

Stock Option Plan Administration: A Guide

Administering a stock option plan requires regular attention compliance obligations.

Events to Watch Out For

There is work to do when:

- the board of directors takes action to grant stock options, which can occur either at regularly scheduled board meetings or at any time at special board meetings or actions by unanimous written consent;
- optionees exercise their stock options, or have questions about how their options work;
- optionees leave the service of the company; and
- the company is fulfilling its tax reporting obligations.

Failure Is Not An Option

Failure to administer a company's stock option plan in compliance with law can result in severe penalties to the company and the individuals involved. For this reason, you should approach administering a stock option plan with a high degree of care. Wrongly administered, you might become subject to SEC or state regulatory action. A financing could be delayed. Or an exit transaction could be put on hold.

What To Do Before Every Board Meeting or Board Consent to Grant Options

Before every set of stock option grants, you need to take the following actions:

- Review the proposed list of optionees. Do you have any optionees located in states in which you might need to make a filing with the securities regulator in order to grant options in that state? Each state's laws are different. Some states require filings and the payment of fees to grant options to an optionee resident in that state (e.g., California); other states have self-executing exemptions provided your plan is administered in accordance with federal Rule 701. Because each state is different, you need to be careful whenever granting options to any optionee located outside of your home state (where you presumably have already done the compliance work to grant options to optionees living in that state). We maintain a 50 state guide to assist in this process.
- Do you have enough shares authorized and available for use in your plan? Increases in plan share reserves or the adoption of a new plan will likely involve stockholder approval as well as board approval.
- Make sure you are updating your stock register.
- Do the proposed stock option grants cause you to run over Rule 701's mathematical

limitations? Remember, Rule 701 has absolute mathematical limitations that you cannot go over. There are three different measurements, and you only have to comply with one of them, but companies can easily surpass the limits of they are not paying attention to this issue.

- Do the proposed stock option grants cause you to have granted more than \$5M in equity awards in the last 12 months, meaning you have a prospectus delivery requirement to meet?
- Have you determined the current fair market value of the stock? Are the options being granted at no less than that fair market value? Has there been a material event since the company's last 409A valuation?
- Are you in the 409A waiting period, when you cannot grant options until the 409A valuation is complete? This delay can occur when your 409A valuation report is in process and you don't know the current fair market value of the stock.

What To Do On Every Option Exercise

- Review the optionee's option exercise form, and ensure it has been correctly completed
- Go back and make sure that you have a set of board minutes or a board consent granting the options (this should be easy to find, and arguably this step is unnecessary because you should have made sure that every option grant was approved by the Board before you gave the optionee the paperwork, but it is always a good idea to go back and check the records to ensure that they are in order).
- If the option is an incentive stock option, prep the employee on the alternative minimum tax consequences.
- If the option is a nonqualified stock option granted to an employee, and it is being exercised at a gain, calculate the income and employment tax withholding amounts the employee must pay the employer to exercise the options. Your withholding obligation exists if the optionee was an employee at the time of grant, regardless of whether the employee is or is not an employee at the time of exercise. See this blog post:
<http://thestartuplawblog.com/nonqualified-stock-options-tax-withholding/>

What To Do When People Leave

When optionees leave, their options revert to the plan if not exercised. Be sure to update your stock option ledger when this occurs.

End of Year Tax Compliance Dates

- By January 31st, Forms W-2 and Forms 1099 need to be delivered to employees and contractors: (i) Who exercised stock options during the year in which there was a gain; and (ii) Who received stock awards or stock bonuses that resulted in income to the recipient.
- By January 31st, deliver Form 3921 to employees who exercised incentive stock options

during the prior year [https://www.irs.gov/uac/Form-3921,-Exercise-of-an-Incentive-Stock-Option-Under-Section-422\(b\)](https://www.irs.gov/uac/Form-3921,-Exercise-of-an-Incentive-Stock-Option-Under-Section-422(b)).

- By February 28, file Copy A of Form 3921 with the IRS with respect to ISO exercises in the prior year. If you file electronically, the due date is March 31 of the year following the year of exercise of the ISO.