EMPLOYEE STOCK OPTIONS

WHAT STARTUPS NEED TO KNOW ABOUT EMPLOYEE STOCK OPTIONS

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INTRODUCTION

Employee motivation, remuneration and, ultimately, retention are common areas of conversation for Start-up founders and business owners alike. While stock options do not exist for the sole reason of motivating employees or founders, it has become an incentivising instrument. This is done via the employee stock option plan.

WHAT IS A STOCK OPTION?

It is an agreement (contract) between the parties that gives an individual the right, but not obligation, to buy or sell stock at an agreed price within a specified time period.

TYPES OF A STOCK OPTION?

Call Option gives the holder the right, not obligation, to buy shares of stock at a predetermined price within a specified time period.

Put Option gives the holder the right to sell shares of stock at predetermined price within a specifie time period.

WHAT IS AN EMPLOYEE STOCK OPTION?

Employee Stock Option “ESO” is an agreement between start-ups and employees wherein a right to buy company’s stock is given to the employees at an agreed price “exercise price” over a certain time period.

ESOs most times come as a call option wherein the employee has the right to buy stock at a pre-set price within a specified time period. It should be noted that ESOs do not refer to granting of stock to employees but the granting of the right to buy stock after meeting certain requirements.

TERMINOLOGIES

For an in-depth understanding of Stock Options, certain terminologies must be explained.

Strike Price

is the predetermined price at which the stock will be bought. It is also known as the exercise price.

Vesting

is the process whereby the option holder (employee) earns the right to buy the company's stock. Thus, an option holder can only exercise stock

Vesting Period

refers to the period of time before the option can be exercised (before shares can be bought). After the vesting period, then comes the exercise period. The Exercise period is when the right to buy the stock can be exercised.

Vesting Schedule

is a plan that outlines when an individual becomes entitled to the shares or options. There are different vesting schedules that operate based on time and performance.

Grant Date

refers to the date the stock options are given to the option holder (employee)

Cliff

is the waiting period before any options vest; it is usually determined by the contract between the parties. i.e., A contract with a 12-month cliff will have a 12-month waiting period. If an employee resigns before the cliff period, they lose their options. Stock options usually vest in chunks over time at predetermined dates, as set out in the vesting schedule.
On a specific date, at the end of the Cliff period, the first portion of the options vests and the remaining options will vest gradually on a time basis i.e., monthly, quarterly or yearly basis.

Expiration Date

is the date when the option contract will expire.

HOW THEY WORK?

Case Scenario

Mrs. May was appointed CEO (Chief Executive Officer) of XYZ, a stock option plan was included in her employment agreement.

On January 1, 2022, she was granted the right to buy 500,000 shares at N10 per share before January 1, 2032. The vesting schedule applied is a 4-year vesting schedule with a 12-Month cliff.

Thus, 12 months after the grant date, when Mrs. May has reached the vesting cliff, she can exercise 25% of the shares and buy stock at the strike price as in

Then on a yearly basis the remaining options will vest. i.e., another 25% would vest after two years, another 25% after three years from grant date and so on.

Finally, after 4 years, Mrs. May will then be able to exercise her right to buy the company's stock.

By January 1, 2032, the option will expire. "Expiration Date".

Benefits

1. Employee retention: it incentivizes employees to stay with the Start-up.

2. It enables employees to have a sense of ownership. Thus, unlocking another level of motivation.

3. It is an avenue for employees to take part in the potential growth of the Start-up.

4. It is an avenue to compensate employees in the company.

Conclusion

In Conclusion, stock options create an environment that can be deemed mutually beneficial. However, it is important that attention is paid to the process of granting stock options. The existence of a stock option pool, duration of the stock options, vesting schedules, inclusion of cliffs amongst other considerations. It is important to consider the tax implications as well as the company's overarching goal. It is advised that the services of a lawyer versed in Corporate Finance be engaged to advise on the grant of stock options with respect to your Company.