

Insights

WHAT HAPPENS TO EQUITY AWARDS IN AN M&A TRANSACTION?

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When a company is considering a merger or acquisition, a key issue for both buyers and sellers is the treatment of outstanding equity awards. There are often competing perspectives on what should happen and what best supports the transaction and business post-closing. Those views may be influenced by the type and amount of outstanding awards, the size and makeup of the group holding the awards, and the terms of any vesting conditions.

In addition to these business considerations, it is critical, particularly in the early stages of a transaction, to review the governing equity documents. The treatment of awards, and what flexibility exists in the context of a specific transaction, can vary based on factors such as the types of awards (e.g., stock options, restricted stock, or restricted stock units), the terms of the individual award agreements and equity plan, and applicable law.

Common approaches to handling equity awards

Generally, there are two primary approaches to addressing equity awards in a transaction:

- **Assumption by the buyer:** Awards may be assumed by the buyer and continued after closing, often converting into or being substituted for equity in the acquiring company.
- **Cancellation and cash-out at closing:** Awards may be canceled in exchange for a cash payment.

It is often not an all-or-nothing approach. Many deals involve a combination of approaches. For example, vested stock option awards may be cashed out at closing, while unvested options are rolled over to the buyer to preserve retention value and incentivize employee performance following the transaction.

Why choose one approach over another?

When awards are assumed, participants may continue to benefit from future stock appreciation. This can be especially valuable where options are currently “underwater,”— that is, where the

exercise price exceeds the current stock price— because participants may still realize value if the acquiring company’s stock rises. The acquiring company also continues to receive the benefit of employees incentivized to increase the value of the company.

By contrast, when options are canceled and cashed out, participants generally receive the difference between the deal price and their exercise price. These payments are often made as a lump sum shortly after closing, providing immediate liquidity. However, this approach eliminates future gains for participants and may reduce the buyer’s ability to use equity-based incentives as a retention tool. In many cases, participants are required to enter into award cancellation agreements prior to the closing, which may include releases of claims in favor of the employer.

Other considerations in determining equity award treatments

The treatment of equity awards depends on several factors, beginning with the terms of the company’s equity plan and outstanding award agreements. Some plans provide for automatic accelerated vesting upon a change-in-control— often referred to as “single-trigger” vesting – to provide a benefit to their employees whose work contributed to creating the transaction value. Alternatively, awards require both a sale and a termination of the participant’s employment before vesting accelerates, commonly known as “double-trigger” vesting, which can provide protection from post-closing termination.

In most transactions, the buyer and seller negotiate equity treatment, considering business factors like employee retention and administrative simplicity. New or revised vesting conditions, and conversion to other types of equity or cash awards, may also be used to match the employee retention strategy going forward.

Because flexibility is defined by the governing documents, employers should carefully review their equity plan documents and award agreements to understand what is permitted in connection to change-in-control events. Employers should also consider the desired outcome in an M&A transaction when establishing their equity program and making the awards, recognizing that transaction negotiations may ultimately result in a different outcome.

Finally, equity treatment decisions often implicate U.S. securities laws and tax considerations. Employers should work closely with their BCLP attorney or a member of our Employee Benefits and Executive Compensation team, along with other advisors, both when establishing equity incentive plans and when preparing for a transaction.

Related Capabilities

- Employee Benefits & Executive Compensation

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