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Feb 13 • 14 tweets • fintechjunkie/status/1625276352977940481

What the heck do you do if a Founder is fully vested and asks for an options refresh?

It happens all the time but with valuations down the answer isn't simple.

A few thoughts on a third-rail topic: 🧵 👇

A well-designed compensation structure creates alignment.

Startups are rarely "up and to the right" all the time, so aligning employees (labor) and investors (capital) to chase the same outcome is critical.

When a business is just an idea, Founders own the entire cap table.

Investors buy ownership in the startup in return for an equity interest in the company.

Employees are paid a salary and granted options in return for their labor.

Options granted to employees align their incentives with enterprise value creation and fill in the cash gap relative to opportunities they have at more established companies.

Cash is precious to a startup, so options are a critical component in attracting and retaining talent.

Founders have to internalize that the more capital efficient their startup is, the more ownership they'll retain over time.

Asking to be treated like a Founder when the startup is an idea but treated like an employee when significant capital has been deployed is illogical.

Another widely misunderstood but important component of granting options is their "strike price".

In the US, section 409a of the IRS's internal revenue code outlines how to determine the fair value of a share of common stock in a company. A 409a valuation is typically conducted by an independent appraisal firm in advance of granting options to employees.

The 409a valuation provides safe harbor for a taxable event. If options are granted at or above the 409a price, they're "out of the money," which helps employees avoid an immediately taxable event.

But the 409a valuation is not always the right strike price for options!

For the past 5+ years, tech talent has been in short supply and therefore startups put in place "employee friendly policies". In this environment, it was assumed the strike price should be as low as legally allowed which effectively transferred value from Investors to employees.

But with the tech ecosystem experiencing a severe correction, the balance of power is shifting. Tech talent can't just pick up and find jobs elsewhere because most tech companies are in the midst of downsizing or right sizing their teams.

Options grants will always play a role in the compensation plans of tech companies, but the pendulum has swung to a more centrist position where employees (and Founders in particular) will benefit from options if and only if Investors earn a return on their invested capital.

So when a Founder asks for additional equity, Investors are likely to ask "why".

Will granting more equity to a Founder change their involvement, their decision making or kink the curve on a startup's exit value?

If the answer is "no" then Investors might say "no" in return.

And while in many countries there isn't a parallel to the 409a construct, the concept of alignment is universal. Options are an important component of a well thought out compensation plan and setting the strike price to incent the right behaviors should be part of that plan.

TL;DR: Tech startups have always used options to give employees a sense of ownership in the company they're building and this isn't going away anytime soon.

But the days of automatic refreshes at artificially low strike prices isn't likely to be the norm anymore.

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