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Stock options 101

Stock options are an excellent way for early-stage companies to attract the talent they need to succeed and to grow. They give employees and other service providers the chance to take a stake in a company's future growth, allowing the company to compete for key talent. Having skin in the game also gives employees and consultants a greater incentive to work harder and make the company the best it can be. An equity arrangement, like a stock option, can be mutually beneficial to both sides of the employment relationship and has become one of the bedrock features of compensation in Silicon Valley.

But do you know what steps you need to take to properly issue stock options to your employees and other service providers? Are the basic terms clear to you?

- First, what is a stock option?
- What documents does your company need to have in place to grant options, and how do they work?
- How will you actually grant the options, and how does vesting work?
- How will the option holder exercise his or her options when the time comes?

You'll need to have a clear answer for each of these questions before you begin to grant equity in your company.

What is a stock option?

A stock option is the right to purchase stock in a company. When a company grants an option, it is merely promising the option holder that he or she will be able to buy a certain number of shares at a particular price. What makes them valuable is that the price per share is locked in at the time the options are granted. When the company is growing quickly (and, ideally, taking on rounds of venture investment), the company's share price will grow, while the option holder's purchase price will remain the same. This gives the option holder the opportunity to make a bargain-rate investment in a successful new company after the options vest.

What is a stock plan?

The foundational document that sets up your company's stock option program is the equity incentive plan, also called a stock plan. Your company's stock plan will establish all of the ground rules for how options are granted, how they work, and what rights the company and the option holder will have.

A stock plan typically must be approved by both the company's stockholders and its board of directors. When approving the plan, the stockholders and directors will authorize a "share pool," which is the maximum number of shares that may be issued for equity awards, including stock options, under the plan. The benefit of this arrangement is that the directors should be able to grant stock options under the plan without seeking additional stockholder approval, as long as they stay within the limits of the option pool. For more information on the amount of shares to reserve in your option pool, please see our article.

How are options granted?

Once you have your stock plan in place, you are all set to begin granting stock options. Each time you wish to grant a stock option, the first step is for the board of directors (or its authorized designee) to authorize the grants. Rather than holding a

board meeting, this step can be done with a basic written consent signed by each director (see our article on using written consents).

The written consent needs to state the name of the option holder, the number of options being granted, the vesting schedule and vesting commencement date (discussed below), whether the options are ISOs or NSOs (the topic of another available article), and the option holder's state of residence (to allow your lawyer to check that state's securities laws to see if a filing needs to be made).

Once the board has approved the options, you need to make the actual grant. This is typically done with a pair of documents: the Notice of Grant of Stock Option and the Stock Option Agreement. Most law firms include both of these documents as forms that accompany your stock option plan. The notice of grant establishes the basic terms of the option grant, including number of shares and vesting. The stock option agreement contains terms and provisions that apply to the stock options. An officer of the company and the option holder should sign each of the documents.

What does vesting mean?

In order to incentivize employees to hang around, stock options vest over time, meaning that employees can only exercise those options that have vested according to the vesting schedule imposed by the company. The standard vesting schedule in Silicon Valley is "one-four" vesting, meaning that vesting occurs over a four-period with a one-year cliff. Under this arrangement, no options vest during the employee's first year of service to the company. At the one-year anniversary of the vesting commencement date, 25 percent of the options vest at once. For the remaining three years of the vesting period, the options typically vest in 36 substantially equal monthly installments.

Aside from the vesting schedule, another important factor in setting option vesting is the vesting commencement date. This is the day that the vesting schedule begins to run. For new hires, usually you will set the vesting commencement date to coincide with the option holder's first day of work with the company. Often, an employee begins work before the stock option plan is in place. In this case, it should be okay for you to set the vesting commencement date in the past.[1]

What does it mean to exercise an option?

After a stock option vests, the option holder may exercise those vested options at any time. "Exercise" is when the option holder actually purchases the stock from the company. The option holder must send the company a written notice (called an exercise notice), specifying how many shares he or she wants to purchase. A copy of the exercise notice is usually included with the stock option agreement that the holder signs when the options are granted. The option holder needs to pay for the shares, but the price per share was hopefully locked in at a good price, well below where the company's stock is now valued.

Some additional issues you need to consider are the difference between incentive stock options (*ie,* ISOs) and non-statutory stock options (*ie,* NSOs) and how to choose the option exercise price.

[1] Although please note that the purchase price should not be set to a price that is different than the fair market value on the date of grant.

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