Startups & Options

In early 2013 a startup client asked me to become his interim CEO after I had helped him develop a winning strategy that landed SBA bank financing. Ultimately, I did not take this role in part because my client got what I strongly believe was extraordinarily bad advice regarding how to structure the equity portion of my compensation.

The following provides a summary of the business situation, which is why I wrote this blog, how valuation figures into options, issues with options and concise guidelines for when options might be appropriate. To protect the guilty, I have redacted all names and refer to the business as “Startup X”. This should not matter as this is a lesson for all startups to internalize—the business itself has zero bearing on what I share below.

Business Situation

I was involved with Startup X for seven months. At the time that the client engaged me he had market test products, product lifecycle vision and core marcom, $3,000 dollars in sales (over 18 months), virtually no inventory, changes he was making to the test product and engaged with a national retailer that expressed interest in distributing his products. Most significantly, my client had no working capital and had recently been rejected for an SBA loan. In other words, this was a typical startup situation.

In roughly four weeks I devised a business strategy that I believed would pass SBA scrutiny, prepared a business plan and developed pro forma financial projections that the business lacked. This work was used as the basis of a new application to the same bank for an SBA loan. I also performed extensive competitive research and supported my client in his dealing with the bank and negotiations with the national retailer.

By the time I passed on the terms my client offered to become Startup X’s interim CEO the business had secured a $250,000 SBA loan and had executed a market test agreement with the national retailer under terms that fit the revised business strategy. In the end I rejected Startup X offer because I was being offered options instead of founders equity with Startup X’s right to repurchase my equity if I failed to deliver on key metrics (i.e., sales, number of distributors and valuation).

What follow is a scrubbed version of what I sent my client to explain why option were not acceptable to me. I strongly believe every startup can learn from what follows.

Startup Valuation & Options

To get the business off the ground, Startup X got friends and family to invest at a valuation of a few hundred thousand dollars. Startup valuations are necessary fictions entrepreneurs need to make it worth their while to invest their time to create something that could lead to meaninglu financial rewards. However, in valuations tha have tax implications, the business has less than zero value.

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Startup X had no valuation event (a formal valuation assigned by a credible valuation professional or an investment by a disinterested sophisticated investor) nor had it made significant business progress in terms that the IRS would recognize. Thus its value in the eyes of the IRS was zero.

When a business has no value, you can transfer equity to others without triggering a taxable event (of course Startup X has potential worth but no actual value from a tax perspective at that point in time). So it is important to understand that startups really have two valuations: their startup valuation and what I call an IRS valuation. They are two different things.

When I got involved with Startup X, the business had no cash to purchase the inventory to fulfill a pending national retailer contract. Moreover, Startup X's debts and obligations far exceeded its gross revenues. It was therefore immanently reasonable and legal, in terms of getting an executive on board, to establish Startup X's valuation at zero value. That a compelling case can be made to new investors that the business deserved a $1MM startup valuation has no bearing on the businesses' IRS valuation.

There was nothing preventing Startup X from transferring its founder equity tax-free. This situation was poised to change but that was the reality at the time I was negotiating my compensation. But instead of striking a deal to grant me encumbered equity, Startup X's advisor insisted that I receive options. I rejected this offer because Startup X and I would have to deal with myriad very negative issues that could easily and legally be avoided.

Issues Startups Face with Options

Overwhelmingly business options are used to provide equity compensation to management and employees after a sophisticated institutional investor puts money in the business, the business is on a great growth trajectory or the business is profitable. From my experience, most investors don't like to inherit option plans put in place prior to their investment as venture investors have their own biases about how they want their portfolio companies' option plans to work (**ISSUE 1**).

Giving someone equity after the IRS would deem the business has value is a taxable event.   The beauty of options is that the person receiving options don't have to pay income tax when they receive options, only after they exercise their option and sell the equity.   You can still grant equity but the person has to pay income tax on the value of equity. Options allow companies to get around immediate-term tax issue. Of course, Startup X had no value in the eyes of the IRS so this was not an issue.

Options come with a strike or grant price meaning that there is a value assigned to the option upon its issue. Valuation professionals are engaged to establish the valuation upon which the strike price is based. Coming up with a valuation to establish options' strike price generally costs money, takes time and is a distraction to the business (**ISSUE 2**). Moreover, why, when the IRS would readily accept that Startup X has no value, would anyone agree to a "fake" value for the sole purpose of creating options

(**ISSUE 3**)? I suppose Startup X could have issued “zero strike price stock options” but why not simply grant stock with buyback terms and avoid a bunch of other very negative issues?

When I thought I would get a grant of equity encumbered by buy-back terms I agreed to take a tiny salary (roughly 1/5 what I was paid at my last startup) until Startup X was funded by a third party. This means I agreed to give up many tens of thousands in income. With the options offer, I would also be required to pay out of my pocket to exercise options that vest, even though I know that upon being granted these options the IRS would ascribe a zero value strike price (**ISSUE 4**).

Options generally vest over time. So if all goes well, sometime after the agreed upon vesting period I would own equity equal to the number of options I exercised. I could, as Startup X’s advisor suggested, exercise my option as they vest by paying the company to exercise them (what a pain and horrible use of my money—**ISSUE 5**). With options I would also have to wait 12 months to sell them after I exercised to avoid paying ordinary income tax on profits (**ISSUE 6**). This adds another year on top of the vesting schedule they were asking me to accept.

There are other complexities and challenges that would need to be considered as well such as the cost of creating an options plan (ISSUE 7), cost/effort of correctly expensing and reporting options (ISSUE 8), liquidity event considerations (ISSUE 9), dilution impact (ISSUE 10) management of options terms and valuation (ISSUE 11), etc. Fundamentally I believe that an unproven startup—one without meaningful revenues and/or profits or investment from a sophisticated third party—demonstrate poor judgment if they take on all of the burdens of setting up option plan before business progress merits it (ISSUE 12) and this is something startups need to avoid.

Bottom line, why would Startup X take on all of this complexity and cost when the IRS would have had no issue with transferring stock for free at this time? By granting me equity now (encumbered by buyback rights), I am free and clear to divest it under capital gains tax laws after 12 months have passed and as soon as Startup X’s buyback expires.

When a Company Should Consider Options

Simply put, options should be avoided until a business has mades significant progress. Due to the cost, complexity and on-going overhead it is rare to find a company with less than $5 million in revenue, millions in funding and/or 30 or more employees that has and options plan.

If the above isn’t enough to convince you that options are bad for startups, dig around the Internet. I wrote the above based on my experience but did a bit of research afterwards and found lots to support for what I laid out here. For example, take a look at these articles: Article 1 and Article 2. The truth is that options plans are great but not for startup businesses, especially those with near-zero revenues and a few employees.

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