Guest Article

Vesting of Founder's Stock

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Founders of a startup are frequently surprised when venture capital firms or other investors ask for vesting provisions to be placed on the founders' stock. The investors are seeking to provide sufficient incentive for each founder to work through the company's critical early formation and development phase. If a founder leaves the startup early in the process, it would be unfair to the other founders and the investors for the departing founder to receive a "free ride" on the continuing efforts of the other founders. The vesting terms cause a forfeiture of the unvested shares, or a repurchase at a low cost, upon termination of employment, thereby eliminating the free ride.

A typical vesting structure is a period of four years beginning either upon the formation of the company or the closing of the first round of outside financing, with a one-year cliff, meaning that one-fourth of the stock vests on the first anniversary. Thereafter, the stock vests ratably with one forty-eighth of the stock vesting each month. In some cases, the stock instead vests annually with one-fourth of the stock vesting on each anniversary. In either case, the founder is 100% vested on the fourth anniversary.

The logic of this typical structure is that it takes a full year to get through the formative stage and, thereafter, the value of the company increases incrementally. The typical vesting schedule tracks this common growth pattern, rewarding the founder proportionately for services during these stages.

But, startups come in many shapes and sizes, and founders can request and obtain variations from the four-year vesting schedule in appropriate circumstances. Following are a few of the most common reasons to adjust the vesting schedule:

1. **Other Contributions.** If a founder has contributed money, intellectual property, or other assets to the company, the stock issued in return for those contributions should be fully vested, because the value has been provided in full and is not contingent on the future services. Any remaining stock issued for services would still be subject to vesting.
2. **Prior Service.** If the VC investment is being made after the formation of the company, the founders frequently are able to obtain credit for the prior services. For example, if the VC investment is made one year after formation, the stock could be 25% vested upon closing the investment, and the remaining stock would be subject to a three-year vesting schedule.
3. **Shorter Startup Period.** If founders reasonably anticipate a shorter period to bring products or services to market, profitability, or sale of the company, then investors have a shorter risk period and the vesting schedule can be reduced commensurately.

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4 Track Record or Expertise. If a founder has a proven track record or expertise that is particularly needed by the company, that founder may be able to leverage this strength into a shorter vesting schedule. But don't overplay this hand. If the investor is convinced a founder is critical, the investor may decide that vesting is even more important to protect against the damage to the company if this key founder leaves the company.

Vesting stock commonly raises two additional issues: acceleration of vesting and the tax treatment of vesting stock.

Founders should always ask for the vesting of their stock to accelerate upon (a) a sale of the company or (b) a termination of employment without cause. This formulation for vesting is called "single-trigger" acceleration, because the acceleration is "triggered" upon the occurrence of either one of the two events. Investors usually want "double-trigger" acceleration, in which acceleration only occurs if the founder's employment is terminated without cause following a sale of the company. Investors are concerned that single-trigger acceleration will make the company more difficult to sell because, if all stock vests upon sale, buyers will be unwilling to take the risk of founders leaving the company shortly following the sale.

Finally, vesting stock creates a tax trap that first-time founders do not expect. The tax code treats the grant of stock to a company officer or employee as compensation for services rendered. The founder is required to recognize income equal to the value of the stock. When a company is initially formed, the stock usually has no value, so the taxable income is $0. But, if vesting is placed on the stock, IRS regulations deem the stock to be granted on the date of vesting. If the company's value increases over time, as anticipated, then the stock gains greater and greater value upon each vesting date and the founder must recognize income on each vesting date. If the startup goes well, this income is quite significant, resulting in substantial income tax at a time when the founder may not have cash available to pay the tax.

Generally, founders can mitigate the previously referenced tax costs by filing an 83(b) election with the IRS. The 83(b) election treats the stock, for tax purposes, as if there is no vesting, thereby eliminating the taxable event upon vesting. But, be careful with this issue. The 83(b) election must be filed within 30 days of grant; no extensions are permitted; the election applies only if the stock is issued in connection with the performance of services; and the potential tax trap could be huge if you fail to file in the 30-day period. Founders facing this situation should consult with knowledgeable tax counsel to determine the availability and effects of an 83(b) election.

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