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Five Rules of Thumb for Issuing Stock Options to Directors and Advisors of Emerging Growth Companies

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A properly selected Board of Directors and Board of Advisors can be an invaluable asset to an emerging company. Building these boards is an early opportunity for a start-up company to gain credibility, industry contacts, experienced counseling and even access to cash. However, the right board members do not always come easily, and although some companies may have their pick of top industry players, many start-ups struggle to recruit board members that are the right fit for their company.

Nearly every start-up has limited cash. This does not, however, have to limit their ability to recruit directors and advisors. A stock option or other equity incentive plan can allow a start-up company to offer prospective independent directors and advisors a financial upside beyond what the company's cash account can currently afford. Additionally, option-based compensation creates powerful incentives for directors and advisors to work diligently to help drive company growth and success. A stock option plan should be established early, and if administered properly, it can become a company's top board recruitment tool.

In counseling hundreds of emerging companies through this process, rules of thumb emerge that help provide guideposts for entrepreneurial companies. This article, built from a series of interviews with attorneys who counsel start-ups in their issuance of stock options, will discuss five of these rules of thumb.

Rule of Thumb No. 1: Reserve 10-20% Of Your Company's Outstanding Equity For A Stock Option Plan.

Equity incentives are a major form of compensation for most emerging growth and technology companies. Without them, most start-ups cannot afford critical labor, let alone a board of directors or advisors. It is critical for a start-up to consider this reality and reserve 10-20% of its outstanding equity for a stock option plan. The exact percentage is often determined on a case-by-case basis. The final figure will depend on the client's situation, including the number of employees of the company and the amount of capital that it hopes to eventually raise.

Whatever the percentage, it pays to plan ahead. Most sophisticated investors will require a stock option pool upon investment, and a company that fails to reserve a sufficient amount of equity up-front runs the risk of being forced to establish a pool at a later date that may dilute the founders' ownership.

Rule of Thumb No. 2: Issue Options According To Value Added And Risk Taken.

Options are often issued as a reward, either for services rendered or risk assumed by the recipient. Thus, the number of shares and ownership percentage covered by the award to a director or advisor should depend on the value added and risk assumed.

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It can be difficult to assess the intangible value of certain directors or advisors, and although a high profile individual is generally awarded a larger option package, the industry credibility and networking opportunities a director or advisor offers are not easily appraised.

However, one can approach this problem from a different angle. Instead of searching for the right percentage, an alternative is to focus on the expected payout. Most true outside directors are looking for an opportunity to make a million dollars over a five year period. Therefore, instead of thinking about the number of shares or percentage ownership, start with the end figure and issue accordingly. As far as advisors are concerned, the same technique is used with a lower payout.

Compensation also depends on the prospects of the company, how far along the company is, and the track record of the founders. This all goes to the company's likelihood of success—the higher the likelihood of success, the less risk there is to compensate for.

In any event, a director's take typically falls between one-half of a percent and two percent, and an advisor's between one-quarter of a percent and one percent. In each case, the company's needs and the qualities of the prospective director or advisor drive the analysis.

Rule of Thumb No. 3: Subject Director And Advisor Shares To A Two-Year Vesting Schedule.

Directors assume general corporate law fiduciary duties and potential liability from the very first day they serve on a company's board. For this reason, independent directors expect to be compensated beginning day one. Highly sought after advisors expect similar rewards. Gradually vesting a director's and advisor's options align their compensation with their actual service while protecting the company in the event that they are prematurely removed from the board. In this circumstance, vesting only allows a short-lived director or advisor to receive the fraction of the option package that corresponds with the director's or officer's actual term of service.

Subjecting a director's shares to a two-year vesting schedule also creates added performance incentive. By default, corporate directors are normally on a one-year term of service. Using a two-year vesting schedule encourages a director to perform well so that he or she is retained for a second term. Moreover, the two-year vesting schedule—as opposed to the four-year schedule typical of employee options—is preferred for directors because it magnifies the incentives for these influential individuals. Options issued to advisors are typically treated the same, so long as the advisor is not otherwise being compensated by the company.

Vesting should be accelerated in the event of a change of control. Many directors and advisors will not serve on a board if this provision is not included. If the board determines that it is in the best interests of the shareholders to sell the company, the directors and advisors should not be restricted from sharing in the value of the acquisition merely because their shares have not yet vested.

Rule of Thumb No. 4: Set a lenient post-termination exercise period when possible.

If a director or advisor's term is discontinued, a lenient post-termination exercise period may be very valuable to an option holder. I advise clients to draft the option grant to permit exercise up to ten years after termination, depending on when the option was granted in relation to when the option plan was adopted. This is because most small companies do not have quick and easy exits, it is onerous to require directors and advisors to pay cash for shares in a company that is far from a liquidity event.

My argument for this method is that subjecting a director or advisor to the typical 30-day to 90-day post-termination exercise period used for an employee optionee holding Incentive Stock Options (ISOs) would be unduly harsh on directors and advisors. Employee optionees holding ISOs receive other forms of compensation, while directors and advisors of start-ups typically do not.

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Rule of Thumb No. 5: Try Not To Jeopardize Relationships.

Up-front communication of a director or advisor's term of service and duties helps to foster a healthy relationship and facilitate a potential termination without jeopardizing relationships. For start-ups, relationships can be an incredibly valuable asset, and although a businessperson's term of service to the company ends, he/she may remain a resource for years to come. Importantly, the director or advisor's tenure should be productive and the rapport built with one another should remain productive in the future.

Assigning duties can be tricky. Because directors have fiduciary duties, additional explicit duties do not normally need to be defined, although some companies have explicit director agreements. For advisors, I recommended that companies avoid too much specificity, but nail down the length of service and the option terms, include an indemnification provision, and provide for confidentiality in a written advisor agreement, the term of which may be terminated at any time. When expectations are clear, everyone is happier.

Conclusion

Ultimately, equity-based compensation should motivate independent directors and advisors by offering them a favorable, but fair, vehicle through which they can profit. Favorable conditions, such as a short vesting schedule and an extended post-termination exercise period, promotes director and advisor interest and keeps them driven. If used properly, a stock option or other equity incentive plan solves a number of problems at once: it helps preserve cash, it serves as a powerful tool for recruiting talent, and it offers a compensation structure that aligns incentives with interests and promotes dedication to growth and success. Establishing and administering a plan is not always easy, but with these five rules of thumb and a solid compensation strategy, everyone can succeed.

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