LOS ANGELES & SAN FRANCISCO

Daily Journal

www.dailyjournal.com

THURSDAY, JULY 6, 2017

PERSPECTIVE

Equity Vesting: Does One Size Fit All?

By Jesse Finfrock

There are few things more important to entrepreneurs and investors than managing founder equity, and some of the most frequent start-up questions we field are about common stock vesting. This piece seeks to address these questions and explain the fundamentals of vesting, as well as to offer some best practices for start-ups and early stage investors.

What Is Vesting?

When a new company issues initial common stock to its founders, the entire amount can be owned by the founders free and clear from the start, or the founders can be required to earn the right to keep the shares. This latter approach is referred to as "vesting" — in that a founder's right to the shares "vests" over time. In order to implement vesting, the founder receives, and technically owns, the entire amount of the covered common stock, but the company retains an option to repurchase any unvested stock at the initial issuance price (typically par value) upon the founder's departure. That repurchase option automatically lapses in pre-determined installments, usually based on the passage of time, but occasionally based on performance of the business or achievement of milestones. However, if a founder leaves the company, then vesting ceases, and the company must affirmatively exercise its repurchase option on any unvested shares.

Why Should Founders Vest (or Not)?

Vesting is primarily an incentive mechanism intended to keep the founders of a company focused on growing the business and to prevent a windfall to founders that leave the business early on. If a founder receives all of her ownership in a company upfront, then she may well move on to another idea or startup rather than focus on her initial company. If instead, a founder must earn her shares over time, then that founder is much more likely to continue to grow the business. Vesting of the founder's equity therefore tends to give early stage investors (as well as directors, employees and advisors) increased confidence that the founder is fully engaged with the company and dedicated to its success. If there are multiple founders, this assurance is particularly important to create confidence in each founder's commitment and contributions to the company.

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However, vesting may not be appropriate for all situations, such as when a company has a single founder, and it is not unreasonable to issue initial founder stock free and clear of vesting. If future investors require, vesting can be layered onto stock that has already been issued. This can sometimes be advantageous for founders who are able to negotiate a better position for themselves with outside investors in exchange for an agreement to re-restrict their shares for a period of time after receipt of the investors' funds.

What Are Standard Vesting Schedules?

The most common schedule vests founder stock over four years, with a one-year cliff. This means that for the first year, the founder receives no vesting at all, but at the end of the first year — provided that the founder is still contributing to the company — a fourth of her stock vests in a lump sum. Then, over the course of the following three years, she receives one thirty-sixth of her promised stock in monthly installments until all the stock has vested at the end of four years. However, there are many variations on this schedule, and while many companies conform to this approach, investors understand that not every start-up (or founder within a start-up) is in the same position. Other common schedules remove the one-year cliff or vest a portion of the shares upfront in respect of major contributions of the founders, such as for intellectual property. Sometimes, the deemed "vesting commencement date" is set to a date prior to the date of stock issuance or company formation to account for the founders' early contributions, so the vesting timetable is shortened. Finally, consultants, advisors, employees and directors who receive equity but are not as integral to the company may well have a vesting schedule shorter than four years.

What Are "Single Trigger" and Double Trigger" Vesting Acceleration?

Single trigger acceleration means that all of a founder's unvested stock automatically vests upon a "change of control" of the company, which is generally an acquisition or other transaction that shifts majority control to new parties. Double trigger acceleration means that a founder's unvested stock vests only after the occurrence of both a change of control and the termination of the founder (usually within a one-year period). Double trigger acceleration is sometimes preferred by investors because one of the key assets of an early-stage company is its founding team. Acquirers and investors may not be as interested in a company if they believe the founders will not be incentivized to remain active in the company after the acquisition. On the other hand, founders generally prefer single trigger acceleration to facilitate their exit or to have certainty regarding their ability to dispose of their shares post-acquisition. If founders have single trigger acceleration, but an acquirer wants them to remain in their roles post-acquisition, portions of the shares can be re-restricted to incentivize their continued service.

Should Our Company Use Performance-Based Vesting?

Generally time-based vesting is preferred to performance-based vesting. In large part this is because time is a definitive and objective measurement whereas performance can be subjective. If performance-based vesting is desired, the company should establish objective conditions as the basis for vesting, tying vesting to well understood and trackable metrics, such as GAAP revenues or number of users. Appropriate metrics are often difficult to identify at a company's founding, so most startups and founders avoid this approach. However, this method may be used to reward the achievement of one or more specific milestones, such as the company's executing a significant contract or delivery of a product prototype. In addition, social enterprises (companies interested in generating social or environmental impact as well as financial returns) may include performance-based vesting based on achievement of pre-negotiated impact goals.

What are 83(b) Elections, and Why Are They So Important?

At a high level, an election under Internal Revenue Code Section 83(b) allows founders to volunteer to be taxed on the value of restricted stock at the time it is received rather than when it vests. Since the value of the stock is typically very small at the time of the founding of a company, the tax bill will be much lower at that time. In the absence of an 83(b) election, the shares would be taxable months or years later as restrictions lapse, when the shares might be worth much more. If an 83(b) election is successfully made, the shares' gain in value over time is not taxed until the shares are eventually sold. Founders only need to submit IRS form 83(b) if their stock has vesting. Many mistakes in company formation are fixable, but if the 83(b) form is not filed within thirty days of the stock issuance — a hard deadline — there is no fix. Unfortunately, if a founder does not make the 83(b) filing, she will be required to pay tax at the ordinary income rate (rather than long-term capital gains tax rate) on the gain in value of vested stock between the time of issuance and the vesting date. The filing must be made within 30 days after the stock is issued, so founders should have their 83(b) forms drafted and ready for execution and mailing immediately after the issuance of their founder stock. Founders should also consult their personal accounts when filing their 83(b) forms since this will ultimately impact their personal taxes and finances. Bottom line: File the 83(b) forms ASAP.

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