

INSIGHTS + NEWS

Corporate Insights: Issuing Stock Options? Be Careful!

BY JULIE K. O'NEILL • JUNE 3, 2024

Many corporations use stock options to incentivize employees and other service providers. A stock option is a right granted by a corporation to an employee, consultant or advisor that provides such employee, consultant or advisor the right to purchase stock during a specific period of time and at a specified price. There are many benefits to the issuance of a stock option by corporations. Granting options may motivate employees and others by giving them a sense of ownership in the company and their work and an opportunity to share in the success of the company. However, while stock options are an attractive form of incentive compensation, it is essential to keep these considerations in mind when granting stock options:

- **Valuation:** At the time of issuance of a stock option, the price per share must be equal to or greater than the fair market value of a share of the underlying common stock. There are different methods to value common stock. If a corporation's stock is publicly traded, the fair market value is determined with reference to the market price of the shares. For privately held corporations, the fair market value of stock means a value determined by the reasonable application of a reasonable valuation method, which can be an independent appraisal or an internal valuation report. A corporation's consistent use of either the independent appraisal or the internal valuation report is presumed to be a reasonable valuation method.
- **Date of Issuance:** Every grant of a stock option must be dated as of the date of Board of Directors' approval. The company must keep accurate and detailed records of every Board of Directors' meeting and written consents in which the grant of one or more stock options has been approved. Additionally, the approval must state the vesting schedule of the option. These steps are to ensure that in the event of a sale, financing, or during any other due diligence review, it is clear that every grant of a stock option has been properly approved. If stock options are not properly approved or an approval is not properly evidenced, issues may arise. For example, other parties to a transaction may require that an option that was not properly approved needs to be approved at the time of the diligence review, in which case the strike price is likely to be higher than the price intended by the company at the time of the erroneous grant, or they may require that such an option be cancelled. In either case the grantee will not be happy.
- **Incentive stock options** may only be granted to employees of the corporation. Further, the employee must be employed by the corporation as of the date of the grant of the option.

There are many other issues and rules to be aware of regarding options. If you need guidance, ask your Bowditch lawyer.