Emerging Companies and Outside Director Compensation

What's the Beef?

By:John Hession
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Entrepreneurs are always inquiring: what do I provide my outside directors as fair and appropriate remuneration for their efforts? An annual cash stipend or flat fee for attendance at Board and committee meetings? Cash and stock options or restricted stock — or just equity alone? Reimbursement of travel and attendance expenses? Other elements of value?

For my thirty plus years in this profession the question has been posed and the answers have rarely departed from the prevailing, constant and universal norm during the last three decades: for an early-stage company, with little or no financing and constrained cash resources, equity is the only currency to offer. While emerging companies need to conserve precious equity, they often do not have the cash resources to offer stipends. Equity also provides the obvious upside for the dedication of considerable effort by an outside director: for today's effort the director receives a potential upside that far eclipses the cold, hard cash of today's dollars. Consequently, for the outside director, equity is the coin of the entrepreneur's realm, the "sheckles" for the start up adviser.

But how much equity is appropriate? While there are variations at the edge of the curves, depending on the stage of the enterprise, the length of the anticipated service, the volume of anticipated Board meetings during any calendar year, the expected dilution from future or further financings, again, the prevailing market norm suggests that a range of 0.5% to 1.0% of the fully-diluted equity capital is an appropriate equity stake for an outside, non-management, non-founder director. Typically, this equity stake vests over three years on a monthly basis and is issued at then-current fair market value. Since it is often perceived that the director is providing certain and immediate value to the enterprise and is also assuming the potential risk of personal liability for fiduciary obligations, vesting commences immediately – a universal market standard. Furthermore, on an acquisition the vesting automatically accelerates, as the outside director is invariably dismissed as part of the sale process, and pundits rightfully believe that the outside director should receive the benefit of the intended bargain: help steer and guide the company to a liquidity event. However, the equity stake may vary at the edges of the market norm if the company is positioned at the earlier stage of the entrepreneurial life cycle. Since equity dilution is expected from a seed, angel or venture capital financing, ranging anywhere from 30% to 60%, at the earlier of the continuum, the equity arrangement might be closer to, or even exceed 1%, as the director needs to be made whole for the intended dilution. Furthermore, if the expectations for an outside director exceed six-eight annual Board meetings, and might also involve additional consulting work, the equity stake might travel as high as 1.5%. However, despite what you might hear, equity arrangements exceeding 3% are highly unusual. I have confirmed this principle through repeated emails over the years to a cadre of attorneys who regularly represent emerging companies, and the statistical pool for market information exceeds several thousands of emerging companies.

One could also argue that an outside director is also taking risk by serving on a Board of a private, early-stage enterprise, but the actual statistics over the last thirty years suggest a compelling contradiction to the popular but unsubstantiated opinion: directors of small, early-stage enterprises rarely get sued for their stewardship of an emerging company. Since the founders invariably sit on the Board of Directors, and also own significant equity stakes, it is infrequent – indeed, rare – that an outside director is sued for service as a director. So don't believe the alarming articles in the press – it is quite unusual that an outside director is sued for conduct as a Board member in the early stages of an emerging company's life cycle. The statistics from insurance providers confirms this principle for three decades.

In summary, compensation for outside directors has been quite uniform, consistent and standard over the last many decades. Outside directors of early-stage enterprises generally receive restricted stock or stock options tantamount to 0.5%-1.0% of the enterprise on a fully-diluted basis, vesting immediately over thirty six months (and as high as forty-eight months), and with full acceleration on a change of control.

But what is the proper form of equity for an outside director: nonqualified stock options or restricted stock subject to vesting? Stay tuned…

For more information on outside director compensation, please feel free to contact Scott R. Bleier.