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# Equity incentive plan basics

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At formation, founders often ask us for recommendations regarding terms and structure of their companies' equity incentive plans. When making these recommendations to new companies, we generally advise that founders choose relatively "standard" and "straight-forward" terms, which have the dual benefit of keeping legal costs in check at formation and signaling to potential investors going forward that the company's "house is in order." Although individual circumstances may dictate deviation, below are some high-level recommendations regarding equity incentive plan structure:

## Size of equity plan share pool

Typical range is between 5% and 20% of the company's fully diluted capitalization.

## Authority to approve equity grants

For corporate governance reasons and in order to avoid "foot faults" with tax and accounting rules, we recommend that the company's board of directors be authorized to approve equity award grants, including stock option grants.

## Types of equity awards

Early-stage companies often only use restricted stock grants and stock options (rather than restricted stock units (RSUs), performance awards, stock appreciation rights, etc.), in order to streamline administration and avoid a number of tax, accounting and corporate governance complications associated with restricted stock rights and grants. As a company matures, employers can introduce additional and more complicated types of awards, although close attention should be paid to the tax and accounting impacts.

## Equity award vesting; acceleration

Early-stage companies generally grant equity awards that vest monthly after an initial a one-year cliff period from the date of hire (rather than the date of grant). Some companies like the monthly period to extend for 36 or 48 months after the initial cliff period has expired. With respect to acceleration upon a change of control, although these provisions are favorable to employees, investors and potential acquirers generally dislike "single trigger" vesting acceleration (as it adversely impacts post-closing employee incentives) and occasionally acquirers force target companies to eliminate acceleration or re-vest awards prior to closing an acquisition transaction. It also can be potentially disincenting to longer-term employees to receive moderate or little acceleration in a transaction, while new hires receive a relative windfall acceleration benefit. Accordingly, we generally recommend against including default "single trigger" vesting acceleration in the option plan itself and instead granting the board latitude to provide for acceleration (or any other non-standard vesting) in specific grants to key employees, or to amend existing grants for all employees if and when an acquisition deal occurs. This approach allows the company to maintain maximum flexibility in attracting investors and negotiating the terms of potential acquisitions, while also incenting key employees who warrant more favorable vesting acceleration terms.

## Repurchase right; right of first refusal

In order to limit its stockholder base to persons connected to the company, many early-stage companies include a company repurchase right (generally at fair market value, as determined by the board) over any unvested shares in the event such stockholder's service to the company terminates, as well as a company a right of first refusal over transfers of vested shares to third parties, except with regard to certain family and estate planning-related transfers.

There are also a few unique issues that we would point out that are specific to stock option awards:

## Type of stock options

Allowing both Incentive Stock Options (ISOs) and Nonstatutory Stock Options (NSOs) under the equity plan provides maximum flexibility to incent new employees. In general, Incentive Stock Options provide recipients better tax benefits over Nonstatutory Stock Options. However, in order to receive these benefits, the employer must comply with a variety of rules. As a result of these additional rules, Incentive Stock Options are more complicated to administer than Nonstatutory Stock Options.

## Transferability of stock options

Non-transferability of options is not only required to comply with tax rules for ISOs and certain federal securities law exemptions under which most options are granted, but is also advisable from the perspective of controlling a company's stockholder base by preventing non-service providers from holdings options or becoming stockholders.

## Early exercise of stock options

Allowing options to be exercised before they are vested involves a number of administrative complexities (*eg*, 83(b) filings, escrow for unvested shares, etc.) that many early-stage companies choose to avoid by not allowing early exercise. If early exercise of an option is being considered, we'd strongly encourage that NSOs and not ISOs be used. In addition, early exercise options also have corporate governance implications, as holders of exercised options (*ie*, shares) are entitled to significantly greater rights (*eg*, voting rights, certain information rights, etc.) than holders of unexercised options to purchase shares. Last, we would caution that early exercise of an option involves complex personal tax decisions by the individual.