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Negotiating Compensation

Ok, you've found your startup, you've survived the interview process, and you've got an offer. How do you decide whether it's fair? What can you negotiate? How should you go about negotiating?

Reviewing your offer

Generally, startup offers compose of several components:

- Cash compensation
- Stock compensation, usually in the form of stock options
- Fringe benefits

We'll look at stock compensation first since it's the most complicated.

Stock compensation

Typically, startups offer stock options to employees (especially engineers—who can't obviously be paid through a commission). The obvious numbers involved are the number of options, the strike price, and the vesting period. You typically know the number of options and the vesting period before you take the job. The strike price, however, can change between your start date and when your options are priced. Typically, the offer letter will contain language such as, “I will recommend to the board that you receive 10,000 options to purchase company stock at the prevailing market price." There's nothing suspicious about this—I've never heard of a company that did not live up to such promises in the offer letter.

What are stock options?

A stock option gives you, the option holder, a choice to buy (also called exercise) a particular stock at a pre-set price (called the strike price) at any time in the future prior to the expiration date. If the price of the share when you exercise is higher than your strike price, then you've made money. Such options are called "in the money" options. Obviously, you wouldn't exercise your options if the market price was lower than your strike price, since it would be cheaper to just buy shares at the market price.

Technically, companies issue **call** options (which are options to buy shares at a pre-set price). The inverse of the call option is the **put** option, which is the option to sell at a pre-set price. In such a case you would make money if the stock went down. Since companies want their employees to help the corporation succeed, they do not issue put options to employees.

Options are highly leveraged instruments; that is, it costs relatively little to issue or buy an option, but the profits (or losses) are magnified by each movement in the stock.

Instead of issuing stock options, corporations can also issue employees restricted stock (stock that can only be sold after a vesting period). It is very rare for privately held companies to issue restricted stock, though, since options are comparatively highly leveraged. In 2009, Facebook switched from issuing options to issuing restricted stock units—this could be because of a technicality—companies that exceed 500 shareholders have to report earnings like a publicly held company. Facebook reached a settlement with the SEC to avoid having to report publicly, and the switch to restricted stock units could be part of the settlement.

Here are the variables in stock compensation that you should think about.

Number of options

This is the *top-line* of options compensation—it represents the amount of equity you own in the company. Many people focus on the number of options they get as though the absolute number means something—it doesn't. What matters is the percentage of the company you actually own. As such, this number only means something when you also know the number of outstanding shares in the company.

To emphasize this, one of my friends joined Commerce One back before it did an IPO. She was offered 20,000 options but the company had so little revenue that at the IPO, the investment bankers reversed-split the stock, so she only had 10,000 options. 6 months after the IPO, the stock had gone to $600/share, and the board decided to split the stock 4:1, so now she had 40,000 options at $150/share. What's the difference between 10,000 options at $600/share and 40,000 options at $150 a share? Exactly nothing.

Typically, the percentage compensation goes something like this:

Table 3-1. Typical Stock Compensation

Title	Percentage of company
VP of Engineering	0.5% and up
Senior Engineer and above	0.1% and up
Entry-level Engineer	0.05%

CEOs that are hired on after the company is founded typically get about 1% to 10% of the company. Venture capitalists typically take 20% of the company if they funded the company at an early stage. CEOs and venture capitalists typically have much higher negotiating leverage over a startup, and so typically get better deals.

Note that these numbers are typically adjusted by the stage of the startup (and thus the amount of risk you're taking by joining the company at this stage) as well as the generosity of the founders and the board. In particular, it is not unheard of for engineers in pre-Series A companies to get as much as 1% of the company. Google was very generous to its employees with options. On the other hand, a few weeks after Pure Software's IPO, Reed Hastings told me that his big regret was not spreading more stock around. My advice to founders is to spread the stock around—having motivated employees participate in your success will be something you'll be extremely proud of.

Startup Funding Rounds

Startup funding rounds are typically labeled as Series A, B, C, D, etc. There might also be pre-Series A rounds of angel or bootstrap financing. If a startup is successful and executing to meet its goals, each round of funding increases the capitalization of the company, as later investors recognize the value that has been built in previous rounds. A "down-round" is one in which the value of the company has decreased, either because the execution did not pay off as expected, or the market conditions have deteriorated between the rounds, as was the case in 2001.

Should you care what stage the company is at? Yes. The later the stage of the company, the lower the risk that the company will not pan out, and hence the less stock typically gets handed out. On the other hand, how much stock gets handed out depends greatly on how much the company needs you as well as the temperament of the owners.

What you should care about is whether the company is profitable. A profitable business means a much higher likelihood of a payout, while an unprofitable business means that yet another funding round is likely to be required, which means that your share of the company will be diluted further.

The percentage of the company you own is not fixed. For instance, as new investors add money to the company, the stock gets diluted. Earlier investors' (and employees') percentage ownership of the company goes down. This is normal. If you feel that you're not getting a fair shake, negotiate for more stock up front, especially if you're getting an offer from an early stage startup. A study I read once indicated that dilution in Silicon Valley is about 1% of the company per year, but for startups, dilution tends to change dramatically as new money comes in. If the company is successful, the valuation of the company will increase at each funding round, so the dilution is usually not a big deal. Hardware startups, however, require huge infusions of capital after the design phase is over and the company has to fund production, so in those cases a big dilution event could pre-date launching the product. This is one of many reasons why many hardware startups outsource their production. Outsourcing production reduces startup costs, thus requiring less capital and dilution of stock. Obviously, if a company's schedule slips or products don't sell as expected, then further rounds could be "down-rounds".

Vesting period

The vesting period is the time it takes for you to own all the rights to your stock-options. The Silicon Valley period is 4 years with a one year "cliff." That means if you leave the company within a year of joining, you forfeit all rights to any options. After the first year, the standard is that each month another $1/36^{th}$ of your options continue to vest. That means if you got 10,000 options and left the job after 3 years, you get 7,500 options when you leave. Note that most option agreements tell you that you have a limited period of time after you leave to exercise those options, so if you think the company has a good chance of success, don't quit your job and forget to exercise those options. It also means that if you really hate your job after 11 months, grit your teeth and stick around for another month just in case the company turns out to be valuable.

I have occasionally heard of 5 year vesting periods (usually also with 1 year cliffs). These are usually far more common outside Silicon Valley, where the average employee isn't as savvy about stock-options. Rather than granting 25% more stock, they tend to be for the same amount of options but take more time to vest. I generally advise against accepting such offers in Silicon Valley unless, you're absolutely convinced that this company will be extremely successful.

Price

The next obvious variable is the price. Since most startups are not traded publicly, this price is set by the board of directors. The board of directors takes into account several factors, including the revenue (usually meager, but can be substantial at a late stage startup), the product development cycle, partnerships that might be occurring, as well as the most important factor, employee morale.

One would think that a big factor in the price would be that of investors who put in money (usually venture capitalists, but sometimes big companies, as in the example of Microsoft investing in Facebook at a $15 billion valuation in 2007). After all, typically the lead investor at every round usually sets the valuation of the company. The reality, however, is that the internal valuation (as expressed by the stock option prices that new employees get) is usually set at $1/10^{th}$ of the price that the previous lead investors got. The reason for this price difference is that investors typically get preferred stock, while employees get common stock. In the case of a liquidation (i.e., the company folds), owners of the preferred shares get their money back before owners of common stock.

No Silicon Valley startup would risk having valuable employees walk out just because they got taken to the cleaners on price—in fact, even in cases where the company did a complete reset by zeroing out early investors' equity and revalued the company at a lower price, employees would usually get new options and are somewhat protected from such events in order to retain them. Think that such resets almost never happen in the case of successful companies? Think again—Veritas was one such example.

Ultimately, however, price does not matter as much as the amount of equity you got, and you can't negotiate over the stock price anyway.

Pre-exercise option

This is now a standard feature of Silicon Valley contracts, and if it's not in your options package you need to negotiate for it. Basically, this lets you exercise your options (even the unvested ones) at the provided strike price the day you receive your options. This matters because of the huge difference between long term capital gains taxes and short term capital gains taxes. Short term capital gains taxes are taxed like income, leading to tax rates of up to 40% on a federal basis, and as much as 50% for Californians. By contrast, long term capital gains usually gets favorable treatment—as low as 15% during the Bush tenure.

The catch is that when you buy the stock, the difference between the current market price and the price you paid is immediately taxed as income. Note that if you join a company and immediately exercise the options before the price goes up, no tax is due, so that's the best time to do it. At an early stage startup, it might make sense to wait since you know that the stock isn't going to go up any time soon.

This is a great tax break, but watch your step. During the 1995-2000 dot-com bubble, folks took extremely high risks to get this tax break. They pre-exercised their options while their company stock was high. After the crash, they could not pay their taxes in April. Again, the solution here is to exercise early, before the disparity between the strike price and the market price is high, or, if you're at a risky company whose stock just did went to the moon, forget about making that extra

25% and just sell—you don't need to compound your risks.

The way the pre-exercise clause works is this—you'll buy the stock and own it like any other stock-holder. That means that if the company goes under you've lost the money, just like any other investor. However, if you leave the company before the options vest, the company has a period of time (usually between 60-90 days) during which it can buy back the stock from you. There's an apocryphal story in which a well known startup's stock administration department was so disorganized that even though an employee had only worked there for a year, the company forgot to buy back its stock so the employee got the benefit of four years of vesting for a year's worth of work! In any case, there's an argument to be made that if you don't believe in the startup you're working for, you have no business being there, and conversely, if you do believe in the startup, then exercising the stock makes sense, as the cost of doing so is usually low.

Anti-dilution provisions

This is unfortunately so rare in employee stock options contracts that I've rarely seen it. The idea with an anti-dilution provision is that as the company sells more of itself to venture capitalists and other investors in later rounds, either you get issued more shares to make up for the dilution, or you have the option to purchase more shares to compensate for the dilution. Note that this would not be the same as anti-dilution clauses in term-sheets used by venture capitalists to protect themselves in the case of a “down-round.”

Qualified versus non-qualified stock options

Tax-law distinguishes between ISO (Incentive Stock Options) and NSO (Non-qualified stock options). There are minor tax differences between them, so I'll summarize them in following table:

Table 3-2. ISO versus NSO

	ISO	**NSO**
Holding Period for long term capital gains	2 years from grant + 1 year after exercise.	1 year after exercise
AMT implications if exercise price lower than current stock price	Timing-based AMT—you get an AMT tax-credit	Not-timing based. All difference is income tax.

One kind of option is not better than the other, since their tax-treatment is only slightly different. However, if a company used to give out ISOs and recently switch to giving out NSOs, then what you want to do is immediately exercise your options as quickly as you get them—it's a signal that the company is expecting a liquidity event soon, since the non-qualified options have a favorable tax-treatment for employees who are getting their options close to the IPO/buy-out date.

Note that of all the companies I experienced an IPO with, only Google provided such a signal.

What is AMT?

The USA has two tax systems, the regular income tax system, and the AMT (alternate minimum tax) system. You pay the higher of the two tax systems in any given year. Of the two systems, the AMT system is actually much simpler—there are fewer deductions allowed. For instance, state income taxes are not deductible under AMT.

AMT first came about in 1969, after a Washington Post article about 155 individuals with incomes over $200,000 who did not pay any taxes by exploiting tax loopholes in the existing tax code. Rather than fix or eliminate all the loopholes, the government decided to simply enact a secondary tax system that eliminated deductions that were available under the standard income tax system, and setting up the tax system such that the tax payer paid the higher of the two systems. This solved the problem of tax payers paying $0 in federal taxes beautifully, and raised additional revenue.

Unfortunately, the AMT system was not adjusted for inflation, which meant that over time, more and more of the middle-class (especially those living in high state income tax states such as California) will be affected. Since fixing the AMT system would require raising the regular income tax in order to be revenue neutral, reforming the AMT has been considered politically unfeasible.

We'll discuss more about AMT in the chapter on tax planning.

AMT implications

Typically, when you exercise your stock options, if there's a difference between the strike price and the current market price, tax becomes due. In the case of ISO, all the tax due is AMT tax. This means that if your AMT tax is lower than your regular income tax, you owe nothing. Conversely, if your AMT tax for that year is higher, you pay the difference, but you get an AMT credit that you can use in future years to lower your taxes when you do sell your stock.

For NSO, there is no confusion—any difference is paid as income tax, and you get your stock cost basis set at the current market value.

Accelerated vesting (change of control)

This is an increasingly common clause in stock options packages, but the amount by which the accelerated vesting happens varies dramatically from company to company, so it pay attention to this clause.

Accelerated vesting is usually an executive-protection clause—it's not unusual for some top management executives to lose their jobs in the case a company gets bought out. To ensure that they don't scuttle deals that are good for shareholders, their options vest at an accelerated rate ranging from 6 months to 2 years when a buyout happens. Yes, that's two free years of work vested immediately upon the buy-out—really sweet, but I don't see that very frequently. Since stock option packages generally aren't any different between executives and rank-and-file, employees get the same package by default.

While I wouldn't quibble much about accelerated vesting as long as there was at least 6 months of accelerated vesting, I would try to make sure that such a clause exists in the stock option agreement—if a big corporation you dislike immensely chooses to buy the startup, you want the option to walk out if the work environment becomes extremely unpleasant, and this is a tool to ensure that you can.

It is interesting to note that options holders and stock holders can get different treatment in the case of a buy-out, and this is generally another reason you want to exercise your stock options early—you will usually get better treatment as a stockholder than as an option holder, and these include voting rights and early notification of proposed buyouts. Stockholders' votes have to be counted in such proposals, while options holders don't need to be notified since they don't actually own the stock.

Compensation in restricted stock

As of early 2009, Facebook has stopped handing out stock options in favor of restricted stock units. Restricted stock is easier to value than options—unlike stock options, there is no cliff where the value of the stock goes to zero unless the company itself loses value and goes bankrupt. Unfortunately, by the time a startup gets to the point where it would rather hand out restricted stock rather than options, the chance of getting a large stock allocation is reduced. At that point, you need to value the company like any other business—is it growing? Is the cash flow growing at the same rate? What is the projected value of the startup?

Note that while getting a large share of the company is gratifying, it is much more important that the business ultimately does well. If a company does well enough, that compensates for almost every other details of the compensation. Both Cisco and Microsoft, for instance, minted millionaires well after the IPO. While joining either today as a software engineer might not make you wealthy, joining Apple in 1998 (at their nadir, when they had to receive an investment from Microsoft) was extremely lucrative.

How do you find out how much stock the company has outstanding?

In understanding stock compensation, it is important to see how much stock the company has issued and what has been authorized (i.e., approved by the board but not issued yet). This lets you know what percentage of the company you will end up owning.

It is frequently difficult to get the answer out of HR or recruiters, but sometimes, existing engineers would be able to answer the question (be wary, however, since many engineers consider discussing compensation to be taboo). Sites such as secondmarket.com, if they list the company, provide a prospectus which lists the amount of stock outstanding.

Finally, if you have any VC friends, you can call them up and ask. This would also be a good time to try to get any scuttlebutt about the company.

In particular, if a company is large enough to have revenue and profit, you can compare the current value of the company (stock price multiplied by number of shares) against a comparable public company. For instance, when I joined Google, Jeff Rothschild suggested that I compare Google against Yahoo, which was already public. Yahoo at that time was valued at $20 billion, while Google's internal valuation was $1 billion. That gave me an idea of the resulting compensation should Google became as successful as Yahoo. It turned out that I was wrong—Google far outperformed Yahoo in the coming years.

Cash compensation

Everyone knows what cash compensation is—salary and cash bonuses. Startups frequently try to get you to take a signing bonus—a one time bonus that you get when you sign, and that you'll have to pay back if you leave within a year. I usually tell people to ignore signing bonuses in their compensation package—that one time bonus in lieu of a reduced salary (most experienced engineers take pay-cuts when they join startups) doesn't mean anything, especially if your company uses percentages to compute pay raises—the effect of the salary reduction compounds over many years.

If you are leaving an established company to join a startup, expect your salary and bonuses to be matched by the startup, but don't expect in-the-money stock compensation to be matched except in the rarest of cases. The value proposition of joining a startup is that you're taking on more risk to get the chance of a higher reward—expecting the extra reward in the form of owning more of the startup and not having to give up any of your equity compensation from the established company is unrealistic.

If you are joining an already profitable startup, you might want to consider taking a pay cut in exchange for more stock. This is usually hard to achieve, since an already profitable company usually wants to use stock equity to make more hires, rather than conserving cash. However, it can be done—just be realistic as to what you can get. A 10% adjustment in trading off stock and cash is plenty. Don't forget to ensure that you have sufficient cash to live on—while an eventual IPO might make you rich, that IPO could take quite a bit longer if the stock market crashes—an already profitable startup has no **need** to do an IPO if market conditions are unfavorable.

I don't get excited about profit-sharing bonuses. Until I joined Google, the largest bonus I ever saw at a startup (even profitable ones) was around $2000. Nothing to sniff at, certainly, but not worth taking into account when you are evaluating your overall compensation package.

Compensating engineers

Many engineers don't really know how to negotiate, and don't negotiate well. This leads to large disparity between what they are paid and what the market would pay them. This allows companies to get away with paying them below market rates, until the employee interviews with another company and discovers how underpaid they were. The resultant backlash usually leads to the employee leaving, even if the current employer were to offer a fair counter-offer. The best way to cope with this is to pay every one a fair salary in the first place, but most companies like to stick to a small percentage increase, rather than matching the salary to the employee's increase in value.

Google was an exception: fresh graduates who got promotions frequently saw raises in the 20% range, plus additional stock grants. This keeps them at market value, and often cements their loyalty to the company in a way that verbal appreciation doesn't do.

In particular, if you see a colleague having to get a promotion by interviewing and getting a better offer, it's your signal to start shopping for a new job. Your current employer is probably not treating you any better than it treated your colleague.

Fringe benefits

In 1992, the only real fringe benefits widely available in Silicon Valley were free soft drinks and health-insurance. In recent years, fringe benefits have undergone a veritable explosion. Here are the fringe benefits that I consider essential:

- Health Insurance. This is a no-brainer—I wouldn't take a job without it. However, if you are married and your spouse has a job that will cover your health insurance, then waiving health insurance as a requirement will let you work at early stage startups where health insurance might not be available.
- Paid Vacation (because everybody needs a break once in a while). The Silicon Valley standard is 3 weeks. More is great, but many people don't even use 3 weeks.

Here are the common fringe benefits:

- Term Life insurance
- Disability insurance
- Free snacks
- Free drinks
- Flex-Time
- 401(k) without matching

Much less common fringe benefits:

- Free meals

- Massage
- Gym
- Paid sabbatical
- Matching 401(k)
- Tuition Reimbursement
- Business-class travel

Except for disability insurance (which I would buy myself if I wasn't already covered by an employer), I would not consider any fringe benefits to be something I would consider substantially part of the compensation—they can go away at any time, and in fact, fringe benefits are one of the first to go when the company runs into tough economic times.

Negotiating

There are two steps to negotiations—the first is to figure out what it would take for you to leave your current job, and the second is to figure out if the package being offered exceeds that amount. The best time to negotiate is during the offer process, as you rarely have as much leverage later. Unprofitable startups, especially during the product development phase, rarely hand out huge raises. If the startup becomes profitable, the stock will make you rich, not the raises.

Many people approach negotiations as though it's a matter of bluffing—whoever bluffs the best gets the best deal. That's not how I advocate approaching negotiation: I don't enjoy bluffing, and I prefer to negotiate from a position of strength. That means several things: even if you already have a job, it is frequently useful to have multiple offers from other companies so you can have an idea of what your market value is. In particular, this means having multiple competing offers is a must if you wish to negotiate. Once you have multiple offers in hand, you can reveal the value of those offers to your preferred employer. I have rarely been in a situation where I'm indecisive after enough rounds of interviews to generate multiple offers—however, if you are indecisive at that point, congratulations: hard choices means you've gotten excellent offers that are likely to be what the market will bear for your talents! In that case, take your time and put together a spreadsheet detailing all the different offers and use that as your guide to make a decision as to what you consider to be interesting.

If getting multiple offers seems like too much work, all is not lost. You can take a relaxed approach to your negotiation since presumably the reason you don't have multiple offers is because you like your current job enough that staying on would not be a problem for you. In that case, you can signal your intent by not changing any of your existing life plans despite the ongoing negotiations. I once took a two-week vacation in such a situation. By the time I got back, my future employer had discovered the shortage of people with my skills—and raised his offer. In this situation, you're not the one who's desperate for a job, so you might as well take advantage of it.

There are many job-sites that recommend that you never name a figure for your employment, claiming that by doing so you set your pay scale lower than you might otherwise get. I disagree. The best judge of what you are worth comes from the market and having competitive offers (preferably multiple offers). Letting one company, no matter how generous, set a bid for your employment without having others to validate that offer does not say anything about what you are worth. Letting the corporation name its price also subjects you to a common psychological trick: the hiring manager first calls you with an initial number, anchoring you to an initial offer. A subsequent offer is made a few days later at a higher level, making you feel like you negotiated a better offer. Checking the market every couple of years to see where you are is by far a more effective way to ensure that you are getting paid market wages than betting on a guess by any company you work for.

You can ask friends at the company about the offers they accepted. This lets you calibrate your offer. However, when making such comparisons, be aware that someone who joined a startup early would (and should) get much more stock than someone who joined much later. The trade-off when joining a startup late is you get much less stock, not just that the fair market price for the stock options are set higher.

Further reading

http://salary.com, http://glassdoor.com. These web-sites lets you look over salaries for a certain job title in a zip code. This can be misleading, since a "senior software engineer" in one company might not correspond to "senior software engineer" elsewhere, especially if a company has wide salary bands.