Startups:

8 things you need to know about Vesting

Let's assume that you have founded a company with your friend, and the equity is split equally between the two of you or you intend to reward your employees with shares in your company. As much as you trust your friend or employees, you would want to ensure that they are fully committed to the company for the long haul. Fortunately, there is a process by which you can agree that shares be earned over a period of time called vesting, one which you should definitely adopt[1]. Here are 8 things you need to know about Vesting:

1 Vesting 101: Why you need it and how it works, Tarek Fouad, accessible at https://www.menabytes.com/vesting-101/.

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1 What is Vesting?

Vesting is a mechanism where founders or employees earn ownership of their shares in a company over a period of time. The breakdown of this time period is referred to as a vesting schedule. Typically, you and your co-founder own your shares as soon as you put money into the company, but you can use vesting to ensure that you get ownership over those shares over a period of time and not at once. The terms and conditions of this arrangement will be stated in a vesting agreement.

2 How does vesting work?

Following our scenario above, each founder will earn ownership of their shares over a period of time. For instance, 1% of the total equity each month for 4 years until the founder is fully vested at the end of the four years.

3 Why Vesting?

Startups should consider vesting for the following reasons: One, it serves as an incentive to founders and employees as it is only after they have remained with the company till the end of their vesting period that they have the rights to the full number of shares to which they are entitled. It also encourages loyalty and personal commitment to see the business grow. Two, it protects the company in case a founder decides to walk away. Because s/he does not have the right to her or his full number/value of shares, s/he does not get to take a huge chunk of the company's equity, leaving the remaining co-founder(s) to struggle with what is left and to rebuild the company.[2]

2. 'What is share vesting', LinkiLaw, accessible at https://linkilaw.com/startup-advice-tips/what-is-share-vesting/

4 Types of Vesting

There are three basic types of vesting. Immediate vesting: there is no schedule, and the employee/founder is 100% immediately vested; Cliff vesting: founders/employees will receive 100% of their equity at once, but after a stated period of years; Graded vesting: founders/employees receive a percentage of their equity each year over a period of years until being 100% vested. [3]

5 Vesting Schedule explained

Take for instance, a vesting schedule for a four-year period, where 1/48th of the founders' share will vest in the founder each month. To ensure that the founder/employee will stick around for at least a year, no shares are actually vested during the first year; rather, the first year's shares are all vested at once at the end of the first year. This is referred to as a "cliff" period. Then, the shares vest at a steady rate until the shareholder is fully vested.[4]

6 What happens if I leave before I am fully vested?

This depends on the provisions of the vesting agreement. If the agreement provides for a one-year cliff and you leave before the end of 1 year, then you don't get any shares. If you leave at the end of year 3, for instance, and the vesting agreement states that by the end of year 3, 75% of the shares would have vested, then you leave with that percentage of shareholdings and the company has the right to buy back the unvested shares at a cost as determined in the vesting agreement.

1 Vesting Schedule: Everything You Need To Know, UpCounsel, accessible at https://www.upcounsel.com/vesting-schedule

2 Ibid at fn1.

7 What happens to my shares if the company is acquired?

Vesting agreements typically provide for what happens in the event that a company is acquired, and the parties are bound by its terms. Where a company is acquired, typically what happens is an "acceleration", which means the occurrence of an event that leads to the partial or full vesting of shares.

8 Vesting and Investors

When considering investing in a startup, Investors will want to know if a vesting agreement is in place and if it's not, they might insist on one before investing. Investors want to know you are in the game for the long-term; that is why they are putting their money in you and your startup! Vesting is designed to manage what is considered one of the biggest risks to investments: founder risk.

If you require advice or assistance in relation to vesting, please contact us at info@U-Law.ng and we will be happy to help you.

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