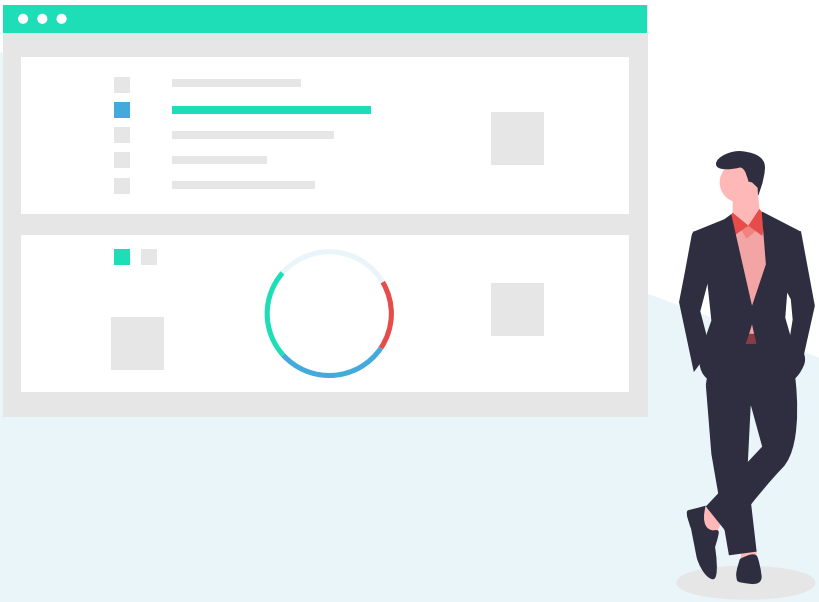
Ledgy

Employee stock option plan

The creation of an employee incentive plan has primarily two goals:

- Reward employees for choosing to go on a path with a new company and give them a stake in the possible payout.
- Give employees the opportunity to have ownership in the company.



What is an employee stock option plan?

A stock option plan, also called ESOP is a very common employee incentive plan in Europe.

Options grant the holder the **right** – but not the obligation – to buy company stock at a set price, at a certain date.

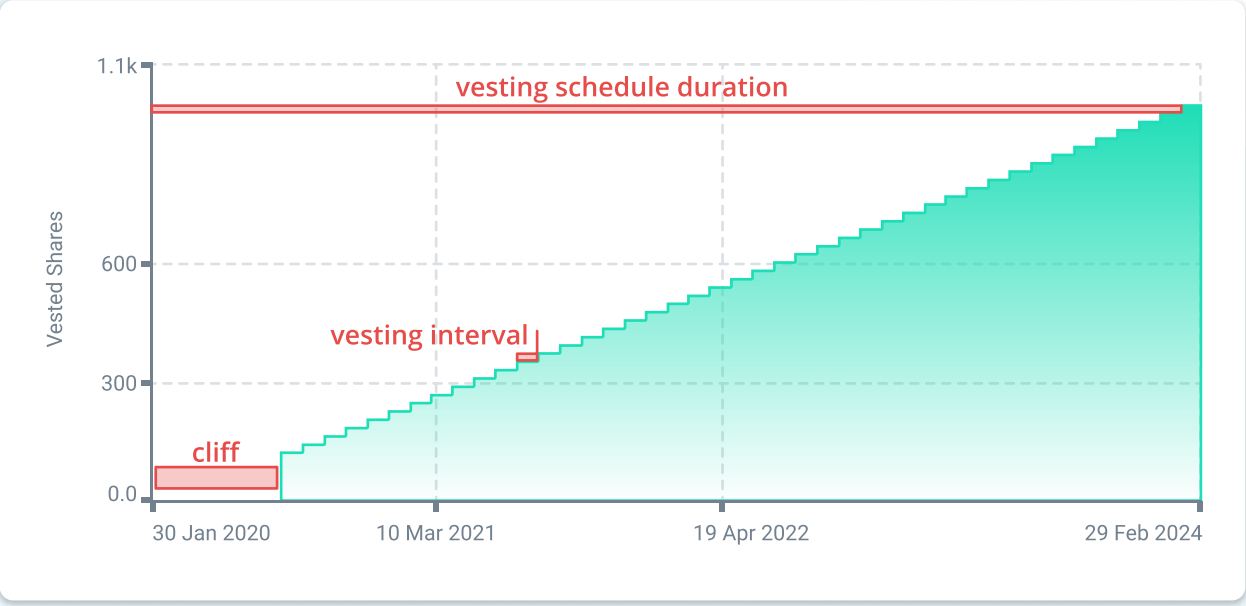
After the purchase (also called exercise), the employee becomes a shareholder of the company.

How does it work?

Almost all employee participation plans have a **vesting schedule**.

A vesting schedule determines how long an employee has to stay employed or otherwise related to the company before being able to exercise the full granted amount.

The vesting schedule comprises of the vesting duration, the interval of "releasing" virtual shares and a cliff.



Vesting duration: Vesting defines how long employees have to remain at the company in order to earn the full granted amount of options. For example, a 4-year vesting duration would mean that after 4 years, all of the granted stock options are fully owned by the employee.

Vesting interval: The interval determines in what increments the grant is being "released" to the employee. The terms vary from company to company (monthly, every 6 months, yearly...) For example, a monthly interval means that the grant is released in equal parts every month.

Cliff: A cliff is the minimum number of months that an employee has to stay before receiving the first batch of virtual shares. This term also varies by company and it can range from 0 to 12 months and more. Cliff only means that the first portion of the vested options is available to you after a "cliff" period of time.

Performance-based vesting: Additionally, the vesting can be structured to vest only when performance conditions are met, e.g. KPIs.

Will employees' ownership get diluted?

All companies need capital to finance their growth. Startups often need to grow so fast that their own revenue would not be enough to finance all the investments required for that growth. That's why startups need outside capital.

Financing rounds: The capital needed for growth will likely come from equity rounds. An equity round is for example when an investor is willing to provide 1M€ for 10% of the company. To give the investor 10% of the company, new shares are created. If there were previously 900,000 shares, 100,000 more are created so that the investor now owns 10% of 1,000,000 shares.

The consequences of financing rounds: The company value and employee share price likely go up, although dilution is incurred in percentage terms.

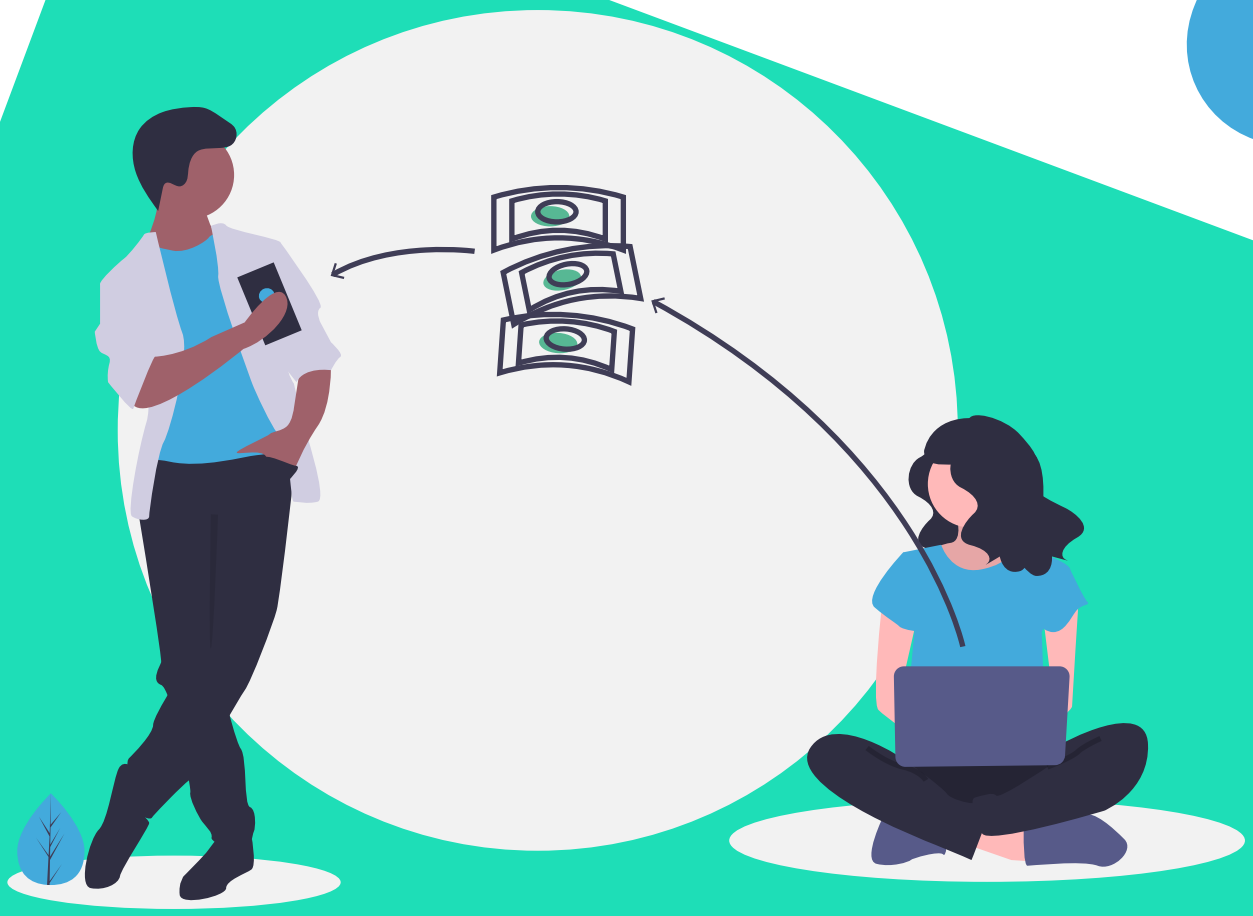
The new investment not only brings capital into the company but also improves its growth potential and chances of success. All stakeholders benefit from this. It could, for example, be that the company was previously valued at 3M€ and is now valued at 10M€ (1M€ investment for 10%) so the share price has more than tripled.

So what is dilution? If an employee previously held 1000 shares, they owned 0.11% of the 900,000 shares. Now they still hold 1000 shares, but as there are more shares, they own 0.10% of the 1M shares. These shares however, are worth triple than what they were before.

When do the stock options turn into cash?

The stock options follow the price development of the actual shares of the company. Once the options are vested and the company calls for the employee to exercise the vested options, the employee can pay the strike price and in return receive common shares. Depending of the agreement with the company, these shares can then be sold at the fair market value when certain conditions are met.

The conditions are written in the **shareholder agreement** and can include: liquidation of the company, change of control on shareholder level, sale of most of the assets, IPO, etc.



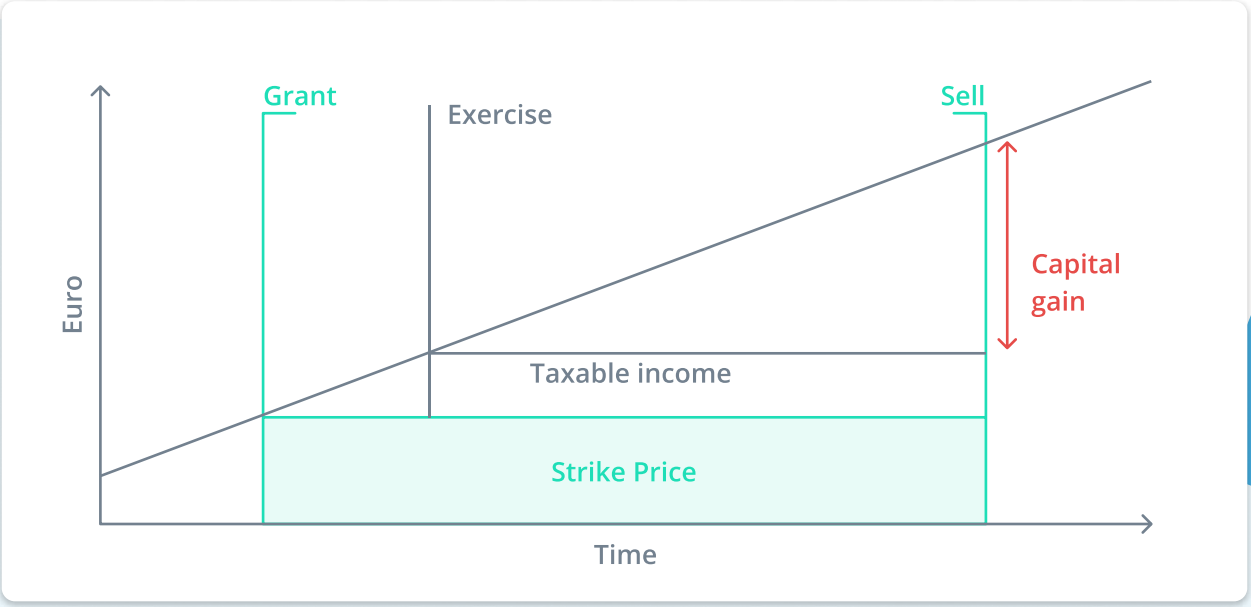
Stock option price

The assignment of stock options is usually free of charge. However, to reflect the value of the shares at the time that they are granted, there is a so-called **strike price**. Typically, the valuation from the last funding round is used to avoid additional taxes. The **employee doesn't pay anything** at the time of the grant.

Once the shares are vested, the employee can be given the option to exercise their right to buy shares. At that time, the employee pays the strike price.
Turn to the person in charge of grants if you want to know more about the terms of the sale of your shares.

Taxes

When: The employee is taxed based on local laws, at exercise and/or at the point of sale.
Tax rate: Exercised stock options and sold shares can be taxed as income or capital gain.



Reporting

When: Most often the employee needs to report to the tax authorities the ownership of options and stock.
What: Your employer will give you a statement called a holding confirmation, which states your ownership.

Contact the person in charge of grants, to receive country specific details about taxes and reporting.

What happens when an employee leaves?

The grant is subject to vesting and since vesting only runs while an employee is associated with the company, the vesting stops when an employee leaves.

The company decides how to treat employees who leave. Some companies determine a window of time in which the employee has to exercise the vested options, the others may require the employee to wait with the exercise until the exit event. It's best to turn to the person in charge of grants and ask for the policy of your company.

If an employee is deemed a bad leaver, certain provisions apply, such as forefeiture of options, vested and unvested.

If the employee leaves, the company usually has the right to buy back vested virtual shares for the fair market value (e.g. last financing round valuation). This gives the company the chance to re-purchase the virtual shares, though typically at great cost. This redemption right clause is common, but the company is not required to exercise the right, and most do not.