

Option Pools: The Balance Sheet's Silent Partner

2H 2023

As is the case in many areas of growth equity and venture finance, the negotiation of how an option pool expansion impacts the equityholders (new and old) is often an exercise in the art of situational ethics as opposed to an interrogation of fundamental economic principles. Simply, each party to the negotiation wants to bear less dilution, and dilution being a zero-sum game, seeks to push the dilution (or at least a ratable portion) to the other party. However, a proper understanding of option pools and their status as a functional asset of the company reveals a clear basis of analogy that should anchor these negotiations to sound economic principles instead of raw leverage dynamics.

Consider an investment of \$20mm in a company using a pre-money valuation of \$80mm, resulting in a post-money valuation of \$100mm and the investor owning 20% of the post-money equity (see the article: [Simple Cap Table Analysis](#)). Assume further that the company's personnel growth strategy will require investments in personnel above base compensation of \$10mm. If these investments are satisfied solely with cash (e.g., as a guaranteed bonus), then the investor's ownership of the company remains 20%, but the value of the company is reduced to \$90mm as a result of the depletion of \$10mm of the company's cash, and therefore the fair value of the investor's investment in the company becomes \$18mm (i.e., 20% of \$90mm).

Alternatively, the company could have issued equity in the company worth \$10mm, which would equate to 10% of the company (post-issuance), which would cause the investor to be diluted by 10% (along with each other owner), resulting in the investor's ownership becoming 18% (i.e., $20\% * [1 - 10\%]$); however, the \$100mm value of the company is unchanged regardless of the increase in the number of shares outstanding as a result of option grants, and so the fair value of the investor's equity in the company is \$18mm (i.e., 18% of \$100mm) – the same value the investment would be if just cash were used.

This is admittedly a simplistic analysis – the economic structure of options (having strike prices, vesting/forfeiture, etc.), the need to spread out the actual cashflows for cash-based incentives over multi-year scales, and the expected value of equity in a growth thesis, as well as other factors, will all impact the comparison between the two approaches in non-zero ways – but the general point is that option pools and balance sheets are at a minimum closely related, if not in some instances nearly perfect analogues.

Therefore, when considering how option pool dilution should be borne across the new and former equityholders and similar matters (such as in the “option pool shuffle” (See: [“Who Bears It,” Part 1: The Option Pool Shuffle](#)), we can justifiably reason by analogy to other more obvious arguments of how dilution should be allocated and apply those principles to areas that may otherwise seem superficially arcane.

If you have any questions, please contact your primary attorney at Seward & Kissel LLP or Gary Anderson at anderson@sewkis.com or Eric Buchanan at buchanan@sewkis.com.



Gary Anderson
Partner, Business Transactions Group
anderson@sewkis.com
(212) 574-1687



Eric Buchanan
Associate, Business Transactions Group
buchanan@sewkis.com
(212) 574-1651