

Bridging the Option Pool Gap

By: Jonathan D. Gworek
June 06, 2007



The size of the equity plan reserve is often a point of heavy negotiation in any venture capital transaction. Investors typically insist that an equity plan be put in place in order to attract and retain future employees. This pool of shares is then factored into the pre-investment capitalization when arriving at the price per share of preferred stock to be paid by the investors. When calculated this way, investors are not diluted by grants under the plan, only the pre-existing shareholders — the founders in particular — are diluted. As a result, the number of shares reserved under the equity incentive plan is of high importance to both investors and common stockholders alike.

While the size of the equity pool is important, it can also vary significantly from one transaction to the next. A typical range for a pool is 15% to 25% after a first round of venture financing. The more complete the company's management team is at the time of funding, arguably the lower the pool needs to be to attract and retain key hires. Investors generally take the position that there should be sufficient equity in reserve to cover the company's hiring plan up to the time of the next institutional round of financing. For a company that is raising a first round of venture, this generally means that the equity pool should be sufficient to get the company through roughly 12-18 months of operations. Investors and management often disagree as to how much equity will be required during this period.

If the investors and the company disagree as to how much equity will be required, but at least agree that the amount should be sufficient to last for a certain period of time — say 18 months — a simple drafting approach can be used to bridge the gap on this fundamental yet important issue. Conceptually, the company agrees that if the equity pool needs to be increased before the 18 months elapse, the Series A preferred stock will get the benefit of an anti-dilution adjustment so that they end up in the same position that they would have been in had the option pool been larger at the time the financing closed. If, on the other hand, the company was correct in its assessment and the equity pool agreed upon at the time of the initial closing is sufficient to last 18 months, no adjustment to the preferred stock is made.

Sample Provision

The following provision would appear in the anti-dilution section of the company's charter.

If within eighteen (18) months of May 30, 2007 (the "Series A Original Issuance Date"), the Board of Directors of the Corporation authorizes an increase to the number of Reserved Employee Shares above 10,000,000 shares of Common Stock (subject to appropriate adjustment to reflect any stock split, stock dividend, reverse stock split or similar corporate event affecting the Common Stock), there shall be an adjustment to the Series A Conversion Price so that, on an as converted to Common Stock basis, the Series A Convertible Preferred Stock would represent 50.00% of the fully diluted shares of the Corporation's

capital stock as of the Series A Original Issuance Date, taking into account the increased number of Reserved Employee Shares as if such increase had been in effect on the Series A Original Issuance Date (including in the calculation of such percentages of the Corporation's capital stock all of the Reserved Employee Shares and not just those shares which were outstanding) and assuming that as of the Series A Original Issuance Date there were 10,000,000 shares of Common Stock issued and outstanding.

For more information on the option pool gap, please contact **Jonathan D. Gworek**.