

# Playing with Fire: Loans to Exercise Options

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There is a current debate as to whether we are in a period of high valuations, irrational exuberance or a down-right bubble. I don't know, but I have seen one artifact from the actual bubble rear its ugly head in recent times: the use of loans to exercise stock options. In short, it is an extraordinarily dangerous thing to do with potentially very damaging consequences.

## The Basics

Currently, the federal long term capital gains rate is capped at 20 percent and the income tax rate for top earners is 39 percent. In general, individuals who sell shares that have been held for at least one year are taxed at the lower cap gains rate, while those who sell shares that have been held for less than a year are taxed at the higher income tax rate. This means if your clients receive a stock option and don't exercise it in advance, they will be taxed at a rate that is 20 percent higher. Accordingly, for startup employees there can be a big tax benefit to purchasing shares so that the lower rate will apply upon a successful exit.

Unfortunately, with today's high valuations, many employees are unable to afford to exercise their stock options. This is particularly true for higher level employees joining promising startups that already have traction. These folks tend to have large option grants — and such companies have expensive shares — so exercising options is often cost prohibitive for all but the wealthiest employees.

One potential workaround is a loan. A company can loan its employees money to exercise their options. In these situations the money doesn't even change hands. The employee signs a note promising to pay the company the required exercise amount sometime in the future and the employee uses that note to pay the exercise price of the option. The transaction is neutral to the company and the employee's tax position is improved. What could possibly be wrong with this?

## The Rub

For one thing, from the Internal Revenue Service's perspective, the long term capital gains holding period only begins when the shares are "purchased." If the purported purchase is made by use of a loan, that purchase will only be considered valid if the borrower has a personal liability to pay all or a substantial part of such indebtedness. So if the loan is a nonrecourse loan (i.e., the company can only go after the shares as collateral if the loan is not repaid), the IRS does not regard this as a sale. Accordingly, the note holder (the company) must have recourse to the assets of the buyer (the employee) to start the capital gains clock ticking (i.e., the borrower will be personally liable for at least a substantial portion of the loan).

## The Reality

Employees entering into such transactions have often gotten comfortable that the loan isn't "real"; in their minds, the company is certain to be successful so the loan will easily be repaid from the massive proceeds of a stock sale in the inevitable IPO, or (worst case) profitable acquisition. If anything were to go wrong, the management team would work something out with the impacted employees. The problem is what happens when the ship goes down.

While everyone thinks that their startup will be a success, the fact is that many, many startups fail. While some do so in tidy ways that involve the orderly repayment of creditors or an acqui-hire, many simply fold up shop without repaying their creditors. Even with well-intentioned management, startups often find themselves shutting their doors in a situation with assets worth far less than their liabilities. When that happens, the creditors effectively own the company (whether through a formal bankruptcy or another process) and appoint a person acting on their behalf to comb through all the company's assets to see how they can recover the money they are owed. The loans that employees used to exercise their options are

among those assets. Unsurprisingly, the creditors want these notes to be repaid.

I'm writing this because I've seen this go wrong — badly wrong. When the technology bubble burst in 2001, many people who had used loans to exercise options ended up being very surprised when those loans came due. First off, the shares that they owned were worthless. Secondly, the board and officers had often resigned en masse, leaving the affairs of the company to be run by a committee of creditors (or a person appointed by such a committee).

These creditor committees were relentless in their desire and ability to extract assets from noteholders. They foreclosed on people's houses and cars, put liens on bank accounts, and sought garnishment of future wages. The former board members and officers had no authority to stop this process. During this period, I received numerous distressed calls from former employees of once high-flying companies. They were generally shocked to find out that they had to repay the money that they had borrowed.

If your clients have the assets to pay the loan off, but would prefer to put the cash to work elsewhere, it might be a reasonable risk to use a loan to exercise stock options. The bottom line, however, is that your clients should only borrow this money if they can afford to pay it back. That seems like common sense, but in good times such as these, our collective common sense seems to fail us. This problem is compounded by the survivor-biased reporting of employees of successful companies who wish (with the benefit of 20/20 hindsight) that they had exercised their options early. It's great to exercise options as a tax planning device, but don't let the tax tail wag the economic dog.

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