Stock Options of Adhesion

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Many startup employees do not negotiate or seriously investigate their stock option agreements. On its face, this is concerning because stock options and other forms of equity compensation are considered a key part of the Silicon Valley system. Accordingly, scholars and regulators have called for fundamental reform of securities laws in the name of startup employees. Yet, talented employees keep flocking to startups and receiving breathtaking paydays, suggesting that something is working right in the startup labor market. This Article analogizes startup employees to mostly passive and uninformed consumers who are offered standardized "contracts of adhesion" when purchasing consumer goods or services. Building on long-standing scholarship asserting that market forces protect these consumers, this Article argues that reputational constraints and a critical mass of informed employees mold equity-compensation in ways that ultimately benefit employees.

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INTRODUCTION

How much should we worry about startup employees when they agree to exchange their valuable services for company stock? Based on accumulating research and evidence, these employees mostly do not bargain effectively (or at all) when agreeing to work for equity.[1] In fact, it is plausible, if not likely, that startup employees do not collect even the most basic information about equity grants, let alone read the details of compensation agreements, before agreeing to the terms.[2] This failure to investigate and bargain is no trifling concern—today's startups can accumulate thousands of employee equity holders with relatively little regulatory oversight.[3] These employee-investors are considered a key element of the Silicon Valley ecosystem[4] and equity compensation is considered a valuable tool for cash-strapped startups to motivate and retain this workforce.[5]

1. *See* EQUITYBEE & HITECH PROBS., EMPLOYEE STOCK OPTIONS SURVEY 2021 5 (2021), https://survey.equitybee.com/options2021/il/ [https://perma.cc/V4H5-47CV] (reporting that only 43% of surveyed Israeli startup employees negotiate the size of their equity grant).

2. *See* Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 937–38 (describing the "typical scenario" as an offer specifying the number of shares subject to the award but not the total shares outstanding and explaining that "[w]ithout this piece of information, the employee cannot know whether the grant represents a 1% ownership stake in the company, 0.1%, or any other percentage."); Yifat Aran & Raviv Murciano-Goroff, *Equity Illusions*, 41 J.L., ECON., & ORG. 196 (2021) (finding that respondents were highly susceptible to the "equity illusion" of increased share numbers without any increase to ownership percentage); EQUITYBEE & HITECH PROBS., *supra* note 1, at 5 (reporting that 66% of surveyed Israeli startup employees do not know what percentage of the company their stock options represent).

3. *See* Aran, *supra* note 2, at 963 ("[E]mployees' investments are susceptible to expropriation, agency problems, and information asymmetry—just as other forms of capital investments are. The current regulatory framework under Rule 701 fails to address these concerns."); Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 613, 622–26 (2017) (describing the large number of employees at some startups and the historical deregulation of equity compensation).

4. *See* Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 577–78 (1999). For an especially thorough account of the Silicon Valley workforce, see ALAN HYDE, WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET (2003).

5. *See* Yifat Aran, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1238–40 (2018) (identifying employee retention through stock options as a key element of Silicon Valley's success); Aran & Murciano-Goroff, *supra* note 2, at 199–200 (summarizing rationales for equity compensation).

For some commentators and policy makers, these concerns warrant fundamental reform. Legal scholars have invoked startup employees in calls for significantly intensifying regulation of private companies, including merit review of individual equity compensation plans and periodic disclosure requirements in the style of public-company regulation.[6] A commissioner of the Securities and Exchange Commission ("SEC") has similarly called for regulators to "reassess whether we have the right balance between public and private markets"—a euphemism for regulating private companies more like publicly-traded companies—partially out of concern for startup employees.[7]

And yet, startup employees make for curious corporate law victims. There is competition for talent among startups, established tech companies, and other sectors.[8] Startup employees have enjoyed famously lavish perks and receive significant cash compensation in addition to their equity stakes.[9] Perhaps most revealingly, they keep coming back—through Silicon Valley's many ups and downs, talented employees have consistently flocked to venture-capital ("VC") backed companies.[10]

This Article tries to explain the extraordinary resilience of Silicon Valley labor markets by likening equity grants to consumer contracts. Law and economics scholars have long theorized how consumer-oriented form contracts—more technically, contracts of adhesion—can evolve into mutually beneficial arrangements despite the lack of bargaining (or even reading) by consumers. According to this literature, even contracts offered on a take-it-or-leave-it basis are ultimately shaped by informed minorities, reputational concerns, and post-transacting exposure of terms.[11] And even when consumer contracts are

6. *See* Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 183–85 (arguing for state-level fairness hearings and a significantly bolstered Rule 701 that would require purchaser representatives and extensive disclosure of capital structure, voting rights, management compensation, stock valuations, and audited financial statements); Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 585–86, 640–41 (2016) (arguing for enhanced Form D disclosure and periodic financial reporting based in part on concern for employees).

7. Allison Lee, Comm'r, SEC, Remarks at The SEC Speaks in 2021: Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021), https://www.sec.gov/newsroom/speeches-statements/lee-sec-speaks-2021-10-12 [https://perma.cc/7P8U-K4WA] ("Then there's the category of investors in [private] markets with much at stake and sometimes little to no negotiating power to obtain needed information: employees.").

8. *See generally* Michael Roach & Henry Sauermann, *Can Technology Startups Hire Talented Early Employees? Ability, Preferences, and Employee First Job Choice*, 70 MGMT. SCI. 3619 (2023) (studying a cohort of PhDs and finding that the average quality of PhDs working for startups was higher than the average quality of PhDs working for established firms); BAIN & CO., TECHNOLOGY REPORT 2021 66 (2021), https://www.bain.com/globalassets/noindex/2021/bain_report_technology-report-2021.pdf [https://perma.cc/UL6A-3UBA] ("The tech talent war is global, cross-industry, and a matter of survival").

9. *See, e.g.*, Cadie Thompson, *Silicon Valley Start-ups Take Perks to New Level,* CNBC (Aug. 19, 2013), https://www.cnbc.com/id/100971904 [https://perma.cc/XAE2-QGM8] ("Start-ups based in San Francisco Bay area are offering novel perks—massages, body analytics, subsidized rents, trips to Tahoe and even helicopter rides—in hopes they will beat competitors to top talent."); Peter Walker, *The State of Startup Compensation, H1 2022*, CARTA (June 27, 2022), https://carta.com/blog/compensation-report-h1-2022/ [https://perma.cc/22VV-DHAP] (reporting that 5 of 17 job functions at startups have median salaries above $150,000 annually).

10. *See* GREGORY W. BROWN ET. AL., AN ANALYSIS OF EMPLOYMENT DYNAMICS AT VENTURE-BACKED COMPANIES BETWEEN 1990 AND 2020 5 (2022), https://nvca.org/wp-content/uploads/2022/02/Employment-Dynamics-at-Venture-Backed-Companies_FINAL.pdf [https://perma.cc/YX8G-AF5H] (finding that job growth at VC-backed firms consistently exceeds job growth in the private sector generally).

11. *See infra* Part II.A (discussing the potential influence of informed minorities); Part III.B (discussing the potential influence of post-transaction revelation and reputational concerns).

facially one-sided, they are systematically enforced with leniency.[12] If this is potentially true of even small-dollar consumer contracts, then it seems very likely to be true of arrangements with highly coveted startup employees.

It is, of course, hard to prove that this kind of uninformed private ordering is occurring, but there are some notable indications. The unicorn era has seen at least two material changes to the equity-compensation model, both of which are largely beneficial to employees. The most noticeable change is a pronounced shift to restricted stock units ("RSUs") in later stages of a startup's private-company tenure.[13] RSUs, as opposed to traditional stock options, retain value even if a company's valuation plateaus or declines, making this instrument well-suited to employees of today's mature startups featuring high (and hard to confirm) valuations.[14] Pre-IPO liquidity programs, which provide employees partial payouts before a company exit, are another innovation suited to the unicorn era.[15] By providing employees liquidity along the way, these programs mitigate the effect of companies staying private for longer.[16] Together, these developments suggest a system of contracting that in fact responds to the evolving needs of startup employees, even if they mostly do not read or understand their agreements. This Article is not the first to recognize these developments in equity compensation practices,[17] but it takes a noticeably more optimistic view than prior analyses by placing these developments in a theoretical framework of uninformed,[18] but ultimately effective, private ordering.

Understanding what works in equity compensation can shed new light on policy debates. Instead of redrawing the line between private and public company regulation, policy makers should lubricate market dynamics through removing tax distortions and requiring modest and targeted disclosure of key information.

This Article proceeds in four parts. Part I describes how startups customarily award stock options, with an emphasis on the benefits of standardization. Part II draws on the existing literature concerning contracts of adhesion to construct a theory for how market forces might operate to the benefit of even passive and uninformed startup employees. Part III identifies recent trends in equity compensation that are consistent with the theory. Part VI outlines policy implications, including a reform agenda focused on targeted disclosure and tax reform instead of fundamental changes to securities law.

I. ANATOMY OF A STOCK OPTION

To set the stage for the analysis, this Part provides a detailed account of how the most common form of equity compensation for non-founder employees—stock options—are awarded, documented, and administered. This description is to some extent historical. It

12. *See infra* Part II.C (discussing the role of strategic leniency in moderated the effects of one-sided contracts).

13. *See infra* Part III.A (discussing RSUs and how they mitigate difficulties associated with mature startups).

14. *See id.*

15. *See infra* Part III.B (discussing pre-IPO liquidity programs and how they serve as an example of strategic lenity by employers).

16. *See id.*

17. Alon-Beck, *supra* note 6, at 169–75 (discussing RSUs and liquidity programs as possible solutions to the challenges of the unicorn era but ultimately proposing wide-ranging regulatory reforms).

18. The observed private ordering is "uninformed" in the sense that most employees are not informed. It is contemplated, however, in Part II.A that an informed minority exists and provides a helpful influence.

describes customary practice over decades of Silicon Valley history. Part II will eventually lay out a theory for how equity compensation practices might evolve in employee-regarding ways and Part III identifies possible examples of such evolution in response to recent market conditions. Before getting to those recent developments, however, it is useful to establish a baseline depiction of historical practices.

A. The Recipients

This Article focuses on non-founder employees of startups. According to industry reports, a plurality of these employees are engineers, but others work in sales, operations, marketing, or other functions.[19]

According to academic research, startup employees are relatively young,[20] technically proficient,[21] and tolerant of employment risk.[22] It is an open empirical question whether they sacrifice income for the thrill and learning that accompanies the startup experience.[23]

In the aggregate, employee stock options and other forms of equity compensation constitute a significant percentage of a company's fully diluted shares.[24] Any individual employee, however, has rights to a relatively small percentage of a company's total

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19. According to a recent report from Carta, a provider of cap table services, startups hired in the following categories and proportions in the second half of 2023: engineering (27.1%), sales (15.9%), operations (9.6%), marketing (6.9%), customer success (5.1%), support (5.0%), product (4.4%), and research (4.3%). *See* Kevin Dowd & Peter Walker, *State of Startup Compensation H2 2023*, CARTA (Mar. 11, 2024), https://carta.com/data/startup-compensation-h2-2023/ [https://perma.cc/9BB8-5LHN].

20. *See* Paige Ouimet & Rebecca Zarutskie, *Who Works for Startups? The Relation Between Firm Age, Employee Age, and Growth,* 112 J. FIN. ECON. 386, 387, 391, 398 (2014) (finding, based on U.S. Census Bureau Data, that young firms employ relatively younger (between 25 and 44) workers and that firms with a relatively young workforce are more likely to raise venture capital).

21. *See id.* at 387, 396, 398 (finding evidence consistent with the theory that startups hire young employees because they "may possess more current technical skills" that are "especially critical to young firms . . . developing new products . . . ."); Roach & Sauermann, *supra* note 8, at 3632 (finding that graduates of high-quality PhD programs disproportionately work for startups).

22. *See* Ouimet & Zarutskie, *supra* note 20, at 387, 398; Henry Sauermann, *Fire in the Belly? Employee Motives and Innovative Performance in Startups Versus Established Firms*, 12 STRATEGIC ENTREPRENEURSHIP J. 423 (2018) (finding based on National Science Foundation survey data that scientists and engineers who go to work for startups rate job security lower than other job attributes); Roach & Sauermann, *supra* note 8, at 3632 (finding among PhDs a correlation between risk tolerance and working for a startup).

23. *See* Ouimet & Zarutskie, *supra* note 20, at 387 (finding that young employees at new firms earn higher wages than young employees at older firms); *but see* Olav Sorenson et al., *Do Startup Employees Earn More in the Long-Run?*, 32 ORG. SCI. 587, 591 (2021) (finding that employees of Danish startups earn less over a 10-year period than counterparts at established firms); Roach & Sauermann, *supra* note 8, at 3624, 3637 (finding that PhDs accepting employment at startups earn lower cash compensation than PhDs working at established tech firms, and expressing doubt that equity compensation makes up for the disparity).

24. *See The Option Pool: Wading or Olympic Sized?*, DLA PIPER, https://www.dlapiperaccelerate.com/knowledge/2017/the-option-pool-wading-or-olympic-sized.html [https://perma.cc/RMU3-K8SX] (stating that an option pool usually equals about 10–20% of a company's cap table); *How to Decide the Size of a Company's/Startup's Equity Pool*, LATHAMDRIVE, https://www.lathamdrive.com/resources/insights/how-to-decide-the-size-of-a-companysstartups-equity-pool [https://perma.cc/V23W-PJ88] (indicating that the typical size of an option pool is 10– 20% of outstanding equity).

shares—usually well under 1%.[25] While executive-level employees likely receive the largest grants, a wide range of employees receive equity compensation at startups.[26]

B. The Basic Incentive Structure

Defined narrowly, a stock option is just a contract. In the context of startups, the contract provides that an employee may purchase a specified number of shares of the employer's stock at a designated price.[27] For tax reasons, the designated price is the fair market value of the startup's stock on the date the option is granted (the employee's hire date for initial grants).[28] The option will be subject to vesting: a requirement to work for a specified period before the employee may exercise the option.[29] Exercising the option requires paying the designated purchase price to the startup in exchange for the shares.[30]

More broadly, a stock option is a key aspect of the economic relationship between startup and employee. The hope of the employee and the startup is that the employee will remain at the company long enough to satisfy the service period, contribute to a rapidly increasing share price, and realize value from the option when the company successfully exits through being acquired or completing an IPO.[31] The realized value will equal the "spread"—the value of the purchased stock on the date of the exercise minus the exercise price.[32] Stated differently, the employee benefits in the amount by which the stock value has increased between the employee's hire date and the date of exercise. If the value of the stock declines or is flat during that period, the option is "underwater" or "out of the money" and will presumably be left to expire without exercise.[33]

C. The Documentation

A startup lawyer's standard formation package will include the documents necessary to create this economic arrangement between employee and startup. A close examination of these documents illuminates why active negotiation by rank-and-file employees is likely to be impractical.

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25. *See* Dowd & Walker, *supra* note 19 (indicating that in 2023 a startup's first employee received an average equity grant of 1% of total company shares and that the percentage declined to 0.17% by hire number 10).

26. ANNUAL EQUITY REPORT, CARTA 16 (Dec. 1, 2022), https://carta.com/equity-report/2022/# [https://perma.cc/7BAD-NSEC] (indicating that over 90% of entry- and mid-level employees received equity grants).

27. THERESE H. MAYNARD, DANA M. WARREN & SHANNON TREVIÑO, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING 337 (3d ed. 2018).

28. *See id.* at 342–43, 355–60 (discussing Internal Revenue Code ("IRC") Section 409A, IRC Section 422, and related tax and accounting rules).

29. *See id.* at 340–41.

30. *See id.* at 343–44.

31. *See* Aran, *supra* note 5, at 1238–40 (discussing the role of equity compensation in binding employees to startups); *infra* notes 135–36 (discussing the concept of mutual lock-in until exit).

32. *Stock Options: Overview,* THOMSON REUTERS PRACTICAL LAW 1 (2024).

33. *See id. at* 16.

1. The Plan

One standard document is the plan (named "stock plan," "stock option plan," "equity incentive plan," or the like).[34] On its face, the plan empowers the board of directors to grant and administer stock options,[35] but this is somewhat misleading. A corporate board has inherent authority to do those things.[36] A plan is still useful, however, in several other respects.

First, a stock option plan facilitates compliance with external legal requirements. Many of the terms of a stock option are driven by tax law. For example, a stock option must meet Internal Revenue Service ("IRS") requirements for an incentive stock option ("ISO") to ensure the most favorable tax treatment for the employee.[37] Requirements for ISOs include, without limitation, that the grantee be an employee, an exercise price equal to at least the fair market value of the stock on the grant date, a requirement to exercise the option within 90 days of leaving employment, a term (expiration date) of 10 years from the grant date, and volume limitations.[38] The plan reminds the board of these requirements and hardwires these terms directly into each individual option granted under the plan as an ISO.[39]

Second, the plan creates a workflow for granting options. The plan indicates that the board can delegate to officers (such as the company's CEO or CFO) authority to allocate a "tranche" of options among new hires, at a board-approved exercise price and subject to an overall numerical limitation.[40] The board, in other words, is not required to be involved in every new hire by the company.

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34. *See, e.g.*, Connor Bathen, *Stock Option Plan Template*, CARTA (Dec. 23, 2020), https://carta.com/blog/equity-templates/ [https://perma.cc/TCB9-J5AF] [hereinafter Carta Plan] (click "download equity templates"); *Stock Plan Toolkit (US)*, ORRICK, https://www.orrick.com/en/Total-Access/Tool-Kit/Start-Up-Forms/Equity-Compensation [https://perma.cc/3D9K-8VAB] [hereinafter Orrick Plan].

35. *See* Carta Plan, *supra* note 34, § 2 (describing the power of the board to make awards and administer the plan); Orrick Plan, *supra* note 34, § 4 (describing the power of the board to make awards and administer the plan).

36. *See* DEL. CODE ANN. tit. 8, § 157 (describing the authority of the board to issue stock options).

37. ISOs, which are governed by IRC § 422, are advantageous because (a) the holder does not incur tax liability until the option is exercised, and the acquired shares are sold and (b) tax is incurred as capital gains rather than ordinary income. *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 360. An option that does not qualify as an ISO is called a nonqualified stock option ("NSO"), and the holder will incur ordinary income upon exercise. *See id.* at 363–64. Startups do sometimes issue NSOs because some of the requirements of ISOs are undesirable, and ISOs are sometimes ultimately treated as NSOs because all of the requirements for ISO treatment are not met. *See id.* at 357, 364 (discussing volume limitations and disqualifying dispositions before the mandated holding period for ISOs). But even then, NSOs will tend to mimic many of the ISO requirements, such as a 10-year term and the requirement to exercise within 90 days of leaving employment. *See id.* at 350 (discussing the standard post-termination exercise period for nonqualified options). For discussion of other differences between ISOs and NSOs, including deductibility by the company, see Gregg Polsky, *Tax Aspects of Incorporations*, *in* RESEARCH HANDBOOK ON CORPORATE TAXATION 72 (Reuven S. Avi-Yonah ed., 2023).

38. *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 355–60.

39. *See*, *e.g.*, Carta Plan, *supra* note 34, § 4(a) (limiting ISOs to employees); Orrick Plan, *supra* note 34, § 5(c) (imposing volume limitations on ISOs).

40. *See* Carta Plan, *supra* note 34, § 2(d) (stating that the board may delegate to an officer of the corporation award decisions for non-officer employees, provided such awards are made on board-approved forms of agreements); Orrick Plan, *supra* note 34, § 4(a) ("[T]he Board may authorize one or more officers of the Company to make Awards under the Plan . . . within parameters specified by the Board.").

Third, the plan ultimately becomes a vehicle for *limiting* the power of the board to grant options. If the company is successful in its early stages, it may eventually secure outside investment. Those outside investors (such as angel investors or venture capital funds) will obtain contractual rights that effectively limit the company's ability to grant equity interests outside of the plan.[41] The plan, therefore, ultimately marks the boundaries of the company's ability to grant equity compensation without investor approval.

2. *The Stock Option Agreement*

As suggested above, an employee's stock option is not only subject to the company-wide plan. It is also subject to an individual stock option agreement between the specific employee and the company.[42] This stock option agreement contains more individualized terms than the plan. Examples include the number of shares subject to the option, the vesting schedule, and the exercise price.[43]

One must be careful, however, to avoid overstating how "individualized" a stock option agreement is. Typically, the company's board will have authorized a single form of agreement for an entire tranche of options to be allocated among new hires by the company's officers.[44] The only truly individualized terms, such as the number of shares, are sometimes separated out on a cover page, sometimes separately entitled as a "notice" of stock option grant.[45] This document design practically screams take it or leave it. Rather than being a starting point for active negotiation, the stock option agreement memorializes the terms of a uniform transaction across a class of employees.

This uniformity is highly valuable to the company. The company will be called upon to track and report the status of awards in connection with new financings,[46] merger transactions,[47] and initial public offerings.[48] Although one or two high-level employees might

41. *See, e.g.*, NAT'L VENTURE CAPITAL ASS'N, NVCA MODEL LEGAL DOCUMENT, CERTIFICATE OF INCORPORATION § 3.3.7 (2024), https://nvca.org/document/certificate-of-incorporation-updated-october-2024/ [https://perma.cc/43JX-KMHP] (prohibiting expansion of a company's stock option plan without investor approval).

42. *See, e.g.*, Connor Bathen, *Stock Option Plan Template*, CARTA (2020), https://carta.com/blog/equity-templates/ [https://perma.cc/P6YK-AWGS] [hereinafter Carta Option Agreement] (click "download equity templates"); *Option Agreement*, ORRICK, https://www.orrick.com/en/Total-Access/Tool-Kit/Start-Up-Forms/Equity-Compensation [https://perma.cc/65NT-X44W] [hereinafter Orrick Option Agreement].

43. *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 338–39.

44. *See supra* note 40 (describing the board's ability to delegate individual award decisions to officers within parameters determined in advance by the board); *Board Approval of Option Grant*, ORRICK, https://www.orrick.com/en/Total-Access/Tool-Kit/Start-Up-Forms/Equity-Compensation [https://perma.cc/2WHW-FCVB] (providing a form of board resolution that sets uniform exercise price, term, and vesting schedule for a tranche of options).

45. *E.g.*, Orrick Option Agreement, *supra* note 42.

46. *See, e.g.*, NAT'L VENTURE CAPITAL ASS'N, NVCA MODEL LEGAL DOCUMENT, STOCK PURCHASE AGREEMENT § 2.2(c) (2024), https://nvca.org/document/stock-purchase-agreement-updated-october-2024/ [https://perma.cc/PWU3-QPCV] (requiring a company to make representations and warranties regarding stock option terms in connection with accepting venture capital financing).

47. *E.g.*, *Merger Agreement (Private Company, Pro-Buyer)*, THOMSON REUTERS PRACTICAL LAW § 3.04(b) (2024).

48. *E.g.*, Abraham J.B. Cable, *Time Enough for Counting: A Unicorn Retrospective*, 39 YALE J. ON REGUL. BULL. 23, 27–28 (2021) (summarizing the terms of outstanding options for an early unicorn startup based on information required to be reported on Form S-1 under the Securities Act of 1933).

be permitted some small idiosyncrasies, negotiating variations with rank-and-file employees risks future headaches.

3. *The Offer Letter*

In fact, if any negotiation does occur between employee and company, it likely occurs earlier in the hiring process in connection with another standard component of the startup lawyer's formation package: the employee offer letter. An offer letter is a three- or four-page outline of proposed terms of employment that is delivered to the employee by the company. The letter covers topics such as salary, benefits, and job description.[49] One paragraph of the letter typically describes a contemplated stock option grant, substantially as follows:

> Subject to the approval of the Company's Board of Directors (the "Board"), you will be granted an option . . . to purchase [Number of Shares] shares of the Company's Common Stock (the "Equity Award"). The Equity Award will vest and become exercisable (as applicable) over [4 years at the rate of 25% of the total number of Equity Award shares on the 1-year anniversary of your start date of employment with the Company and 1/48th of the total number of Equity Award shares on each monthly anniversary thereafter], subject to your continuous service with the Company through each vesting date. The exercise price or purchase price per share of the Equity Award will be equal to the fair market value per share of the Company's Common Stock on the date the Equity Award is granted, as determined by the Board in good faith . . . . The Equity Award will be subject to the terms and conditions set forth in the Company's [Equity Plan Name] and the Company's standard form of stock option agreement . . . which you will be required to sign.[50]

This form language suggests that the only provisions up for negotiation are the number of shares and the vesting conditions. Other terms will simply be designated in the company's "standard form of stock option agreement." However, in reality the scope of the negotiation is even narrower than this provision suggests. Vesting is likely to be uniform across the entire tranche of employees, for reasons described above, leaving only the number of options open to debate.[51]

Surprisingly, perhaps, the best available evidence suggests that employees do not negotiate or seriously investigate even this essential term. In a recent survey of Israeli startup employees by EquityBee,[52] most respondents indicated that they do not negotiate the number of shares in an option grant.[53] Moreover, media accounts, survey data, interview-based research, and experimental research suggest that employees often do not know what

49. *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 339 (describing offer letters).

50. *Offer Letter*, ORRICK, https://www.orrick.com/Total-Access/Tool-Kit/Start-Up-Forms/Employment-and-Consultant/Employee%20Offer%20Letter [https://perma.cc/XDD6-BDW6]. Brackets have been removed from the quoted language.

51. *See supra* note 46–48 and accompanying text (describing the advantages of uniform option terms).

52. EquityBee is a company that finances stock option exercises by employees. EQUITYBEE, https://equitybee.com/ [https://perma.cc/2REM-WGAF].

53. *See* EQUITYBEE & HITECH PROBS., *supra* note 1, at 12 (reporting only "43% of startup employees negotiate their stock option packages").

percentage of a company's shares they are potentially receiving in an equity grant.[54] This raises the question of whether employees attempt even a rudimentary valuation of their equity stake. They certainly cannot be performing the kind of liquidation waterfall analysis, prevalent in the corporate finance literature and among VC investors, that models how an estimated company-wide value would flow through a company's capital structure.[55] Such an analysis would require not only an estimate of company value but also an understanding of both the employee's common stock ownership percentage and any senior rights of preferred stock owned by VC investors.[56]

D. Later Events

A stock option agreement is not the kind of contract that is signed and performed in one fell swoop. It is instead embedded in an ongoing relationship and requires periodic performance or administration. This subpart identifies the key post-contracting moments.

1. Exercise on Termination of Employment

When an employee leaves employment—either by choice or because of termination by the company—the standard stock option agreement provides the employee a relatively short period of time to either exercise or forfeit the option. The typical period is 90 days.[57] This short fuse gives the company some certainty around its cap table but places the employee in a potentially difficult situation. Termination of employment will not necessarily coincide with a liquidity event, meaning that the employee must come up with the cash to exercise and potentially pay tax (if the option is not an ISO) on the spread.[58] The employee must determine whether to do so without the benefits of a ready market for selling the shares or reliable price information to evaluate the potential gains (or losses) of exercising.

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54. *See id.* at 14 (reporting survey results); Aran, *supra* note 2, at 937–42 (describing research interviews and media accounts); Aran & Murciano-Goroff, *supra* note 2, at 205–12 (presenting results of experimental research in which participants irrationally valued an increase in absolute number of shares).

55. *See* Aran, *supra* note 2, at 937–42 (discussing the importance of "exit waterfalls" in valuing startup stock and employees' lack of information necessary to perform the analysis).

56. *See infra* note 124 and accompanying text (discussing typical valuation methods for startup financing). It is possible that employees use some alternative method when evaluating their stock option grants. For example, they might assume that the exercise price of an option grant accurately reflects the grant-date fair market value of the stock, which is a tax law requirement normally satisfied through a "409A valuation" from an outside service provider. The employee might then project an assumed growth rate for the value of the underlying stock, which could be used to estimate future spread value. Though this method might place undue confidence in 409A valuations, see Aran, *supra* note 2, at 949–50, it is not illogical as a back-of-the-envelope estimate. This Article will accept, however, the prevailing view that many employees are simply uninformed.

57. *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 340 (describing the standard period as 30-90 days for nonqualified options and the three-month limit for ISOs).

58. *See* Aran, *supra* note 5, at 1265–67 (discussing the difficulty of the exercise decision prior to IPO).

2. *Acquisition Payouts*

If all goes according to plan, the employee will still be employed by the company when it achieves a successful exit. The most common form of exit is an acquisition of the company by an established firm.[59]

The plan ordinarily gives the board broad discretion over how to treat options in a merger or other form of acquisition. For example, the following provision gives the "Administrator," defined earlier in the document as the company's board, the following alternatives in the event of an acquisition:

> (A) the continuation of such outstanding Awards by the Company (if the Company is the surviving corporation);
>
> (B) the assumption of such outstanding Awards by the surviving corporation or its parent;
>
> (C) the substitution by the surviving corporation or its parent of new options or equity awards for such Awards;
>
> (D) the cancellation of such Awards in exchange for a payment to the Participants equal to the excess of (1) the Fair Market Value of the Shares subject to such Awards as of the closing date of such Corporate Transaction over (2) the exercise price or purchase price paid or to be paid for the Shares subject to the Awards; or
>
> (E) the cancellation of any outstanding Options or an outstanding right to purchase Restricted Stock, in either case, for no consideration.[60]

On its face, the provision is concerningly one-sided. In addition to the right to simply cancel options pursuant to (E), there is no guidance regarding the terms of any substitute option or what exactly it means for an acquirer to "assume" the option. Even seemingly objective standards like Fair Market Value are determined by the board rather than rigorous process. The provision creates plentiful opportunity for exploitive conduct.

The custom, however, is for the acquirer to at least pay out merger consideration in the amount of the spread on vested options.[61] It would, after all, be rather aggressive to cancel a stock option that could be validly exercised the moment before the transaction. Moreover, employees might very well receive something additional for *unvested* options. Unvested options may be replaced by economically equivalent options under the acquirer's plan or converted into some kind of bonus pool that gets paid out after satisfying a service

59. *See generally* NAT'L VENTURE CAPITAL ASS'N, NVCA YEARBOOK 30–33 (2023), https://nvca.org/wp-content/uploads/2023/03/NVCA-2023-Yearbook_FINALFINAL.pdf [https://perma.cc/Z9VM-R7BP] (reporting the number of IPOs and M&A transactions by year).

60. Orrick Plan, *supra* note 34, § 10(c).

61. *See* Mischa Vaughn, *What Happens to Stock When a Company Is Bought?*, CARTA (June 22, 2022), https://carta.com/blog/equity-stock-company-acquired-acquisition/# [https://perma.cc/PH56-2HRQ] (describing what happens to vested equity awards in different sale scenarios).

period.[62] While this kind of largess may at first seem puzzling, the acquirer has a strong interest in keeping its new workforce happy and motivated.[63]

3. Exercise & Sale in IPO

If the company is successful enough to conduct an IPO, rather than being acquired, the employee's situation improves considerably. The employee now has a reliable market price to guide exercise decisions and a liquid market to raise cash for tax liabilities.[64] It may even be possible to pull off a cashless exercise, avoiding the difficulty of coming up with the cash.[65] There are still some potential tax traps. If the employee wants the benefits of ISO tax treatment, he or she will need to hold the stock for one year after exercise, and the stock could decline in value over that period.[66] Also, exercising the option might launch the employee into the alternative minimum tax.[67] Broadly speaking, however, the employee who rides a startup all the way through IPO has usually ascended into rarefied air.

II. A THEORY OF UNINFORMED PRIVATE ORDERING

Based on the description above, a significant portion of startup employees fail to read or negotiate stock option agreements, and they sometimes fail to investigate even basic information about ownership percentages.[68] Does that necessarily mean startup employees are unprotected by market forces and private ordering?

One way to approach the question is to start with the substantial academic literature concerning the paradigmatic uninformed contracting party: consumers who purchase goods or services under "contracts of adhesion" such as terms of use for online services, insurance contracts, or terms of sale for small purchases.[69] For decades, prominent legal

62. *See* Scott Kupor, *How Startup Options (and Ownership) Works*, ANDREESSEN HOROWITZ (Aug. 24, 2016), https://a16z.com/how-startup-options-and-ownership-works/ [https://perma.cc/2G44-VXE7] (discussing the possibility of unvested options being assumed by the company or being cancelled and replaced with options on new terms); Mary Russell, *Double Trigger Acceleration and Other Change of Control Terms for Startup Stock, Options and RSUs*, STOCK OPTION COUNS. (July 27, 2023), https://www.stockoptioncounsel.com/blog/change-of-control-terms-for-startup-stock-options-restricted-stock-and-rsus/2018/6/4 [https://perma.cc/5B9D-RB3J] (discussing how unvested stock options are sometimes preserved by being converted into future deal consideration, RSUs, or other new forms of award considered to have equal value to the unvested options).

63. *See* Kupor, *supra* note 62 (discussing efforts to "re-incent" employees).

64. *See* Aran, *supra* note 5, at 1265 ("To exercise stock options for a public firm, an employee does not need to invest her own money because she can sell some stock to finance the exercise price and to meet the income tax liability triggered by the exercise.").

65. Sometimes the plan or option agreement provides for a cashless exercise in which shares net of enough to cover the exercise price are issued. *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 344–45.

66. *See id.* at 360–64 (describing the prevalence of disqualifying dispositions).

67. While the exercise of an ISO is generally not a taxable event, it does count as "preference" income under the Alternative Minimum Tax ("AMT"). For an excellent description of this complicated issue, see *id.* at 360–62.

68. *See supra* notes 52–56 and accompanying text.

69. According to one influential article, a "contract of adhesion" is defined by seven characteristics: (1) it is in a form that clearly purports to be a contract, (2) it was drafted by or on behalf of one of the parties to the contract, (3) the drafter participates in repeat transactions of the relevant type, (4) the contract is mostly presented on a take-it-or-leave-it basis, (5) the document is signed by the non-drafting party, (6) the non-drafting party does not regularly enter into the relevant type of transaction, and (7) the primary obligation of the non-drafting party is payment of money. *See* Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1177 (1983).

scholars have debated the legal and policy implications of the "no-reading problem" in these consumer contracts.[70] This literature provides a theoretical starting point for understanding how startup employees might benefit from some degree of market discipline despite their own no-reading problem. Specifically, it suggests at least three mechanisms through which the interests of a contracting party might be accommodated in the formulation or administration of contracts despite that party never negotiating or even reading the contract: the catering of terms to an informed minority, the effects of post-transaction reading, and systematic under-enforcement of one-sided terms. As discussed further below, these mechanisms plausibly operate in the market for equity compensation.

A. An Informed Minority

Most basically, scholars theorize that a seller of consumer products might concede on some terms to satisfy the preferences of an informed minority.[71] Because of the considerable benefits of standardizing arrangements across all customers, even uninformed consumers might benefit from these concessions as they are baked into the seller's standard terms.[72]

On balance, contract scholars seem skeptical of this dynamic in the context of *consumer* contracts. Whether it pencils out for any considerable percentage of consumers to read the fine print depends on the cost to consumers of becoming informed and the likely benefits of doing so.[73] For anything but the most basic and widely available price information, it may be rational for most consumers to simply assume the worst and spend time

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70. *See* Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545, 546–48 (2014) (presenting evidence that consumers rarely read contracts); Shmuel I. Becher & Esther Unger-Aviram, *The Law of Standard Form Contracts: Misguided Intuitions and Suggestions for Reconstruction*, 8 DEPAUL BUS. & COM. L.J. 199, 203–04, 209–14 (2010) (reviewing prior studies of whether consumers read contracts and presenting new survey research); Rakoff, *supra* note 69, at 1179 (stating that "[v]irtually every scholar who has written about contracts of adhesion" accepts that consumers sign such contracts without reading or understanding them). It appears that this literature originated in the 1940s in articles by Karl Llewellyn and Friedrich Kessler. *See* Randy E. Barnett, *Consenting to Form Contracts*, 71 FORDHAM L. REV. 627, 627 (2002) (attributing the term "contract of adhesion" to Kessler); Rakoff, *supra* note 69, at 1197–1220 (discussing prior literature originating with Kessler and Llewellyn).

71. *See* Becher & Unger-Aviram, *supra* note 70, at 204–06 (describing this theory as the "law and economics approach"); R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS. L.J. 635, 636 (1996) (summarizing and critiquing the informed minority argument); Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679, 690–92 (summarizing arguments for how reading consumers may serve as proxies for non-reading consumers); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979) ("Rather than asking whether an idealized individual is sufficiently informed to maximize his own utility, the appropriate normative inquiry is whether competition among firms for particular groups of searchers is, in any given market, sufficient to generate optimal prices and terms for all consumers.").

72. *See* Rakoff, *supra* note 69, at 1226 n.190 (discussing the institutional costs of changing standardized contracts).

73. *See* Schwartz & Wilde, *supra* note 71, at 648 (considering search costs in constructing a model of consumer behavior); Cruz & Hinck, *supra* note 71, at 657 ("The single most important determinant of the number of informed consumers is the cost of information.").

on something more enjoyable than reading standard form contracts.[74] Whether it then makes sense for sellers to make concessions to atypically informed customers depends on a number of inputs, such as: the cost to sellers of altering standardized contracts,[75] the importance of a particular term to a seller,[76] the ability of sellers to discriminate between informed and uninformed customers,[77] and the ratio of informed to uninformed customers. Some scholars have developed formal models that produce estimates of how many consumers need to be informed to impact prices and other terms.[78] While these models are conceptually useful, they are not empirically based, and one can get widely varying results by adjusting the dials and knobs.[79] That said, it is often asserted that a relatively large number of consumers would need to be informed to produce the effect,[80] leading some commentators to doubt that the invisible hand is a particularly effective mechanism for consumer protection.[81]

The market for equity compensation, however, might very well be more conducive to helpful market discipline. Given the potentially large payouts and opportunity costs for a tech worker selecting a job, it is reasonable to assume that he or she puts more effort into investigating terms of employment than investigating the warranty for a toaster oven. This is especially true for participants in a "high-velocity" labor market in which employees move frequently between ventures and presumably gain some experience with equity awards over time.[82] Even if most startup employees are inexperienced or indifferent investors, startup employees as a group must accumulate some practical knowledge about stock options over time.

For example, some indication of an informed minority is found in the choice-of-entity literature. Practitioners and academics have long sought to explain the puzzling use of tax-inefficient C-corporations for startups, rather than pass-through entities such as LLCs.[83]

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74. *See* Cruz & Hinck, *supra* note 71, at 667–69 (discussing the effects of free-riding by uninformed consumers and game theoretical models in which consumers discount all transactions as if non-price terms were unfavorable).

75. *See* Rakoff, *supra* note 69, at 1126 n.190 (referencing "the institutional costs of changing forms and procedures").

76. *See* Cruz & Hinck, *supra* note 71, at 675 (identifying "the cost savings to the producer of the inefficient terms" as a particularly important factor).

77. *See id.* at 672–75; Schwartz & Wilde, *supra* note 71, at 662–66.

78. *See* Schwartz & Wilde, *supra* note 71, at 655 ("Under relatively plausible assumptions respecting costs and consumer preferences, the illustration showed that a market may behave competitively if as many as two thirds of the consumers in it know only the prices they themselves pay.").

79. *See* Cruz & Hinck, *supra* note 71, at 675 ("As our formal model has shown, it may be possible for an informed minority of as little as 1% to cure imperfections in form contracts or it may be necessary that 90% of consumers be informed before a particular efficient term will be expected.").

80. Schwartz and Wilde indicated that one-third of consumers would need to be informed to produce the desired market discipline on price terms for a hypothetical dishwasher market. *See* Schwartz & Wilde, *supra* note 71, at 655. Though this was not an empirically based claim, the one-third number has taken on a life of its own. *See* Cruz & Hinck, *supra* note 71, at 651 n.58 (criticizing an over-reliance on Schwartz and Wilde's estimate).

81. *See* Cruz & Hinck, *supra* note 71, at 675–76; Rakoff, *supra* note 69, at 1226 n.190.

82. *See generally* HYDE, *supra* note 4 (describing Silicon Valley as a "high-velocity labor market").

83. *See generally* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1738 (1994) ("In Silicon Valley, notwithstanding the concomitant loss of tax benefits, a substantial number of new ventures are carried out by newly-formed corporations."); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 137 (2003) ("A typical start-up is organized as a corporation under state law, which means that it is treated as a separate entity from its owners for tax purposes."); Gregg

One theory is that the decision is driven in part by the strong desire among Silicon Valley employees for a very specific form of equity interest: stock options issued from C-corporations.[84] While there are certainly other factors driving choice of entity,[85] it is perhaps revealing that employee preferences even make the list of potential explanations.

In addition, the very research that motivates concern for stock option recipients suggests a nontrivial number of informed and assertive startup employees. The EquityBee survey, turned on its head, tells us that 43% of respondents *do* negotiate their stock option grants and 66% of respondents know how long they have to exercise their options if they leave employment.[86] The experimental research, when viewed optimistically, reports that 18.3% of participants "grasped the basic characteristic of venture capital finance as convertible preferred stock."[87]

Together, these indications of an informed and assertive minority suggest we are a long way from the overwhelmingly passive and indifferent consumers depicted in the consumer contract literature. It therefore seems plausible that even uninformed startup employees sometimes free ride on the diligence and experience of an informed minority.

B. Post-Transaction Revelations

Contract formation is not the only opportunity to investigate contract terms. Contract scholars have hypothesized that sellers might tread carefully with consumers out of concern that exploitive provisions will surface in the course of disputes, harming the seller's reputation with future customers.[88] For this helpful dynamic to occur, at least three conditions must be met: (1) sellers are repeat players with reputational concerns, (2) customers have occasion to investigate contract terms post-contracting, and (3) there is a sufficient flow of information such that information surfaced in disputes somehow reaches future customers.[89]

In the consumer context, there are reasons to doubt these conditions exist. It is not clear that new customers—those same ones who do not ordinarily read or investigate contracts—would learn of other customers' disputes in ways that would meaningfully alter contracting behavior.[90]

In the market for startup employees, however, this story is more plausible. First, scholars have long observed that both financing sources and founders are (or would like to be)

Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-ups*, 70 HASTINGS L.J. 409, 411 (2019) ("Most advisors across the United States consistently recommend flow-through entities, such as limited liability companies and S corporations to their clients. In contrast, a discrete group of highly sophisticated lawyers, those who advise start-ups in Silicon Valley and other hotbeds of start-up activity, stubbornly prefer C corporations.").

84. *See* Fleischer, *supra* note 83, at 167–73; Polsky, *supra* note 83, at 446.

85. *See* Polsky, *supra* note 83, at 420–35 (reviewing the traditional factors for choice of entity in Silicon Valley, such as tax-exempt investors in venture capital funds).

86. *See* EQUITYBEE & HITECH PROBS., *supra* note 1, at 5, 15 (discussing a survey taken by employees).

87. *See* Aran & Murciano-Goroff, *supra* note 2, at 197 (stating the percentage of employees who understood that venture capital finance is a convertible preferred stock).

88. *See* Becher & Unger-Aviram, *supra* note 70, at 208 (discussing contract terms sellers give buyers).

89. *See* Shmuel I. Becher & Tal Z. Zarsky, *E-Contract Doctrine 2.0: Standard Form Contracting in the Age of Online User Participation*, 14 MICH. TELECOMM. & TECH. L. REV. 303, 314 (2008) (noting the importance of the information environment and branding to this theory).

90. *See id.* at 314–20 (discussing several "chokepoints" for the adequate flow of information in the context of traditional consumer contracts).

repeat players with incentives to carefully cultivate their reputations.[91] Second, contracts for equity compensation are embedded in a long-term relationship that typically ends in some kind of administration of the award: a decision to exercise (or not) at termination of employment, exercise and sale of underlying shares at IPO, or some kind of payout in an acquisition.[92] These are all occasions for employees to engage with the details of their equity grants in ways that they might not at the outset and to notice terms that are one-sided or unfairly administered. Finally, information flows in Silicon Valley. Employees famously diffuse knowledge as they cycle through jobs, live their lives in geographic clusters, and gossip on online forums.[93] If an employer engages in perceived sharp practices, one would not expect the affected employees to suffer privately.

In fact, there are high profile examples of companies receiving negative attention for compensation practices. For example, Zynga famously attempted to "claw back" equity compensation in the run-up to its IPO.[94] According to press accounts, the company's management determined that equity compensation payouts would be too large for some employees, prompting the company to terminate some employees (resulting a loss of unvested awards) unless those employees agreed to give up some of their existing equity grants.[95] The maneuver sparked considerable criticism and was viewed as a potentially destabilizing betrayal of the core incentive bargain between startup and employee.[96] More recently, Uber faced not only negative press but also a class action lawsuit for the way in which it handled RSUs (a form of compensation discussed in more detail in Part III) in its IPO, allegedly imposing additional tax costs on employees.[97] These higher-profile examples can be added to smaller, but still publicly known, disputes relating to equity compensation.[98]

Taken together, these insights and examples suggest an environment where employees can reveal and publicize sharp practices to the detriment of founders' or investors' carefully cultivated reputations.

91. *See, e.g.*, Vladimir Atanasov, Vladimir Ivanov & Kate Litvak, *Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence From Litigation Against VCs*, 67 J. FIN. 2215, 2218 (2012) ("Overall, our findings indicate that reputational mechanisms discipline and deter widespread abuse of power by VCs, especially against founders."); John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 316 (2013) ("The entrepreneur's desire to maintain his reputation, we were told repeatedly, can and does serve to check his incentive to extract everything he can from the current venture.").

92. *See supra* Part I.C (discussing post-grant events requiring administration of stock options).

93. Alon-Beck, *supra* note 6, at 139 (discussing forums where startup employees are known to complain about stock options).

94. Thomas A. Smith, *The Zynga Clawback: Shoring up The Central Pillar of Innovation*, 53 SANTA CLARA L. REV. 577, 578–83 (2013) (describing the incident at Zynga based on press accounts).

95. *See id.*

96. *See id.*

97. Dave Lee, *Uber Employees Sue Over Stock Price Decline*, FIN. TIMES (Aug. 27, 2020), https://www.ft.com/content/234fb83c-f3fb-4ecd-b0a1-2c4d838d660e (on file with the *Journal of Corporation Law*).

98. *E.g.*, Evan Epstein & Abe Cable, *Startup Litigation Digest #2*, U.C. CTR. FOR BUS. L. S.F. (2023), https://startuplitigation.substack.com/p/startup-litigation-digest-2?r=3bftoe [https://perma.cc/T3FC-23NC] (describing litigation against a startup named Socure filed in U.S. District Court for the SDNY alleging that the company prevented a terminated founder from exercising stock options).

C. Strategic Lenity

Another insight from the consumer context is that we should not over-interpret facially one-sided contracts. In certain conditions, both consumers and sellers have a rational basis for granting sellers broad discretion in formal contract terms, even when actual policies are more consumer friendly.[99] This dynamic, which I will call strategic lenity, is not itself a mechanism for molding contracts to consumer interests. Rather, it is a reason to worry less about one-sided provisions that might otherwise cast doubt that informed minorities and post-transaction revelations operate as described above.

This theory starts by recognizing problems of incomplete contracting. Even engaged and informed consumers and sellers would have a difficult time writing contracts that cover all possible contingencies.[100] One strategy for coping with this problem is to allocate discretion to one of the parties. But which one? Law and economics scholars argue that it is most efficient to allocate discretion to repeat sellers, rather than consumers, if sellers are most constrained by reputation and are therefore most likely to exercise the discretion in good faith.[101] One account gives the example of a product return policy for a consumer item.[102] It might be hard to specify completely when a consumer should be entitled to a refund. The terms of sale might therefore define the return period narrowly (30 days) to police bad faith conduct by consumers, but the seller might have a considerably more liberal policy in practice due to reputational considerations.[103]

Once again, some contract law scholars are skeptical in the context of consumer contracts. Perhaps consumers do not refer to their contracts and make a stink when dissatisfied; even reading the contract might seem futile. Or perhaps consumers do glance at the contract, but discovering the one-sided exculpatory clauses only discourages the consumer from pursuing the matter.[104]

But, again, the theory is more plausible in the context of equity awards to startup employees. Take, for example, the standard clause in an equity incentive plan concerning sale or merger of the company discussed in Part I.C.2 above. In theory, the contract could attempt to specify when unvested options should carry forward and create a more rigorous method for determining the value of replacement awards. But so much depends on future considerations, such as the company's prospects and alternatives at the time of acquisition, the full extent of employee benefits resulting from the deal, and the compensation policies of the acquirer. Instead of trying to anticipate these contingencies ex ante, it may be rational for the informed minority to rely on the soft power of industry norms and reputational considerations.

99. *See* Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827, 828 (2006) ("When firms are influenced by reputational considerations, contracts that appear on paper to be one-sided against the consumer may in reality be implemented in a balanced way.").

100. *See id.* at 831 (giving an example of a publishing contract in which the author's failure to perform would not be "easily and accurately observable by the court").

101. *See id.* at 829–30.

102. *See id.* at 833-34.

103. *See id.*

104. *See* Becher & Unger-Aviram, *supra* note 70, at 206–07.

III. INDICATIONS OF UNINFORMED PRIVATE ORDERING

Part II lays out a plausible theory of how equity compensation arrangements might consider the interests of even passive and uninformed employees. But does that actually happen in any material way? One way to test the theory is to focus on how equity compensation practices adapt to changing market conditions. If these arrangements are subject to market discipline, we would expect them to evolve in value-enhancing ways, rather than persisting in a suboptimal state, when circumstances change.

In fact, the startup ecosystem *has* changed considerably in the last decade. It has been widely acknowledged that startups are staying private longer as they put off IPOs and rely on record levels of private funding at increasingly high valuations.[105] In this Part, I explore the ways in which this development stresses equity compensation arrangements and the ways in which the market has already reacted to partially relieve those stresses. The point of this analysis is not to argue that these market responses erase all concerns about employee-investors or that they are entirely motivated by concern for the interests of employees. Rather, I make the more modest argument that these developments at least *mitigate* current stresses on equity compensation and are *consistent* with the theory of uninformed private ordering presented in Part II above.

A. The Shift to RSUs

It is perhaps fitting that the most significant change to equity compensation in the unicorn era originated with one of the seminal unicorns: Facebook. In 2008, Facebook shifted from the traditional instrument of choice—stock options—to an entirely new instrument for startups—RSUs.[106]

In the context of a private company, an RSU is a right to receive a specified number of shares upon satisfaction of two conditions: (a) a service period and (b) an exit for the company within a specified period (usually 7 years). RSUs do not have an exercise price.[107] When the conditions for issuance are satisfied, shares are issued outright and without additional consideration.[108] Compared to an option, this is a substantial change in economic terms. The employee receives value even if the company's value stagnates or declines, and

105. Alon-Beck, *supra* note 6, at 179–80 (describing the trend of startups staying private longer); Cable, *supra* note 3, at 621–23 (describing differences between the dot-com era and the era beginning with Google and Facebook); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 459–61 (2017) (describing the causes of delayed IPOs).

106. *See* Aran, *supra* note 5, at 1287 (identifying 2008 as the year of the shift); Yifat Aran, *The RSU Time Bomb: Regulating Startup Equity Compensation in the Unicorn Era*, *in* RESEARCH HANDBOOK ON THE STRUCTURE OF PRIVATE EQUITY AND VENTURE CAPITAL 11–12 (Brian Broughman & Elisabeth de Fontenay, eds., 2023) (describing Facebook's pioneering shift from stock options to double-trigger RSUs).

107. The second "liquidity trigger" is designed to avoid dry tax. *See* Aran, *supra* note 106, at 1 (describing "Facebook-type" RSUs).

108. For an excellent summary of pre-IPO RSUs, see Francisco Palao-Ricketts & Eric Graffeo, *Part I: What Are 'Double-Vest' RSUs and Why Are They Making Headlines?*, GOODWIN (Feb. 16, 2023), https://www.goodwinlaw.com/en/insights/publications/2023/02/02_16-what-are-doublevest-rsus [https://perma.cc/MCJ7-QV4Ps]; *see also* Aran, *supra* note 106, at 1, 13 (describing the terms of double-trigger RSUs and comparing to stock options).

there is no need for the employee to pay an exercise price out-of-pocket and risk a financial loss.[109]

Over time, other mature startups followed Facebook's lead.[110] On average, startups now transition from options to RSUs after 5.5 years from incorporation and after reaching a post-money valuation of $1.05 billion.[111]

1. Why Options in the First Place?

To understand this new practice and how it relates to current market conditions, it is helpful to first revisit the reasons for using stock options in the first place from a tax, corporate law, and corporate finance perspective.

First, a stock option solves a potential tax problem. Neither founders nor employees want to incur taxation upon grant or vesting of pre-IPO equity interests for which there is no liquid market. This would result in "dry" tax, meaning tax liability without a source of funds from which to pay the taxes.[112] Founders avoid this undesirable result through a bit of transactional hocus pocus. They "buy" their stock with a collection of nascent intellectual property ("rights in the company's business plan" and the like). Because they do this when the value of the shares is still plausibly low (the company has not raised funds at a higher valuation yet), they avoid any tax on the date of purchase and pay advantageous capital gains rates upon eventual sale of the stock.[113] This same strategy, however, does not seem to work for rank-and-file employees. Presumably, that is because they do not have such rights to contribute, and even if they did it would become increasingly difficult to treat such amorphous rights as fair value for the stock as the company's valuation grows over time.[114] Accordingly, an option proves to be a far superior instrument from a tax planning perspective. As long as the option has an exercise price equal to fair market value

109. Alon-Beck, *supra* note 6, at 169–70 (discussing advantages of RSUs).

110. *See* Aran, *supra* note 106, at 2–3 (providing examples of prominent startups that use RSUs).

111. *See* Alon-Beck, *supra* note 6, at 169–70 (reporting that "[m]any companies" issue RSUs once they reach a valuation of $1 billion); Jared Thomas, *RSU vs. Stock Options*, CARTA (Dec. 8, 2023), https://carta.com/learn/equity/rsu-vs-stock-options/ [https://perma.cc/QZ8V-NUND].

112. *See* Francisco Palao-Ricketts, Eric Graffeo & L. Morgan Frisoli, *Part III: What Primary Mitigation Strategies Exist for Companies With Double-Vest RSUs That May Be Expiring?*, GOODWIN (Mar. 3, 2023), https://www.goodwinlaw.com/en/insights/publications/2023/03/03_02-part-iii-what-primary-mitigation-strategies#8 [https://perma.cc/63PS-L7M7] (explaining the concept of dry tax in the context of RSUs).

113. If the shares are subject to vesting (a requirement to remain in a managerial role for a specified period), the founder must make an election to be taxed at issuance rather than at vesting under IRC Section 83(b). *See* MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 375–77 (discussing the taxation of founders' stock). There is a lively academic debate regarding whether this tax treatment is appropriate. *See, e.g.*, Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60, 69–70 (2011) (highlighting the role that this tax treatment plays in creating inequality); Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 910–12 (2003) (suggesting, with some ambivalence, that this tax treatment might be an effective form of subsidy to high-tech startups); *see generally* Gregg D. Polsky & Brant J. Hellwig, *Examining the Tax Advantage of Founders' Stock*, 97 IOWA L. REV. 1085 (2012) (arguing that this tax treatment is revenue neutral from the government's perspective).

114. *See* Polsky, *supra* note 37, at 81 (explaining why a Silicon Valley startup would shift to stock options "once the stock has more than insignificant value").

on the date of grant, taxation is deferred until exercise for nonqualified stock options ("NSOs") or even to sale of the underlying shares for incentive stock options ("ISOs").[115]

Second, an option avoids unintended control and monitoring rights. As mere contracts to buy stock, options do not carry voting or inspection rights.[116] By issuing actual shares to founders and only options to employees, corporate planners avoid imbuing rank-and-file employees with voting rights that could translate into hold up rights for major corporate decisions and information rights that might divulge sensitive corporate and financial information more broadly than necessary. If one supposes that the intent of an equity grant was only ever to create a particular financial incentive structure, then a contractual right to equity is better suited to the task than actual stock and the nonfinancial rights that come with it.

From a corporate finance perspective, however, an option seems suboptimal for rank-and-file employees. The value of an option has considerably more downside risk than actual stock. Consider a company that has granted stock options to employees with an exercise price of $10 per share. If the company stagnates or experiences even a slight decline in value to $9.90 per share, the option is underwater and in a practical sense of no value to the employee.[117] Of course, companies can (and do) compensate for this downside risk by increasing the underlying share number of an option, thereby increasing the potential upside of the award.[118] But this volatility seems ill-suited to the risk-profile of the typical startup employee who has tied up his or her most valuable asset (human capital) in one investment and who might find a moderate (by Silicon Valley standards) payout to be life altering.[119] In the end, however, this drawback is outweighed by tax and legal considerations, especially in the company's early stages when exercise prices are still low enough to be trivial if there is a long period of company growth.

115. For a description of the basic differences between NSOs and ISOs, see sources cited *supra* note 37. For NSOs, the source of the exercise price requirement is IRC Section 409A. *See* David I. Walker, *The Non-Option: Understanding the Dearth of Discounted Employee Stock Options*, 89 B.U. L. REV. 1505, 1525–26 (2009). In the absence of Section 409A, IRC Section 83 would control the taxation of a NSO, and that provision would allow for a discounted exercise price. *See id.* at 1521–25 (indicating that discounted options would still be taxable only at exercise and not at vesting, except in very unlikely situations in which options might be treated as restricted stock). For ISOs, the exercise price requirement flows from both Section 409A and IRC Section 422, which requires an exercise price equal to grant date fair market value in order to receive the benefits of ISO treatment. *See id.* at 1526–27.

116. In fact, even after options are exercised, employees may have assigned away voting rights or may face coordination problems in effectively exercising voting rights. Aran, *supra* note 2, at 925 n.194.

117. Even an underwater option has value, which can be estimated with models such as the Black-Scholes-Merton Model. *See* Walker, *supra* note 115, at 1530–31. But that kind of value is likely to be something of an abstraction to the typical startup employee.

118. For example, the company might consider an option for 10,000 shares to be equivalent to a restricted stock grant for 2,500 shares. *See* Alon-Beck, *supra* note 6, at 170.

119. *Cf.* Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. RSRV. L. REV. 51, 86–90 (2015) (arguing that certain features of fiduciary law might be explained by relative appetite and capacity for risk as between founders and VC investors); Matthew Wansley, *Beach Money Exits*, 45 J. CORP. L. 151, 167–71 (2019) (discussing founders' non-diversifiable risk and diminishing marginal utility for large exits). Given the average startup employee's lack of diversification, this seems likely to be true even if the employee is relatively risk-tolerant compared to the average participant in the labor force. *See* Roach & Sauermann *supra* note 8, at 3632–33 (discussing the risk preferences of startup employees).

2. *The Effects of the Unicorn Phenomenon*

The unicorn phenomenon changes this cost-benefit calculation, especially in a company's later stages. For one, downside risk has been all too real for some later-arriving employees in unicorns. There are prominent examples of companies that eventually reached an IPO but seem to have completed most of their explosive growth at some point in their private-company phase, at least judging by the current stock price.[120] There are also examples of companies that were acquired for relatively large aggregate values but at prices that may have resulted in relatively low payouts to common stockholders due to layers of preferred stock liquidation preferences.[121] Such transactions can wipe out all or most spread for high-strike-price options, even when the company's exit might be judged a success for most investors and employees.[122]

These difficulties are potentially amplified by heightened information asymmetries between employee and company. As described in Part I above, an option potentially requires exercise decisions prior to an exit. Whether it is prudent to exercise an option depends on the value of the underlying common shares. But that can be exceedingly hard to determine for companies that have completed many rounds of preferred stock financing, with each round potentially carrying favorable features such as enhanced liquidation preferences and anti-dilution protections.[123] There is also a lot of noise in the unicorn era. Companies tout post-money valuations from preferred stock financings as status symbols, but these kinds of valuations are of questionable utility in valuing common stock.[124] For options granted early with trivial strike prices, the decision to exercise may be obvious even with these complicating factors. But for later-arriving employees with higher strike prices, these informational challenges significantly complicate exercise decisions. The problem is especially acute for terminated employees or employees reaching the end of a 10-year option term, who will be required to decide whether to pay the exercise and potentially incur tax without an IPO or acquisition to reveal a clear value of the underlying shares.

120. *See* Cable, *supra* note 48, at 26–29, 33–35 (identifying seven early unicorns with post lock-up trading prices below the price of the last private financing).

121. *See id.* at 38–40 (describing the example of Good Technology and identifying other early unicorns that sold for amounts below the company's last reported private valuation).

122. *See id.*

123. *See* Cable, *supra* note 3, at 638–40 (discussing how capital structures with multiple rounds of preferred stock complicate the exercise decision).

124. As corporate finance and corporate law scholars have detailed, a post-money valuation places a value on a new round of preferred stock and then imputes that per-share value to the common shares. Preferred stock, however, should carry a higher per-share value than common stock because of the financial preferences granted to preferred stock. As a result, post-money valuations systematically overstate company-wide and common value. *See generally* Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120 (2020); *see also* Robert P. Bartlett, III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation, in*, RESEARCH HANDBOOK FOR MERGERS & ACQUISITIONS 149–50 (Claire A. Hill & Steven Davidoff Solomon eds., 2016) (discussing reasons why valuations from preferred stock financings are not appropriate measures of company-wide value).

3. How RSUs Help

RSUs speak directly to these challenges of plateauing valuations and opaque capital structures.[125] In the example provided above, where a company's per share value declined from $10 to $9.90, the RSU would still spit out stock worth $9.90 per share, and it would do so without any exercise decision by the employee.[126] The employee would experience a compensation decline proportionate to the valuation decline, rather than a total wipe out of option spread. While it is true that this downside relief comes at the expense of some upside potential compared to holding an equivalent grant of stock options,[127] the tradeoff seems well suited to the typical employee, whose utility function and personal financial situation were never an ideal fit for options in the first place.[128]

In addition to this superior risk-profile, an RSU requires fewer investment decisions. Because RSUs are simply settled rather than exercised, the employee does not need to make any decision if employment terminates.[129] He or she simply waits to see whether the liquidity condition is satisfied or not.[130]

To be clear, RSUs do not solve every problem. To delay taxation until a liquidity event, an RSU must have a relatively short fuse, on top of the service and liquidity conditions. This is because IRC Section 409A effectively mandates that an RSU have a seven-year time limit, essentially precluding the use of RSUs in the early stages.[131]Some companies are now approaching the end of that seven-year runway without great options for extending awards.[132]

It is also not the case that companies use RSUs for entirely employee-regarding reasons. When Facebook began the practice, it was likely motivated by the desire to stay under the threshold for public company status under federal securities laws and by accounting

125. Francisco Palao-Ricketts & Eric Graffeo, *Part II: Why Do Private Companies Shift From Stock Options to Double-Vest RSUs?*, GOODWIN (Feb. 23, 2023), https://www.goodwinlaw.com/en/insights/publications/2023/02/02_23-part-ii-why-do-private-companies [https://perma.cc/7ACL-NWYJ] (discussing problems with stock options at "high-value companies" where employees "perceive less opportunity" for future growth).

126. *See* Aran, *supra* note 106, at 13 (comparing options and RSUs).

127. Alon-Beck, *supra* note 6, at 170 (explaining the RSUs have "less upside potential" than options).

128. *See* discussion *supra* note 119.

129. *See* Aran, *supra* note 106, at 13 (comparing options and RSUs).

130. *See id.*

131. This is apparently driven by IRC Section 409A, which would impose tax upon satisfaction of time-based vesting conditions were it not for the "substantial risk" of not satisfying the exit-based vesting condition. By adding a seven-year time limit to the exit-based vesting condition, such condition is at substantial risk of not being satisfied. *See* Sinead M. Kelly, *Double-Trigger RSUs and the Question of the Seven-Year Term*, BAKER MCKENZIE (2022), https://www.bakermckenzie.com/-/media/files/insight/guides/2022/doubletrigger-rsus-and-the-question-of-the-sevenyear-term.pdf [https://perma.cc/G72J-HRFK]; *see also* Aran, *supra* note 106, at 1–2 (stating that the seven-year period is driven by Section 409A of the US Internal Revenue Code (IRC)).

132. *See* Aran, *supra* note 106, at 2–3 (citing Stripe, Airbnb, and Foursquare as examples); Palao-Ricketts, Graffeo & Frisoli, *supra* note 112 (discussing the drawbacks of issuing replacements awards or attempting to cash out existing awards).

advantages.[133] Today, industry publications tout RSUs for causing less dilution than stock options.[134]

For purposes of this Article, however, the emergence of private-company RSUs does not need to be either a perfect solution or entirely employee-regarding to support Part II's vision of uninformed private ordering. The bottom line is that a mutually beneficial alternative to stock options was on offer at just the time when the traditional option instrument made less sense for later-arriving employees. The startup labor market, despite its no-read problem and myopic focus on absolute share numbers, took the bit. One plausible explanation is that an informed minority understood the subtle case for the change, and the average (uninformed) employee went along for the ride, believing that things would work out.

B. Employee Liquidity Programs/Secondary Markets

RSUs are not the only market development that has spun out of Facebook's unusually long incubation period. Facebook's ascent also sparked secondary markets and "liquidity programs" that allow employees to realize value before an exit transaction.

1. The Traditional Model: Mutual Lock-In

In the traditional model, startup employees waited for liquidity along with founders and other investors. The implicit bargain was mutual lock-in: nobody cashed out until everyone cashed out.[135] This arrangement maintained incentives on everyone's part to march the company toward an exit transaction.[136] Mutual lock-in was enforced through a combination of contractual rights, regulatory restrictions, and market realities that prevented shareholders, including employees who exercised options, from selling shares. Conversely, the only way for an investor to acquire shares of a startup was to purchase new shares from the company in a capital-raising or "primary" transaction.

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133. *See* Aran, *supra* note 5, at 1287; Victor Fleischer, *Why Facebook Is Paying the Tax Tab on Employee Compensation*, N.Y. TIMES DEALBOOK (Sept. 10, 2012), https://archive.nytimes.com/dealbook.nytimes.com/2012/09/10/why-facebook-is-paying-the-tax-tab-on-employee-compensation/ [https://perma.cc/8JXR-7PLA] (explaining how RSUs helped Facebook delay public-company status); Jessica Love, *Facebook's Accounting Ruse With RSUs*, KELLOGGINSIGHT (Apr. 8, 2013), https://insight.kellogg.northwestern.edu/blogs/entry/facebooks_accounting_ruse_with_rsus [https://perma.cc/FJT6-4QZ6] (discussing accounting advantages of RSUs over stock options).

134. *See* Palao-Ricketts & Graffeo, *supra* note 125 (identifying less dilution as an advantage of RSUs over options).

135. *See* Steve Blank, *How to Make Startup Stock Options a Better Deal for Employees*, HARV. BUS. REV. (Apr. 3, 2019), https://hbr.org/2019/04/how-to-make-startup-stock-options-a-better-deal-for-employees [https://perma.cc/VY8E-CM5A] ("All employees – founders, early employees (who received far fewer options than founders, but more than later hires), and later ones all had the same vesting deal, and no one made money on stock options until a 'liquidity event.'"). *C.f.*, Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 8–10 (2012) (discussing investor lock-in and the venture capital model).

136. *See* Blank, *supra* note 135 ("The rationale was that since there was no way for investors to make money until then, neither should anyone else. Everyone—investors, founders, and startup employees—was in the same boat.").

2. *The Emergence of Secondary Markets*

As detailed by other legal scholars, mutual lock-in began to erode in the run-up to Facebook's 2012 IPO. A new species of intermediary—or "secondary market"—emerged. It sought to take advantage of strong investor demand for the pre-IPO stock of Facebook and its contemporaries by matching buyers and sellers in private transactions.[137] At the time, it was unclear whether these markets would survive past the Facebook frenzy.[138]

The successors to these original secondary markets now facilitate a variety of transaction forms.[139] Some secondary markets primarily match buyers and sellers on an ad hoc basis.[140] The more successful secondary markets contract with companies to facilitate various forms of "liquidity programs."[141] These company-sponsored liquidity programs might involve the sale of shares to a VC investor as a complement to a planned primary offering, an auction of company shares on terms controlled by the company, or a repurchase of shares by the company on a one-time basis or at regular intervals.

As with other components of entrepreneurial finance, trading volume on secondary markets fluctuates. Activity appears to have peaked in 2021 when the two largest players, Nasdaq Private Markets and CartaX, enthusiastically reported total trading volume of $13 billion and $7.4 billion, respectively.[142] By 2022 trading volume at Carta had declined by more than 50% from 2021 levels.[143] Nasdaq Private Market did not reveal its total trading volumes for 2022 but reported that for parts of the year, "private markets were, for all

137. *See* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 193 (2012) (describing SecondMarket and SharesPost as "fueled by demand for pre-IPO stock in highly visible venture capital-backed companies such as Facebook, Twitter, Groupon, LinkedIn, and Zynga").

138. *See id.* at 196 ("[I]t remains to be seen how Facebook's transition into a public company will affect the secondary trading marketplace.").

139. The original secondary markets have now been acquired and operate under new names. SharesPost is now operated by Forge Global (formerly Equidate). SecondMarket is now operated by Nasdaq Private Market. Other major secondary markets are CartaX and EquityZen.

140. Forge and EquityZen are examples of platforms that facilitate individual transactions between buyers and sellers. *See* David F. Larcker, Brian Tayan & Edward Watts, *Cashing It In: Private-Company Exchanges and Employee Stock Sales Prior to IPO*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 9, 2018), https://corpgov.law.harvard.edu/2018/10/09/cashing-it-in-private-company-exchanges-and-employee-stock-sales-prior-to-ipo/ [https://perma.cc/QV2V-E682] (comparing EquityZen and Nasdaq Private Market); Jared Klee, *Fat Tailed Thoughts: How to Sell Your Startup Equity*, FINTECH & FIN. (Feb. 11, 2022), https://fat-tailedthoughts.substack.com/p/fat-tailed-thoughts-startup-secondaries [https://perma.cc/2C8B-KQ4X] (comparing EquityZen and Forge to CartaX and Nasdaq Global Market).

141. *See* Pollman, *supra* note 137, at 196–99 (discussing the evolution of SecondMarket from a broker of individual transactions to a facilitator of company liquidity programs). Nasdaq Private Market and CartaX are examples of secondary markets that assist with company-sponsored liquidity programs in which the company repurchases shares or controls the terms of an auction process for the company shares. *See* Larcker, Tayan & Watts, *supra* note 140; Klee, *supra* note 140.

142. *See* Peter Walker, *The 2021 Carta Liquidity Report*, CARTA (Jan. 25, 2022), https://carta.com/blog/the-2021-carta-liquidity-report/ [https://perma.cc/GF5Z-J6JE] (discussing the exceptional venture capitalist funding in 2021); NASDAQ PRIV. MKT., 2021 ANNUAL PRIVATE MARKET REPORT (2021), https://www.nasdaqprivatemarket.com/category/market-reports/ [https://perma.cc/QQ76-VSUB] (highlighting NASDAQ 2021 Private Market Reports).

143. *See* Kevin Dowd, *The Carta Liquidity Report: 2022 in Review*, CARTA (Jan. 26, 2023), https://carta.com/blog/liquidity-report-q4-2022/ [https://perma.cc/W2ZJ-G772] (reporting 2022 trading volume of $3.1 billion).

intents and purposes, closed."[144] Only one platform, Forge, consistently releases quarterly trading volume because it is a publicly traded company. In the first six months of 2023, it reported a trading volume of approximately $280 million, down from $750 million in the first six months of 2022.[145] The news in 2024 was mixed. Carta announced that it would shut down portions of CartaX due to perceived conflicts with its core business, but Carta also indicated it would continue to facilitate company-sponsored liquidity programs.[146] In an encouraging development, OpenAI moved ahead with a large purchase of shares from employees despite the controversy surrounding the company's founder.[147] In general, 2024 was considered a rebound year for secondary markets.[148]

Current market fluctuations aside, secondary markets constitute a meaningful and mutually beneficial response to lengthening private status. Traditionally, equity compensation has proven a powerful tool for binding employees to successful startups, with employees understandably hesitant to face the difficult exercise decisions and tax traps accompanying former employee status.[149] However, the typical early employee is not as well situated as the average VC to serve as ultra-patient capital while the company optimizes the timing of an IPO in the unicorn era.[150] Therefore, secondary markets solve a morale problem by trickling out just enough liquidity to keep the workforce motivated.[151]

3. *Relationship to Formal Contracts*

Besides being an employee-friendly alteration to the incentive bargain between company and employee, secondary markets and liquidity programs are relevant to this Article's analysis because of how they interact with formal stock option agreements. More specifically, it is informative that stock option agreements do *not* acknowledge or allow these transactions, meaning that they depend entirely on the approval and goodwill of companies. In other words, they are an example of strategic lenity—a generous implementation by the company of a one-sided contract.

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144. NASDAQ PRIV. MKT., STATE OF THE PRIVATE MARKET 3 (2023), https://www.nasdaqprivatemarket.com/wp-content/uploads/2023/11/2022-Annual-Private-Market-Report.pdf [https://perma.cc/UU7Z-DTY3].

145. Forge Global Holdings, Inc., Quarterly Report (Form 10-Q) 36 (Aug. 8, 2023).

146. *See* Marc Vartabedian, *Carta, a Key Silicon Valley Player for Startups, Stumbles, Prompting Customers to Consider Competitors*, WALL ST. J. (Jan. 12, 2024), https://www.wsj.com/articles/carta-a-key-silicon-valley-player-for-startups-stumbles-prompting-customers-to-consider-competitors-89800bb8 (on file with the *Journal of Corporation Law*) (discussing the consequence of accessing customer data leading them to competitors).

147. *See* Shirin Ghaffary, Ed Ludlow & Gillan Tan, *OpenAI Tender for Employee Shares Is on and Extended to Jan. 5*, BLOOMBERG L. (Dec. 1, 2023), https://news.bloomberglaw.com/artificial-intelligence/openai-tender-for-employee-shares-is-on-and-extended-to-jan-5# (on file with the *Journal of Corporation Law*) (discussing the OpenAI tender offer).

148. *See* Sarah McBride, *Silicon Valley's Secondary Markets Are Bigger Than Ever*, BLOOMBERG L. (Dec. 18, 2024), https://news.bloomberglaw.com/private-equity/silicon-valleys-secondary-markets-are-bigger-than-ever (on file with the *Journal of Corporation Law*).

149. Aran, *supra* note 5, at 1263–67 (describing how stock options serve to bind employees to successful startups).

150. *See* Ibrahim, *supra* note 135, at 17 ("Both entrepreneurs and employees may have all their financial and human capital tied up in the start-up and wish to diversify.").

151. Secondary markets may also serve a housekeeping function by clearing the cap table of former employees. *See* Larcker, Tayan & Watts, *supra* note 140 (indicating that companies frequently allow former employees to transfer shares in secondary markets). Former employees might be undesirable shareholders because of litigation risk or non-responsiveness in the event of an acquisition.

Sometimes, a stock option plan, option agreement, or company bylaw contains an express prohibition on secondary transfers of shares acquired through stock options. The language resembles the following:

> Notwithstanding anything to the contrary, no Participant or other stockholder shall Transfer (as such term is defined below) any Shares (or any rights related to or interests in such Shares) acquired pursuant to any Award (including, without limitation, Shares acquired upon exercise of an Option) to any person or entity unless such Transfer is approved by the Company prior to such Transfer, which approval may be granted or withheld in the Company's sole and absolute discretion.[152]

More commonly, a stock option agreement indirectly prevents unauthorized secondary transactions by subjecting all sales to an onerous right of first refusal in favor of the company.[153] On its face, such a provision does permit transfers of shares acquired through options, but only after the employee first offers the shares to the company for repurchase on the negotiated terms. In fact, it is practically difficult to arrange a sale to a third party who knows the company can swoop in and buy the shares out from under the deal.[154] A right of first refusal, therefore, functions more like an approval right as the company is asked to waive its rights in advance of a proposed transaction. Companies apparently use rights of first refusal because there is some legal uncertainty about a complete prohibition on transfers.[155]

How could the emergence of secondary markets—such an important alteration of the incentive bargain between startup and employee—be absent from the formal contracts, which leave all discretion to approve secondary sales with the company? In the nomenclature of Part III above, company approval or facilitation of secondary sales are examples of strategic lenity. It would be difficult to write a contract that completely specifies when and how an employee can partially cash out. Whether a secondary transaction is in the mutual interest of the employee and startup might depend on the company's cash requirements, the prospects of an impending exit, the status of the employee, and the identity of the proposed purchaser. The parties respond to this difficulty by leaving the action in one party's hands. The company is the natural choice because of its need to keep its workforce motivated and broader reputational concerns, which constrain the company's actions.

Returning to our motivating question of how worried we should be that employees do not read or negotiate their stock options agreements, the example of secondary markets serves as a reminder that a one-sided contract does not necessarily evidence a one-sided relationship between employee and company.

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152. *See* Orrick Plan, *supra* note 34, § 12(a).

153. *See* Carta Option Agreement, *supra* note 42, § 11 (demonstrating a stock option agreement template).

154. MAYNARD, WARREN & TREVIÑO, *supra* note 27, at 384–86 ("The reality is that rights of first refusal are a powerful chill on the shareholder's ability to sell the covered shares.").

155. *See id.*

IV. Policy Implications: Building on What Works

Currently, the loudest calls for reform of equity compensation at startups come from securities law scholars and regulators.[156] These reform proposals tend to rely on the key tool of public-company regulation: extensive disclosure of financial statements.[157] While this focus may be understandable given the strong pedigree of that regulatory tool in federal securities law, it is incongruent with this Article's analysis.

In public markets, financial disclosure effectively protects most investors because trading markets digest the information and reveal its significance through prices.[158] Because private markets lack that powerful mechanism, the typical startup employee, who has a demonstrated inability or unwillingness to seriously investigate even relatively basic information,[159] has little chance of deriving meaningful conclusions from financial statements.

One proposed response is to lower the threshold for mandatory status as a public company—forcing mature startups to go public earlier and list shares for trading. Congress has visited and re-visited this issue,[160] and it is an open empirical question whether the current approach of allowing a relatively long period of private status is producing social costs or benefits.[161] Whatever one's views on this issue, it would be a *fundamental* reform of U.S. securities laws to impose public-company regulation on a large percentage of startups, and enacting such a reform in the name of startup employees should be motivated by a *fundamental* failure of the current hands-off approach to equity compensation at private companies.

This Article, however, largely vindicates the current approach to regulating equity compensation at startups. Competition for talent, the necessity of maintaining employee morale, reputational concerns, and the practical necessity of standardizing compensation contracts across employees combine to constrain companies and mold prevailing compensation practices in employee-regarding ways. These dynamics appear to provide a substitute form of investor protection that largely justifies generous securities law exemptions for equity compensation.[162]

That is not to say, however, that effective private ordering necessitates a completely hands-off approach or that existing law is optimal. At least three directions for reform follow from this Article's analysis: (1) abbreviated disclosure suitable to startup employees, (2) disclosure of information to the SEC as a condition to exemption, and (3) elimination of tax traps and distortions.

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156. *See supra* notes 6 & 7 (describing calls for reform).

157. *See id.*

158. *See* Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253, 2259–60 (2014).

159. *See supra* notes 52–56 (reviewing evidence of employee indifference and misunderstanding).).

160. *See* Cable, *supra* note 3, at 624–28 (describing the reform history of Section 12(g)).

161. *Compare* Alexander I. Platt, *Unicorniphobia*, 13 HARV. BUS. L. REV. 115, 154–79 (2023) (arguing that allowing startups to operate in stealth mode has produced social benefits) *with* George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J.L. & BUS. 221, 283–86 (2021) (arguing that longer private company status diminishes the role of securities regulation in providing widespread transparency benefits).

162. *See* Cable, *supra* note 158, at 2277–84 (surveying private-placement exemptions and identifying mechanisms for investor protection that can potentially substitute public-company regulation).

A. Selective Disclosure to Employees

The consumer contract literature offers one direct lesson for equity compensation policy: tailor any required disclosure to the limited attention span of the audience. If a contracting party demonstrates limited ability or desire to read or negotiate contracts, then only the pithiest display of information stands a chance of being absorbed.[163]

In the equity compensation literature, one proposal takes a similar approach and deserves serious consideration. Yifat Aran has recommended that Rule 701, pursuant to which equity compensation is issued under federal securities laws, be reformed to prioritize the most essential information. Specifically, Aran proposes that Rule 701 center disclosure on liquidation scenarios that communicate the payouts to an individual employee at different company valuations.[164] This proposal cuts to the chase in potentially mitigating the complexity of later-stage capital structures without divulging the kind of commercially sensitive information contained in financial statements.[165]

B. Disclosure to SEC

Currently, Rule 701 is a self-executing exemption. That means issuers do not make even a basic informational filing to claim the exemption. When it comes to equity compensation, therefore, we do not have even rudimentary data of the type reported on Form D for Rule 506 offerings.

Policy makers and researchers could better understand the successes and shortcomings of the equity-compensation market if there were a Form D equivalent for Rule 701. Such a "Form 701" should at least include types of awards (options versus RSUs), underlying share numbers, and exercise prices for options. Such information would help regulators assess future reforms by shedding light on the extent and nature of equity compensation.

Issuers may claim that some of this information—exercise price in particular—is proprietary or sensitive. While those kinds of objections may be valid regarding detailed financial information,[166] they seem less compelling when it comes to share price.

C. Fixing Tax Traps and Distortions

To the extent this Article points towards more fundamental reform, those efforts are best reserved for tax policy rather than corporate or securities law. That is because a major theme of this Article is the formative, and sometimes distorting, role of tax planning. To recap, core features of options and RSUs are driven by the Internal Revenue Code and implementing regulations, including: the use of stock options rather than other instruments in early stages,[167] setting the exercise price of options at fair market value on the grant

163. *See* Ayres & Schwartz, *supra* note 70, at 580–81 (proposing that some contract terms be placed in an "unexpected terms" box as a condition to enforcement).

164. Aran, *supra* note 2, at 952–55.

165. *Id.*

166. *Id.* at 930–42 (acknowledging that disclosure of financial information is sensitive but disagreeing with issuer claims that information regarding capital structure is similarly sensitive).

167. *See supra* Part I.C (describing tax reasons why companies use options).

date,[168] the 90-day exercise period for options after leaving employment,[169] the 10-year term on options,[170] the double-trigger vesting scheme for RSUs,[171] and the seven-year term on RSUs.[172]

Some of these examples are distorting in the sense of potentially crowding out alternative arrangements that might be superior in a world without taxes. Maybe, for example, startups and employees would prefer in-the-money options with exercise prices somewhere between zero and grant-date fair market value.[173] From a risk-reward perspective, this instrument would represent a kind of midway point between traditional options and RSUs that might appeal to moderately risk-preferring,[174] but under-diversified, employees. Yet tax law effectively prohibits in-the-money options. With so many features of compensation dictated by tax planning, it seems likely that some mutually beneficial innovations are never even seriously explored.

Other tax-driven features of equity compensation just seem arbitrary and punitive. An employee who is laid off from a job in one of Silicon Valley's occasional downturns will not appreciate the time pressure ISO rules impose by prescribing a 90-day exercise window,[175] or an employee at a unicorn may have provided exemplary service for years only to see significant RSU value vanish into thin air because the IPO market hits a snag and Section 409A imposes a seven-year deadline.[176] One could add to these examples other tax traps, such as alternative minimum tax and price declines between settlement of RSUs and the end of a lock-up period.[177] In short, the equity compensation system mostly works in the aggregate, but it has some sharp edges in individual cases.

To date, the major legislative effort to address these issues is a flop. In 2018, Congress enacted IRC Section 83(i), which defers taxation of option exercises or RSU settlement for up to five years.[178] This reform may be directionally right in that five years of tax deferral *might* help avoid dry tax, but it is clumsy in the details. For one, a five-year deferral just kicks the can down the road. With today's long incubation periods, for example, an employee who exercises an option upon termination might still face dry tax five years later if the company still has not exited. In addition, Section 83(i) is conditioned on at least two problematic requirements that do not align with prevailing practices in Silicon Valley. One of these requirements is that 80% of a company's employees receive options or RSUs, as

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168. *See id.* (identifying IRC Section 409A and Section 422 as the reasons for setting exercise prices at fair market value on grant date).

169. *See id.* (describing requirements for ISO treatment, including the 90-day limit).

170. *See id.*

171. *See* sources cited *supra* note 107 (indicating that the liquidity trigger in a Facebook-style RSU is intended to avoid dry tax).

172. *See generally* Kelly, *supra* note 131 (indicating that the seven-year term is motivated by Section 409A).

173. *See* Walker, *supra* note 115, at 1509 ("[T]heorists have demonstrated that in many cases, the best option design, from a standpoint of optimizing incentives and risk, would be a discounted option.").

174. *See* sources cited *supra* note 22 (discussing the risk preferences of startup employees).

175. *See* Part I.C (describing requirements for ISO treatment, including the 90-day limit).

176. *See* Aran, *supra* note 106 (identifying companies that have reached or approached the seven-year limit without a triggering liquidity event).

177. *See* sources cited *supra* note 67 (discussing the potential application of Alternative Minimum Tax upon exercise of ISOs); *see also* Lee, *supra* note 97 (discussing a lawsuit against Uber alleging that its early settlement of RSUs increased tax liability of employees).

178. *See* Alon-Beck, *supra* note 6, at 187–91 (describing Section 83(i)); Aran, *supra* note 5, at 1266 n.169 (describing Section 83(i) and its limitations).

applicable, under the relevant plan in the election year.[179] This requirement of broad participation might be okay in spirit, but it is out of step with the usual pace of equity grants, which are made to batches of different employees in different years.[180] The other problematic requirement is that companies refrain from certain repurchases of stock.[181] This requirement potentially disqualifies companies with employee-friendly liquidity programs of the type described in Part III.B above. As one law firm memo concluded: "it is hard to imagine a situation where [Section 83(i)'s] limited benefits would outweigh the burdens to both employee and employer."[182]

Perhaps it is time for tax scholars and policymakers to consider more meaningful tax reform. In particular, maybe tax law should be less prescriptive of equity compensation contracts and try to reflect the market reality that pre-IPO equity has only speculative value that does not yet warrant tax realization. Achieving this kind of reform in the United States requires a variety of changes and deserves its own article-length treatment. At a high level, candidates for alteration include Section 409 concerning deferred compensation arrangements and Section 422 concerning requirements for ISO treatment.[183]

The application of Section 409A to private company equity compensation has been head-scratching from the start. Congress enacted these heavy-handed provisions in response to perceived abuses of deferred cash compensation by executives at Enron—a large and notorious public company.[184] By the time the reforms were completed and implemented, they imposed strict requirements on equity compensation at startups.[185] It is hard to see the connection between the motivating incidents at Enron and pre-IPO stock options and RSUs. Yet Section 409A has effectively prohibited in-the-money options at startups and has been a key factor in creating the current "RSU time bomb" because of industry perceptions that the provision requires a seven-year time limit on RSU awards.[186] Congress or Treasury could consider exempting private company equity compensation from these regulations.[187]

Section 422 regarding ISO status also deserves attention. At first blush, these ISO rules look like an accommodation to startup employees. ISO treatment generally allows the option holder to defer taxation to sale of the underlying shares—meaning that no tax is incurred at exercise. This is crucial relief for a former or long-term employee forced into an exercise decision prior to a liquidity event. However, Section 422's favorable tax treatment comes at a puzzling cost to employees: the option must be granted with an exercise

179. John Aguirre et al., *Practical Implications of Section 83(i) Option and RSU Tax Deferral,* WILSON SONSINI (June 19, 2018), https://www.wsgr.com/en/insights/practical-implications-of-section-83-i-option-and-rsu-tax-deferral.html [https://perma.cc/BRL7-NNUJ].

180. *See* Part I.B (discussing how companies issue tranches of options to new hires).

181. *See* Aguirre et al., *supra* note 179.

182. Victoria H. Zerjav, *Section 83(i): Considerations and Pitfalls for Private Employers*, HOLLAND & KNIGHT (Mar. 12, 2019), https://www.hklaw.com/en/insights/publications/2019/03/section-83i-considerations-and-pitfalls-for-privat [https://perma.cc/Q3RL-DFKJ].

183. *See supra* notes 37, 115, 131 (discussing the effects of Sections 422 and 409A).

184. *See* Gregg D. Polsky, *Fixing Section 409A: Legislative and Administrative Options*, 57 VILL. L. REV. 635, 641–42 (2012).

185. *Id.* at 644–45.

186. *See* Aran, *supra* note 106, at 1.

187. *See* Polsky, *supra* note 184, at 635–51 (considering Treasury's authority to exempt private companies from 409A).

at grant-date fair market value (no in-the-money options), the option must be exercised within 90 days of employment ending, and the option must have an overall 10-year limit. Due to these conditions, the ISO rules may create almost as many problems as they solve for startup employees. Policymakers should consider easing these conditions, at least for private companies.

While such an approach might be viewed as unduly favorable,[188] it is not without precedent. Advantageous treatment is *already* on offer, after all, for employees who receive ISOs, but only after the company and employee run Section 422's gauntlet of suboptimal mandated terms and holding periods.[189] It is a strange system that offers numerous subsidies to startups,[190] founders,[191] and investors[192] while subjecting rank-and-file employees to this unpredictable and sometimes harsh tax environment. Israel, which has one of the more robust venture-capital markets outside of the United States, treats startup employees more generously and predictably.[193] Under the Israeli tax system, taxation of equity compensation may be deferred until a liquidity event if relatively accommodating conditions are met such as an election by the company and placement of the equity in an escrow account until taxation.[194]

Conclusion

This Article presents a new perspective on equity compensation in the unicorn era. In this telling, the driving force behind take-it-or-leave-it contracts is not exploitation but rather an institutional imperative of standardization. The standard arrangements produced by this system are not as one-sided as sometimes portrayed, even if there are occasional pitfalls. In the aggregate, the presence of an informed minority and reputational constraints impose a helpful market discipline that can adjust to changing conditions. Such a glass-half-full perspective does not dictate a hands-off policy approach, but it does suggest a new policy agenda that builds on the system's historical successes.

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188. *See* Donald B. Marron, How Should Tax Reform Treat Employee Stock and Options? 6–7 (2017), https://www.taxpolicycenter.org/publications/how-should-tax-reform-treat-employee-stock-and-options [https://perma.cc/W5BU-8E2D] (raising concerns that a proposal for advantageous treatment of stock options would favor equity over cash compensation but offering a technical solution of imputed interest); *c.f.*, Fleischer, *supra* note 113, at 69–70 (raising concerns that advantageous tax treatment of founders' stock contributes to income inequality). Full ISO treatment includes not only deferral of realization until sale of the shares, but also taxation at favorable capital-gains rates. *See generally* Maynard, Warren & Treviño, *supra* note 27. This Article's focus is primarily on the timing issue. Perhaps capital-gains treatment *is* a bit too generous to expect for all private-company equity compensation.

189. *See* Maynard, Warren & Treviño, *supra* note 27, at 360–64 (describing the challenges to obtaining the full benefits of ISO treatment).

190. *See* Abraham J.B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-ups*, 2 Mich. J. Priv. Equity & Venture Cap. L. 195, 202–08 (2013) (describing state and federal programs providing for investment in local startups).

191. *E.g.*, Gilson & Schizer, *supra* note 113, at 909–15 (describing favorable treatment of founders' stock as a form of subsidy).

192. Manoj Viswanathan, *The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (or More) Tax-Free*, 120 Colum. L. Rev. F. 29, 35–38 (2020) (describing significant tax subsidies to investors through the qualified small business stock exclusion of IRC Section 1202).

193. Aran, *supra* note 106, at 17–23.

194. *Id.* at 15–17.