

Issuing Stock Options Under an Equity Incentive Plan

Article By:

Jenna M. Stewart

Private companies often adopt equity incentive plans in order to issue stock options to their employees, directors and consultants. However, once the plan is adopted, there are a number of things that a Company should consider when granting stock options. This article provides a list of questions for private companies to consider when issuing stock options under an equity incentive plan.

1. Authorized

- *How many shares is the Company authorized to issue under its Equity Incentive Plan?* Equity Incentive Plans have a set number of shares that are authorized to be issued under the plan. Before issuing a stock option, you need to confirm that the anticipated option issuance, in addition to any prior issuances under the plan, is within the authorized number of shares. The authorized number of shares can be increased by approval of the Company's board of directors and, if incentive stock options are being issued under the plan, the increase should also be approved by the Company's stockholders. Further, certain states may have filing and/or stockholder approval requirements if the number of shares authorized for issuance under the plan is increased. For example, if the plan is exempt under Corporations Code 25102(o) in California (see discussion on Blue Sky filings below in Section 4(b)), shareholders must approve the increase within one year and an additional supplemental filing and fee is required.

2. Exercise Price

- *What will the exercise price for the stock option be?* To be exempt from Section 409A of the Internal Revenue Code, stock options must be granted with an exercise price equal to or greater than the fair market value of the Company's stock at the time of grant (i.e. the date the board of directors approves the issuance). Under corporate law the board of directors must determine fair market value at the time of grant of each stock option. Therefore, the board of directors should have a reasonable position as to how it has determined the fair market value of its common stock. Typically this would be through a recent sale of shares of common stock or a valuation by a third party.

3. Board Approval

- *When will the board of directors approve the stock option issuance?* The Company's board of directors must approve all stock option grants, including the name of the recipient, the number of shares, the vesting schedule and the exercise price. This can be done either in a board meeting or via unanimous written consent. If done by written consent the board approval date is the date the last director signs the consent. It is important to note that the date the board approves the issuance is the grant date for tax, legal and accounting purposes. The grant date can be different from the vesting commencement date (i.e. the employee can be given credit for vesting prior to the grant date) which often occurs for new hires, but the grant date must be used to determine the exercise price of the stock option. Therefore, although you do not have to circulate a unanimous written consent every time a new employee starts working, you do want to have the board of directors approve stock option issuances sooner rather than later in order for the employee to receive an exercise price equal to the fair market value closest to the employee's start date of employment. You also want to make sure any offer letters that the Company extends include language that states that any promised equity compensation is subject to the approval of the board of directors and does not contain an exercise price.

4. Recipient

- *Who is the stock option being issued to?* Equity incentive plans may vary from one to another, but there are a few basic parameters most plans incorporate:
 - The recipient must be a person, not an entity.
 - The recipient must be a Company employee, director, consultant or affiliate on the grant date. In other words, the board of directors cannot approve/grant a stock option prior to the first day the recipient provides services to the Company. Additionally, if the individual is not an employee, the Company should have a written agreement in place with the recipient documenting their relationship to the Company, such as an offer letter or consulting agreement.
- *Where does the recipient live?* Depending on the recipient's residence, you may need to consider state Blue Sky filing requirements. For example, private companies issuing to residents of the State of California may claim an exemption under California Corporations Code 25102(o) if (i) the securities that are subject to the plan are exempt from registration under the Securities Act of 1933 pursuant to federal Rule 701, (ii) the plan meets certain additional requirements detailed under the California Code of Regulations, including stockholder approval of the plan within one year of when the first security is issued to a California resident under the plan, and (iii) an exemption notice under 25102(o), filing fee and a consent to service of process, are filed with the California Department of Business Oversight within 30 days after the initial issuance of a security under the plan (you can find a list of FAQ's on the topic [here](#)).

5. Documentation

- *What happens after the stock option is issued?* A customized stock option notice should be prepared and executed by both the Company and the recipient. Additionally, the Company's stock option ledger and capitalization table should be updated to reflect the issuance.

To summarize, stock options can be a very useful tool for companies if used correctly but there can be pitfalls if certain steps are not taken. In addition to the above considerations, it is important to familiarize yourself with the unique terms of your Company's equity incentive plan and to work with your corporate counsel to ensure that stock options are issued in compliance with your Company's plan.

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