

Startup Equity Nightmares

How to avoid mistakes when managing your company's equity

Startup founders are known for moving fast and avoiding bureaucracy. But when it comes to managing their company's equity, such a go-it-alone attitude can backfire—badly.

“The stock-options backdating scandal that led to the criminal trials of executives of many well-known companies in the early 2000s is just one example of how poor recordkeeping can get companies in trouble and lead to a huge public relations and human resources nightmare,” says Georgina Lai, a director of product development for Nasdaq Private Market. The lesson: Companies need to be careful about ensuring that their equity programs are effectively designed and in compliance with applicable regulations.

For startups armed with big ideas but tiny budgets, equity is “the most valuable currency you have,” says Lee Schindler, an emerging companies and venture capital partner at the law firm of Perkins Coie. Spending it correctly can help you attract the right investors and maximize your employees' performance over the long haul.

Here are some tips for how to avoid mistakes and manage your company's equity more wisely:

Hand out equity carefully

When two friends start a business together, it's common for them to automatically split equity 50-50, but that can ultimately hurt performance. If one founder is the CEO, the primary innovator and the only full-time employee, that founder deserves a bigger slice of the pie, Schindler says. Founders who don't get their deserved slice of equity may start to feel resentful and less motivated to work hard.

Another common mistake at a company's founding is giving a big equity stake to an institution in exchange for its intellectual property, or to an academic who contributed a key idea but doesn't work for the company. “The vast majority of the stock should be in the hands of the team that will be adding value to the core intellectual property,” Schindler says. “Otherwise, you're removing a big carrot for your management team, which will be driving your valuation going forward.”

Don't improvise

"Managing stock plans can require jumping through a lot of hoops. The company's board must formally approve any stock options and changes to those options," says Christine McCarthy, an executive compensation partner at the Silicon Valley law firm Orrick, Herrington & Sutcliffe. Founders who bypass these formalities risk running afoul of Internal Revenue Service rules, including Section 409A, exposing option recipients to penalties and taxes that could render the granted options "almost worthless," McCarthy says.

"Given that stock plans typically get more complex as a company grows, stakes are high for companies that don't design or administer their plans carefully," notes Nasdaq Private Market's Lai. One tech security company tripped up on its policy for granting restricted stock units (RSUs) by setting the vesting schedule around the employee's hire date. As a result, the company now must declare a "taxable event" almost every day of the year, at considerable administrative expense. Another firm, a large software maker, made a drafting mistake in its equity plan, which led a judge to force three senior executives to forfeit nearly half a billion dollars in options gains.

Think long term

Too many founders "think about today, and only today" when designing their equity strategy, says Carine Schneider, President of Equity Management Solutions at Nasdaq Private Market. This leads to several common mistakes when setting up a plan:

- Failure to stagger equity awards. Giving someone a big equity incentive to join your company and handing it out in one lump sum, gives little incentive to that person to stick around.
- Restricting the equity instruments you can use. Stock options, RSUs and restricted stock awards: When and where to offer these incentives depends on the maturity of your company, where an employee is based and other factors. "A good plan will allow you to grant any kind of equity award that the company's board deems appropriate at the time," Schneider says.
- Failure to plan for growth. Some plans place heavy restrictions on the circumstances in which options can be granted. Changing these plans can be onerous when a company grows and wants to give out more options.

"The most common kind of short-term thinking, however, happens when companies put blanket restrictions on the sale of vested shares," Schneider says. Private companies have good reasons to carefully control share sales. Some companies virtually forbid them until the company goes public or is acquired. But as the years wear on without an exit event, valued employees who accepted lower salaries in return for equity stakes will start to see their peers at public companies profiting from selling their publicly traded stock. By reducing restrictions on the sale of a portion of a shareholder's equity—or by sponsoring a structured liquidity event at which an employee can sell a portion of his or her shares—a private company can reward its founders and employees for work well done without giving up their incentive to stay.

Equity is a vital tool for attracting and retaining top talent when your startup has little more to sell than a dream. Handle it poorly and your equity plans could start giving you nightmares instead.

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