The Making of a Winning Term Sheet: Understanding What Founders Want

Part II. Vesting Acceleration, Reallocation of Founder's Stock, Option Pool Dilution, and Founder Liquidity

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Know your target market. It is one of the most fundamental principals of any successful marketing strategy. Investors who understand what the founders of a startup really care about will stand a better chance of winning the competitive deal. This article, which is the second in a two part series, will discuss several provisions that investors can use to make a term sheet more attractive to founders of a startup. Specifically this article describes the following: acceleration of vesting for founders' shares; the re-allocation of unvested founders shares upon a founder's termination; sharing the dilutive impact of the option pool, and founder liquidity. While these terms are seen with varying degrees of frequency, and are not necessarily what would be considered "market", they all have precedent. And for investors the timely use of any one or more of these provisions might be the difference between winning or losing a highly sought after investment opportunity. In the end, giving up marginal deal protections will prove a shrewd strategy if the result is a stronger portfolio of companies.

Forfeiture of Unvested Stock

One of the great and unpleasant surprises to many founders is the realization that venture investors will require that their stock be subject to vesting. In short, this means that the founders need to earn the right to keep their stock after the financing is complete by continuing as an employee. The vesting period is typically three or four years, with the stock vesting on monthly or quarterly basis over this period. Once the stock is vested, the founder typically retains the stock even if he leaves the company. But if the founder leaves the employment of the company before this time period has elapsed, the founder forfeits the unvested portion of the stock. This vesting requirement puts all founders at risk that they could be divested of a significant portion of their stock if the board of directors determines that a founder is no longer a "good fit". Risk of forfeiture of unvested stock also arises in the context of an acquisition. For a full discussion of stock vesting, see "Founders' Equity," by Mary Beth Kerrigan, *VC Spotlight*, Q3 07.

Underlying the question of whether and when stock should be forfeited is the fact that in most cases the forfeited stock returns to the status of authorized but unissued common stock. As a result, a founder's loss inures to the benefit of all the remaining stockholders, both common and preferred, whose ownership percentages in the company all increase proportionately. In this way, vesting creates an inherent conflict between founders and those who might benefit from their termination. This dynamic is not lost on well informed or advised founders, and heightens a founder's sensitivity to the risks of forfeiture.[1]

Acceleration Upon Termination Without Cause

To alleviate a founder's legitimate and very real concerns, an investor could agree to allow the founder to retain all or a significant portion of his unvested stock — in essence "accelerating" the founder's vesting schedule — if the founder is terminated without "cause".[2] While the definition of "cause" becomes critically important in this context, if the founder avoids conduct that constitutes cause, the founder maintains control of his own destiny as it relates to stock retention. The downside to the company and the investors is that a departed founder will need to be replaced, and the person replacing the departed founder will require equity. While this is likely to be true, given the disproportionately high equity stakes that founders have, it is unlikely that the founder's replacement will require as much equity as was accelerated upon termination without cause.[3]

Acceleration Upon Change of Control

Founders may also be at risk of forfeiting equity in connection with an acquisition or other change in control of the company. At the time of such an event the founder's stock may only be partially vested under the original vesting schedule. The question arises at this time as to what should happen to the unvested stock of the founder, and more specifically whether such stock should be treated as though it was either fully or partially vested and therefore participate in the proceeds distributed out at the time of the acquisition.[4]

Venture capitalists often resist "acceleration" upon an acquisition. A number of rationales may be offered. Investors will argue that the purpose of vesting is to keep founders incentivized for the agreed upon period of the vesting schedule, and that the founder has not "earned" his stock until this period has elapsed. Investors might add that if the founder is allowed to accelerate, the founder may have "walk away" money thereby impairing the enterprise value to a potential acquirer who will be required to pay extra to retain the founder going forward. In theory it is also possible that the founder may not be retainable at any cost because of the "walk away" money that results from acceleration. Alternatively stated, the acceleration will require the buyer to offer incentives for the founder which costs the buyer will need to factor into the cost of acquiring the company. This in turn will depress the aggregate consideration to the other stockholders. Another reason that investors may resist acceleration upon a change in control is that to the extent unvested equity is forfeited, the ownership percentages of the other equity holders goes up proportionately. While a windfall of this nature would certainly be a nice result to the investors even if unplanned and unanticipated, investors should not be planning on this outcome when they make their investment decision so this rationale seems to be without any strong, underlying principal.

The founders naturally have a different perspective. They argue that the purpose of vesting is to keep them invested through a successful liquidity event,[5] and that once this objective is satisfied the vesting no longer serves any meaningful purpose. Moreover they feel that their hard efforts contribute significantly to the company's ability to attract a buyer, and the founder should be compensated for these successful efforts and contributions. In addition, founders will point out that they may not realize "walk away" money upon an acquisition, or alternatively that they could retain a high level of passion and personal motivation for additional monetary or other reasons. They may also question the validity of a rationale that suggests that they should bear their own cost of retention post-acquisition believing that this cost is more appropriately borne by the buyer. Finally, they may point out the conflict described above and the fact that the forfeiture of their unvested stock benefits the investors by increasing their ownership stake.[6]

Any venture firm seeking to win a deal with a group of founders that appreciate the implications of vesting can improve their prospects with the founders by allowing the founders to vest, either in whole or in part, if they are terminated without cause. Similarly, the terms of a venture financing can be made more attractive to founders if their stock accelerates in whole or in part upon an acquisition.

Reallocation of Founders Stock Among Founders Upon Forfeiture

As discussed above, unvested stock that is forfeited by a departing founder is typically repurchased by the company at nominal cost as a result of which all the stockholders end up with a higher ownership percentage. But this is not the necessary result, and founders often question whether this outcome is the right one. While certainly not common, an alternative would be to have the stock that would otherwise be forfeited be automatically transferred to the other founders rather than reverting back to the company. This would result in no change in ownership to the venture capitalist, the departing founder would end up with the correct percentage he had earned, and the remaining founders' ownership would increase.

Investors may object to this reallocation scheme for several reasons in addition to the fact that it is not customary. Investors point out that the departing founder's stock needs to be recaptured by the company so it can be re-deployed to find a replacement. Investors may also feel that the reallocation approach would result in a windfall to the remaining founders who have no greater a claim on the forfeited stock than any other stockholder. And as mentioned above, there is also the underlying fact that investors prefer the more customary approach as a result of which their percentage ownership would go up substantially.

These points all have merit as do the typical founder responses. As noted above it is very unlikely that the full block of forfeited stock would be needed to hire the departing founder's replacement. The broader question is whether it is fair that all ownership positions, including the investor's, should go up proportionately if a founder forfeits stock. There is no correct answer to this question and perceptions of fairness predictably turn on whether one is an investor or founder. The fact is that the founders allocated their stock between themselves before the investors became involved in the business, and that such allocations were based on the assumption that the founders were committed to the enterprise. Any founder who was not committed or well suited to the enterprise would not have gotten as much equity at the outset had this information been known at the time of formation. Rather, that founder's share of the initial equity would have been allocated to the other founders who by definition accounted for one-hundred percent of the initial equity. On this basis founders rationalize that the stock of any founder which is forfeited should revert to the other founders and that otherwise the investors enjoy an unfair windfall.

A venture firm seeking to do a deal with a group of founders that are sensitive to this re-allocation issue can improve their prospects with the founders by allowing the founders to re-allocate forfeited stock among themselves. To be clear this is by no means customary. If investors are open to this idea but concerned about the need to attract a replacement for the founder, a middle position can be agreed upon whereby the departing founder's forfeited stock is re-allocated to the other founders except for that amount that is necessary to attract his replacement. This amount would revert to the company so that it can be re-deployed for that purpose.

Sharing the Dilutive Impact of the Option Pool

The size of the equity plan reserve required in a venture transaction is often a point of heavy negotiation. Investors typically insist that an equity plan be established in order to attract and retain future employees. This pool of shares is then factored into the pre-investment capitalization when arriving at the price per share of preferred stock to be paid by the investors.[7] When calculated this way, investors are not diluted by grants out of the plan, only the pre-existing shareholders-the founders in particular — are diluted. Founders are often unaware of this very significant term until they learn about it in their first venture financing and it can be a very unpleasant realization. As a result, the number of shares reserved under the equity incentive plan is of high importance to both investors and common stockholders alike.

While this approach is typical, there is no requirement that the option pool dilute only the founders in the manner described above. To improve the terms for the founders, investors might agree that the dilutive impact of the option pool reserve will be borne by both common stockholders and preferred stockholders equally after the funding. Alternatively, part of the dilutive impact can be shared by the preferred stockholders.

Founder "Liquidity"

In certain venture financings, in particular later stage financings, it is not unusual for investment proceeds to be distributed out to existing stockholders as part of a redemption offer. This distribution of proceeds out to founders is common in early stage financings other than in situations in which there is significant deferred salary or founder that has been used to fund operations. But founder liquidity does not necessarily need to be reserved for later stage venture transactions. Like most terms, this too is a matter of negotiation. Since founders are typically very much aware of the riskiness of the business enterprise, they might well be motivated by the offer of some liquidity. Offering founder liquidity might also result in the investors getting more of the company which in the end might prove to be benefit for the investors.

Summary

While some of these terms may negatively impact the return on investment with respect to underperforming investments, if the result is that a fund includes a higher percentage of winners in its portfolio, the overall return on investment to the fund should be improved. In addition, developing a reputation as an investor that is "founder friendly" will result in more deal flow in the long run.

See also:
The Making of a Winning Term Sheet: Understanding What Founders Want – Part I. The Special Founder Liquidation Preference

For more information on the term sheets, please contact **Jonathan D. Gworek**.

Footnotes.

1. For example, assume a company with two founders each of whom own 50.00% of the company. Also assume that this company completes a round of venture financing after which each of the founders owns 25% of the company and the venture capitalist owns 50% of the company. Now assume that one of the founders, who was also the chief technical officer, leaves the company before all of his stock is vested as a result of which 1/2 of his stock, or 12.5% of the stock of the company, reverts to the status of authorized but unissued stock. If this were the case, the rest of the issued and outstanding stock, including the venture capitalists stock and the departing founder's earned stock, would all increase as a percentage of the company by 12.5%.

2. While beyond the scope of this article, provision can also be made for acceleration in the event of constructive termination or what is commonly referred to as resignation for "good reason".

3. To continue the example from footnote 1, the founding CTO was terminated and forfeited 12.5% of the capital stock of the company, but in most cases it is unlikely that the company will need to use the full 12.5% forfeited to attract a replacement CTO for a venture backed company.

4. While outside of the scope of this article, there are a number of ways of dealing with acceleration upon a change in control including the so-called double trigger by which stock vests only upon some second trigger following an acquisition-typically termination without cause or resignation for good reason. The double trigger approach really is best suited for situations in which the target option holders are offered substantially equivalent replacement equity in the buyer. This is often not the case such as in an all cash deal. While cash escrows can be established to mirror the continued vesting of stock in cash deals, such arrangements can become complicated and cumbersome.

5. As a result, it is not unusual to see definitions of "acquisition" that distinguish true liquidity events, such as an IPO or cash or public company stock acquisition, from lesser liquidity events

such as a private stock deal. Alternatively, though less common, “acquisition may be defined by reference to a dollar threshold.

6. The investors are not the only stockholders who are potentially conflicted in this way. Any stockholder whose stock is not subject to vesting may be conflicted as they stand to have their ownership interests, and share of the acquisition proceeds, increase proportionately to the extent unvested stock is forfeited.

7. For example, assume that the venture investors are putting in $5,000,000 at a $5,000,000 pre-money valuation for a 50% ownership stake in the company. Further assume that the venture investors will require a 25% option pool post-funding. These requirements imply that the “rest” of the capitalization at the time of the funding must be comprised of 2,500,000 founder shares, and 2,500,000 shares reserved for future issuance under an equity incentive plan.