WHIPLASH: The Pitfalls of Acceleration

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STARTING UP:
Practical Advice for Entrepreneurs

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WHIPLASH: The Pitfalls of Acceleration

No, this is not a column about personal injury law. I am talking about accelerated vesting of stock and stock options.

Vesting is the concept that stock ownership should be based on the achievement of the goals of the business. Vesting is often imposed by founders on each other's stock and on stock given to new hires. Investors almost always require vesting on the theory that when their check clears your bank they have done all they said they would do yet all you have done is promise to achieve success. Vesting provides an "incentive" for you to keep your end of the bargain. For example, you and I may agree that you will receive 10,000 shares of stock in my new venture if you join the team. Implicit in this is that you will be applying your skill set to help the team achieve "success" for the business. If the business is successful then you have "earned" the ownership of these 10,000 shares.

What I really want is success, not your best efforts. In an ideal world you and I would come to agreement on what milestones must be achieved in order for your stock to vest. For example, if you are responsible for product development then we might agree that a certain portion of the 10,000 shares vests on completion of a beta version of the product and another portion vests on first customer shipment. However, I don't see milestone vesting very often for a variety of reasons including (a) the difficulty of defining milestones, (b) the tendency of business strategy and goals to shift over time and (c) the fact that there are very few jobs where achievement of a milestone is within the control of the person. "Calendar vesting" is usually chosen as a surrogate for milestone vesting. A typical calendar vesting program has the person earning ownership over time if he or she is still employed by the company- e.g. a four year linear vesting period with employee earning 25% of the stock each year. Common vesting periods range from three to five years with annual, quarterly or monthly vesting. Where quarterly or monthly vesting is used the first vesting often occurs after 6 or 12 months of employment to make sure that the person is fitting in as a member of the team. The vesting I see most often is 4 year vesting: 25% after one year (cliff vesting) and then quarterly thereafter for the next 3 years.

Vesting takes different forms. If I grant you a stock option the vesting will take the form of an "exercise schedule" which governs how many shares you may obtain if you exercise the option. If you receive an outright stock grant then vesting is usually in the form of how many shares you will forfeit if you cease to be employed.

So what does all this have to do with Whiplash/Acceleration? The idea behind acceleration of vesting is that whatever schedule we agree upon should "accelerate" upon the achievement of "success events" such as an initial public offering or an acquisition of the company. For example, assume we agreed on 4 year linear vesting as a surrogate for milestone vesting. In one year a Fortune 500 company appears and offers to acquire the company for $1,000 per share in cash. This is success and we ought to throw away the 4 year vesting schedule and say that you earned all of your stock as of the date of the acquisition - i.e. we should accelerate vesting. Sounds like a sensible idea, but is it? May be, but acceleration might cause whiplash.

Here are some things to think about:

Not all acquisitions are "home run" events. Some acquisitions are survival events or strategic moves that in themselves do not constitute the "success" which might justify acceleration. Investors who put in $2 million might not see a $3 million acquisition after 3 years as a success event which entitles management to accelerated vesting. In addition, some investors don't like the idea of providing a built in incentive for management to sell the company cheaply and thereby become fully vested.

Should everyone have accelerated vesting? It may make sense for early employees to accelerate but what about the person you hired last month - should she vest fully if the company is acquired this month?

<u>The "Earnout"</u>. Sometimes an acquirer will make a large portion of the purchase price available only on a contingent "earnout" basis - i.e., if the acquired company makes its numbers then additional payments will be made. In this situation the Founders have an interest in keeping the troops motivated to achieve the earnout and acceleration of vesting might not foster this goal.

<u>The Initial Public Offering</u>. Going public is usually viewed as a success event. Shouldn't acceleration occur in this case? First, acceleration may be an illusion because the underwriters may require "lockups" from everyone anyway. In addition resales of stock are subject to securities law limitations. Acceleration will result in an increase in compensation expense for accounting purposes for any difference between the fair market value and the exercise price of stock options that was being recognized over the original vesting period. There is no such impact if the options were granted with an exercise price equal to the fair market value on the grant date. The compensation expense associated with a stock grant will also accelerate when the "home run" event becomes probable. Companies should consider the impact of this additional earnings hit on their IPO!

If these are all of these potential issues why not be flexible and leave it to the Board to accelerate vesting if appropriate. Aside from the issue of who the Board will be at the time, it may not be possible for acceleration to be discretionary. For example, one of my clients was recently acquired by a public company. Because the acquisition price was relatively large, the public company had to do the deal in a way which qualified for "pooling of interests" accounting treatment in order to avoid a large goodwill charge to earnings. The complex pooling rules would not have allowed a discretionary acceleration in vesting. Fortunately for my client all of the stock and stock option provisions had automatic acceleration of vesting on an acquisition. Although this may have caused a problem in an "earnout" acquisition, it happened to work out fine in this pooling transaction. Having said this, management was not thrilled that detailed disclosures had to be made to stockholders about the acceleration in order to avoid the imposition of a "parachute excise tax" by the IRS. There is always something!

So, should you accelerate vesting? It depends. Just brace yourself for a possible whiplash if you do.

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