



HIRING

The Lack of Options for (Startup Employees') Options

by Scott Kupor

hiring · management · compensation

One of the many tradeoffs that early startup employees choose to make is between cash, and options. For some employees however this may end up being a Faustian bargain of sorts.

At first glance, the calculus seems simple: the employee will take more stock options for less cash, because over time the payoff could be huge (making the loss in early salary, and their willingness to take that risk on an unproven company, very much worth it). Given the success rate of most startups, it's a risky proposition — but it's also one that has allowed more of the wealth outcomes of new businesses to be distributed among more of the employees who put in the hard work of building that business in the first place.

But there are a number of issues with this model — primarily in pitting the “cash-rich” against the “options-rich”.

That's the catch: Exercising options

requires cash

Startup employees get stock options that typically vest over a four-year employment period, so if they choose to leave the company after four years (or at any time for that matter), they have only 90 days in which to exercise or forfeit the options. And that's the catch: Exercising requires cash. Not only do you have to pay the company the exercise price for each share (because they are stock *options*, not actual restricted *stock* units), the IRS then taxes you at year end on the difference between the then-existing fair market value of the stock and the exercise price.

For companies whose stock prices have appreciated significantly, the out-of-pocket amounts can be huge and thus prohibitively expensive for many employees. In some ways, it's a "success disaster": Why should employees be penalized for actually succeeding in building a business that is now worth so much — too much for them to afford — as a result? This defeats the very power of startups for sharing and leveling gains among those who contributed to building the company (especially as compared to more traditional, established businesses where such gains are even more disproportionately distributed).

But these employees can make so much money off their options! So why is this scenario unfair? Because only the employees that are cash-rich can afford to pay both the company and the IRS. For employees who are cash-poor yet options-rich, those "options" suddenly don't seem to present many "options"... They can either try to find a bank or a friend or a family member to loan them the money (generally something only a privileged few have easy access to) — or they can say good



to their paper millions. Only the rich get richer.

The living dead equity problem

One seemingly simple and elegant proposed solution to this problem is to change the option exercise period from 90 days to 10 years. This way, cash-poor, options-rich employees can freely leave a company at any time and maintain the “optionality” of their options by waiting to exercise until the company goes public, gets acquired, or the shares otherwise increase in value. Problem solved!

Well, not exactly. There is a more fundamental issue at the heart of this seemingly good solution: A 10-year exercise window is really a *direct wealth transfer* from the employees who choose to remain at the company and build future shareholder value, to former employees who are no longer contributing to building the business/ its ultimate value.

That doesn't seem very fair at all. Are there any other management practices where one would optimize for former employees at the expense of current employees? I can't think of any.

Actually, I take that back — there *is* one place where this practice holds true. It's called “dead money” in the National Football League, and it refers to the salary cap charge that an NFL team must take for a player who has been cut from the roster, but for whom the team has remaining “accounting” charges. For example, a signing bonus for a player, although paid out up front, must be allocated for salary cap purposes across the term of the player's contract. Thus, a team that elects to cut a player after year three of a five-year contract gets charged the remaining 2/5ths of the signing bonus for those final two years *even though the player is gone*



from the team. The net effect is that the team cannot re-capture that money against the salary cap to fund a new replacement player or pay its remaining players more. The money is therefore “dead” — a penalty on the remaining team’s players that does nothing to further the objectives of the team.

The logical equivalent to the NFL’s dead money problem is “dead equity” in a startup. A startup that elects, for example, to extend the option exercise window for departed employees is actually creating dead equity at the expense of the “live equity” held by the remaining employees. Just as dead money disadvantages the remaining team members, so too does dead equity affect the remaining employees and resource allocations a startup is able to make (no matter where the company falls on the GAAP vs. non-GAAP accounting-for-options debate).

An economics question vs. a fairness question

The challenge in broadly adopting the 10-year exercise rule for all employees at the outset of the company as a solution is that it disadvantages employees who choose to make a long-term commitment to the company relative to those who leave.

Are there any other management practices where one would optimize for former employees at the expense of current employees?



But this is not just a question of what's "fair"; it's a question of economics. To understand the economics, we need to describe how options and a company's option pool work.

There are four groups of people who will own the company: investors, founders, employees, and former employees. When a company is first started, the CEO often puts aside a pool of common stock from which to grant employee options, generally around 15% of the company's capitalization.

Over time, that pool shrinks as options are extended to new employees or as existing employees are given additional grants. The pool can be replenished when employees leave — either because they leave before their options are fully vested or because they don't exercise vested options within the 90-day period that currently exists — so those options go back into the pool. When the pool gets exhausted altogether, the company will often ask shareholders to increase the size of the pool (i.e., getting them to approve an increase in the number of authorized shares the company can issue).

But, the pool can't magically increase without impacting all existing shareholders, because $100\% = 100\%$. If an employee owned 1% of the company before the pool increase and then the company increased the option pool by 10%, that employee now owns 0.9% of the company. Increasing the pool dilutes ownership. Just because a company can increase the nominal size of the pool to whatever level it wants, doesn't change what the company was worth before it increased the pool.

Many early startup employees are generally okay with some dilution because, at least in theory, increasing the option pool to hire more people helps grow the company — which in turn hopefully increases the value of the company. So wh



an employee might own less of the company than before, he or she would rather own 0.9% of a company worth \$1 billion than 1% of a company worth nothing. 1% of 0 is still 0 after all.

So what happens when you allow employees who elect to leave the company to enjoy a 10-year exercise window? Well, as any Black-Scholes fan knows, the value of an option increases with time to expiration. Rationally, the now-former employee will hold off until the end of the exercise expiration window before deciding whether to exercise at all. This means that stock options that would have otherwise been returned to the company's option pool now remain outstanding for up to 10 years.

Thus, in order for the company to give existing employees more options or give options to new employees hired to grow the company, the option pool has to be refreshed at a faster rate than if some unexercised options had been returned to the pool. And since refreshing the pool means dilution for all those who are still employed by the company, it's the *remaining* employees who get diluted in order to allow former employees to keep their optionality (not to mention also enabling those former employees to now collect a new set of options from another employer, in their next gig!).

The 10-year "solution" thus takes money/option value out of the pockets of the current (and growing) employee base to line the pockets of former employees who are no longer contributing to the business. To convey just how material this wealth transfer is, we've built a simple model that you can tailor to your own company's circumstances:

download model here

credit: Irvin Chan/a16z



In our model, we estimate that moving from the current 90-day window to a 10-year window will cost the average remaining employee as much as 80% in incremental dilution. That's real money to anyone, but especially to the people who are working hard to generate shareholder value. Even more damaging than that dilution, however, may be the inability of the company to increase the option pool at the rate required and thus be unable to hire new employees or refresh existing employees. Recall that since companies need a vote of shareholders to continually increase the pool, at some point, existing shareholders won't like the idea of supporting former employees who are no longer contributing to the success of the company and may therefore refuse to approve increases to the option pool once exhausted.

Talk about disenfranchising your remaining employees and not being able to attract new ones.

Increasing the option pool to hire more people helps grow the company, which in turn hopefully increases the value of the company

In full disclosure, investors of course are impacted by the wealth transfer we describe above, too. But they have means to protect themselves that employees and other common stockholders do not. For example, because investors hold preferred stock, they can get a say on option utilization (often via legal protective provisions, or because they are on the board and can directly weigh in on the



discussions). So, nobody should shed a tear for investors, and definitely not on this topic!

So where do we go from here?

One existing solution to the “dead equity” problem has been — and still can be — to *make exceptions* where appropriate for certain exiting employees. In fact, employers make exceptions all the time for certain employees, depending on their contribution to the company, critical skill set, and so on. Some employees get paid more, some employees get change-of-control provisions in their option grants, some employees get sign-on bonuses, some employees get bigger expense accounts. And, yes, some employees should get longer than 90 days to exercise their stock options when they decide to leave given the value they contributed to the ultimate outcome and likely success of the company.

This solution isn't everything, however. For one thing there's a risk of reinforcing existing favoritism or unfairness. For another, it — just as the 10-year exercise window solution outlined above — doesn't address the real, underlying reason for how startup companies even got here in the first place.

Fundamentally, we are here because companies are choosing to stay private significantly longer than the time period for which the four-year option vesting program was originally invented. It's a historical anachronism from the days when companies actually went public around four years from founding. Today, however, the median time-to-IPO for venture-backed companies is closer to 10 years.

Matching vesting more closely to the IPO time frame for companies makes logical sense and would significantly reduce the overhang of options from exited



employees. This would likely mean increasing the vesting period — and size of the option pool — for stock options from 4 years to 6-8 years to more closely match the actual illiquidity period of modern startups.

The four-year option vesting program is a historical anachronism from the days when companies actually went public around four years from founding

Many startups will argue that there's a collective (in)action problem with the longer vesting period: That is, unless everyone does it together, anyone who diverges from this will have an immediate recruiting challenge in an already tough hiring environment.

But, a way to truly compete for the very best and long-term oriented employees would be to offer even greater amounts of employee options grants. For example, why not offer stock option grants that are 50% more than the nearest competitor's — but with the provision that a departing employee cannot exercise his or her stock options unless there has been a liquidity event? If you stay, you're a serious owner, but if you don't want to be part of the company for any reason you won't be an owner. This solves all of the issues: cash rich vs. poor; competitive offers; and the bad incentive problem (e.g., encouraging employees to quit to build their own diversified stock portfolios).



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The fundamental issues of fairness and disproportionate benefits for those who are cash rich vs. poor are critical ones that can't be ignored, and must be addressed. In this case, increasing the option exercise window and at the same time disadvantaging employees who remain loyal to their employers just kicks the can down the road and does nothing to address the real underlying issue.

Simple solutions to complex problems don't work. They have unintended consequences that sometimes harm the very principles people are trying to protect in the first place. And other solutions (like handcuffing employees for the long term) may result in other problems, such as adverse selection; there's still a balance that needs to be struck with supporting mobility of employees while also building value for the long term. The bottom line is that if companies are going to continue to stay private longer, we need to fundamentally re-think the stock option compensation model. We need better, careful, and more thoughtful solutions.

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