EPISODE 315

[INTRODUCTION]

[0:00:00.2] JM: When an engineer is offered a job at a tech company, that engineer's compensation is often partly in cash and partly in equity, which is shares in a company. How should an engineer evaluate that offer? How should they negotiate? In the world of equity compensation, costly and avoidable mistakes are routine, and this hurts both companies and employees.

Josh Levy was on Software Engineering Daily previously to talk about the Amazon Web Services Open Guide, and this was one of the most popular episodes that we've ever had. In this episode, Josh returns and is joined by Joe Wallin, a lawyer who has been involved in startups for many years. I discussed with Joe and Josh *The Open Guide to Equity Compensation*, which is a resource designed to clear up the confusion around stock, options, and fundraising. It's a tremendously useful and concise overview of what an engineer or a founder needs to know when it comes to equity financing.

I really enjoy this conversation, it was very educational for me, very useful for me, and I think if you're involved in discussions around equity compensation, this is a useful conversation for you to listen to as well.

[SPONSOR MESSAGE]

[0:01:24.2] JM: Heroku's operational experience lets teams focus on what's important, maintaining application health, and providing an optimal experience for end users. Listen to our podcast with Andrew Gwozdziewycz from Heroku's engineering team to learn more about the importance of application health, and best practices for monitoring application user experience.

This episode aired on February 28th and you can find it on the Software Engineering Daily Website. You will also learn about Heroku's metrics platform architecture and how it laid the foundation for autoscaling. This was a fascinating episode, and if you haven't heard it already, I hope you tune in to it. Thanks to Heroku for being a sponsor of Software Engineering Daily.

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[INTERVIEW]

[0:02:18.2] JM: Josh Levy and Joe Wallin are authors of *The Open Guide to Equity Compensation*. Josh and Joe, welcome to Software Engineering Daily.

[0:02:27.1] JW: Thanks for having us.

[0:02:28.2] JL: Great to be here.

[0:02:29.3] JM: Today we're talking about equity compensation. When an engineer is offered a job at a tech company, their compensation is partly in cash and party in equity for most positions. Shares of the company are what compose the equity. Josh, you are an engineer. Why is it important for an engineer to understand at how the equity part of the compensation works?

[0:02:55.7] JL: Right. If you think about jobs in general, knowledge workers of all kinds have different kinds of compensation; from salary, to benefits, to equity, and we'll talk a little bit about some of those kinds of equity, I'm sure. Especially for software engineers, traditionally, high-tech companies have often had a lot of growth and that they meant that they've increasingly found it really valuable to incentivize people with ownership of the company in some form. It turns out that just a lot of the value of your compensation might turn out to be the equity component like the stock, or the stock options, or the RSUs.

This is even more the case in folks who are joining early stage startups, because often people want to join startups because they think the company is going to roll very fast and so it makes a lot more sense to say, "I'd like a piece of this company rather than a specific salary." Everyone knows there are cases of people becoming enormously rich on startups that have done well like Facebook did, or Google, or any of the other really enormous ones, and many smaller ones too, people have done very well. It's a big factor for especially high value tech workers, like programmers.

[0:04:06.5] JM: Joe, you are a lawyer. Explain some common situations that you see engineers suffering from when they don't understand how the equity works.

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[0:04:19.0] JW: Sort of like a question. Yeah, I'm a lawyer. I represent mostly companies, although sometimes founders, individually, or executives negotiating their deals for companies. Yeah, the stock option landscape is — Or the equity comp landscape is unfortunately — It's just sort of a little bit of a maze. It's partially due to the face that we have complicated tax laws, and the tax laws make things more difficult than they need to be. You want to put all these sort of — You want to call them — I want to use the word contraption, but there are basically workarounds, some people can try to not get themselves in this tax situation where they can't afford to pay the bill. I've been involved or have seen plenty of people decide they want a particular type of equity award and then later regret it.

Receiving a big chunk of shares that's going to vest overtime and the value of which today is more than you can pay tax on. That's a situation where it doesn't make any sense to accept that award at all, because if you can't pay the tax today, you're certainly probably not going to be able to pay it when the award vest.

Cognizance of the tax rules and in light of the stage of the company that you're joining, you just sort of need to know, "Hey, for a company that's early stage, if I can't afford the tax hit of getting restricted stock, then I need to probably do an option. Maybe I shouldn't negotiate my post-termination of service to exercise period to be longer than the typical 90 days." You have all these weird tax rules. For example, the 90-day thing, you might just wonder, "How did it come to be that companies just sort of default it to only giving former service providers 90 days to exercise their options of have them lapse?" You might wonder, "Where do that — How did it even come to be? Who dreamed that up? Who imagined it in the first place?"

I think the archeology of it is that back when congress passed the rules on incentive stock options, congress said, "Well, your option won't be considered an incentive stock option if you don't exercise it within 90 days of leaving." The rule doesn't say you can't have five years to exercise that after leaving. The rule says, "If you don't exercise it within 90 days, then it won't qualify as an ISO."

Anyway, I think that's the reason why we find all these companies that are just written in 90 days, you have 90 days. Conveniently , it ties in to helping companies keep their cap tables

clean, because it wants to keep track of former workers for years and years. That is a problem. Although I do think that — Josh has written about this, or actually other people in the community at-large and we've sighted them in the equity comp guide, have written about the 90-day things can be unfair in quite a few different circumstances.

[0:06:55.5] JM: Yeah. It seems to me that at least as often as the times in which the company is doing it, because it serves the company's interest of the cap table being clean. It is just because the company is moving really fast and the people in charge of the company maybe don't know much about equity compensation and so they just copy-paste some text from one document to another. Is that accurate?

[0:07:23.6] JW: I think most companies working with — Hopefully, working with good council and following industry standard approaches to things. I think company founders get a beat into them pretty hard by their lawyers and their advisors that, "Hey, when it comes to your legal documents, don't try to be a creative engineer. Your creativity needs to be reserved for your product offering, not your legal stuff."

[0:07:52.0] JM: Is that true? Is that something that should be kept in mind, or do you think there is room for creativity?

[0:07:58.8] JW: I think there's room — Sorry Josh, to interrupt.

[0:08:01.8] JL: I was just going to say that as someone who's been an early stage companies, it's just that it's such a shortness of time and where you put your effort. I think it's often not maliciousness or —

[0:08:14.4] JM: Not a good idea.

[0:08:15.5] JL: Or founders trying to be unfair. When your lawyer says, "This is going to be a lot of work not to take the standard path." It will take you a lot of time and attention to focus on this. You just have to decide, "Am I going to put this much of my effort into this and not into the 75 other things I have to do this month?" So it's hard to have progress with that. It just tends to — The momentum of convention is very hard to overcome.

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[0:08:40.3] JM: Yeah. Even though it would be great, but I just think about from the starting a company perspective, there would be all kinds of cool things that you could do around equity compensation. Like you said, you probably want to reserve that time and bandwidth to building the actual company. A quote from the Open Guide to Equity Compensation, which you are both authors of, "Costly and avoidable mistakes are routine and this hurts both companies and employees." Why are the mistakes around equity compensation so common, especially if everything is so standardized?

[0:09:21.1] JL: I'll start. I'm sure Joe will have a lot more to say. I think that there's a variety of reasons. Like I said, some people, I think, sometimes assume that it's like companies trying to give employees a bad shake, and that's not always the case. Sometimes it is just a straight up negotiation tactic that if an employee doesn't understand what equity looks like and how it works, it's just very hard to make a fair negotiation happen. You very well might accept something that's just a lot less. If someone says, "I'm going to pay you $100,000," you know what that's worth. If they say, "I'm going to give you 100,000 stock options," there's a lot more things you have to understand to even have a guess at what it's worth. Even then, it will be a probability.

It's just much easier to have asymmetry of knowledge around what a company knows when it's giving you its own stock, versus what you're getting as an employee. I think there's just a big asymmetry of knowledge. Some of it is around the company's data, and some of it is around how the system works. I think a lot of what the guide is trying to address is some of the things around how the system works. I certainly can say that I've had a lot of engineer friend over the years, and myself including, thought about startup offers at different times. I felt I just — I didn't understand very well how the system worked or others didn't, and it seems like it's important, at least given the complexity of the system we're in, that everyone at least understands the system, and then makes fair discussions and understanding of what their offers are and negotiate around that.

[0:10:56.0] JM: Yeah. Let's get into this from the engineer's perspective. Eventually, I want to get into it from the founder's perspective so we can understand things from both angles. Starting with just the engineer who receives an offer letter from a startup company, there are several

types of compensation; there's cash, there's benefits, there's equity. The cash and the benefits are pretty easy to understand, and that's where we're focusing on equity in this conversation. What are the different types of equity compensation that might be included in that offer letter? Let's start with Joe.

[0:11:35.7] JW: Sure. The most common would be just stock options, but as companies get more mature, there might RSUs that are offered. On the opposite side of the spectrum of the companies really close to — Really recently formed company, the options might be either immediately exercisable or they might be actually just restricted stock awards. That's sort of the spectrum. The spectrum is driven by a couple of different things. The bigger company gets and the closer it gets to doing an IPO, the more likely it's going to want to maybe use something like RSUs and a lot of companies ramping toward their IPOs will go to RSUs, and they'll do that because they will have a high degree of confidence they're going to get to liquidity events of some kind, and so those kind of awards can make sense.

Options can work great for most private companies that are sort of beyond the founding stage and pre hitting a real significant — Maybe a pre-series C, or something, pre-product market fit, or pre-significant revenues. The reasons why options are great in that context is because you can give someone an award that will incent them given the sort of runway of the company. Potentially, significantly, incent them. they can receive the option tax free, but as long as its priced a fair market value. It can be — The options can be great, and usually those are the most common awards I see for that type of company.

[0:13:02.5] JM: The purpose of equity compensation is to attract the best talent and to align the incentives between individuals and the interests of the company. Josh, you have been in situations where you're in charge of employees. You've been in situations where you're an engineer at the bottom of the rung and you're getting tired, I'm sure. Given your experience in different areas of the management ladder, why is equity such an important tool for attracting talent and aligning the incentives of the different people involved?

[0:13:43.5] JL: Right. It really is a key element for, especially, companies that are growing. If a company is fairly static growth, like relatively small growth, then having ownership of the company is kind of equivalent to knowing what the value of that is, hopefully in cash or some

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sort. If you are expecting the company to grow, then it means I'm getting something now that will be worth much more later.

That has a lot of benefits. One is that everyone wants the company to grow, so they're going to work harder to make the company grow and everyone knows they kind of are all in the same boat and everyone rowing in the same direction is helpful. Secondly, if you think it's going to be really big, then you'll have some of the best engineers will join that company, so that it's really around perception of growth that really makes the best people join. Once you're in, makes you try to perform in the interest of the company. That helps the company in a lot of ways and for the employers that are there. It generally helps the employees. That's a high level, at a very specific level. For employees who are understanding what the value is and are really motivated by what direction that they think a company is going to go in. It can just be really exciting to say, "Well, I own this percentage of this great company."

It's just also a personal feeling of like having some ownership, I think, can be pretty viable, especially at early stages when you are a small number of folks and you feel like you each have a chunk of the company.

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[0:15:19.0] JM: Indeed Prime flips the typical model of job search and makes it easy to apply to multiple jobs and get multiple offers. Indeed Prime simplifies your job search and helps you land that ideal software engineering position. Candidates get immediate exposure to the best tech companies with just one simple application to Indeed Prime.

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[INTERVIEW CONTINUED]

[0:17:06.0] JM: Stock in a company is the representation of ownership, and the ownership value that you have is represented by how many shares of stock you have. The total ownership of the company is distributed among the total number of stock shares. In order to know what your stock shares are worth, you need to know the total number of outstanding shares. These are the total shares that have been initialized in the company's existence. Only then can actually know the percentage of ownership that you hold. This sounds fairly straightforward, but there are plenty of gradations that make it more complex than it might be at first glance.

Joe, what are some of the ways that employees get confused around this terminology of ownership and stock shares?

[0:18:01.5] JW: Sure. It is, I think, confusing, because in a typical company, the founders will have issued themselves founder stock and they'll have set aside an option pool of some amount. That might be a pretty straightforward start. If you have three founders and each of them own two million shares, so there's six million shares outstanding and you have an option pool of, let's just say, two million to make our math easy. We have eight million shares outstanding on a fully diluted basis. While if you received option to acquire 800,000 shares, you could take 800,000 over that eight million and figure out, "Well, on a fully diluted basis, at least my percentage looks like this right now."

Then, what happens, of course, as companies start doing things like convertible note offerings, maybe they're issuing warrants to one party or another, and then the math gets a little more

complex. Maybe the convertible notes have valuation caps, so that when the company actually gets to its fixed priced financing, the valuation on the financing might be a $10 million pre-money, but you might have a bunch of notes that are coming in at the valuation cap of, say, six million.

Dilution works in a way that can be a little more extreme than people think and it affects the option holder. It can be not the easiest thing to figure out, like, "Hey, what am I looking at here post — " Say, you join a pre-series seed in the middle of a note round. It might not be the easiest thing to discern where your equity percentage is going to arrive at after the financing. You're going to have some make educated guesses about the valuation of which the company is going to raise the money and other things like this and sort of make a guess.

Of course, that's just the series seed round, so you probably going to have at least a series A, or hopefully, series A after that. If the company is going to be a success, there's going to be a series B too probably, and maybe even a series C. You kinda think to yourself, "Well, if I'm starting with an option of 800,000 over eight million fully diluted, after all those rounds of financing, where do I think would it wind up?" Who knows? I think most people — And Josh can come in on this. I think most people when they are evaluating their offer, they are looking at it in terms of where are these right now? Is that a fair offer? Is that a fair offer based on their skillset, and everything else. I think a lot of people will get too obsessed about trying to speculate too far down the road, 'cause it's just so hard to know.

[0:20:18.7] JL: One thing I would throw out there if you're an old hand, a lot of those terms that Joe just mentioned makes sense too. If you're wondering what fully diluted means, or some of those terms, we do define all of those in the guide, I would say look for the boldface terms. That's one of the things I've noticed with this kind of discussions is, often, folks who have not spent time just learning about this, it's just a lot of terminology and you're just like, "What does that means?"

[0:20:42.7] JM: Yes.

[0:20:43.4] JL: Part of the guide is trying to cover some of that terminology, and you can't talk about it without using the terminology. If any of that didn't make sense to you, check out the boldface.

[0:20:54.1] JM: Agreed. We will get into some of those terms. Joe pointed out something that I'm not sure if I entirely agree with. He said that when you are evaluating your stock, you really want to look at the present situation of the company. From my point of view, if you're looking at joining a startup, you really want to think about the long term implications of the company. You want to think about almost like how big could the company potentially get, and under those circumstances, how valuable would my stock be, cause you don't want to be thinking about the average case, because if you're thinking about the average case, then you should probably go work at a big company. You want to be thinking about what are the outsized returns that I might be able to get. I want to join this startup because the market doesn't identify those outsized returns as well as the market can identify the average returns at a big company.
Josh, does that resonate with you?

[0:21:52.2] JL: I actually think you're both right. I guess the way I would describe it — And much of this guide is really around sort of how I describe to a friend if they are asking advice. Is that you really have to think of different scenarios. It's like an investment, but it just turns out that there are several scenarios. When you're investing it, your money in something, you might be thinking, "Well, there's a chance I might do really well. There's a chance I might do really poor," but you're trying to figure out what those risks are.

This is the same, you're investing your time and you're trying to say, "I'm going to put my time into this company and what are the probabilities of different outcomes." That is a function both of the value now and the possible value in the future and the probabilities of those different outcomes.

In the case of equity, there are some key different outcomes. We tend to think about just big, or small, but there are some key different kinds of outcomes that would really impact you specifically, and it's worth actually, I think, thinking about each one. First off, you shouldn't be joining a startup unless — We seem to be focusing on startups. Some of this does apply to

bigger stage companies. You could be joining Apple, or Google and getting RSUs, but let's talk about startups.

If you're joining a startup, most startups fail. They just do. You should be okay with that and understand that you have that risk tolerance going in. Again, like an investment. You're investing your time and you're saying, "A lot of my compensation is going to be possibly zero, because the startup will fail. I'm okay with that, because there's a probability of a big win," or "I really want to work with this team," or "I'll learn a lot." All of those are really good reasons.

Secondly, there are some other scenarios that are not the things we always immediately think about as like, "Well, it turns into the next Facebook." It obviously could, in which case, if you're the next Facebook, the little details are often going to be lost and you're just going to be happy you're part of the ride if you have a little piece of that, 'cause it will be worth a lot. You might want to say, "Could this company be enormous? Could it be Uber? Could it be something like this?" Maybe it could, and that's great.

You might still join a company because you're not looking for a unicorn sort of thing, but you're looking for a healthy ownership in a company that will still be healthy and somehow be sustainable or find an exit inside to another company that has liquidity where you would get some of that cash within a few years. That second scenario is something you should explicitly think through and you should actually talk about when you're joining a company and see what their strategy is, 'cause some companies are like, "Yeah, we're totally open to being acquired," or it might — "This is something we're going big." Usually, companies will always tell you they're going big, but it's worth thinking through those different scenarios. Not everything will go as planned, and so either secondary exits. Exits are very important to understand, because a large chunk of startups exit to a bumpy acquisition, and then that results in liquidity, and then that liquidity will be calculated based on all the rules and parameters of your equity ground. That's the stuff that a lot of the things that Joe is alluding to. Things like liquidation preferences and so on.

Knowing about that will help you evaluate the middle level of outcomes. If the terms of the deal are good, then during that exit, you'll probably get something. If the terms of the deal are poor — Like in some deals a few years back, there were high liquidation preferences, which meant

that investors got paid back first at an exit, which meant employees didn't get anything, or got less than they expected. That's happened for a lot of companies. That's a probability. You can work out that and have some control over that scenario as well.

[0:25:13.4] JW: Right. That's the issue of sort of the liquidation preference overhang, which I think if you're going to work for a company that's done multiple rounds of preferred financing, you know that some of the rounds have been very, very large. I think that's a legitimate question you can ask, "Okay. What is our liquidation preference overhang?" What I mean by that is what amounts do the preferred stockholders have to be paying back for the common holder share, or anything?" I think if you're looking at going to working at Unicorn, that's a fair question to ask.

[0:25:44.4] JM: Right. This gets us into the two kinds of stock. I want to reset for the boilerplate question, 'cause I kinda want to vacillate between these boilerplate questions in these more complex discussions. Broadly speaking, there are two kinds of stock; there's common stock, and preferred stock. Joe, explain the difference between these types of stock.

[0:26:05.6] JW: Sure. Under the corporate law, common stock is just a stock which is entitled to the residual value of the assets of the company after all the debts have been paid and after any stock with liquidation or other preferences has been taken care of. Preferred stock is called prefer, 'cause it has rights, preferences, and privileges the common doesn't have. Most common is the so-called liquidation preference, which means if I buy series A preferred stock and I pay a million dollars to that series A preferred stock. If the company sold for a million bucks, then I'm going to get every bit of the proceeds of the sale is going to go to me, 'cause I have a million dollar liquidation preference. No one is going to get anything else.

Frequently, the math, the way it works is the preferred stock is convertible into the common. The way that documents are usually drafted today is preferred stockholders are going to receive the greater of the following on a sale or liquidation of the company. They're going to receive either the liquidation preference pack, if that will be a greater amount, of they're going to receive the amount they would have received had they converted the common stock.

Usually, that's what a charter documents are drafted now. My example, I paid a million dollars, I bought a million dollars of series A preferred stock. Let's say in invested out a $9 million pre-

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money, so the post was 10 million and I have 10% of the company. If the company sells for $5 million, 10% of $5 million is still less than nine million bucks, so the way it would work in a situation with what we refer to as non-participating preferred stock is the company is sold for five million, it'd take my million off the top. Everyone else would share the four million and that would be it.

If the company sold for $50 million, 10% of $50 million is $5 million, so I'm going get the greater of my liquidation preference, or what I would have been paid had I converted the common. In this instance, converting into common would have given me five million. So I'm going to take five million, I want to be treated as a common stockholder.

There are other variations on the preferred stock. Sometimes preferred stock is participating, meaning — This is a legitimate question for anyone to ask if they're going to work for a company, "Hey, tell me about you liquidation preferences and sort of what the cap table looks like. Show me a summary cap table and tell if your liquidation preferences are participating or not." Participating means that the series A stockholder, or the preferred stockholders always get their liquidation preference and then they also participate as common basis. That's a pretty sweet deal.

Say, I invest a million dollars and a $9 million pre. In my simple mathematical example, let's just say I own 10% of this company, I have a million dollar liquidation preference. If my liquidation preference is participating, then regardless of what the company sells for, I'm going to get my million bucks and then whatever is left over is I'm going to get 10% off. These little nuances can affect returns to option holders for sure, and I think they are legitimate things for perspective hires to ask about.

[0:28:51.7] JM: That raises an interesting question; what are the other things that prospect of hire should ask about? I'm given my offer letter — We'll get to negotiation a little bit later. I get my offer letter and there are some things that are ambiguous to me. What are those ambiguities that I should be looking out for and how should I resolve them?

[0:29:12.9] JL: I think that's this a complicated question in a sense that it also will depend on your position in the company and how much information you can expect. I think, in general, you

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should ask for as much as feasibilities as a company will give you. Certain companies might not be able to give you absolutely everything. They aren't going to show you the entire cap table, perhaps. They might be able to give you a good sense of how things are setup and what the terms of the previous investors and things like this are so that you have an idea what those future scenarios might look like that Joe was mentioning.

In general, I would say the sort of meta advice is make sure you trust who you're going to go work for. I think, in general, if you don't, it's very hard to have an adversarial and a negotiated agreement on everything to do with compensation and have a good work environment and have it work out really well.

In general, you should not only be asking for information, but you should be evaluating, "Does it seem like this company is being fair and honest and like sharing with me things that are appropriate when I ask for it?" That's one thing to think about as you're asking the other question, because certainly not a large number of companies, but there are certainly plenty of people who have been hired into startups or companies under very little information or not enough detail. They couldn't really fairly evaluate the offer. I've known many people who have signed offers with very little understanding of what the value is. They just hope that it's fair, because it's 5,000 options, it sounds good to me.

In general, as you mentioned, you want to know percentage ownership. You want to know the previous investors and what sort of terms they might have as Joe is mentioning, 'cause they will be paid off first in the case of an exit. You want to understand whether this company is trying to go really big long term. That means you probably won't have liquidity for a long time if it's very early.

You want to understand the percentage ownership that might be in the future, so what sort of fundraising will be needed in the future. Those are some key questions. Then, there's the more technical things, certainly, about the actual form of the equity compensation. Is it a stock option? Is it an ISO? Is it an NSO? All the different things that Joe is also mentioning, and they're discussed in the guide where there are specific tax implications and pitfalls around what form it takes.

You could often negotiate some of that too depending on your leverage, the stage of the company, all that. A lot of it does depend on your leverage and how much the company wants to hire you, versus others, someone else.

[0:31:42.4] JM: Getting back to our boilerplate terms, stock options are contracts that allow you to buy shares. We will discuss options in a little more detail. Why do companies offer stock options instead of just awarding RSUs? I guess I should — RSUs are restricted stock units. This is just sock that you get that the company sets aside for employees. Joe, you and I were talking offline that this is one of the most common questions. Why do I get these options that I have to pay for rather than just getting stock? Explain this concept, Joe.

[0:32:22.9] JW: Yeah, it's mostly about tax problems, because the tax code, the federal, the income tax law, basically, says, "Hey, if you receive anything of value in connection with your services to an employer, then you have to pay tax on it, even if it's an e-liquid item. If a company transfers stock to you, you can't turn around and sell the stock, 'cause it's a restricted security and of the federal security's laws and there's no market for it. You're also submitted to a variety of contractual restrictions on transfer. The IRS is still going to say, "It's just as if your receive cash and you use the cash to buy the stock."

If you're sitting around and you're average American worker and your company wants to give you $100,000 of stock, you're going to say, "Whoa! Hold on. I don't have the ability to write the IRS a check right now for $30,000 or whatever it's going to be. It's not going to be an insignificant amount of money. If you're an employee, if the company has to withhold the income and employee's side, employment taxes from you, which means you have to write the company a check.

The company has an obligation to play the employer side of FICA, but the big pain here is coming out of your pocket. You're not going to take a stock award if you can't afford to pay the taxes, or you shouldn't. RSUs have an even worst problem. Let's just say they give you RSUs on $100,000 worth of stock today, but the RSUs vest in quarterly incremental in the next four years, let's just say, for the sake of example. The problem with that is that when your quarterly portions vest, the value might be even more than the value now and you get on the same problem at the one year mark when one quarter of your stock or RSUs are vested, you're going

to get one quarter of the shares of stock issued to you and you're going to have to write a check to the company to fulfill the company's employing tax withholding an income tax withholding applications. Most people can't afford that. Most people can't afford it.

Most people say, "Hey, I can't afford to pay tax today. It's too expensive, too painful. Price me a stock option at fair market value and I'll go on for the ride."

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[0:34:25.8] JM: You are building a data-intensive application. Maybe it involves data visualization, a recommendation engine, or multiple data sources. These applications often require data warehousing, glue code, lots of iteration, and lots of frustration.

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[INTERVIEW CONTINUED]

[0:35:56.8] JM: For people who are unfamiliar with the idea of a vesting schedule, stock and options have a vesting schedule. The vesting schedule defines when the equity becomes available to the employees. Whether this is RSUs or options, the typical situation is a four-year

vesting schedule for your equity with a one year cliff. Meaning that for the first year, you do not get any of that equity. That's the cliff.

Then after you pass that point and you've proven yourself as a desirable employee where the company actually wants to give you percentage of the company, you instantly get this allotment of your equity, and then you start to accrue more equity at a more steady rate afterwards. What are some of the aspects of the vesting schedule idea that confuse people?

[0:36:54.7] JL: I think you gave a really good summary of how it works. Not any of that is usually carved in stone, sometimes, for example, advisors might have a different vesting schedule than employees, if ever you're an advisor to a startup, or other variations like that that's common. Sometimes employees might actually be able to just negotiate a change to that, though companies like to keep things consistent also.

I think vesting itself is a pretty understandable. I think some of how it interaction with other things can be confusing. Stock is not yours until it vests. You just have to understand that. Then, once it vests, you tend to think that it's just permanently yours. As we're alluding to earlier, there are these exercise windows on stock options in particular. Vesting can occur on stock, or on options. If it occurs on options, you might think of it as yours. Those are still options and you have to exercise them.

If you do not exercise right away for whatever the reason, 'cause you don't have the cash, or you didn't get around to it, or because the taxes or something would hurt you. Those options are yours, but the options only have a validity for a certain period, which often is only to the 90 days after you leave a company.

Even if you're vested, there are some cases where you might realize that you can't hang on to the stock in a sense, that you can't exercise the options without paying a lot of additional taxes, or paying a lot out of pocket. That can be something around vest — It's not quite around vesting, but it's related in terms of understanding whether the stock is really available to you eventually.

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[0:38:30.4] JM: We have created a pretty reasonable picture for the basic situation that is common for equity compensation. This is this vesting schedule. You're typically given options. The reasons you are given options is because of the tax complexities. There's actually a large section about taxes and the interaction between taxes and equity in the Open Guide to Equity Compensation. Let's get into some of those details. I know this is not taxes engineering daily, and I don't want the listeners to start to fall asleep, but this is basically like the crocs that creates the complexity in your equity compensation. I don't know how you can make this entertaining. Joe, how do taxes affect how an employee should think about their equity compensation. What do they need to know?

[0:39:29.6] JW: Yeah. It's a big question. I guess the biggest thing is you want to make sure you have some knowledge before you agree to take a tax hint. For example, if a lot of people historically made mistakes around incentive stock options, because you might have read and it's not technically legally wrong, but you might have read there's no ordinary income tax as a result of the exercise of an ISO. That is true. There's no ordinary income tax. However, there is your spread on the exercise of an ISO as an alternative, minimum tax adjustment, and things get confusing when you start talking about the alternative minimum tax. It's beyond the can of most — I think, most people to figure it out in their own. You really need to go and talk to your tax return preparer or adviser and do some mathematical examples to make sure that if you exercise an ISO, the empty adjustment doesn't trigger a substantial amount of tax due. It's possible that you could trigger a substantial on a tax due on an ISO exercise.

I guess the cautionary stamen for everyone is, "Hey, make sure you're thinking ahead and understand the tax consequences of these awards." In other classic examples, that RSU example, like, "Hey, I've had executives in private companies, or incoming executives to companies that represent say, "I want an RSU," and they're familiar with RSUs at Microsoft, or Amazon. It's a totally different situation when you have a public company like Microsoft or Amazon and they can actually withhold from the shares they deliver to you to SaaS by your income tax withholding obligation. There's a public market, it's completely different.

The RSU in a private company, you're basically setting yourself up to suffer, basically, a time bomb in the future. You're going to hit with a tax bomb. You're setting a booby trap for yourself. It's not a good plan for a private company that's in its earlier stages to take an RSU.

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The point is always just know what's coming down the road on taxes when you're thinking about these rewards. That's the beauty of options. If you have an option priced at fair market value, you, the optionee, control, generally speaking, so much investing. You control when it's exercised. In RSU, typically, vest on a schedule and it's out of your control. I don't know what you want to add to that Josh.

[0:41:48.5] JL: Yeah, I might have a couple of things. I think that, yeah, all of that is really important about getting the right advice and understanding. There's a couple of specific traps that people need to be aware of and that it's sometimes they're now a pretty common knowledge of people will tell you about them often within a company. They kind of have a big impact on how you think about things, which is that, in general, options are good, as Joe mentioned, and you get to choose when you exercise, which gives you more flexibility, depending on whether you have cash on hand and when and if you can pay the taxes, and so on.

There is one case that's well-known that can cause you a lot of taxes, which is if you have an ISO and you exercise and there is a spread between the price that you're paying for the stock and that it's fair market value, then that spread is an AMT event, and that's what Joe was talking about. That particular one is one where it's very — It can burn you both ways, because you could have a situation where you didn't exercise an ISO stock option, and then once there is a spread there, then you either have to pay a very large amount of taxes and to exercise and keep it, which some people did during the .com boom of the first time, they would often have a lot of these taxes and then realize they have immense bills, tax bills they can't pay.

You might think ahead and realize you just have to walk away from your stock options and lose every — Have nothing, which is better than having a debt to the IRS. That was sort of the trap that is mentioned in the guide. That's something that a lot of people work carefully to avoid now, but it kinda has a big implication on how you do things. One way is to do NSOs, another way is to — Makes you exercise early. There are a few ways around it, but it's just a big got you.

[0:43:34.3] JM: Given that we've talked some about the equity compensation situation at this point, how should an employee use their understanding of equity compensation to negotiate

effectively? Maybe this is an employee who is receiving an offer letter. Maybe it's an employee who is sitting at a company that's been at the startup for a while, or maybe the big company for a while. How can you use that as leverage, that knowledge? Josh, 'cause you've worked at companies a little bit more. How have you used that to leverage to you advantage?

[0:44:05.9] JL: How have you used the knowledge of equity compensation to your advantage?

[0:44:08.8] JM: Yes.

[0:44:10.2] JL: There's a lot to be said for just understanding the rules of the game. There's a whole bunch of benefits. One is if your employer is actually giving you a low offer, a potential employer is giving you a low offer, then you actually can understand and have some sense of that. Especially if they're giving you not so much a low, but a misleading offer, or they're not telling you key information. For example, they're telling you the number of shares, but never telling you percentage ownership, whatsoever, when it comes to stock or options. That's just like not telling you key facts. That's like paying you monopoly money, really. That's not a fair — You just don't know what the value of that money is. That sort of thing you can avoid by understanding the rules. I think that that's just clear basic good sense.

There are some cases where the more you know about the system also when it actually comes to negotiation. A negotiation does matter in job offers. There are lots of blogs and discussion on this if ever you go Googling around where people have made big changes in their offers by having sensible negotiation strategy. That you can negotiate or debate certain points that matter to you. Maybe you want to have more equity, because you think the company will take off and that will be a big plus in the future and you don't need the cash. You're fine for cash, or you're happy living on ramen, whatever you prefer. That gives you some flexibility and you have to understand the rules in evaluating your preferences.

In the other hand, maybe you have a lot of bills and you're like, "I really don't want a bunch of these options that I think might not pan out unless you pay me a really good salary. I'm just not going to join." That's good to understand that that's your priorities. The company should do that too, should understand that.

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Final thing is that during negotiations, there's just lots of different variations and leverage you can pull aside to just cash versus equity. You might ask for a bonus to cover taxes, or you might ask for a follow on grant if you reach certain objectives to just — Or at least informally agree on something like that. There's lots of things you can discuss once you understand what the structures are.

[0:46:04.4] JM: We are nearing the end of our time. We got about 10 minutes left. I want to talk some about the founder's perspective. In the Open Guide, you have the section dedicated to the stages of a startup; you startup bootstrap, you don't have any money, then you have a series C, then you have a series A, series B. Along this path, there is dilution occurring. Joe, how does the ideal strategy for equity compensation from the founder's point of view? When your employee base is ramping up, you're getting more and more seasoned people, so maybe you have to them more. How does the ideal strategy for equity compensation change a long this timeline of different fundraising events?

[0:46:51.6] JW: I guess one big thing people need to think about is if the company is pre-series seed, if it hasn't — Maybe it's way is convertible. If It hasn't raised a fixed price financing with investors, then the company probably hasn't been forced to have a set amount set aside for use in the equity incentive pool.

Frequently, when the founders come together, they put 15% to 20% of sort of the issued shares into a stock option pool. If there's no external restraint, if there's no investor who's come in and imposed a restraint on that amount, that amount can be increased. The founders can increase themselves, so it's pretty easy.

I think one thing to just keep in mind is if you are negotiating for a job with a company that's already done a fixed price financing with a venture fund, that venture fund almost undoubtedly imposed a limit on what the company could do. The venture fund forced the company to set aside a certain amount of money for equity compensation. Now, the amount that you're going to get out of that pool is going to be defined by the market and what investors are typically willing to bear for a particular role. There's just going to be more scrutiny of the size of your award post the first fixed price financing. Pre the first fixed price financing, maybe there's more room to negotiate.

I read a great article on Medium not too long ago. I forgot who wrote it, but I'm sure you could find it if you Googled it. The article is all about how we should be more like Steve Ballmer. The article was about — Everyone should be like Steve Jobs.

[0:48:28.3] JM: I read that.

[0:48:29.5] JW: It was a great article.

[0:48:30.4] JM: It was.

[0:48:30.5] JW: There was a point in that article where it said, "Hey, Ballmer was employee number 30 at Microsoft, but somehow got 8%."

[0:48:37.1] JM: Yeah.

[0:48:38.3] JW: The question mark, I think, in the article was just how did he do that? I don't know. I suspect he got 8% because there was no external — Microsoft hadn't raised money from a VC yet, and entered into a sort of constraints that companies now enter into when they take money from VCs.

[0:48:56.4] JM: Yeah. We touched on the importance of taxation from the employee's perspective. Joe, what about the perspective of the founder? How do taxes affect the founder and the architects of the company?

[0:49:11.9] JW: Usually, at the company founding, typically, you receive all your shares tax free, because — If the three of us wanted to come together to start a company and let's say we're all going to be equal founders. We'll each going to receive a million shares, or two million shares for our contribution of cash and IP. Even though we'd all be investing schedules, we'd file 83(b) elections and we would indicate that, "Well, the value of the shares I received when I came in to found this company with these guys was the amount I paid for the shares, and we agreed to pay a thousand bucks so we could open a bank account for a few thousand bucks and to get started." You'd file and 83(b) and then you wouldn't have any additional taxes as thing vest.

Usually, founders, unless they just sort of blow it and don't file the 83(b) election — Usually, founders have a pretty nice tax situation in terms of their founder shares. They start their capital gains, holding period, and so that's good. Founders are subject to the same sort of problems later if there's a reworking of the cap table. Say, a year in, the three founders come together and one of the founders clearly deservers more equity because of just the way things have worked out in terms of roles and responsibilities and time commitments. In that situation, so we're a year in, we're going to have to confront a tax problem then and try to figure out how to make sure when we work the equity, the founder who's getting additional shares doesn't pay tax somehow. That can be tricky. Generally, from the outside it's a pretty good outcome for founders.

[0:50:35.1] JM: Josh, as somebody who's been working at startups for a while, how should a company create an atmosphere where it's okay for people to talk about equity compensation openly?

[0:50:48.3] JL: I think one of the key things about a well-run company and startups in particular, is that you have a certain amount of fairness and trust around how employees are treated. One of the key things I would — I think as you're a founder, or as an executive in a company, or as an employee, that everyone ideally works towards this team, encouraging that kind of filter.
I don't think it necessarily means 100% full transparency about everything, even companies that try full transparency can't be transparent about absolutely everything. There're just a lot of reasons that sometimes it's hard. I do think it's fundamentally important to be transparent about the things that you can be and to do enough of that that you have some trust that the company is being honest and fair and not taking advantage of its own employees. A company that doesn't do that often ends up paying a price down the road later.

A couple of things just to think about are like sometimes you'll see people talking about how they negotiated their offer up by a factor of two, or four, or something incredible like that. That means that company was giving a much lower offer to begin with than the employee was initially worth. Sometimes, that's because of a competitive offer and that's sometimes is a factor. Usually, when something like that happens, what it means is that the company was perhaps lowballing the offer a little too much. That sort of thing is, I think, unhelpful. That's an example,

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where companies that give pretty fair offers and are known for giving fair offers, helps everyone. It doesn't mean you don't — You go with incredibly insane offers for everyone. You can't do that and run a company effectively either. You don't take advantage of people's lack of knowledge, or ignorance of the system to close the deal. Instead, we take advantage of the fact that they want to work there, and this is a good company, and it has a good future and you come with a pretty reasonable compensation plan. Generally, that bites both sides of the table later when people aren't compensated fairly.

Those are kind of some general thoughts. I do think, typically, employees will often and sometimes compare notes, or do that sort of thing. It's rare to have a company be completely transparent about this cap table, or have all employees know their cash salaries, of each of those cash salaries. I think it's an interesting experiment. There's no reason you can't, but it makes it — There are certain problems sometimes to having a complete transparency.

[0:53:06.4] JM: Yeah. I think Buffer is experimenting with this, if I recall.

[0:53:10.0] JL: Right. That's an example where I think it's great they're doing that. A lot of companies may not want to be the first company ever to try the most extreme version of something, like complete transparency, and so you just like do [inaudible]. It's a great aspiration and that I think it's good that companies are fair about these things. At the same time, there's unexpected consequences and just lots of legal bills and things to think about some of these things sometimes in changing the way the contracts and things are done.

I think founders really should push for that, but it's worth being understanding as an employee that you can't just expect a company to be completely different than all others only based on the A aspirations or B. You'd have to think about the realities of common practice as well.

[0:53:52.4] JM: Okay. Joe and Josh, I want to thank you both for coming on Software Engineering Daily, and thanks for writing this *Open Guide to Equity Compensation*. I think following in the footsteps — Or I guess this preceded the AWS Open Guide. Josh, you and I had a conversation on Software Engineering Daily a while ago about the Amazon Web Services Open Guide, which you wrote, or which you started with some other people. I think this continues down the path of your goal with open guides, where you are making information that

is basically locked up in the minds of the collective available in a single place. These open guides are super useful and I encourage people to check them out, just this really good reading material. Thank you both for creating this resource.

[0:54:39.7] JL: Thanks Jeff. I encourage folks to check out the Guided, and also contact us — Or file a poll requests and contributions. You're more than welcome to contribute to these guides as well, or potentially even talk to us about helping write other things in the future. Hope to see you online.

[0:54:55.5] JM: That's right. These are on GitHub. They are alterable by the public.

[0:54:59.3] JL: Exactly. Yeah, that's something we're excited to hear from folks.

[0:55:03.7] JM: Okay. Thank you both.

[0:55:04.9] JW: Thanks for having us on the show.

[END OF INTERVIEW]

[0:55:13.3] JM: A few things before we go. If you like the music on Software Engineering Daily, you might like most recent album called Commodity, which features a lot of the songs that air on this podcast. My artist's name is The Prion on Spotify, Apple Music, and Amazon.

Also, Software Engineering Daily is having our second meet up, March 9th at Galvanize. You can find details on our meet up page. Finally, we are about to post our second listener survey, which is available on softwareengineeringdaily.com. This is your opportunity to have your voice heard and let us know how we can improve.

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[END]

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