STARTUP LEGAL PLAYBOOK

How to solve employee equity issues during a down round

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Decreased valuations cause unpredictability around cash cycles and shortening runways. But beyond the financial considerations, a down round also compels founders to face tough questions impacting the many employees who have gone above and beyond to support the company's growth. First, stock options have decreased. Second, you may need to let some of your people go, which raises other issues for the company's equity. In this article we walk you through best practices to navigate these challenges.

What happens to employee stock options in a down round?

If the valuation of your startup declines, option grants and other equity compensation packages that you offer can face significant risk. The decrease in value of the stock options impacts the compensation of your employees.

The mechanics of an equity arrangement can take various forms, but the most common one is an employee stock ownership plan (ESOP). The plan lays out several factors governing how the options will be paid out. For example, the ESOP will often say that the exercise price will be the fair market value of the underlying shares on the date of grant—i.e., the price the options are paid at will be what the market values the shares at on the day of payment. The expectation is that, over time, valuation will grow and significantly exceed the applicable exercise price, allowing the employee to profit from the equity upside.

After a down round, the opposite occurs: valuations have decreased. Now you need to consider other strategies to help make equity-based incentives more attractive, if at all financially possible. These include topping up option grants (i.e., providing additional equity in the company) to help offset declines in equity value, or repricing options to align with the current, lower company valuation. For the latter, you will want to watch for potential negative tax consequences.

Depending on the terms of the option grant, employees may be able to delay exercising options until valuations have recovered. After all, a down round is not a death sentence for a startup. It may simply signal a bump in the road—and can happen even if a founder has done everything right.

In addition, options granted to new employees should have updated exercise prices to reflect the current situation. Before implementing any option-related changes, you should always consult with your advisors to understand the full impact of these changes on the business, tax liabilities and capitalization table.

What happens to equity when you let employees go?

In an effort to cut costs, you may need to trim your workforce. In that case, you and your team should familiarize yourself with two legal paths to letting people go: layoffs and terminations.

The difference between layoffs and terminations

It is important to understand the legal difference between terminations and layoffs, as these distinctions can have implications for equity compensation. Termination means the permanent end of employment; layoffs are, by definition, a temporary suspension of employment.

- **Terminations.** Typically, employers can permanently dismiss employees without cause at any time; however, you must provide notice (or pay in lieu of notice), among other things, in accordance with the employee's statutory, contractual or common law entitlements. Notice periods can vary greatly and are generally determined on a case-by-case basis. They usually depend on the length of employment and enforceable employment contracts.
- **Layoffs.** Employers can temporarily lay off employees, so long as employees consent to the layoff or the employment contract allows for it. However, employment law imposes limits on the duration of layoffs. Going over the permitted duration creates a risk that the layoff will be deemed a termination of employment. For example, in Ontario, layoffs usually cannot exceed 13 weeks in any period of 20 consecutive weeks, unless the employer continues to provide certain assistance to the employee (e.g., compensation, benefits). Unlike termination, temporary layoffs will probably not impose advance notice rights or pay in lieu.

Terminations, layoffs and equity compensation

Depending on the terms of the equity incentive plan, terminations and layoffs can both seriously impact employee equity packages.

The terms contained in the equity plans and related agreements will normally set out the treatment of outstanding grants in the event of a termination or layoff. For example, ESOPs provide for the expiration of options after a specified number of years following the date of grant. When an employee is terminated, both unvested and vested options may quickly expire and become un-exercisable. It is important to review the terms of equity arrangements and determine whether there are any risks of employees forfeiting equity that has already vested (meaning, it's been earned).

To discuss these issues, please contact the author(s).

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