Milestone-Based Vesting For Startup Founders

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Scott Kupor, COO and a managing partner at Andreessen Horowitz, recently published an article on Fortune.com (titled "Your next business partner should come with a prenup") in which he reviews several of the common pitfalls of business partnerships and wisely suggests to address them using a prenup agreement.

One critical issue Kupor discusses is the vesting of founder shares in a startup. It is well understood that it is in the best interest of the company, its employees, its investors and the remaining co-founders to make sure that if a founder voluntarily quits for some reason, he does not get to retain all of his equity. In fact, most startups nowadays have a 3-4 year vesting period for the founders' shares.

Kupor suggests that founders reconsider the vesting period because, he claims, it now takes much longer than it used to for a private company to reach the public markets. Therefore, the vesting period should be extended to maintain the long-term incentive that the vesting mechanism provides.

While extending the vesting period has some advantages, the heart of the problem lies elsewhere. The traditional vesting formula is based on the assumption that value is accrued linearly. That is, that the value of the company always grows as time passes and that it grows at a constant rate.

In reality, however, value does not grow linearly. In fact, it may even decrease in certain instances over a company's timeline. A down round is an obvious example of a decrease in a company's value. Another common example of a value decrease is a pivot.

> *A startup may iterate over multiple business models before hitting on the right one.*

Many startups nowadays go through one or more pivots before reaching product-market fit and scaling. Those pivots reflect a realization that the previous business model failed, which corresponds to a decrease in the value of the venture. Moreover, when value increases, it usually does not increase at a constant rate. A startup may iterate over multiple business models before hitting on the right one.

The value of the venture during its initial attempts of product-market fit is much lower than its value after the right model has been found. The company may have spent three months or three years figuring out the right model, but the length of that period is irrelevant. Value increase takes place only when a working model has been found.

This phenomenon of a startup's value increasing at very specific moments and not gradually over time is actually the rule and not the exception. A startup's value increases at many isolated and well-defined events, such as the recruitment of key team members, a successful PoC (proof of concept) of the core technology, the first customer signing up or the closing of a financing round. A chart representing the value of the venture will more closely resemble a step function than a linear one, and the time between each value-increasing step may vary considerably.

An alternative approach to founder vesting, which creates a better correlation between the vesting level and value creation, would be to define a set of value milestones, each of which unlocks an additional part of the founders' equity. Moving from one milestone to another may be faster or slower depending on how the venture performs. Moreover, in principle, the venture might go back in the value scale, thus decreasing the amount of the founders' vested equity.

Defining the value of a startup obviously can be tricky, but even a crude milestone-based vesting formula will probably be much better than a traditional time-based formula. Here are some possible ways to define the value milestones.

An easy way to define a milestone-based formula for startups that are likely to require venture funding would be to base the formula on the valuation of the company at the various financing rounds.

For example, a co-founder should get nothing if he voluntarily leaves the company before a round valuing the company at $1 million. If he voluntarily leaves the company *after* being valued at $1 million but *before* being valued at $5 million, he should have 10 percent of his total equity vested, and so on. Reaching more than 50 percent vesting before reaching $100 million is in most cases not recommended, and accelerating to 100 percent should take place only upon an exit event.

A different approach to quantify value is to use a relevant business metric, such as revenues, active users, number of customers or number of deals. Key events, such as the successful development of a prototype or first customer shipment, also generally correlate well with value.

> *Founding a company is a commitment that should be taken seriously.*

Criteria based on valuation, metrics, events and time are not mutually exclusive, and can be combined in a variety of ways to construct the most appropriate vesting formula for a given venture. For example, one recommended time-based provision is a one- year overriding cliff, meaning that no vesting takes place before a full year has passed. Founding a company is a commitment that should be taken seriously; a co-founder who quits before a single year has passed should not leave with any equity.

Founder vesting is usually implemented using a mechanism known as reverse vesting, which forces the leaving party to sell his “unvested” equity to the company or to the other shareholders at predefined terms. Such mechanisms often have tax consequences and need to be reviewed in light of local regulations.

Milestone-based vesting is a very effective way to make sure that if a co-founder voluntarily quits the venture, he does not walk away with too much equity. The case in which a co-founder is forced out of the venture or from his previous position is quite different.

In that case, the founder can no longer be held responsible for value creation and should be compensated as if all or most of the value has already been created. This is achieved using accelerators that take effect in such scenarios and accelerate the vesting level of the founder to a higher level. This mechanism is very similar to the very common upon-exit acceleration clauses usually found in the employment agreement of founders.

To summarize, founder vesting is an important mechanism aligning the interests of all stakeholders of a young venture. Traditional time-based vesting is too simplistic and does not address more complex scenarios — which are pretty common nowadays. Milestone-based vesting is a simple alternative that resolves most of the pitfalls of the currently used time-based vesting formula.

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