

Commentary
Rethinking Vesting Schemes and a Proposal for an Alternative
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2021-10-12

This commentary is an examination of conventional thinking about vesting schemes and limitations of liability in early-stage startup founder-investor contracts and proposes concepts for how the founder-investor relationship can be improved in a way by providing tangible, realistic incentives for both founder and investor.

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The conventional thinking is that vesting schemes ensure long-term commitment by founders, but in the case of early and even mid-stage startups, in return they get only shares that are highly speculative in value and for which there is no secondary market. If there were a market for such shares, there would be a multitude of websites for trading them.

Valuing startups is a highly speculative exercise, even for major accounting firms (which litter their opinions with disclaimers and conditions). For early-stage startups (sometimes even at a Series A round), it's all about **hope** and not metrics, with some spreadsheets rendered useless pieces of paper. Comparables are the best valuation tool but don't do the trick because every startup is unique. The fact is that there are no comparables in the domain of early-stage startups, only **wishful thinking**.

Next, there is a false belief that vested shares are more valuable than unvested shares, or even that there's a difference between the two. But consider: Unvested shares can be voted just as vested shares. Unvested shares become fully vested in the event of a trade sale, so they stand on the same ground as vested shares. Both vested and unvested shares suffer under the restrictions on transfer and the commitment to vote in favor of a new financing and both are subject to the ROFR.

Even where vested shares can be sold to a third party if an investor does not exercise his ROFR, third parties might be discouraged to buy because they would step into the founder's shoes and be subject to all the terms and restrictions in the SHA. They might find the SHA terms unsatisfactory, diminishing the value (if any) of vested shares to the same level as unvested shares.

In the event of a subsequent financing a founder might be able to cash out his vested shares, but they rarely do.

Then there are the good leaver-bad leaver terms – Investor’s tell founders: “don’t leave because if you stay you will have the benefit of vested shares but, by the way, those shares will be illusory in value.” That renders vested shares just as unvaluable as unvested shares.

The situation is different in the case of ESOPs at companies where there is a track record of revenue generation, or the company is publicly traded. That provides predictability as to future value. For early-stage startups, there is no predictability other than the **hope** of a trade sale or a much later financing where a founder could take out some cash. But that’s illusory, too, because by that time his unvested shares will have vested. In the meantime, his vested shares are just as valueless as his unvested shares.

As originally conceived, corporate ESOPs were designed primarily to increase employee motivation and productivity to drive up profits on a current basis, with continued employment service as secondary. For founders of early-stage startups, the motivation (at least during the first 4 years or longer) is to develop a technology that might provide a platform for generation of profits in the **distant** future.

The dynamics of corporate ESOPs don’t apply to early-stage startups. However, over time, the concept gained currency and filtered down to VCs and lesser risk funding financiers without so much thinking about the dynamics. Of course, stock options are an important part of VC business, but one must think in degrees, and early-stage startups are at an entirely different degree. One size doesn’t fit all and as discussed above; the promise of vested shares doesn’t provide much value in exchange for a founder’s commitment to his company.

Given that upon examination the effectiveness of vesting schemes is illusory, and all the impositions and expectations on founders, and restrictions on transfer of shares (giving investors a ROFR and other rights to acquire founder shares), there should be equivalence by founders getting some tangible value in return.

The conventional underlying thinking for the ROFR and share transfer restrictions is that investors want to avoid unwanted shareholders and, of course, to keep the startup closely held by buying the shares themselves. But, if they want the option to avoid that, they should give founders something in return. Investors get the unrestricted right to freely transfer their shares to parent and sister companies, affiliates, and group companies. On the other hand, founders can’t even transfer their

shares to a family member without the investor's permission. This whole thing lacks balance because even if a founder transfers his shares to his sister, he could still work at the company.

As a result of all this, the true dynamics of the founder-investor relationship in early-stage startups have shaped themselves like clouds and gone away. The concept of vesting schemes has become so embedded in the way business equity financing is done that both founders and investors believe in vesting schemes as a sacred value.

An Alternative.

As a prelude, for the reasons discussed above, the distinction between vested and unvested should be dispensed with and all shares that a founder gets over time treated the same.

The crucial missing element in traditional vesting schemes is the lack of founders getting a degree of certainty about having a particular buyer for their shares as well as the price per share, and still give investors real value and benefits in return, including a ROFR so that they can also avoid unwanted potential shareholders. This can be solved by entitling founders to sell their shares to investors, in other words, a **put option**.

Shares should be granted to founders over time, and the period can be borrowed from traditional vesting schemes, such as, e.g., four years (25% per year). But the motivation for long-term commitment would be tangible for founders due to a put option. As discussed below, there must be conditions to exercising the put option.

A put option would provide founders a security blanket and, because its value could be calculated into the future (discussed below), they would have even more motivation to long-term service than any traditional vesting scheme by several orders of magnitude. The sense of comfort and security would translate into more confidence in founder work and would raise their energy level.

What is needed is a solid frame of reference from which a reasonable calculation can be made for the valuation of founder shares. There is only one number that fits this recipe – the investor's price per share at the original subscription (call it a "Reference Price"). There are no other references to be found, but only speculations that are vague and illusory at best.

The original price per share represents the investor's risk. Thus, the put option price should be a percentage of or discount on the Reference Price. That would be the best numerical measure. The

discount on the Reference Price on the put option price would lower over time. That would give founders a higher price for their shares in the future, thereby giving them a fortified incentive to give longer commitment better than any vesting scheme. Thus, a traditional vesting scheme, the benefits of which are illusory at best, could be dispensed with, along with all the text that goes with it.

I have not run any numbers on what the original Reference Price should be initially or the discount over time, but they are subject to calculation. The original Reference Price should be low enough so that investors don't feel as though they're unreasonably taking on more risk and moderate enough so that founders feel that they're getting something meaningful, but it should not be a token amount.

There would have to be conditions to exercising the put option. For example, (a) it could not be exercised during the first [two] years after the SHA is signed (giving investors security against a founder bugging out when shares are worth less than nothing) (b) the balance sheet of the company must to some degree be in better shape than it was at the time the original investment was made (or something like) (c) a founder who left voluntarily (a bad leaver) would still have his put option but at a higher discount on its price (d) the ROFR would stay and (e) other conditions (this concept is in the early development stage).

There is no need to punish a founder who is fired due to him having breached a warranty. He would get the same higher discount as a founder who leaves voluntarily. Why? Because he would be subject to investor claims that would likely **exceed** the put option price which the investor could set-off against the put option. The SHA templates used in practice today are unnecessarily punitive. Even in the face of a breach, why should a founder forfeit all that he has earned prior to the breach? Do investors want to put the fear of God in their founders (partners)?

An investor's only downside would be the probability that a founder would exercise his put option at a time when its price is lower than the FMV of the shares. But, as discussed above, shares in early-stage startups defy any valuation.

On the other hand, the upside for investors is that the put option is akin to a bonus for founders, giving them security and certainty. Therefore, at the term sheet stage, investors could leverage that into getting a bigger chunk of equity than they would get for the same investment amount without a bonus. Or they might even get a bigger chunk of equity in exchange for an even lower investment amount.

For founders, given the option of accepting an offer from an investor offering the bonus and another investor that did not, the founder's decision might weigh in favor of the investor offering the bonus. There is a lot of investor money chasing after too few startup deals with potential. Offering the bonus would fortify an investor's faith in a founder in a tangible way, and founders would recognize that and be grateful. Also, **a put option would cement the partnership relationship, beneficial to both founder and investor.**

So long as the Reference Price is set right, there would be little probability that founders would exercise the put option to bug out.

For any early-stage investor who first adopts the put option concept, it would be the **forerunner** in innovating the legal and business relationship between founder and investor. That would look pretty good on its website and in its promotional material.

If the concept gains traction, the setting of the Reference Price and discount levels would settle into standardized terms, just as is the case of terms of traditional vesting schemes. In the beginning there would be a lot of negotiating but that would eventually asymptote. It would evolve into a new custom and practice.

I'll add that the concept is not new. In the Swedish startup templates, if a founder breaches a warranty and the investor makes a claim, the founder can satisfy the claim by offering the investor enough of his shares to settle the claim, which is a set-off. That's akin to a put option. The problem is, at the early stage, as discussed above, it's just impossible to value shares, which means the set-off would have no value and thus the founder would still be stuck for the full liability for the investor's claim.

Rethinking Founder Liability

I believe that templates can be simplified, shortened, made more clear, and add a few terms that are missing. In terms of shortening, vigorous writing is concise. A sentence should contain no unnecessary words, a paragraph no unnecessary sentences, for the same reason that a drawing should have no unnecessary lines and a machine no unnecessary parts.

The changes also will take into consideration risk allocation and the parties' relative ability to bear a risk. For example, if a founder breaches, under certain conditions he would be bankrupted by the consequent liability. Founders accept this liability because they feel that they have no choice in order to get a bag of money from investors.

I always advise my founder clients of the monumental liability that they could be subjected to for breach of warranty. They reply that they have no choice, and they have no money anyway, so what difference would it make if they are bankrupted. Such conditions provide no deterrent to breach. However, if that unreasonable risk is accepted, which is greater than the risk investors take, a founder should get something in return for having taken the risk. I don't accept the notion that just because something has been done in the past, it should be done in the future without taking a second look to see if it really makes sense.

Investors take the risk that they might lose money on a particular deal. But they have a multitude of other deals where they will make money, thereby blending their risk overall in their portfolios. Some say that only 10% of their portfolio succeed. Founders, on the other hand, don't have a portfolio that would blend and offset their risk. Many don't have a Plan B. They are required to devote all their energy and resources to one project and if it fails, they must start from scratch again. Investors, on the other hand, have many projects running in parallel and so that can afford to take a loss in one project in stride and others will keep them floating.

Some contracts provide that a founder's liability for a breach be limited to the amount of the investor's investment, or a percentage thereof. I believe, however, that a founder should not have any such liability at all. The conventional thinking is that the potential liability serves as a deterrent to bad behavior and a founder not devoting all his energy to a project.

But such a deterrent is ineffective because founders are also encouraged to act with good behavior and to devote all their energy to a project in many cases by an independent drive springing from an inherent desire to solve challenging problems, and they are sincere. They are, of course driven by the promise of money, but that's in the distant future and, if only 10% of startups succeed, such promise can't be the only reason they are driven to devote all their energy to a project. They are also eager to please. Historically, innovation is driven by spirit just as much as the promise of fortune. In Sweden, at least, that is what all founders do.

In Sweden, there is little or no litigation by investors against founders for breach of warranty. That might be an indication that the threat of potential liability is an effective deterrent against bad behavior. I would argue, however, that it is not, as the culture in Sweden is different. In the US, there is much litigation among founders and investors, and most cases get settled before going to court. That might be an indication that in the US the threat of potential liability is **not** an ineffective

deterrent. A comparative analysis between the cultures in Sweden and the US in this context is beyond the scope of this commentary.

Those are the conditions that exist here in Sweden. A contract should reflect the conditions, behavior and culture which exist in a particular country and industry.

Of course, for every right there must be a remedy and a mechanism to deter bad behavior by founders. In the case of early-stage startups, considering my thoughts above about a put option as an alternative, the remedy could be that a founder forfeits his put options in the event of a breach of warranty (but not suffer any other monetary penalty). The level of the forfeiture should correlate to the degree of a founder's bad behavior, a correlation coefficient if you please.

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Founders face many challenges. Going from a sound idea to a useful product or solution requires many different thought processes and a large quantum of perseverance in the face of real-life adversity. Let's dispense with any potential adversity between founder and investor so that founders can face the challenges ahead of them without distraction.

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The concepts presented in this commentary are at an early stage and refinements will follow to take into consideration other factors and dynamics. Comments are welcomed.