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PERSPECTIVE

Equity Compensation is About Retention

By William E. Growney Jr.

At the outset of nearly all Silicon Valley incorporations, the company's founders and legal counsel plan the basic equity incentive strategy for the company's future service providers. Applicable tax laws, federal and state securities laws, the company's hiring retention needs, and the competition for labor are essential considerations in this dialogue. Over time, the number and type of equity awards change and the pool of shares reserved for issuance will need to be refreshed. My advice to clients is to generally stay within commonly accepted terms, treat equity like cash and budget it out accordingly, and realize that equity compensation is a single component of an employee's total compensation package and is not a guarantee of life-changing wealth even for successful companies.

Keep It Simple

There is a pervasive belief amongst technology startups, particularly those that are founded by software engineers, that a perfect algorithm can be developed which will deliver precisely the right compensation over time to each employee based on the employee's market value. Examples of this quest are seen in custom vesting schedules designed to deliver constant economic value over the vesting period as the value of the shares increases, so called "grunt funds" or dynamic equity that reward individuals based on hours worked or other factors, and performance based vesting models. The problem with these alternative models is that they do not scale and do not serve the ultimate purpose of equity compensation, which is retention.

At the end of the day, it is still human beings who have to administer the equity program (this is true even for so-called automated platforms such as eshares and Shareworks), run intelligible reports, and conduct due diligence. A company of three or four employees that wants to have a vesting schedule that is front-weighted or back-weighted or that allows vesting to be based on hours worked is one thing. That same model applied across hundreds of employees is entirely different. Merely explaining a custom vesting schedule to employees used to standard four year vesting is, in my experience, exceedingly difficult. If the employee doesn't truly understand what he or she is receiving, then the grant loses worth and ultimately will fail to keep the employee striving to increase the value of such equity. The analog in cash compensation is the annual commission plan which is notoriously difficult to get right even for those sales professionals whose contributions are easily quantifiable. Imagine having to create a single, long-term variable cash compensation plan for every type of employee at a 500 person company.

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For these reasons, I routinely encourage founders to stick with the basic four-year vesting schedule. Additional bells and whistles like early exercisability of options or acceleration of vesting on termination following a change in control are the few additional features that management should consider. The cap table is going to get complex enough on its own over time without making it purposefully so.

Mind the Budget

Every company should have an annual equity budget that is used for new hire grants, refresh grants and merit or promotion grants. While it is true that, unlike cash, companies can theoretically print more shares, to do so punishes existing stakeholders and most investors significantly constrain companies' ability to increase the size of stock plans. Early stage companies generally only need to concern themselves with new hire grants and with modest hiring plans can usually easily fit within the existing pool or a subsequent increase. As these companies mature, however, and need to grant shares to recently promoted employees or employees who are finishing their initial vesting period, the budget starts to tighten up and failure to make allowances for these grants can result in real morale issues or difficult board and stockholder discussions. As shares become scarce, it is important to make sure that those shares that are available are issued to those employees who are performing the best and whose retention is most valuable to the company. There is a strong compulsion in many companies to spread the shares out evenly across the employee base in order to avoid difficult conversations (similar to bonus or raise discussions) but depending on the budget and the anticipated need, it is ultimately in the company's best interests to give more shares to fewer individuals than to effectively incentivize no one with uniformly paltry grants.

Be Realistic

Given the daily business deadlines and the local housing prices, it is easy to believe that every employee at successful startups receives life-changing wealth upon a liquidity event such as an IPO or acquisition. The reality is that for most employees at most companies, a sale of the company may mean a new car or a down payment on a new house, but not early retirement. An employee who has 25,000 shares of a company that sells for $500 million and has 50 million shares outstanding will gross $250,000 before taxes. A nice outcome but certainly not life-changing and when you subtract the exercise price of the shares paid to obtain them and divide by the vesting period that it took to earn them, it is likely closer to a series of really nice annual bonuses.

Some founders and entrepreneurs really struggle with this issue especially given the usually very large ownership stake that they enjoy. They do the math themselves for their employees and realize that the lion's share of the reward goes to a handful of founders and very early employees. Yet they seem to forget that it was them and the other early employees who took the biggest risks. Often they worked for free (in spite of minimum wage laws requiring otherwise) with no guarantee that venture-backing or revenues would ever occur. In addition, they were likely the ones who were most responsible for the company's ultimate success. The goal of a successful equity compensation plan should be retention, not generational wealth creation for every employee, new and old.

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