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Founders – vesting and leaver provisions

The leaver provisions

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FOR WHAT MATTERS

During the negotiation of a term sheet for a potential funding round, Founders can be asked by their potential investors to sign up to particular terms to encourage the Founders to stay with the investee company for a certain period of time that are both an incentive for those Founders to stay with the investee company for that time period as well as an enforcement mechanism that can be applied against those Founders should they not remain with the investee company for the agreed upon period of time.

The mechanism for this is how the shares owned by the departing Founder are treated when they leave.

These are commonly known as the 'Leaver Provisions'.

In practice, Leaver Provisions commonly arise in the funding round documentation (typically in the articles of association) definitions of:

1. Good Leaver;
2. Bad Leaver; and
3. Leaver's Percentage (aka Vesting)

These terms are explained below, although it is worth noting that many investors will take a different approach to definitions and penalties.

Good leaver

Historically 'Good Leaver' provisions included: leaving after the agreed upon period of time, death, permanent incapacity, retirement and wrongful or unfair dismissal.

If, based on the definition of 'Good Leaver', a Founder is judged to be a Good Leaver, a departing Founder in these circumstances might be entitled to keep all their shares.

However, the latest BVCA documents (being the industry standard documents used by most VCs) have sought to simplify leaver provisions by not having multiple tiers of leaver (i.e. no need for intermediate leaver or very bad leaver constructs) and having just good and bad leavers. Under these latest versions 'Good Leavers' are anyone who is a leaver and not a 'Bad Leaver' (see below).

Under the new BVCA documents, a Founder who is a Good Leaver will:

- keep a certain proportion of shares subject to vesting arrangements (please see 'Vesting' below); and
- the remaining shares owned by the departing Founder (that have not vested/become 'safe', see 'Vesting' below) are converted to deferred shares (deferred shares are shares with no economic rights (dividends and capital returns), no voting rights and many other share rights 'turned off', in other words deferred shares are pretty much worthless shares).

Bad leaver

The new BVCA documents define 'Bad Leaver' as: resigning prior to the agreed upon period of time (suggested as four years following completion of the investment round), summary dismissal, committing a crime (other than driving offences) and breach of restrictive covenant (restrictive covenants are promises not to liaise with investee company's current customers, staff and to trade in a similar business for a particular time frame or within a certain distance of the investee company once an individual has left the company).

If, based on the definition of 'Bad Leaver', a Founder is judged to be a Bad Leaver, typically, all the shares owned by a departing Founder will be converted into deferred shares.

Vesting

Whilst investors use Leaver Provisions to incentivise Founders to remain with the investee company for a particular time period, many investors concede that it could be considered unreasonable, where a Founder has agreed to stay for three years, that if the Founder leaves (unless in a Bad Leaver scenario) before the agreed period (for example, after 2 years and 6 months) for all of those Founder's shares to be converted into deferred shares.

To cover this eventuality, it is usual to agree a vesting schedule or a form of Founder share vesting, to safeguard Founder shares over time.

Vesting is where an agreed proportion of Founder shares becomes 'safe' from the leaver (other than Bad Leaver) provisions and irrespective of what happens, those 'safe shares' can be retained by the Founder and sold on an exit, alongside all other shareholders.

There are different types of vesting:

1. 'Straight line vesting' – this is where shares become 'safe' on a daily/weekly/monthly basis. For example, if a Founder owned 3,600 shares and agreed a vesting time period of three years and monthly straight-line vesting, then 100 shares each month, would become safe from the leaver provisions until after 3 years when 100% of the Founder shares are safe (100 shares safe pcm x 36 months = 3,600 safe shares). Straight line vesting is also often subject to a cliff, which means that if a Founder leaves in an initially defined period (usually the first 12 months), then the vesting won't apply.
2. 'Milestone based vesting' – this is where an agreed number of shares become 'safe' once certain targets have been met. For example, once certain levels of annual recurring revenue (ARR) had been met, a certain percentage of Founder shares becomes 'safe'. This construct is relatively uncommon.
3. 'Safe at completion' – this is commonly where an investee company has been running for some time, has already raised at least one institutional investment round and a new investor is coming on board. It is commonly considered unreasonable for the new investor to demand that all Founder shares be subject to leaver provisions and it is therefore often agreed that the Founder has a certain percentage of shares that are 'safe' from day one. For example, at the completion of the investment, 25% of Founder shares are safe from the leaver provisions on day 1 and the remaining 75% is subject to the leaver provisions for an agreed upon period of time.
4. 'Acceleration on Exit' – this is when on an exit event (an exit event is a share sale, asset sale covering the majority of Company assets or initial public offering) any remaining Founder shares that have not vested (not become 'safe') for any reason, the Founder's unvested shares automatically vest so that 100% of the Founder shares become 'safe' prior to the exit event.

These different types of vesting can also be linked together. For example, 75% of Founder shares subject to 'straight line' vesting to ensure the Founder remains for a particular time period, but 25% subject to reaching an agreed ARR milestone target.

How to improve your position as a Founder?

Whilst it is true that Company itself receives the cash into its bank account, it is really the Founders and their teams as individuals that are being invested in. It is the Founders' entrepreneurial spirit and innovation, together with their relationships with the Company's customers, employees and stakeholders that the investors are relying on for the Company to grow and produce a return for them on an exit event.

It is crucial from an investor perspective, to ensure that key individuals are incentivised to remain with the business and have a stake in the success of the company going forward. It is also important for investors to be able to recalibrate the caps table in a leaver scenario so they can appropriately incentivise any new hires required to replace the leaver.

The impact of leaver provisions can be softened by negotiating appropriate vesting provisions to ensure that time spent with the Company is rewarded, seeking to agree a percentage of shares that are safe on day one (and ensuring the relevant definitions are sufficiently tight so that Bad Leaver events are genuinely within the control of Founders).

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