In this section we're going to talk about assumption of stock options. Remember all of those options that you gave to your employees as you were growing your company? They matter and who you treat them in an acquisition has a big impact on what the employees are getting from the acquisition.

Clint: What are the possible things that could happen to employee stock options in an acquisition?

Brad: There are a couple of specific things that happen. First, they can either be assumed by the acquirer or not. The way the stock option agreements are written and the type of transaction you do has an impact on this.

First and foremost it depends on whether or not the stock options have any value. In a lot of transactions, for example a sale of a company that's below the liquidation preference, the investors would get all the money and the stock options don't have any value anyway.

Even in an upside case some of the higher priced options might not have any value because they might be priced at a stock price above the transaction price. First is understanding whether the options have value or not.

Let's assume that the options have value. You still have this scenario where the buyer could be assuming the stock options or not. If they assume the stock options, there is a whole series of things that you have to understand around the vesting. In the stock option context you have to understand what happens with acceleration, who actually has their stock options and what form of plan they turn into on the buyer side.

If the buyer isn't assuming the stock options, then it's likely that the options are accelerating vesting based on the way the plan works. The consideration is going to have to go to buy out the actual options in the plan. Although, that's not always the case because there are some situations where the options might cease to exist if they're not assumed.

Clint: Let's take the scenario where the options do have value. What's the motivation on the buyer's side? Would they want to assume the options or not?

Brad: Again, it varies and to some degree it's a negotiation. Most buyers view existing stock option plans as a retention dynamic for the existing employees of the company that they're buying. When a company buys another company, oftentimes they want the people to stay with the acquired company for some period of time, sometimes as long as possible. Other times for a year or two.

Unvested stock options, in the context of a plan assumption, can be part of that retention. In other cases a buyer views it as creating a retention pool that's separate from the stock option plan and doesn't really care about moving the stock option plan over, but instead want to substitute the retention for the stock option plan. Fundamentally it becomes somewhat of a negotiation at the time of the acquisition.

Fifteen years ago it was very hard because of the way accounting rules worked to change things at the time at which the acquisition happened. Today it's actually quite easy to change things when the acquisition happens. That's why there's oftentimes a negotiation around assuming the stock options, using them as retention or substituting some other type of retention pool for the stock options.

Clint: As an entrepreneur selling my company, what would be the best for my employees? Having to assume, or not?

Brad: It depends on how you think about the stock options and the length of tenure of the company. There are some entrepreneurs who, when the company is acquired really want all of the options to accelerate because the people at the company at that moment in time they view as having really helped build the value up to that point. They view the retention as a separate piece.

There are other entrepreneurs who very much view the stock options as future retention. The entrepreneurs, if they're staying with the company, also want those employees to stay with the company. The reason the company is being acquired is presumably to add upside on a go forward basis.

As the entrepreneur, first and foremost I think you have to have a philosophy about how you want them to be treated, but it's not your own decision. It's a decision that includes your investors because fundamentally, anything you do with the stock options different than what the plan says is a change of the capital structure of the company.

Some investors are going to be very dogmatic about getting every last penny for themselves in the context of the transaction. Many investors are going to be a lot more flexible as they look at the whole transaction and try to figure out what mechanisms they can use to maximize what's going on.

Of course, if there's an earn out of any sort in the transaction, it's in the investor's interest to make sure that the team stays together to actually get that earn out. There's even another layer of conversation around it when that's in place.