
Stever's Stock Learnings

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I've been with many startups, and have learned a lot about stock and how it works. The hard way. Here is my current understanding of stock. It may be great; it may be horribly wrong and incomplete. Some of this is from a phone conversation with a lawyer specializing in startups. Some is from my general bank of knowledge. Some is from experience.

I have worked for several startups, and been involved in three companies going public: BACHMAN INFORMATION SYSTEMS, FTP SOFTWARE, and INTUIT, INC. No, none of them have made me independently wealthy, yet.

I make no warranty as to the accuracy of any of this information; use it at your own risk! Treat this as amusing fiction; by the time you read it, the laws may have changed, and that's all it may be. Hire a good lawyer who knows the world of pre-public companies to help you understand the legal and tax implications of any given situation.

What is stock?

Stock represents ownership in a company. If you own 10,000 shares of stock in a company that has a total of 1,000,000 shares issued, you own 1% of that company.

How many shares you own is less relevant than what percentage of the company you own. The number of shares you own can change, while your percentage ownership stays the same. A company can split their stock, exchanging two new shares for each old share. The new shares are half the price of the old share. A company may reverse-split, exchanging two old shares for each new share. The new share will be twice the price of an old share. Company often split or reverse-split before going public, to adjust the per-share price to a salable level.

FTP had very few shares outstanding when it was founded. By the time it went public, it had split around 160 for one, to bring the share price down enough to sell.

What are reasonable percentages to own?

There are no set guidelines as to how much stock is "a lot." Thinking in percentage terms, if you own 1% of a company that you think will be worth \$100,000,000 on the open market, that means your stock is worth \$1,000,000.

It is rare for an individual who is not a principal founder of a company to own more than a percent or two of a company. When a company goes public or goes through rounds of financing, all

shareholders get diluted and end up with an even smaller percentage of the company. Of course, the increased dollar value of the stock (theoretically) more than makes up for a diminished percentage ownership.

At BUILDING BLOCKS INTERACTIVE, pretty much everyone started with .5% to 5% of the company, vesting over five years. The entrepreneurs are the exceptions. If we make our projections, they each will own enough to buy a small country. This is typical. When FTP SOFTWARE went public, a 1% ownership would have been worth around \$3.5 million. The largest shareholder owned 33% of the company. You do the math.

What are options?

An option is the right to buy stock on or after a future date at a given price (the “strike price”). If you have 100 options whose strike price is \$3 and the stock is selling for \$10, you can “exercise” your options and buy the underlying stock for \$3/share. You now own \$1,000 worth of stock, but only paid \$300 for it. If the company is public when you exercise the options, you can then sell immediately, making a \$700 profit.

For companies past the founding stage, options are the most common way of giving employees ownership. They have the advantage of not causing an income hit when they are granted, so employees can receive them when the company is private without worrying about having to find cash to pay an unexpected tax bill.

The disadvantage of options is how the IRS treats them when you exercise them. When exercising a \$3 option when the stock’s value is \$10, the IRS counts it as if someone actually gave you \$7 and you bought the shares for \$10. That \$7 counts as real income (taxable at the normal income rate), *even though no cash changed hands, and even though the stock may not be public, and thus not convertible into cash!* The danger is that exercising options in a private company creates a tax liability, which you must pay that year. Exercising options in a public company also create a tax liability, but you can immediately sell some shares to cover the taxes.

Movements in the stock price after you’ve exercised options are treated as capital gains. When you sell the shares, the gain or loss is calculated from the market price when the options was exercised to the final selling price of the shares.

Example:

JANUARY 1 You are granted 100 \$15 options for the stock.
MAY 1 The stock’s market value reaches \$20.
MAY 15 You exercise your options and buy 100 shares.
DECEMBER 1 You sell your shares for \$27 per share.

You have no tax liability on January 1. On May 15, you have income of \$500. On December 1, you have capital gains income of \$700.

I do not know if the stock's final capital gains holding period ("short term" or "long term") is calculated from the time you receive the options or the time you exercise them. Since in 1996, there is no difference in the two tax rates, the point is moot at the moment.

How is stock in a private company different from stock in a public company?

Stock in a private company is "unregistered stock." That means it is not registered with any of the public stock exchanges, and can not be sold to the general public. It can also be called "restricted stock," since there are often other restrictions on the stock. Some of these are net worth or income requirements set by the SEC. Others are spelled out by an explicit stockholder's agreement. Stock certificates of restricted shares are usually stamped with a legend stating that they are restricted.

One restriction on private stock comes from the SEC's Rule 144. You may not sell restricted shares to the public until you have owned it for more than two years, even if the company goes public in the meantime. This prevents insiders from buying stock immediately before a public offering, and then turning around and selling at a huge profit, without having taken any of the risk of holding shares in a private company.

August 99: Since originally writing the above paragraph, I've learned that the holding period these days can be anywhere from 6 months to 3 years, and there are bills before Congress to do away with the holding period altogether.

Often there are other restrictions which give a company the right of first refusal if a shareholder wants to sell shares to another private investor. Once you've negotiated a selling price with the outside investor, the company may pre-empt the sale and buy the shares from you at the price you were going to sell to the outsider.

Can I sell my stock in a private company?

Yes. But you may have to wait two years if your stock falls under Rule 144. There may also be further restrictions in your shareholder's agreement, such as a right of first refusal, etc.

What is fair market value of stock in a private company?

You need to know the fair market value of stock in a private company to calculate income from exercising options. Since there's no public market, it's hard to come up with a figure. The number can be set by the Board of Directors, often after having an outside auditor do a valuation. It can also be set by actual stock transactions. For example, if a new investor buys in at \$6/share, that implicitly sets the fair market value of the stock at \$6.

What is my stock/option offer worth?

There's no real way to answer this unless a company is public. In that case, your stock is worth its market value. Your options are worth the underlying stock's market value minus the option strike price. A few questions can go a long way in helping you explore your offer:

- » **How much is my stock likely to be worth, given management's current projections of valuation at the time of IPO or acquisition?** Before offering you stock, the management presumably went through that calculation, and should have some idea of the answer. (Otherwise, they're giving chunks of the company away without knowing how much they're giving up. Not a wise policy!)
- » **When is an IPO or acquisition likely to happen?** Receiving \$10,000 worth of stock when the IPO isn't planned for 5 years is a less than underwhelming prospect. On the other hand, with young companies, there may be no real idea of when the IPO can happen.
- » If the company has no intent of going public in the foreseeable future, then ask **How will I ever realize value from the stock?** Stock is no good to you if there's never a way to sell it.
- » You may also want to ask **What are my shares worth at the current valuation?** While the company may be private, if it is doing external fund-raising and getting \$5/share, then you can be pretty sure your shares are currently worth that.

If you can't get straight, understandable answers to these questions, keep asking. The management should have thought these through and should have decent answers. Lack of answer can be a danger sign. (In the case of one company where I worked, the management kept people very in the dark about valuation. When the company went public after a decade of hard work, everyone found out that their stock was almost worthless, while the lead entrepreneur was worth enough to last several hundred lifetimes.)

What is vesting?

Often stock or options "vest" over time. When something is vested, that means it's yours. When it is unvested, it belongs to the company. Say you are given 1,000 options in the company when you join, and they vest 20% a year. Each year you receive 20% of the shares (200 shares). After the fifth year, all the options are yours, free and clear.

From your point of view, this is almost like receiving 200 options each year. One reason for thinking of it as a single grant of options with a vesting schedule, is that the strike price of options is often tied to the market value of the underlying stock *when the options are issued*. When vesting, that means that all the options have a strike price related to the market value when the initial grant is made. If you were given 200 options each year as a bonus, each set of options could have a different (presumably higher) strike price.

What happens to my vesting schedule if the company goes public or is bought out?

Stock or option grants should spell out what happens when a company goes public or is acquired. If you have “accelerated vesting,” an IPO or acquisition can trigger changes in your vesting schedule (usually, all your options vest immediately).

Make sure you know up from what will happen in the event of a sale. While vesting schedules can be changed after they are initially set, some acquisitions become impossible if the stock status changes too close to the acquisition. This is mainly a problem for acquisitions where the companies’ stock is “pooled.” Building Blocks has issued most of its early stock and options with accelerated vesting. In the event the company is sold, you will vest immediately.

Are there tax implications to vesting?

When stock vests, it is taxable income equal to the fair market value of the stock. If the stock is getting more valuable each vesting period, you can rack up large tax bills. In a private company, you can’t sell the shares to pay the tax bill, so you must pay out of your own pocket. Founders can file form 83(B), which lets them take the income hit when they get the stock, rather than when it vests. Of course, if the shareholder leaves before the stock has fully vested, they have already paid the tax on the unvested portion. I don’t know if 83(B) can be used for later-stage stock awards.

When options vest, there are no tax implications. This is one reason options are so often preferred.

What’s dilution?

Dilution happens when the company issues new stock to raise money or grant options to employees. The existing shareholders keep the same number of shares, but since the total number of shares is now larger, each shareholder’s percentage ownership just declined.

For example, GenericCo has 1,000 outstanding shares. Chris owns 10% or 100 of those shares. GenericCo then issues 500 new shares to a new investor. This is a 50% dilution (500/1,000). There are now 1,500 shares outstanding. Chris now owns only $100/1500=6.67\%$ of the shares.

In theory, companies are wise enough never to dilute their shareholders unless they believe the dilution will be more than made up for by the increase in value the dilution brings. In the above example, if the new investor provides the money for GenericCo to create a new product and grow to ten times its former size, Chris ends up ahead. It’s better to have a 6.67% share of a \$100 million company than a 10% share of a \$10 million company.

Can I be awarded stock or options based on my performance?

Here’s what Joe Hadzima, lawyer, has to say:

If vesting is based on the achievement of performance goals (as opposed to calendar vesting) then the “variable accounting rules” probably apply. By way of contrast, the normal accounting takes the difference between the fair market value of the option or stock on the date of grant and subtracts the exercise price or sale price. The resulting spread is “compensation expense” for (the company’s) book accounting purposes and is recognized over the vesting period. In variable accounting, the spread is measured when the performance is achieved. This can result in a much larger spread/compensation expense- in one case for a client of mine it was \$500,000. The solution which has worked in the past (but should be checked with your auditors) is to make the option fully vested in say 7 or 10 years if the optionee is still employed then but allow the optionee to exercise early if the performance goal is achieved. In many cases this works from a business viewpoint because if the goal (usually a sales goal) is not met you are likely to fire the optionee anyway because things are not working out .

When should I exercise my options?

This is a really tricky question. Each person’s situation is different. Here is a summary of the concerns:

- » When you exercise your options, it creates taxable income. So you want to exercise when the stock price is as low as possible, to avoid the tax bill.
- » A later rise in stock price is taken as a capital gain and taxed at a lower rate. So again, you want to exercise while the price is low, so much of the later price rise is taxed as a gain rather than as income.
- » If the company is private, however, you can’t sell any shares you acquire until you’ve held them for two years (that’s RULE 144). So you have to be able to pay the tax with your own cash. *And*, even if the company goes public a month later, you still have to wait out your holding period.

When INTUIT went public, they made it possible for option holders to exercise their options and immediately sell enough shares to cover the taxes (in fact, they even took care of paying the taxes for us!). The downside was that we had to pay the full income tax rate

What’s a public offering?

When a company “goes public,” that company’s stock becomes available on a stock exchange, and the public can buy and sell the stock. A public offering works like this:

1. An investment bank, the “underwriter,” buys the shares from the company at the IPO price. They determine the price based on what they think they can resell the shares for. In theory, they should price the stock so accurately that the price doesn’t move much once the shares hit the open market.
2. The underwriter then sells those shares to institutional investors, and those lucky enough to be part of the old boy network of public offerings.

3. Those people then create the “aftermarket” by selling the shares on a stock exchange to the general public.
4. The investment bank takes a 3-7% commission off the IPO price for assuming the risk of underwriting, and for working so very, very hard for so many long weeks. It’s no coincidence that investment banking is possibly the most lucrative profession in existence. Interestingly, they still get paid their commission even if a stock is so hot that they have to beat buyers off with a stick (e.g. NETSCAPE, INTUIT, FTP SOFTWARE). It could lead the cynics among us to ask what risk the I-bankers are taking, in that case, and what value they’re adding as salespeople to justify a commission on such a hot property.

When you hear a company “went public at \$10/share,” that means step #1 happened at \$10/share. The company received \$10/share, less the commission. The institutional investors probably paid \$10/share for the shares. They then turned the shares over to the public for a tidy profit. In the case of INTUIT, for example, the IPO price was around \$18, and the first public share traded at \$27. (I know; I almost bought it.) For Netscape, the numbers were something like IPO @ \$18, first trade in the \$70s.

I believe in the company a lot. Can I buy shares at the IPO?

Probably not. No one except the “old boy” network can buy at an IPO. Sometimes an investment bank may set aside a limited number of IPO shares for insiders such as employees to buy. These are called “directed shares.”

Once the aftermarket springs into existence, moments after the IPO, you can buy and sell on the open market. For a hot start-up, there is no way to get stock at the IPO price.

The investment bankers told me I should ...?

Investment bankers are in business to earn the highest possible commissions **for themselves**. I have heard bankers from very respectable investment banks deliberately mislead stockholders into leaving hundreds of thousands of dollars on the table, because it would increase the bank’s fees. When I asked about it, one of the bankers said “It is the shareholder’s responsibility to know how the game is played. If they choose not to hire outside advice, that’s their prerogative, and anything I do, as long as it’s legal, is fine.”

Even the most ethical people I know in I-banking have had discussions with me that lead me to doubt their integrity when consumed by the passion of The Deal. I’m sure there are honest ones out there, but I wouldn’t know how to tell the difference. As long as they’re compensated on the stock price as of the IPO, and don’t have to take the same lock out risk as the shareholders, their incentives are *not* aligned with yours.

Even from the company's perspective, the I-bankers' incentives are only aligned to the point of getting the best stock price for the IPO, and keeping the price propped up for about 3-6 months. They never inherently have the firm's long term best interest at heart.

What is a lock out agreement? Should I sign one?

A lock out prohibits shareholders for selling their shares in a public company, usually for three to six months after going public. Lock outs prop up share price by keeping large shareholders from dumping shares on the market and tanking the stock price. Supposedly, after the lock out, the market has "stabilized." (The Netscape founders each sold several tens of millions of dollars worth of shares as soon as Netscape's lockout expired. The underwriters assured the public that such selling was simply "normal diversification" on the part of the founders. I tend to think that the founders were simply smart enough to realize the stock was overvalued by a factor of 15. But hey, what do I know?)

Conceptually it's very weird, since the investment bankers are paid their commission on the propped up share price. From the company's point of view, it's great, because it lets the company raise the most money from the IPO. From the individual shareholders' point of view, it's a mixed blessing. If a shareholder would rather sell and not keep their fortunes tied to the company, they'd rather not be locked up. And both the company *and* the shareholders would probably rather pay the commissions based on the non-locked-out price, since that's what the company and shareholders will have to deal with longer-term.

The bankers will urge you to sign a lockout agreement. They will use phrases like "team player" and "it will be in your best interest." Make sure you understand exactly why it's in your best interest to sign before you sign *any* legal document. And remember that the investment bankers are not charging their fees because they're psyched to be part of your team.

If you own shares in a non-public company, you are bound by the terms of the shareholder agreement—which you probably signed without reading. The shareholder agreement often specifies that you consent to signing a lock out if a company goes public, so you may not have a choice about signing.

Consequences of signing a lock out: You can't sell your shares for the duration of the lock out. You *can* sell your shares in the IPO (even restricted shares), at the IPO price, less underwriter's commission.

Consequences of not signing: You can sell your shares on the open market only if the Rule 144 holding period has expired. You can not sell your shares as part of the IPO; you sell at market prices. You pay your broker's commission (though sometimes the underwriters will agree to sell shares for you commission-free). You may jeopardize the public offering price because the institutional investors may get squeamish about having lots of un-locked out shares around.

When a company goes public, why are large and small shareholders' interests different?

At the end of the lock-out period, the large shareholders can suddenly sell huge blocks of stock. If they do so, that will tank the share price. To a large shareholder, that's not too important. When you own 1,000,000 shares, you're still rich whether the price is \$20 or \$10 per share.

To small shareholders, however, \$10/share can be the difference between being rich or not. A small shareholder wants the stock price to be held as high as possible by lock-out agreements, yet wants to be free to sell their own shares.

Large shareholders want everybody to lock out their shares, however, because otherwise it can lower the public offering share price. Large shareholders make their initial chunk of money by selling as part of the IPO, so they want the highest IPO price possible.

What are the tax ramifications of options vs. stock?

	Options	Stock
Amount taxable at normal income tax rates	Fair market value of the stock the date of the exercise minus the strike price of the options.	Fair market value of the stock the day it is received.
Amount taxable at capital gains rates	Movements of the exercised shares up or down from the fair market value when the options were exercised.	Movements of the stock up or down from the fair market value when the stock was received.
When the normal income tax liability happens	When options are exercised.	When the stock is received.
When the capital gains tax liability happens	When the stock is sold.	When the stock is sold.

Summary of Stock vs. Options

	Stock	Options
What is it?	Ownership in a company	The right to buy a share of stock at a future date, at a given price (the “strike price”)
Receiving them is treated as a taxable event	Yes	No
Can vest over time	Yes	Yes
When normal-income tax hit happens	When received or vested	When exercised
Amount of income taxed at normal rate	Fair market value of stock when received/vested	Difference between fair market value at time of exercise and strike price of options
When capital gains tax hit happens	When sold	When the stock received is sold
Basis for capital gain	Fair market value when stock received or vested	Fair market value at time of option exercise
What restrictions do they come with	<p>If you receive shares in a public company, they are free and clear immediately.</p> <p>If you receive shares in a private company, you must hold them for 2 years, under “rule 144.”</p> <p>Investment bankers may require you to sign a lock out agreement which puts further restrictions on shares.</p>	

	Stock	Options
Other ways to sell them, or other restrictions on sale. (These become important when needing to pay off possible income events, as described above.)	<p>Sometimes yes:</p> <p>REGISTERED SHARES: You received stock in a public company; or</p> <p>RULE 144 SHARES:</p> <p>the company is public; and</p> <p>you received the shares more than 2 years ago (but they may have vested more recently); and</p> <p>you file form 144 or form 144(k), as needed; or</p> <p>REGISTERING UNREGISTERED SHARES: you received shares when the company is private. It went public, but you haven't held the shares long enough to qualify for #2. You arrange with the company to have your restricted shares registered on or after the IPO; or</p> <p>PRIVATE TRANSACTION: the company is private, you have a buyer for your shares, and the stockholder's agreement lets you sell shares privately.</p> <p>Sometimes no:</p> <ol style="list-style-type: none"> I-BANKERS: As part of a round of financing, investment bankers may require you to sign a lock out agreement that keeps you from selling shares that would otherwise be free and clear. 	<p>Public companies sometimes have a market in which you can sell options directly.</p> <p>Usually, options get exercised and the resultant stock is sold. To determine whether that stock is salable, consider the purchase date as the date the options are exercised.</p>
Other	I ran into a stock sale restriction called Rule 701 at one point, but never really understood what that was.	Strike price is usually set at roughly the fair market value of the stock when options are issued.

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