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# Emerging Biotech Compensation: Mitigating the Effects of a Volatile Stock on Equity Grants

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We participate in hundreds of pre-commercial biotech board meetings every year. At these publicly traded companies, the compensation committee frequently raises the question of how to effectively mitigate the effect of stock price volatility on stock option grants. Companies prefer to have the exercise price of the grants they are awarding to employees reflect a reasonable fair value of the company's stock. Unfortunately, this is not always the case, particularly in this market where stock prices can become temporarily dislocated from a normal pattern and result in overly punitive or generous option exercise prices.

Good governance requires that a company have a well-documented and actioned plan for granting equity in a consistent manner. This is particularly true with stock options that have an exercise price which needs to be set based on the fair market value. So how should companies that are frustrated with the outcomes of their current approach think about alternatives to consider? Below we summarize three potential solutions that can assist in mitigating the issue yet still promote good governance and responsible equity grant practices.

1. Grant restricted stock or restricted stock units (RSUs) as part of the equity mix. This is the most prevalent approach companies take. Unlike stock options, restricted stock or RSUs are not an option to purchase company stock and hence do not have an exercise price. Therefore a company can incorporate their use into a program that also includes stock options and mitigate (but not eliminate!) the issue with an all stock option program. Full-value shares can also assist in retention of executives given they have an immediate value at grant, although admittedly many executives prefer the tax efficiency and leverage of stock options.
2. Spread annual grants over multiple grant dates. This concept is less prevalent than the idea above, but is certainly an approach that companies consider. In this instance a company would determine an internal annual target for an individual's grant but spread the grants over two or more grant dates (e.g., January and July 2020). Similar to dollar/cost averaging, this approach attempts to diversify the individual's exercise prices across multiple dates. Companies exploring this alternative should consult with appropriate accounting professionals to ensure the approach is structured in a way that avoids any punitive accounting implications and be sure to weigh the cost of any

additional administrative complexity it creates.

3. Develop an averaging period to determine the exercise price. This is the least common but perhaps the most intriguing alternative. Companies can create an averaging mechanism to set the exercise price. To be exempt from section 409A and its associated punitive tax impact for stock options, a company must meet the following requirements:

- The decision to measure the option exercise price must be made at the beginning of the period and is irrevocable;
- The individual recipients and their award sizes must be identified at the beginning of the averaging period; and
- The averaging period cannot be more than 30 days before or 30 days after the grant date.

Similar to the second point above, the appropriate tax professionals should be included in the design of the program to ensure compliance with 409A.

All three alternatives are viable paths to reduce the common issue biotechnology companies face when granting equity to employees. To evaluate these alternatives, a company would be well served to look back and model what the results would have been had the company decided to take each of these paths as opposed to their current approach.

## About the Author

Terry leads the Life Sciences practice and advises companies from venture-backed to multinational on executive compensation strategy, incentive design, governance/disclosure, and transaction-related arrangements.

## About Pearl Meyer

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