

# Five Key Errors in Designing Equity Compensation Plans in Closely Held Companies

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I have had dozens of conversations with business owners who want to share equity with some or all employees over the past several years. I start by asking what they are thinking of doing. With almost unflinching consistency, they say:

1. I'm planning to give out 10% of the equity or rights to the equity.
2. I'm planning to give most or all of whatever percentage I've decided to give up front to those eligible.
3. Employees will only be able to exercise their awards when the company sells or goes public.
4. Only key employees will get equity.
5. I will base the amount each person gets on a percentage of the company that I have heard or read makes sense.

In some cases, one or more of these ideas makes sense. But more often than not, they don't.

## Error One: The 10% Solution

When I ask people how they arrived at this number, they usually say, "It just seemed reasonable" or "That's what I have heard other people do." But 10% of one company is in no way comparable to 10% of another. Say Company A is three years old, has 50 employees, is already making a profit, has little debt, and has an exciting new product already in production. Company B is one year old, has 10 employees, some good ideas, but no profits and products only in development. Company C is 20 years old, has 100 employees, has steady growth, and is reasonably profitable, but does not expect any major breakthroughs in its business. Is 10% of each of these companies the same? No. It's not even close. Each company's employees will get radically different amounts. Decisions about giving away large amounts of owner equity should not be made with simplistic assessments of "reasonable" numbers.

## Error Two: Most of the Equity to Be Given Will Be Given Out Up Front

Owners often want to reward and motivate the people who have helped them build the business. So whatever they have decided to give out, they either give out now or maybe reserve a small percentage for later. This raises some serious difficulties. First, what happens if you need to add new key people or replace existing ones? There is no more equity to give them, which creates a divisive "them" versus "us" problem. Second, you've

created a lottery. Say you are giving out stock options. After a very good year, you give 2% of the company to Mary, your CFO, at \$20 per share. You've wisely reserved some additional equity to give out next year. But your company hits a rough patch so by the time the new sales director, Joe, comes on board a year later his options for 2% of the company have an exercise price of just \$15. Joe just got a much better deal than Mary. Is that fair? Third, you have lost the opportunity to give out more equity in the future without reducing your own ownership.

### **Error Three: Unless We Sell or Go Public, No Exercise Is Allowed**

Put yourself in the employee's shoes for a minute. You have just been told you're getting \$50,000 worth of equity, but you have to stay three years for it to vest. When it does vest, you can exercise it only if the company is sold or goes public. You think, "Gee, I may not be here in three years, and if I am there is no guarantee that either of these things will happen at all. This \$50,000 you just gave me seems to be worth maybe \$20,000 given the uncertainty." These numbers are reasonable approximations of what research indicates employees actually do think. There is a real asymmetry in equity awards. Stock awards seem like real money the day you give them, dollar for dollar. But all of us tend to discount future promises of money based on time delays and uncertainty in far greater measure than it would be economically "rational" to do. So adding lots of strings means you need to give out more to have the same effect.

### **Error Four: Only "Key" Employees Will Get Equity**

Company leaders like to tell their workers that "people are our most important asset." But then when it comes to equity practices, it turns out only some people really are important. Years of research tell us that giving out ownership broadly to employees make sense: companies that do grow faster and yield better returns for their investors than companies that concentrate equity in the hands of a few people. Imagine a company in which everyone had a reason to care about treating customers well, working efficiently, and, most important, coming up with lots of new ideas about how to do everything better. Wouldn't that be a more profitable company? And a more enjoyable place for everyone, owners included, to work? Sharing ownership more broadly, even if it means extra dilution, usually more than pays off in the end.

### **Error Five: How Much Each Employee Gets Will Be Based on Some Number I Read or Heard**

You might have seen the number in a compensation survey or heard it at a conference. Maybe you heard the CFO should get 1% of the company, for instance. What the employee really wants to know is how much will I be getting in dollars I can count on. So consider each person individually. What number given out periodically would be enough to attract, retain, and motivate good people? Surveys and what you hear from peers can help in making this judgment, but you know your people best, as well as what else you offer to employees, and only you can ultimately make the right choice.

## Building a Dynamic Model

So what to do? Here is what we have learned works best:

1. Give out equity in smaller chunks more often. This will average out the lottery effects of changes in stock price while retaining flexibility to give equity to new people.
2. Focus on giving away a percentage of growth targets, not a percentage of the company. Each year, set a goal. It may be sales, profits, or something else. If you meet it, then all the eligible employees would get an amount of equity that represents a percentage of the value of meeting that target. If you meet a stretch goal, you can give out more. This lets you as the owner focus on the value of your ownership, not the percentage. It gives the employees an annual goal to shoot for, making equity awards an achievement, not an entitlement. And if you don't meet the target, you don't have to dilute your ownership anyway.
3. Give out ownership more broadly. Most technology companies give ownership to everyone, but so do many of the most admired U.S. companies, like Southwest Airlines, Starbucks, and Whole Foods, companies that have been "game changers" in their industries.
4. Working with the employees, figure out what amounts are needed to have a real impact on how they think about the company. If the company is small enough, you can do this on an individual basis. You might even ask employees to suggest a number and then work from there. Use surveys, if available, to set some reasonable parameters, but don't just aim to be at or above the median.
5. Create a liquidity alternative other than sale or an IPO if neither of these events is highly likely in the near term. Somehow, a lot of people have the notion that this just can't be done. Of course it can! It's just a matter of finding the cash (easy for me to say). But imagine instead that you created an incentive plan that was a bonus instead of equity. People never seem to say "but how can I come up with the cash to pay the bonus?" Think of equity compensation simply as a bonus based on stock value.

These are just of the few of many considerations that go into crafting a plan that is right for your company and your people. Sadly, most business owners make these decisions based on the advice of someone with limited experience or perspective, often using back-of-the-envelope, intuitive strategies. You wouldn't make other spending decisions of this magnitude this cavalierly, and you shouldn't with equity compensation either.

*The NCEO publishes [The Decision-Maker's Guide to Equity Compensation](#), the only book available specifically designed to help owners of closely held companies decide how to craft equity plans.*