

Resource

December 19, 2023

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In the article [Secondary Sales and Tender Offers](#) we covered some of the basic tenets of tender offers and how they differ from other secondary sales. Now we'll turn to deal terms—specifically, if your company is contemplating a tender offer, here are some of the threshold terms to consider.

What equity holders can sell shares in the tender offer, and how many shares can they sell?

Private companies are not subject to the rules that require public tender offers to include all security holders and offer the same price to everyone, so private companies have broad discretion in setting the eligibility terms for their tender offers. That being said, antifraud rules applicable to private company tender offers do require thorough disclosures to potential sellers, and there are fairness

considerations. So companies should keep in mind that they'll need to describe (and potentially, defend) to anyone in the eligible seller group the criteria they've created for determining who can participate, how many shares they can sell, and the purchase price. Typically, there is only one price.

Most companies approach eligibility decisions by considering stockholders in three main categories: investors, former service providers, and current service providers. Whether each of these groups of equity holders is included in the offer depends on the goals of each deal. When former employees or early investors are included in the offer, it is often for the practical benefit of being able to remove these stockholders from the cap table, so companies will typically allow them to sell up to 100% of their equity.

For current service providers, approaches tend to be more bespoke. Service providers are often further subdivided into different categories—founders and executives, current employees, and/or independent board members—with unique eligibility criteria for each category. For current employees, it is not uncommon to see companies limit participation to only include employees who have been with the company for a certain period of time (often, at least two years). The number of shares an eligible employee can sell is typically limited to a certain percentage of equity holdings—for example, 20% of vested shares is a common metric—to ensure that employee equity ownership after the tender offer is meaningful enough to continue promoting retention and value creation. The calculation of shares eligible for sale can be limited to vested options and/or stock, or it can include both vested and unvested holdings. Whether or not the formula includes unvested holdings, it is almost always the case that only vested equity can be sold, as a sale of unvested equity issued under a stock plan can require amending equity agreements and plan documents and can have negative tax implications for the sellers and purchasers.

For founders and top executives, companies are often especially sensitive to creating the appearance of preferential treatment and want to limit information about their transaction proceeds as much as possible. In addition, stockholders want to ensure founders and executives remain incentivized to drive value. If founders participate, they will often have a separate proceeds cap. Some deals are structured so that a small number of equity holders—typically, fewer than five—sell shares in a transaction preceding and apart from the tender offer (and apart from the eligibility parameters set for the tender offer). This separate sale approach is sometimes taken when certain sellers are “backstopping” the tender offer, meaning that the stockholders sell shares to the purchaser prior to the tender offer and commit to sell additional shares after the tender offer if the total number of shares tendered doesn't meet a specified minimum. These transactions would be described in the tender offer

notice, including the fact that insiders participated and the price paid for their shares. Of course, arbitrarily claiming that a single transaction is actually multiple separate transactions isn't an effective way to circumvent the tender offer rules or avoid disclosures (and risks running afoul of antifraud rules), so advice from experienced legal counsel is extra important in these scenarios.

What type of shares will be purchased and at what price?

The purchase price is typically determined with reference to the price of the company's most recent equity financing. If the shares subject to the tender offer are a recent series of preferred stock (or if the company plans to exchange the tendered shares for a recent series of preferred stock), the tender offer price will typically be the same as the per-share price paid by investors in the company's most recent preferred stock financing round. On the other hand, if the tendered shares are common stock or an older series of preferred stock, it is common to see the tender offer priced at a discount (typically 5% to 20%) off the most recent preferred stock price. The discount can be driven by the characteristics of the stock—for example, a less favorable liquidation preference or exit multiple—and by tax considerations if the company wants to avoid the appearance (and tax consequences) of employees being paid more than fair market value for their shares.

What is the tax treatment of proceeds paid to employees?

If the per share purchase price paid to any company employee is above the fair market value appraisal in the company's most recent 409A valuation (as is virtually always the case), would the portion of proceeds exceeding the 409A valuation be treated (for tax purposes) as compensation or capital gains? If treated as compensation, the company must withhold applicable employment taxes on the payments, and employees will be taxed on those proceeds at ordinary income rates. On the other hand, if the full purchase price is treated as payment for the shares, employees that meet certain holding periods and other requirements may be eligible for lower tax rates. So why don't companies structure their tender offers so that all factors point to capital gains tax treatment? Because companies don't want to negatively affect (i.e. drastically increase) the appraised fair market value of their common stock in the next 409A valuation, and the factors leaning towards more favorable tax treatment for sellers are often in tension with the factors leaning towards a minimal 409A valuation increase. Whenever a company grants stock options, those options must have an exercise price that is not below the then-current fair market value of the underlying shares, else the company and grantee would be

subject to costly tax penalties for violation of Rule 409A. It could be inconsistent for a company to claim that the \$10 per share it paid for an employee's common stock in a tender offer was the value of the shares (i.e. no portion of that payment was disguised compensation), but then grant options at \$2 per share because that is the "fair market value" for the common stock. For this reason, a company should always involve its auditor/valuation firm to understand what effects any tax characterizations in the secondary will have on future valuation reports.

It should be noted that any decision on the tax treatment of a particular transaction ultimately rests with the IRS—even if the company evaluates the evidence and makes a decision with the support of its tax advisors, the IRS could later disagree with the conclusion if the company is audited. Even so, there are various structuring decisions that can strongly support one tax characterization over another, so companies should involve both lawyers and auditors to structure the deal in a way that supports its tax priorities.

Relevant Factors for Tax Characterization

Factors Supporting Compensation Characterization	Factors Not Indicating Compensation
Goal is providing liquidity to stockholders	Goal is providing additional shares to the purchaser
Purchaser is insider (company, majority stockholder, affiliate of Board member)	Purchaser is outsider (new investor, minority stockholder)
Sellers are all (or mostly all) employees	Sellers include many non-employees (former employees, investors)
Shares purchased are common stock	Shares purchased are preferred stock
Certain shares purchased at a higher price because they are held by employees or by a certain group of employees (founders, executives)	All shares purchased at same price
Shares purchased represent a large percentage of company capitalization	Shares purchased represent a small percentage of company capitalization

Is the purchaser of shares in the tender offer the company or a third-party investor?

The most common approach is a purchase of shares from existing stockholders by one or more investors. The company is not the purchaser (or seller) of shares in the offer, but it is still involved in the deal by contributing to disclosures, coordinating any required approvals and waivers, and facilitating the actual transfer of the shares. Depending on what stockholders and types of equity are included in the eligible selling group, after the purchase, the investors in this type of deal would own common stock or (typically, an older class of) preferred stock. If the tender offer price paid by the investors was equal to the most recent preferred stock financing price, the deal may include a commitment by the company to exchange the shares purchased in the tender offer for the most recent series of preferred stock, although this investor-favorable term is only seen in a small minority of deals.

An alternative scenario would be a repurchase of shares from existing stockholders by the company, usually following the sale of new preferred stock to investors. Sometimes, the preferred stock financing is divided into two closings to ensure that the investors achieve a specific ownership percentage. The company and investors would conduct an initial closing for a portion of the total contemplated investment, and then the company commences the tender offer. When the offer expires and the company has a firm count of shares tendered, there is a subsequent closing in which the investors purchase additional preferred stock to reach their ownership targets.

While the investor-led approach is more prevalent, company repurchases are increasingly common, especially when management liquidity is driving the deal. Note though that there are some important factors to consider with this approach. Companies and existing stockholders might find it less desirable because investors receive the (typically, senior) liquidation preference for the full amount of their investment, but the company isn't retaining (and broadly benefiting from) the full investment. Also, company-led repurchases more often support the taxation of proceeds as compensation (see "Relevant Factors for Tax Characterization" chart above), or, in certain circumstances, a company-led repurchase may need to be reported and taxed as a dividend, both of which options would result in larger tax bills for sellers. Additionally, company-led repurchases can impact—for all stockholders, regardless of whether they participate in the repurchase—whether the company's stock qualifies for preferential qualified small business stock (QSBS) tax treatment (although this may not be relevant for later stage companies that would not meet the QSBS requirements anyway). An investor-led tender offer would not have the same effect, but any shares purchased by the investor(s) in the tender offer would not be QSBS.

While the discussion above covers some of the threshold aspects for any tender offer, this is not an exhaustive list of tender offer deal terms. Companies will also be very interested in evaluating factors such as the mechanics for option holder participation, whether to include non-U.S. sellers and allocation of transaction expenses. Gunderson attorneys have represented clients in over 250 private company tender offers over the last five years, providing our team with unmatched experience and market intelligence on these unique deals. If your company is considering a tender offer and you are interested in hearing from our experts, we encourage you to reach out to a Gunderson contact to continue the discussion.

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