Do I Need A Share Reserve to Grant Compensatory Stock Options?

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Stock options are key to startups. Despite some larger companies adopting restricted stock award plans, options are still the way to go for startups. They are a vital recruitment, incentive and retention tool.

Share Reserve for Compensatory Stock Options

I was recently asked by a private company: Do I have to adopt a stock option plan with a share reserve in order to grant compensatory stock options?

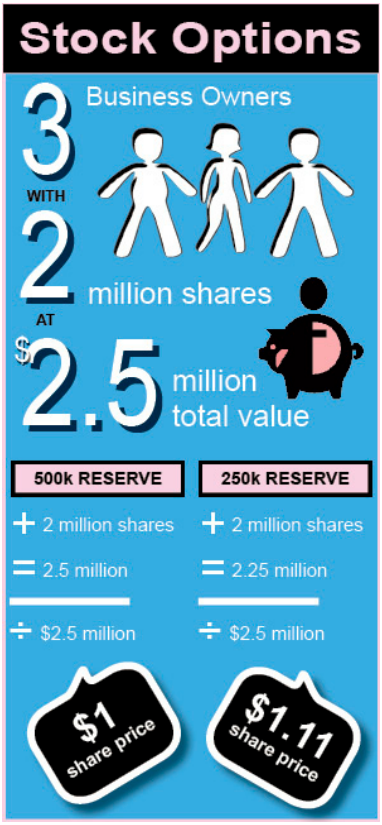
The question was motivated by the concern that it was too early to put a stake in the ground regarding the size of a share reserve. You see, the founders didn't know yet how many shares to reserve under a plan and didn't want to establish a reserve that might be too large because that would then drive down the price per share in the company's anticipated financing.

For example: Suppose your company has 3 founders who own together 2M shares, you have a share reserve of 500K shares, and you have been offered a pre-money valuation of $2.5M. If the price per share in your offering is determined on a fully diluted basis, your price per share would be:

$2.5M (pre-money value) divided by 2.5M (fully diluted share figure), or $1.00 per share.

Now assume that your 3 founders own together 2M shares, and you have a share reserve of 250K shares, and you have been offered a pre-money valuation of $2.5M. If the price per share in your offering is determined on a fully diluted basis, based on these numbers, your price per share would be:

$2.5M (pre-money value), divided by 2.25M (fully diluted share figure), or $1.11 per share.



As you can see from the examples above, having too large a share reserve will drive down your price per share in your offering. (Of course, there is always the risk too that your investor will require you to have a share reserve of a certain size…) But the answer to the technical legal question above is that there is no federal or state securities, tax, or other law that requires you to adopt a stock option plan with a share reserve in order to grant compensatory stock options to employees or non-employee service providers. (However, what you do need to do is make sure that you have enough stock authorized in your articles or certificate of incorporation to be able to honor your stock options when they are exercised.)

The federal securities law exemption for stock options, Rule 701, for example, does not state that you need a plan or that options have to be granted pursuant to a plan with a share reserve. It exempts:

"[O]ffers and sales of securities (including plan interests and guarantees pursuant to paragraph (d)(2)(ii) of this section) under a written compensatory benefit plan (or written compensation contract) established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent, for the participation of their employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities from such persons through gifts or domestic relations orders."

Thus, under Rule 701 it is possible to grant stock options without a stock option plan with a share reserve, as "stand-alone" grants so long as the grants are made under a "written compensation contract."

Similarly, many states' securities laws do not require that options be granted only under a plan with a share reserve. In Washington, for example, it is not necessary, as long you notify the Director of the Washington State Department of Financial Institutions in writing thirty days before offering the options in this state, and provide the Director with a copy of the documents pursuant to which you plan to make the awards.

The Drawbacks

There are drawbacks to granting options as "stand alone" grants:

1. No "Incentive Stock Options" under the Internal Revenue Code may be granted except pursuant to a stock option plan with a share reserve that has been approved by shareholders. Some employees may prefer ISOs (although as I have written before, I think ISOs are ***overrated***.)

2. Under some states' securities laws, it will be easier to find a securities law exemption for the option issuance pursuant to a plan that has been approved by the shareholders (e.g., California).

3. It may be administratively more difficult to make stand-alone grants; the documentation may not be as easy to pull together as it usually is for stock option plan documents.

4. Due diligence questions might arise later because you made stand-alone grants rather than pursuant to a stock option plan.

Why You Might Want To Make Stand-Alone Grants

Why would you want to grant stock options as stand-alone grants?

You may want to put off adopting a stock option plan because you only plan 1 or 2 small grants and don't want the complexity of adopting a plan. Similarly, you may just not know how many shares to reserve in your plan and thus want to defer adopting a plan for that reason.

Washington State Securities Law

Under Washington law, if you grant stock options other than pursuant to a stock option plan pursuant to which you can grant ISOs, you have to give the Washington State Department of Financial Institutions 30 days notice before the offer is made. See RCW 21.20.310(10) (bullet points added for ease of reading) that defines a particular kind of security exempt from registration in Washington:

(10) Any security issued in connection with an employee's stock purchase, savings, pension, profit-sharing, or similar benefit plan if:

(a) The plan meets the requirements for qualification as:

- a pension, profit sharing, or stock bonus plan under section 401 of the internal revenue code,
- as an incentive stock option plan under section 422 of the internal revenue code,
- as a nonqualified incentive stock option plan adopted with or as a supplement to an incentive stock option plan under section 422 of the internal revenue code, or
- as an employee stock purchase plan under section 423 of the internal revenue code; or

(b) the director is notified in writing with a copy of the plan thirty days before offering the plan to employees in this state. In the event of late filing of notification the director may upon application, for good cause excuse such late filing if he or she finds it in the public interest to grant such relief.

TIP: If the entity involved is an LLC that wishes to make grants of equity interests in the LLC, because LLC equity grants are not treated as incentive stock options (unless the LLC has checked the box to be taxed as a corporation and met the other requirements), you will want to file a notice with the DFI. But remember, granting equity options in an

LLC has significant tax and legal complexities, and you will really need to discuss any proposed LLC option plan with an experienced business and federal tax lawyer.

Your Stocks, Your Future

Stock options are critical for most startups, and formal stock option plans with share reserves are the best approach for most companies. It is generally my view that you shouldn't avoid adopting a stock option plan because of a fear of adopting too great a share reserve. However, if you are not ready to adopt a stock option plan with a share reserve, there are ways to proceed without a reserve or even a plan, by using stand-alone grants.

For more information about Stock Option Grants try:

- PRIVATE CORPORATION STOCK OPTION GRANT CHECKLIST
- WHAT IS THE DIFFERENCE BETWEEN WARRANTS AND OPTIONS?
- WHAT'S BETTER FOR AN EQUITY INCENTIVE–RESTRICTED STOCK OR A STOCK OPTION?