Start-ups and Compensating Employees with Equity

By Mike Bruner

Equity is a key tool for start-ups. Often lacking in resources when compared to larger, more established firms, every aspect of a growing business must be used as a tool to further the goals of the firm. “Our resources are limited and equity is a strong weapon for us. We don't have angel investors or venture capital, so we worked with our corporate investor and agreed that it is okay for us to use equity as compensation," said C.J. Okumura, co-founder of Abwiz, a local San Diego-based biotech start-up.

Start-ups tend to be high-risk, high-reward ventures. A recent white paper from the Harvard Business School titled Performance Persistence in Entrepreneurship sheds light on the topic. First-time entrepreneurs have an 18 percent chance of “succeeding" (where success is considered to be starting a company that eventually holds an initial public offering, or IPO), while previously “failed" entrepreneurs have a 20 percent chance of success. A crucial part of getting a business off the ground for many companies is having cash invested in the firm by outside investors. As of calendar Q3 2012, total venture capital (VC) investments were down six percent year-over-year, according to reports by CB Insights, a venture capital database.

However, there always are those intrepid individuals willing to follow their dreams and launch a business. And although overall VC funding was down through late 2012, that same CB Insights report presents data indicating that Q3 2012 was a record quarter for quantity of VC investments, with 835 investments overall. As Jim Carrey put it in the film Dumb and Dumber, “So you're telling me there's a chance!"

Before running off and launching a start-up business however, one of the most important things an entrepreneur must think through is how to best handle equity in the company. The founder, or founders, likely will want to maintain as much equity as possible, while any outside investors will desire equity as well to compensate for use of their cash.

On top of the two common groups of founders and investors, employees often are compensated with equity as an incentive for working at a start-up. Typically, start-ups are equity rich and cash poor. Rather than compensate employees with precious funds, managers turn to equity as a greater portion of compensation packages as compared with other organizations. The chance of

large future returns from ownership in the firm, even with a smaller salary, can be an appealing option for many employees.

Stock compensation primarily comes in one of two ways: either as a direct stock grant (i.e. an employee is “paid" stock as part of his or her compensation); or through stock options (the “right" to purchase stock at a set price on a later date). Direct equity compensation granted by the company is taxed immediately as income to both the company and the employee. Stock options also are taxed as income, but not until the option is exercised. Both options and grants are often tied into a vesting period, where the employee earns the stock or options over a period of time. For example, an employee is hired and given 10,000 shares of stock vesting over four years. In this scenario the employee would receive 2,500 shares after the first year, 2,500 shares after the second year, and so on. Due to their tax advantages, stock options are sometimes preferred over stock grants, although both forms of compensation are in common use.

If a start-up manages to gain outside investing (from for example an angel investor or venture capital), it is common for the founders and investors to set aside a pool of stock from which to tap for future employee compensation. Sizes of this pool of stock can vary. The purpose is to ensure that an appropriate amount of stock is available with which to incentivize employees as owners while at the same time maintaining significant ownership with the founders and investors.

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