"Who Bears It," Part 1:
The Option Pool Shuffle

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The "option pool shuffle" (i.e., the negotiation of who bears the dilution of an increase to the option pool in connection with a new equity investment round) is a core aspect of valuation and cap table analysis for venture capital and growth equity investors. While any company issuing its equity will prefer that the new money bears a proportional share of dilution resulting from the expansion of the pool, the new money will always have a strong preference – and often a strong argument – that the resulting dilution should be baked into the pre-money valuation (and therefore borne only by the company's existing owners).

As dilution is a consequence of any investment – no matter how favorable the valuation is to the existing owners – the employee stockholders will always end up with a smaller percentage of the company once the investment is made. As a result, there is typically a "refresh" of the option pool to ensure that there is enough available equity capital to top-up (at least to some extent) the existing team members and have additional equity "dry powder" to compensate new personnel.

In a meaningful sense, the company's option pool should be thought of as part of the company's working capital given its role as a substitute for using cash from the company's balance sheet to compensate and incentivize employees (see article "Option Pools: the Balance Sheet's Silent Partner"). Although balance sheet analysis is often a secondary factor, if even a factor at all, to other drivers of valuation in relatively early-stage companies, working capital is an important consideration in any valuation analysis – inadequate working capital should, all other things being equal, result in a correspondingly lower valuation. If, for example, the company has a large accounts payable to its employees for unpaid wages, the company will have trouble seriously arguing that the company's valuation shouldn't be reduced dollar-for-dollar by the amounts owing. So too is the case with a company that has historically starved its option pool.

As a result, the negotiation of who should bear the dilution resulting from the option pool expansion can be framed as a downstream effect of whether the company has created a working capital surplus or deficit based upon its historical practices around equity grants.

If the company has historically failed to adequately equitize its key personnel, the new investors can make the argument that, at a minimum, the portion of the option pool increase which is designed to "right-size" the employee share of equity should be borne by the existing equityholders. Otherwise, the existing owners are rewarded (at the expense of the new investors) for their failure to properly capitalize the option pool. On the other hand, if the employees have been appropriately equitized and therefore the goal of the pool expansion is simply to adequately provide for employee dilution mitigation and reasonable equitization of new employees on a go-forward basis, an argument can be made that the expansion is akin to creating additional working capital for the company, and therefore all equityholders, including the new investors, should bear their

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proportionate share of the resulting dilution (see the article "Two Sides of the Same Coin: the Relationship of Valuation and Dilution in Pricing Venture and Growth Equity Deals").

It is worth noting that where the pool expansion (and corresponding dilution) is negotiated in the context of the pre-money valuation, the parties can opt to "split the baby" by either agreeing to a proportionately lower pre-money valuation but having the purchaser bear its pro-rata share of dilution from pool expansions, or a proportionately greater pre-money valuation but have the option pool expansion borne solely by the pre-money holders. Among other reasons to invest at a greater pre-money valuation with the expansion being borne solely by the pre-money holders include a greater headline valuation price for the company, which may be of particular value in environments where companies are worried about the impact of down-rounds and/or other valuation signals being given to the marketplaces. The shuffle can also be a way for a new investor to claw back some of the value from a company-favorable valuation that had been previously negotiated.

Understanding the nuances of the economic principles and effects of option pool expansions will allow you to better analyze investments and make a well-reasoned and convincing arguments for your position. As you will see in the next article, "Who Bears It," Part 2: Economic Arguments for Convertible Note / SAFE Dilution, dilution from the option pool is only one factor that investors should consider when seeking to optimize their investments in growth equity and venture capital companies.

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.

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