The Dime💰 - Paying in Equity

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Happy New Year, folks. Welcome to 2025. I hope your holiday went well. I'm looking forward to what we share together this year, and hope you'll keep opening and reading. Let's dig in though, here's this week's edition of The Dime💰.

One of the most vital issues you will have to solve as a founder is distributing equity in your company. You will constantly ask yourself who should have equity, how much, and why. It's a very difficult question to answer and each question should be answered on a case by case basis. There's no real balancing test or formula that can fast track this as each person at each stage provides different value. What you should always keep in mind is that you need to be as effective as possible when doing so because at the end of the day each person who has equity in your company needs to play a vital role in its success and ensuring that it moves forward.

Typically in the beginning it appears that every single person who expresses interest in taking your company to the next level should get a piece of it. I mean it's only fair right? Usually the early conversations with those people are very rosy and the possibilities are endless about where you can go in the future. Over time though, when you have to execute, the rose tinted lenses tend to become a bit more clear and those endless possibilities don't look so endless anymore. Sometimes these relationships even end, whether you let them go, or they volunteer to leave, or simply stopped showing up. But you already gave your equity away, the only way to get it back is to use company cash to buy it. The tools I'll introduce you to in this Dime may help you navigate those a bit better and also ensure that your cap table stays a bit cleaner for a longer period of time.

Vesting

Vesting is one of the most powerful tools you can use to protect your equity and incentivize commitment from team members. The concept is simple: instead of granting equity outright, you grant it over time or upon achieving certain milestones. This ensures that equity is earned and not just given away.

A standard vesting schedule in startups is four years with a one-year cliff. This means that an individual doesn't actually own any of their equity until they've been with the company for at least one year, at which point 25% of their shares "vest." After that, the remaining shares vest incrementally each month or quarter over the next three years. If someone leaves before the cliff period, the company retains their unvested shares.

Why is this important? It gives you a safety net. If someone joins your team but turns out not to be the right fit—or worse, they ghost the company—you aren't stuck with them holding a chunk of your equity. It's a safeguard that aligns ownership with contributions. And don't forget, this applies to you as well as a founder, especially if you have co-founders or investors. Founder vesting shows your commitment to the business and reassures investors that you're here for the long haul.

SEC Rule 701 Employee Incentive Plans

If you're looking to issue equity to your employees or contractors, *SEC Rule 701* is your go-to guide. This regulation provides a framework for private companies to offer stock options, restricted stock, or other securities as part of employee incentive plans without registering them with the SEC.

Here's the key: Rule 701 is meant to make offering equity affordable and simple for startups. It allows you to issue up to the greater of $1 million, 15% of your total assets, or 15% of your outstanding securities in any 12-month period without triggering SEC registration requirements. But you're not off the hook entirely—if you issue more than $10 million in equity in a 12-month period, you'll need to provide detailed disclosures, including financial statements and a description of the risks involved.

Why should you care? Rule 701 makes it easier to create equity-based incentive plans that reward employees while staying compliant with securities laws. Keep in mind, though, that these securities must still comply with state securities "blue sky" laws, so it's worth working with an attorney to ensure you're on solid ground.

Option Agreements

Option agreements are the bread and butter of startup equity compensation. They give employees the right to purchase company stock at a fixed price—known as the exercise or strike price—sometime in the future. Options are typically granted as part of a company's equity incentive plan and subject to a vesting schedule.

One of the main advantages of options is that they serve as an alternative to giving equity away outright. Unlike direct equity grants, options allow you to offer the promise of ownership while keeping the actual ownership—and its impact on the cap table—on hold until the options are exercised. This is a game-changer for maintaining a clean cap table, as the dilution only happens when an option holder exercises their options and converts them into actual shares.

Just like equity, options can—and should—be subject to a vesting schedule. For instance, you might offer a four-year vesting schedule with a one-year cliff, so the option holder earns the right to exercise their options incrementally over time. If they leave before vesting fully, the company retains the unvested options.

When it’s time to exercise, the option holder pays the strike price for the shares they’ve vested in. Here’s how that works:

1. **Determine Vesting:** The option holder can only exercise the portion of their options that have vested. For example, if they’ve vested in 50% of their options and their total grant was 1,000 shares, they can only exercise 500 options at this point.
2. **Pay the Strike Price:** The option holder pays the agreed-upon strike price to purchase the shares. For example, if the strike price is $1 per share, they’ll pay $500 to exercise 500 options.
3. **Convert to Shares:** Once exercised, the options convert into actual shares, and those shares are added to the cap table.

Until the options are exercised, they don’t appear on the cap table as actual shares. Instead, they exist as a "right to purchase," meaning there’s no immediate dilution or impact on ownership percentages. This delayed impact makes options particularly appealing for startups aiming to conserve ownership while still incentivizing team members.

By structuring compensation through options, you create a win-win scenario: employees see the upside potential of your company’s growth, and you retain flexibility in managing your cap table until those options are exercised. It’s a tool that, when used correctly, can drive commitment and align incentives without giving away the store too soon.

When giving away equity don’t restrict yourself to one universe. There are may tools and different deals that can create an outcome that allows everyone to be happy. That’s it for this week’s edition of The Dime💰. Don’t be stingy with the 🏀. Pass this to a friend.

See y’all next week.

CJB

Members Discussion No Comments