

# Employee Memorandum: Explanation of ISO Grant (Private Company)

A Lexis Practice Advisor® Practice Note by  
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This Employee Memorandum: Explanation of ISO Grant (Private Company) explains how a grant of incentive stock options (ISOs) will impact the recipient. This form includes practical guidance, drafting notes, and optional and alternate clauses.

This form is drafted assuming that the entity granting the incentive stock option is a private company. It is intended to supplement a separate ISO award agreement that governs the issuance of the options.

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**Date:** [date]

**To:** [recipient name]

**From:** [company name]

**Re: Grant of Incentive Stock Options (“ISOs”)**

**Introduction**

This memorandum provides a brief overview of your grant of incentive stock options (“ISOs”) from [company name] (the “Company”) under the [equity plan name] (the “Plan”). This memorandum does not comprise a complete and exhaustive legal analysis on this subject and you are advised to consult your legal and/or tax advisor(s) about the implications of your grant of ISOs. For additional details, please refer to your [name of award agreement] (“ISO Agreement”) dated [date] and the Plan. The Company does not guarantee the tax treatment of any ISO grant.

**Overview of ISOs**

As part of your compensation package with the Company or its affiliate, you will receive a stock option grant, which is an equity-based award that has the potential to provide you with an ownership interest in the Company. Your option grant will provide you with the right to purchase the number of shares of Company stock set forth in your award agreement at a pre-established price, called the “exercise” or “strike” price, until your award terminates or expires. You may decide to exercise only a portion of your option or not to exercise your option at all.

Stock options are treated as either a nonqualified stock option or an ISO. The stock options being awarded to you are intended to be treated as ISOs and have been designed to meet the requirements set forth in Section 422 of the Internal Revenue Code (the “Code”). Should you choose to exercise your option, your ISO grant should provide for more favorable tax treatment than a nonqualified stock option, but only if you meet the holding requirement described further below. . Should your ISOs fail to meet all of the ISO conditions, including the holding requirement, your stock option grant (or a portion thereof) may be treated as a nonqualified stock option.

This memorandum outlines key information regarding your ISO grant. However, we recommend that you carefully review the terms of the Plan and your ISO Agreement for a full understanding of your option award.

**Optional “Overview of ISOs” Section Third Paragraph:**

The Code imposes a limitation on the value of ISO grants to a single employee. No stock option granted to an employee can qualify as an ISO to the extent that it and any other ISOs granted to the employee would be first exercisable in any calendar year for shares that have an aggregate fair market value (determined as of the grant date) that exceeds \$100,000. If the aggregate fair market value of the shares related to such option awards exceeds \$100,000 for the calendar year that such awards first become exercisable, then the portion of the options exceeding that limit are treated as nonqualified stock options.

**Drafting Note to Optional “Overview of ISOs” Section Third Paragraph**

The \$100,000 limitation for ISOs limits their utility for large-value awards. A company may want to explain that this is a legal limitation in an ISO explanatory memorandum intended for high-level executives who may be accustomed to larger option grants. Typically, companies granting ISOs will provide an ISO award up to the limit for such individuals along with a separate grant of nonqualified stock options.] See 26 C.F.R. § 1.422-4 for rules on applying the limitation.

This memorandum outlines key information regarding your ISO grant. However, we recommend that you carefully review the terms of the Plan and your ISO Agreement for a full understanding of your option award.

**Grant**

Your ISOs are being granted to you in connection with the services you provide to [the Company OR related entity]. The specific terms and conditions of your ISOs are set forth in the Plan and your ISO Agreement, including any vesting conditions.

In order to accept your ISO grant, you must sign the ISO Agreement and return a copy of it to [company representative and

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contact information]. Acceptance of your ISO grant is your acknowledgement of the terms of the ISO Agreement and the Plan and does not mean that you must exercise your ISOs in the future.

#### **Drafting Note to “Grant” Section Second Paragraph**

If there is an alternative method for accepting the grant (e.g., via e-sign), add a description to this paragraph.

You should be sure to keep a copy of your ISO Agreement and the Plan for your records.

## **Vesting**

Your grant of ISOs may be unvested on the date of grant and may be subject to certain time- and/or performance-based vesting conditions, subject to your continuous employment with the Company or its affiliates through the applicable vesting date(s). Please see your ISO Agreement for the vesting terms that apply to your ISOs.

#### **Drafting Note to “Vesting” Section First Paragraph**

Option awards are commonly subject to time-based vesting, performance-based vesting, or both. If the grant is fully vested upon grant, this section can be revised to provide instead that the option award is fully vested as of the grant date. If the company typically imposes the same conditions for all optionees or if you want to tailor the memorandum to each optionee’s vesting conditions, you can use Alternate “Vesting” Section First Paragraph, which will need to be modified as applicable.

#### **Alternate “Vesting” Section First Paragraph:**

Your grant of ISOs is unvested on the date of grant and may be subject to certain time- and/or performance-based vesting conditions, subject to your continuous employment with the Company or its affiliates through the applicable vesting date(s). The vesting terms for your ISO grant are as follows:

- [percentage]% of the options granted under the ISO Agreement named above are time-vesting ISOs, subject to the following [cliff OR graded] vesting period: [time-vesting schedule].
- [percentage]% of the options granted under the ISO Agreement named above are performance-vesting ISOs, subject to the achievement of the following performance goals: [performance-vesting terms].

Please see your ISO Agreement for details regarding the vesting terms that apply to your ISOs.

You are not required to exercise your ISOs, in whole or in part, when they vest. Upon your termination of employment from the Company and any of its affiliates, any unvested portion of your ISOs will be automatically forfeited. Depending on the circumstances of your termination, you will have at least three months to exercise any vested portion of your ISOs. *For further details on exercising your options upon termination, see the following section.*

## **Exercise**

You may elect to exercise your ISOs after they satisfy the vesting requirements applicable to your option grant, at the exercise price set forth in your [ISO Agreement]. The exercise price of your ISOs is set forth in your ISO Agreement and is equal to at least 100% of the fair market value of the Company’s stock on the date of grant (or, for employees who are 10% shareholders, 110%). Should you elect to exercise your ISOs, you may exercise all or only a portion of the ISOs that are then vested.

Your options will expire on [expiration date], which is [the tenth anniversary of your grant date OR shorter period], (or, for employees who are 10% shareholders, [the fifth anniversary of the grant date OR shorter period]). Any vested portion of your ISOs that you do not exercise prior to the expiration date will be forfeited automatically.

Your ISOs will be granted to you in connection with your employment, and therefore you must remain an employee of the Company (or a related entity) at all times during the option period, beginning on the grant date. The ISO rules set forth in the Code provide guidelines regarding your ability to exercise your ISOs after your employment terminates for any reason. Generally, you will have [three months OR shorter period] from the date of your termination to exercise your vested ISOs (or until your ISOs expire, whichever occurs sooner). If you suffer a termination due to disability, you will have [one year OR shorter period] from the date of your termination due to disability to exercise your vested ISOs (unless your ISOs expire sooner). If you

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die at a time when you are eligible to exercise vested ISOs, your estate will be permitted to exercise the vested ISOs as set forth in the Plan.

#### **Drafting Note to “Exercise” Section Third Paragraph**

The ISO rules generally require the optionee to have an employment relationship with the issuer or a related company from the grant date through the time of exercise, except that it is permissible to allow former employees up to three months after termination to exercise (or 12 months in the case of a termination due to disability). While it is not mandatory for plans to allow post-employment exercise, most do so to the extent permitted. Similarly, if the optionee dies during their period of employment or within a post-employment exercise period, the optionee’s estate or heir may exercise the option as set forth in the plan (usually companies require exercise within a 12-month period after the optionee’s death).

To exercise your vested ISOs (or any vested portion of your ISO grant), you or your estate must complete the exercise notice attached to your ISO Agreement and return it to [contact person] at [address/e-mail address].

#### **Drafting Note to “Exercise” Section Fourth Paragraph**

Tailor the exercise instructions to comply with the company’s administrative procedures in place for exercising options.

With your exercise notice, you must remit payment to the Company in an amount that equals the per share exercise price multiplied by the number of shares you elect to exercise. The ISO Agreement and/or Plan explains the methods by which you can pay the exercise price. The Company will also provide to you any documentation that you must sign upon becoming a shareholder.

### **Holding Period**

Should you exercise your options and acquire shares, you must satisfy certain holding requirements in order for your stock options to maintain their ISO qualification. You must hold the shares that you acquire upon exercising your ISOs for (i) at least one year from the date you exercise your ISOs, and (ii) at least two years from the date the Company granted your ISOs. If you do not satisfy these holding requirements, your options will not qualify for favorable tax treatment and will be treated instead as nonqualified stock options.

### **Federal Tax Considerations**

Unless your ISOs fail to satisfy their qualification requirements, your ISOs generally will receive favorable tax treatment. Generally, you will not incur income tax at the date of grant or upon exercise of qualifying ISO (unless the alternative minimum tax rules result in taxation to you upon exercise), and the profit (if any) made on your sale of the acquired shares (a “qualifying disposition”) will be taxed as long-term capital gains. This means that the amount equal to the excess of (i) the amount realized upon the sale or other disposition of Company shares over (ii) the exercise price paid for the Company shares (the “spread value”) will be taxed at the long-term capital gains tax rate applicable to you, depending on your tax bracket. Likewise, you will recognize a long-term capital loss if the amount realized upon the exercise of your ISOs is lower than the exercise price paid for the Company shares.

If you do not satisfy the holding period requirement (a “disqualifying disposition”), the options will not receive favorable ISO tax treatment. Generally in such case, you will incur (i) taxable ordinary income equal to the excess of (A) the fair market value of the acquired shares at the time of exercise over (B) the exercise price of the acquired shares, and (ii) taxable capital gains income (short- or long-term depending on whether the shares were held for at least one year) on an amount equal to the excess (if any) of the amount realized upon the sale or other disposition of the acquired shares over your basis in the acquired shares (determined as the sum of the exercise price and the gain on the shares through the exercise date). However, if the amount realized upon disposition of the shares is less than the fair market value of the shares on the exercise date, the taxable income for the options is limited to the excess of the amount realized on the sale over the exercise price.

The below example illustrates the qualifying and disqualifying disposition tax treatment:

John receives a grant from the Company of 2,000 ISOs with an exercise price of \$25 per share. John exercises his ISOs 13 months later, when the fair market value of each share is \$40. John sells 1,000 of his shares 6 months later (i.e., 6 months after exercise, 19 months after grant) for \$45 per share. John sells the next 1,000 of his shares another 8 months later (i.e.,

14 months after exercise, 27 months after grant) for \$55 per share.

- John's first sale is a disqualifying disposition because he did not satisfy the holding period requirement for those shares. His basis in the shares upon disposition is \$30,000 (\$25,000 total exercise price + \$5,000 total gain in share value from exercise date to sale date). John will report \$15,000 (\$40 fair market value on exercise date - \$25 exercise price = \$15 x 1,000 shares) as ordinary income. He will also report \$15,000 (\$45,000 sale proceeds - \$30,000 basis) as a short-term capital gain.
- John's second sale is a qualifying disposition, and John will report \$30,000 (\$55 sale price - \$25 exercise price = \$30 x 1,000 shares) as a long-term capital gain.

The above example is intended to be broad in nature and may not apply to the specifics of your particular situation. The Company cannot guarantee any particular tax treatment and whether a cashless exercise of your ISOs may trigger the treatment of a portion of your ISO grant as nonqualified stock options. You should consult with your own tax advisor regarding the consequences of your specific ISO grant.

### **Alternative Minimum Tax Implications**

When you exercise your ISOs, the spread value between the strike price and the current fair market value at the time of exercise is added to your income in the year of exercise for purposes of calculating an alternative minimum tax ("AMT"). This may or may not cause you to incur an AMT; whether an AMT will apply to you will depend on your specific circumstances. You should consult with your own tax advisor regarding the AMT and whether it will apply to you.

### **Transfer Restrictions**

Your ISOs (and the right to exercise your ISOs) may not be transferred to others, other than by will or the laws of descent and distribution. The ISOs are only exercisable during your lifetime by you.

### **More Information Regarding Your ISO Grant**

The Company is pleased to be able to offer you an opportunity to share in its long-term growth and development. Should you have any questions about your ISO grant, please contact [company representative and contact information].

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### **Henrik Patel, Partner , White & Case LLP**

Henrik P. Patel is the Global Head of the Employment, Compensation & Benefits Practice at the global law firm, White & Case LLP. Henrik advises numerous US and non-US clients (including public and private companies, boards of directors and executives) on executive compensation and employee benefits aspects of various corporate transactions, including mergers, acquisitions, divestitures, spin-offs, succession planning, debt and equity financings, initial public offerings, private equity and leveraged buyout transactions and banking transactions. He has extensive experience with financial services institutions, private equity and hedge fund clients.

Henrik also provides ongoing counsel to public and private companies, compensation committees and executives with respect to day-to-day executive compensation and employee benefits matters, including corporate governance matters and best practices, executive compensation plan design, employment contracts and equity incentive compensation arrangements, as well as advising on related regulatory, securities, tax, public disclosure and ERISA issues. He negotiates and drafts employment, retention, separation, change of control, non-competition, non-solicitation and other compensation-related agreements, plans and provisions, as well as relevant sections of proxy statements, periodic and current reports (e.g., Forms 8-K, 10-K and 10-Q) and registration statements.

Henrik is a frequent contributor and speaker at Global Equity Organization (GEO) and National Association of Stock Plan Professional (NASPP) conferences. He was named to the "40 Under 40" list of outstanding M&A lawyers by The M&A Advisor and has been named a recognized individual by Legal 500 in Employee Benefits & Executive Compensation.

He received his JD from New York University School of Law and BA in Political Science from Tufts University.

### **DeVoia Stewart, Associate , White & Case LLP**

DeVoia is a member of the Employment, Compensation & Benefits team. Her practice is focused on providing advice with respect to a variety of employment, executive compensation and employee benefits issues raised in the context of corporate transactions, particularly in mergers and acquisitions and financing arrangements. DeVoia drafts executive employment agreements, equity award agreements and other types of employee agreements. DeVoia also advises clients on a range of employment law matters, including those related to the hiring of new employees and employer compliance with federal, state and local employment laws.

### **Caroline Cima, Associate , White & Case LLP**

Caroline Cima is an associate in White & Case's Employment, Compensation & Benefits group within the Firm's Mergers & Acquisitions practice. Caroline is resident in the New York office.

Caroline provides counsel to public and privately held companies, financial institutions, and executives on an array of employment, executive compensation, and employee benefits issues, particularly in connection with corporate transactions, including conducting due diligence.

Caroline earned her J.D. from Columbia Law School, where she was the managing editor of the Columbia Journal of Law & the Arts. Caroline is a member of the LGBT Bar Association of Greater New York and the New York City Bar Association.

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