Founder "Fairness"

By Frank Demmler

Not all founders are created equal. That inequality should be reflected in the distribution of the founders' equity pie.

Many of you are already in business and perhaps are living with the consequences of having taken the Three Musketeers approach to share distribution, i.e. dividing 100% by the number of founders.

Some have ignored this advice because it still doesn't strike you as "fair." Others, still, "got it," but aren't comfortable initiating what is likely to be a contentious discussion, i.e., "What do you mean that you deserve more shares than me?!?!?!"

Do not despair, there are remedies, although they need to be crafted carefully, and will require legal assistance to make them effective and enforceable.

FOUNDER SHARE BUYBACK AGREEMENT

The most frequently used method to address equitable division of the equity among founders, particularly if not addressed at the founding of the company, is to make the founders' shares subject to buyback by the company.

Before I discuss the mechanics, let me clarify what this means. You know those shares of stock you got when the company was founded? Remember the sense of pride? Guess what? You don't really own them, if this mechanism is utilized!

"Wait a minute! You're telling me that the shares that I own outright today, I'm not going to own outright if I follow this suggestion?"

Yep.

"Why would I agree to that?"

If you accept an investment from a venture capitalist, you will agree because it will be an integral part of the deal.

If you remain a private company, you will agree to this provision, because I'm going to try to convince you as to why it's "fair."

What is it?

A founder share buyback agreement is like vesting for stock options. Based upon some defined schedule and conditions, the company has the right to buyback some, or all, of your shares. Usually the buyback provisions will expire over time, meaning that as time passes the number of shares subject to buyback declines (and the number of shares you own outright increases).

For example, in many of the deals in which I've participated, it has been fairly typical for the founders to own 25% of their shares outright at the initial closing, with 75% being subject to buyback. After the first anniversary of the closing, the buyback will expire on a monthly basis on one/thirty-sixth of the remaining shares for the following three years

(36 months). After four years, none of the shares are subject to buyback (one year plus 36 months of buyback expiration).

The primary elements of the buyback agreement are:

Initial share rights

What portion, if any, of the shares are owned outright at closing (25% in the example above). Some deals are structured so that no shares are owned outright until the first anniversary, at which time some relatively significant percentage, such as 25%, will no longer be subject to buyback.

The term

This is often consistent with the company's stock option vesting schedule, if there is one, but not necessarily so.

The vesting schedule

In the example, it's one/thirty-sixth per month starting after one year, for a total of four years. There is nothing magical about four years. It might be three years, or five years, for that matter. It depends upon the specific circumstances of your situation; who benefits from shorter or longer; and the relative power of the participants structuring the agreement.

Cliff vesting

Cliff vesting is the situation in which the time between expiration events occur is relatively long and the amounts of stock are relatively large. For example, it would be cliff vesting if your deal said the buyback provision expired on 25% of your stock per year on the first through fourth anniversaries of the initial closing. While both examples would allow you to own all of your stock outright after four years, the difference between one/thirty-sixth per month and one-fourth per year is significant.

Why go through all this trouble?

In most cases, founders stock is actually intended to compensate the founders for what they did do to launch the company; what they are doing now for the company; AND **<u>what they are going to contribute in the future</u>**.

You may not have thought of it in that context, but let's say you started your company with your best friend and you split the stock 50-50. After three months, your partner comes to you and says, "This is a lot harder than I thought. I'm going to get a regular job. Lots of luck! I wish you well."

Oops! He's owns one-half of the company, and he just walked out leaving you high and dry. Is that "fair"? I don't think so.

Similarly, an investor is betting on the founding team's ability to build the business and achieve a liquidity event. Their explanation for the buyback agreement will go something like, "If for some reason you were to leave the company, you wouldn't have held up your part of the bargain, so you shouldn't own all that stock after you leave while your co-founders are still in the trenches earning their stock.

"In addition, we would have to go out and recruit a replacement for you. That replacement will be assuming the important functions that you currently perform. As such, we will have to make a significant equity commitment to that person. This is only 'fair.'"

FOUNDERS ON THE SIDELINE

This also highlights the problems of splitting the founders' pie equally when not everyone is participating in the business full time. That may be "fair" for what has happened to date, and the relative contributions of the people involved, but it often doesn't take future contributions into consideration.

If one founder is working at the business full time 24/7, constantly concerned about the company's fragile state, worried about paying bills and employees, sacrificing his family life, foregoing salary (or taking greatly reduced compensation), it will not be too long when this "fair" stuff begins to look a lot different.

Since the non-participating founder's stock isn't subject to buyback, the primary way to bridge this "fairness" gap is through granting a meaningful number of stock options. These can vest over time, as above, but at least can go a long way to leveling the playing field.

ADVICE TO ENTREPRENEURS

- Founder share buyback agreements should be considered when you are starting your business.
- "Fairness" must be viewed in a broader context than the here and now.
- It is critical to think through these issues in the early days (ideally before launch) while rational minds prevail. When the issues that make these considerations important arise, it's likely that the emotional quotient of the discussion will overwhelm rational portion.
- Surround yourself with professionals, mentors, and advisors who have "been there, done that" and can help you level the playing field.