estate or heir may exercise the option as set forth in the Plan (usually companies require the estate or heir to do so within a 12-month period after the optionee's death).

To exercise your vested NQSOs (or any vested portion of your NQSO grant), you or your estate must complete the exercise notice attached to your NQSO Agreement and return it to [contact person] at [address/e-mail address].

Drafting Note to "Exercise" Section Fourth Paragraph

Tailor the exercise instructions to comply with the company's administrative procedures in place for exercising options.

With your exercise notice, you must remit payment to the Company in an amount that equals the per share exercise price multiplied by the number of shares you elect to exercise. The NQSO Agreement and/or Plan explains the methods by which you can pay the exercise price. The Company will also provide to you any documentation that you must sign upon becoming a shareholder.

Federal Tax Considerations

As a recipient of NQSOs, generally, you will not recognize income upon the grant or vesting of your NQSOs. However, once you exercise your NQSO option, the difference between the fair market value of the shares you acquire on exercise and the exercise price is taxed as ordinary income. This is referred to as the "spread" value of your NQSO. Your employer will report the spread value as compensation on your Form W-2 for the year that you exercise your NQSO.

When you decide to sell your shares, the difference between the sale price and the fair market value of the shares will be taxed at the capital gains rate. If you hold the shares for one year or more, any gain will be taxed at the favorable long-term capital gain rate. In comparison, if you hold your shares for less than one year, any gain will be taxed at the ordinary income tax rate (short-term gains are taxed as regular income) which is usually higher than the long-term capital gain rate.

The below example illustrates the tax treatment:

John receives a grant from the Company of 2,000 NQSOs with an exercise price of \$25 per share. John exercises his NQSOs 13 months later, when the fair market value of each share is \$40. The "spread" between the stock price and the exercise price ($\$40 - \$25 = \$15$), multiplied by 2,000 shares, is \$30,000, which will be taxed as ordinary income. John did not incur any brokerage fee or commission on the exercise, so his cost basis for the shares is \$80,000, determined as the

total exercise price (\$50,000) plus the compensation amount (\$30,000). The Company is required to withhold income and employment taxes at the time of exercise and will generally receive a tax deduction equal to the amount of ordinary income recognized by the recipient.) Subsequently, John sells 1,000 of his shares 6 months later (i.e., 6 months after exercise, 19 months after grant) for \$45 per share. John sells the next 1,000 of his shares another 8 months later (i.e., 14 months after exercise, 27 months after grant) for \$55 per share.

- The proceeds from John's first sale are taxed at the less favorable ordinary income tax rate (i.e., short-term gains treatment) because he did not satisfy the one-year holding period for long-term capital gains treatment. John will report the \$5,000 gain (\$45,000 sale proceeds - \$40,000 adjusted basis) as ordinary income to be taxed.
- John's second sale qualifies for long-term capital gains treatment because he satisfied the one-year holding period. John will report \$15,000 (\$55,000 sale proceeds - \$40,000 adjusted basis) as a long-term capital gain, which will be taxed at the more favorable tax rate.

The above example is intended to be broad in nature and may not apply to the specifics of your particular situation. The Company cannot guarantee any particular tax treatment. You should consult with your own tax advisor regarding the consequences of your specific NQSO grant.

Transfer Restrictions

Your NQSOs (and the right to exercise your NQSOs) [may OR may not] be transferred to others[, other than by will or the laws of descent and distribution]. Refer to your NQSO Agreement for applicable rules. The NQSOs are only exercisable during your lifetime by you.

Drafting Note to "Transfer Restrictions" Paragraph

Private company stock options are frequently subject to strict limitations on transfer, which may or may not include transfers to heirs in the event of the grantee's death.

More Information Regarding Your NQSO Grant

The Company is pleased to be able to offer you an opportunity to share in its long-term growth and development. Should you have any questions about your NQSO grant, please contact [company representative name and contact information].

Henrik Patel, Partner, White & Case LLP

Henrik P. Patel is the Global Head of the Employment, Compensation & Benefits Practice at the global law firm, White & Case LLP. Henrik advises numerous US and non-US clients (including public and private companies, boards of directors and executives) on executive compensation and employee benefits aspects of various corporate transactions, including mergers, acquisitions, divestitures, spin-offs, succession planning, debt and equity financings, initial public offerings, private equity and leveraged buyout transactions and banking transactions. He has extensive experience with financial services institutions, private equity and hedge fund clients.

Henrik also provides ongoing counsel to public and private companies, compensation committees and executives with respect to day-to-day executive compensation and employee benefits matters, including corporate governance matters and best practices, executive compensation plan design, employment contracts and equity incentive compensation arrangements, as well as advising on related regulatory, securities, tax, public disclosure and ERISA issues. He negotiates and drafts employment, retention, separation, change of control, non-competition, non-solicitation and other compensation-related agreements, plans and provisions, as well as relevant sections of proxy statements, periodic and current reports (e.g., Forms 8-K, 10-K and 10-Q) and registration statements.

Henrik is a frequent contributor and speaker at Global Equity Organization (GEO) and National Association of Stock Plan Professional (NASPP) conferences. He was named to the "40 Under 40" list of outstanding M&A lawyers by *The M&A Advisor* and has been named a recognized individual by *Legal 500* in Employee Benefits & Executive Compensation.

He received his JD from New York University School of Law and BA in Political Science from Tufts University.

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DeVoia is a member of the Employment, Compensation & Benefits team. Her practice is focused on providing advice with respect to a variety of employment, executive compensation and employee benefits issues raised in the context of corporate transactions, particularly in mergers and acquisitions and financing arrangements. DeVoia drafts executive employment agreements, equity award agreements and other types of employee agreements. DeVoia also advises clients on a range of employment law matters, including those related to the hiring of new employees and employer compliance with federal, state and local employment laws.

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Caroline Cima is an associate in White & Case's Employment, Compensation & Benefits group within the Firm's Mergers & Acquisitions practice. Caroline is resident in the New York office.

Caroline provides counsel to public and privately held companies, financial institutions, and executives on an array of employment, executive compensation, and employee benefits issues, particularly in connection with corporate transactions, including conducting due diligence.

Caroline earned her J.D. from Columbia Law School, where she was the managing editor of the Columbia Journal of Law & the Arts. Caroline is a member of the LGBT Bar Association of Greater New York and the New York City Bar Association.

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