Founders' Equity

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A highly negotiated, sensitive provision in a venture capital transaction centers on what percentage of founders' stock should be subject to additional vesting and the ramifications that result. The following are key issues and suggested approaches to satisfy concerns of both founders and investors regarding this topic.

Founders' Perspective. Most founders receive their equity upon incorporation, which often is at least a year prior to the initial venture capital round. Therefore, founders are usually surprised by the vesting terms that venture capitalists will impose on their equity. From the founders' perspective, they already own the stock and it is difficult to concede such ownership in order to satisfy the investors' desire for the Company to retain the right to buy back unvested shares upon the founders' employment termination.

Investors' Perspective. Venture capitalists will confirm that the two most important factors regarding an investment decision pertain to the (i) quality and experience of the founding team, and (ii) potential market size towards which the Company's products or services are directed. Consequently, they want to protect against the possibility of prematurely losing founders, together with their full equity position, after their investment. Vesting of founders' equity protects against this possibility because founders are motivated to stay the course to receive the benefit of their equity position and, should they prematurely leave or be terminated, the unvested shares can be (i) used to attract suitable replacements, or (ii) reallocated to other founders, management, or employees.

Cliff Vesting. Standard vesting terms provide that 25% of founders equity will "cliff" vest after one year with the remaining 75% vesting quarterly or monthly over a three or four year period. This approach can be modified such that a negotiated percentage of equity immediately vests at closing (i.e., 25%), which is usually a function of how long the founders have been part of the Company (i.e., the longer the period the more likely the founders will attempt to negotiate a higher percentage of immediately vested equity). However, this effort is balanced against the investors' desire to require that a larger portion of equity be subject to vesting in order to sufficiently incentivize the founders to continue to work for the Company. Another compromise is for the founders to have their unvested shares subject to a shorter time period (i.e., two years or less).

Repurchase Price. A second approach often employed by founders pertains to the repurchase price paid by the Company for the founders' equity if the founders leave the Company. The standard approach is to allow the Company to repurchase unvested shares at the nominal price paid by the founders for the stock if the founder leaves the Company for any reason. Alternatively, founders can request that the purchase price be equal to the fair market value (FMV) at the time of the repurchase (usually valued in good faith by the Board of Directors or at a price mutually agreed upon by the parties). Investors often view the founders as having not yet "earned" the stock upon premature departure or termination and, therefore, are generally

reluctant to allow the founders to benefit from an increase in equity value. This view is bolstered by the fact that had the founders received an option in lieu of stock, the founders would not be entitled to exercise the unvested portion of their option upon departure. The usual compromise is to differentiate the purchase price based upon the reason the founders have left the Company. If the founders leave the Company voluntarily or are terminated for cause, the Company has the right to repurchase the shares at the price paid by the founders. However, if the founders are terminated without cause or constructively terminated (i.e., the founders leave for "good reason"), the shares are repurchased at the current FMV. Lastly, a very unusual scenario requires the founders to sell back vested shares at the FMV upon termination regardless of the reason.

Acceleration. Another common provision associated with founders' equity relates to accelerated vesting upon a change of control of the Company (COC). Founders often request 100% of the unvested shares accelerate and vest immediately upon a COC. Investors are generally reluctant to accept a full acceleration clause as it could make the Company less attractive to a potential acquirer because the acquirer will want key management (oftentimes including the founders) to be motivated to remain with the Company after the acquisition for at least a transition period. The more traditional approach if a COC provision is accepted is to permit at least one year of accelerated vesting to occur. If not satisfied with this proposed percentage, the founders could request a "double trigger" (i.e., additional acceleration after the COC if certain events occur). The double trigger is generally tied to the termination of the founders (usually without cause) within a certain period of time after the COC. For example, if 25% of the founders' stock accelerates upon a COC, the founders can also request that an additional 25% automatically accelerates in the event they are terminated without cause within six months thereafter. However, this practice can be difficult to implement if there is cash only consideration at closing as it is difficult to determine what percentage of the founders' shares should be included in the sale and/or subject to the double trigger.

Conclusion. Founders and investors must strive to effectively understand the key needs and requirements of the other as part of the negotiation of a successful venture capital transaction. The treatment of founders' equity is one such key need and requirement. In light of the various alternatives that exist with respect to founders' equity, consensus should be attainable regarding vesting, repurchase rights, and acceleration, which is desirable in order that all parties may focus their attention to growing the Company into a highly successful venture from which all can benefit.

For more information on founders' equity, please contact **Mary Beth Kerrigan**.