

Private company stock option grants: a founder's guide to who gets what, when

In a private company setting, after the founders have been issued fully vested or restricted stock under their stock purchase agreements, the employees, consultants, advisors and directors who are subsequently hired commonly receive equity compensation through stock options. There are a number of reasons for this, including ease of administration, macro- and micro-market norms and a desire to minimize the capital commitment for the individuals who are to receive equity awards. Consistency is also important, as it helps avoid separate negotiations with each individual on the nature and terms of equity grants. Founders find this best accomplished by sticking to an "everyone gets stock options" principle, so that the only negotiation is about how many shares are covered by the stock option grant and what the vesting schedule should be.

An exception to the "stock options only" principle sometimes occurs during negotiations to attract and hire an experienced senior executive who may request restricted stock, but even then the benefits of an "everyone having the same" form of equity may prevail.

In this article, we provide an overview of some of the key considerations in making stock option grants: who gets an option, the size of the option, vesting terms and pricing.

Size of the option pool

After the formation of a startup and prior to any significant financing, companies should and often do consider establishing a pool for providing equity grants to initial employees, consultants, advisors and directors. For example, if the founders hold 9 million shares, a pool of 1 million shares might be set aside for equity grants, including stock options, to be made between formation and the anticipated time of a first financing. In this case, the pool would be 10 percent of the shares expected to be issued or granted under options and other equity awards prior to the financing. There is no magic to 10 percent; the number should be based upon what the founders think they need in their particular situation. However, as a practical matter, some amount between 5 percent and 20 percent would be typical. See our article with [more considerations about sizing an option pool](#).

A new pool is often created as part of the negotiation for the first substantial financing, typically to provide for enough shares to cover the estimated number of option grants between the first and the second financing. A typical pool following a Series A financing would be of around 15 percent of the number of post-financing shares outstanding or reserved. Of course, the shares of stock for the pool and for stock option grants should be for common stock, as there are tax rules that make it very difficult to grant stock options for preferred shares (or stock that has distribution preferences).

Grant size

Prior to the first financing, it is common to have consultants, advisors, board members and non-officer employees receive option grants of .25 percent, .5 percent or 1 percent of the stock, respectively (or, using the 10 million share example above, 25,000, 50,000 or 100,000 shares) depending upon experience and anticipated level of contribution as well as projected time

commitment. Sometimes, the founding team identifies an executive-level hire for a permanent, full-time position. In those cases, a much larger grant could be considered; perhaps 2 to 5 percent for a seasoned VP of Sales or CTO (if one is needed in the early days), to as much as 10 percent for a seasoned industry-experienced CEO.

For grants to employees, startups often move towards a relatively rigorous process in which employees in specific job titles receive a fixed (not a negotiated) amount of stock. Such a hiring matrix helps the management team use the allocated stock pool more effectively and creates consistency among employees (always a virtue). Further, after the company is funded, investors will expect the company to have such a matrix, and the board will expect management to keep all grants within the amounts specified in the matrix (and, if amounts fall outside the matrix, the board will expect management to justify the exception). Such a matrix is usually based on industry surveys conducted by companies such as Radford, Advanced HR, J. Thelander Consulting and the Ravix Group. It is also not uncommon for angel or venture capital investors to provide guidance and help create company guidelines, which may be strongly influenced by local market practices.

Vesting

It's important to make the grant sizes proportional to expected impact, but it is equally important to set the vesting properly. All stock option grants should have some vesting period because, with rare exception, the contributions the recipient will make will be in the future. If the person isn't succeeding, or if disagreements arise, the management team will want to be able to terminate the relationship and recoup the unvested shares subject to the grant.

With early advisors and key consultants, it is common prior to financing for grants to vest over a relatively short period, such as a year or two, since many of these initial contributors are expected to play a meaningful role in the launch stages getting the company off the ground, not serving it over an extended period. For more information about founder vesting, please see our article [here](#). Vesting is usually time based, typically monthly, but can also be based upon specific activities. These activities could include attending important meetings such as advisory board meetings, performing specific activities or delivering certain work product. Note that there can be accounting consequences associated with such performance-based vesting; however, those consequences are likely not meaningful, as long as the relevant activities are performed prior to a first financing.

Even with early employees, startups should consider adopting the most common vesting formula: a one-year cliff before an employee vests any shares. Typically, 25 percent vests on the one-year anniversary of hiring or of the option's date of grant and monthly thereafter for the next three or four years. Of course, providing for some special vesting for an employee joining early might be justifiable, but in general the earlier that standard vesting is adopted, the better. The reason for a one-year cliff is simply that a decision has been made to not award shares to employees who leave or are terminated before they have served for a year.

Pricing

Setting the purchase price (the "exercise price" or "strike price") of a stock option also is a very important consideration. Incentive stock options (ISOs) must not have a purchase price that is less than fair market value (FMV) of the common stock on the applicable date of grant. With respect to non-statutory stock options (NSOs), Section 409A provides a specific set of factors that should be considered when determining FMV and setting the purchase price of an NSO, including a presumption of reasonableness if a third-party independent valuation report is obtained and approved by the company. Significant individual tax and adverse accounting effects may apply if NSOs are granted with a purchase price that is less than FMV on the date of



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grant. Typically, due to the heightened concern with mispricing stock option awards, the board of directors makes determinations with respect to pricing, often in consultation with legal counsel, investors and the company's chief financial officer.

In terms of human impact, however, the higher the purchase price for a stock option, the less incentivizing the award may be, unless the grant size is enlarged (which increases dilutive impact). Therefore, it is not uncommon for a company that matures to a high valuation to experience issues with granting stock options and, ultimately, to give consideration to granting different types of equity awards (such as restricted stock units or RSUs). But these types of issues usually crop up after a few financings and are usually not present at the startup stage.

In the end, we would like to finish off by saying that one size *does not* fit all in making these determinations of who gets what and when. We strongly suggest that founders and board members of early-stage private companies consider their unique circumstances when putting in place a stock option program and granting equity awards, including their corporate goals (both long-term and short-term), any company philosophy and what is really necessary to attract and retain key personnel in the talent pools that are available to the company.

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