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PERSPECTIVE

Equity incentive plan considerations for startup founders

By Daniel R. Kahan

One of the most complicated topics startup founders confront is how to provide compelling incentives to employees and other service providers while preserving scarce cash. In addition to navigating myriad tax traps and managing employees' expectations, founders must address fundamental questions about the form, terms and timing for granting equity incentives. This article highlights some initial considerations founders should think about as they evaluate the adoption of an equity compensation program.

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THE BASICS:
What Is an Equity Incentive Plan?

An equity incentive plan, often referred to as an "option pool," is a legal structure for issuing a number of types of equity awards. Startups, often in cash-conservation mode, frequently want to provide incentives to employees and service providers by offering them some type of ownership interest, or equity, in the company. Startups that want to provide equity awards can do so through a number of different types of instruments, including stock options, restricted stock, restricted stock units, performance stock units and warrants.

These types of awards often have different terms and features, as well as varying tax consequences (both for the company and the recipient). Startups may also vary the terms of awards granted to different employees. Notwithstanding these differences, startups frequently want to define a set of common terms that apply by default to all awards issued from the equity incentive plan, including how awards are issued, restrictions on transfer, whether awards can be modified after issuance (and by whom), and what happens in the event the company is acquired. Having a single plan in place that sets some default terms and applies to all equity incentive awards, regardless of their form, helps simplify the process of issuing and maintaining such incentives as the company grows and the number of awards outstanding increases.

In adopting an equity incentive plan, companies need to consider:

- the number of shares that can be subject to equity awards;
- the types of awards that can be issued by the company;
- common terms that will apply to all awards;
- which governing body or bodies of the company can issue awards; and
- what happens to awards when service providers leave.

Plans also often address what will happen to awards if and when the startup is acquired or conducts an initial public offering. Some companies prefer to handle this on an award-by-award basis rather than setting a default rule in the plan document.

An equity incentive plan is memorialized in a plan document approved by the company's board and stockholders. Individual equity awards are memorialized in award agreements, or contracts between the company and award recipients. Many plans permit these award agreements to modify or supersede the default terms of the plan, but award agreements do usually reference and incorporate the terms of the plan to avoid having to repeat those terms in each award agreement.

TIMING:
When Should a Startup Create an Equity Incentive Plan?

Many startups do not adopt equity incentive plans until required to do so by an outside investor. Angel and venture capital investors often require startups to adopt equity incentive plans immediately before a financing transaction, and may structure the plan adoption in a manner that does not dilute the investor's stake in the company. Based on this common practice, founders sometimes conclude that the best time to adopt an equity incentive plan is on the eve of a financing transaction.

That thinking can be shortsighted. Consider adopting an equity incentive plan early in a startup's lifecycle, perhaps even at the time the entity is formed. Although there may be no outside pressure to adopt a plan early on, having a plan in place will help conserve cash and demonstrate to prospective investors that the startup's founders have been thoughtful about recruiting and retaining key personnel.

SIZE:
How Many Shares Should Be Subject to an Equity Incentive Plan?

When thinking about how many shares should be added to an equity incentive plan, startups should consider the following:

- What types of employees (e.g., technical, administrative) will the company need to hire in the next six to twelve months?
- How senior will these new hires be in terms of their prior experience and role in the startup?
- Will equity incentives be offered to nonemployee service providers (e.g., contract software developers, staffing agencies)?
- Does the startup need to set aside equity to retain existing employees?
- How much dilution in ownership are the existing stockholders willing to bear?

On the last point, founders should keep in mind that, even if a plan is adopted early, investors may require the startup to "refresh" — or add additional shares to — the plan before the investment is completed. Even in the absence of an investment, a startup may decide to increase the size of the plan based on its recruiting and retention needs. Accordingly, founders should set the initial plan size with these prospective increases in mind rather than assuming that dilution occurs only at the time of a plan's adoption.

CONCLUSION

Startups that adopt and implement well-designed equity incentive plans can use equity awards as a tool in recruiting and retaining key personnel — functions critical to a startup's growth at any phase. This article outlined some of the early choices that go into designing a plan, but many more choices — such as the types of awards to issue, the sizes of awards, vesting provisions, and how awards should be treated if the startup is sold — will also need to be made. In the short term, these choices can have important tax and legal compliance consequences and, in the longer term, can affect the terms and results of potential financing and acquisition transactions. Startups should therefore work closely with their legal, tax and other advisors in designing any equity incentive plan to ensure the plan contributes to the company's long-term success.

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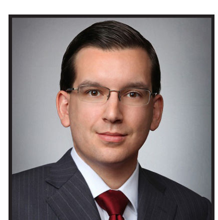
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