Using stock ownership to attract employees and advisors

Appeared in the Tri-City Herald, May 26, 2002

Savvy startup companies know they need experienced management teams and well-connected advisors to survive and compete. But how does a new venture, with big dreams but scant financial resources, attract and keep top-notch executives and advisors? One solution is a stock option plan.

Simply put, stock options give designated employees the right to buy shares of the company at a fixed price for a certain number of years into the future. The idea is that as the company becomes successful later, the stock value appreciates significantly. The employees get to buy the shares at the previously agreed upon price, then sell them later at a higher market value and pocket the difference.

"This is different than employee stock ownership plans, where an employee group owns a large stake in the company," said Gary Kocher, a partner at the Seattle office of the law firm Preston Gates & Ellis. "With stock options, rather than buying the shares outright when the options are first granted, you reap the value of the stock when there's a liquidity event – such as when the company is acquired or goes public," he explained.

Kocher said stock option plans are "widespread, almost universal" with the law firm's business clients. He does about 15 plans each year.

Companies like stock options for three reasons, said Bernie Hansen, a Seattle-based business consultant who advises many Tri-Cities tech companies. "They help you compete for high-value contributors," he said. "They incentivize people to work for the long-term success of the company. And, they encourage people to stick around long enough to reap the rewards."

Offering options allows new ventures to devote more of their limited startup funds to developing products and entering the marketplace, rather than on large salaries, Kocher added. "It also aligns employees' interests with those of the investors, who want to see a timely return on their money," he said.

Patricia Irving's Richland company, InnovaTek, has used stock plans for employees since she founded the firm in 1998. Irving recently added another option plan to attract high-powered advisory board members.

"Most people who are being pursued for board positions aren't really interested in traditional forms of compensation like salaries," she said. "In fact, prospective board members we approached told us they wouldn't consider anything other than stock."

Stock plans benefit both employees and the company, Irving believes. "We are attracting people who, by design, are contributing to the future success of the company. If we are successful, they are rewarded – and they will help us get there."

Stan Mansfield experienced a heightened sense of ownership when his firm launched a stock option plan recently. Mansfield is Chief Operating Officer of InStar Corporation, a Kennewick company that develops software for insurance companies. The company is using a stock plan to attract strategic partners and advisors. But the plan also extends to others at InStar, including Mansfield himself. "Having a financial stake in InStar's long-term success has instilled an even stronger sense of responsibility, pride and loyalty," he said.

Stock options have been called "golden handcuffs" because they pay off later in the company's life cycle. Options are usually subject to vesting, meaning that when someone is 25 percent vested, he or she can cash in only 25 percent of the options. The typical vesting schedule is 25 percent annually over a four-year period, Kocher said. Employees must stay until they are fully vested to get the most value from their stock, because options that are not vested when the employee leaves are typically forfeited.

InnovaTek has a buyback clause in its option agreement, where the firm has the option of buying the stock back if people leave after just a few years. "We don't want to make the mistake Microsoft made, where a lot of stock options got cashed out early and they lost a lot of people in the process."

Kocher admitted that some entrepreneurs shy away from allocating the typical 20 to 25 percent of shares to option plans for fear of diluting the company's value. "It's usually better to own a smaller piece of a larger pie," Kocher said. "If the option plan lets you recruit top talent, the pie—meaning the company's overall value--will continue to grow over time."

Companies considering stock plans should seek legal counsel who understand the tax and reporting issues surrounding stock options, Kocher said.

Option plans range from about $1,000 to $5,000 or more, depending on the complexity, Kocher said. Some law firms offer a package for startup companies that includes basic documents such as company incorporation, stock option plans and employee confidentiality agreements for $1,500.

Said Kocher, "For companies that want to grow by taking in outside investment money, being acquired or going public, option plans are a good alternative."

# # #