Vesting terms that make sense

By Ian Hlatky

Founders of early-stage companies often wrestle with determining what vesting terms are appropriate to impose upon service providers' equity awards. Broadly speaking, vesting terms differ depending upon whether the service provider is an employee, an advisor or an independent contractor/consultant. Each scenario is addressed in turn below.

Employee vesting

The *de facto* standard for employee vesting is to vest such equity awards monthly over a four-year period starting from the date that the employee first starts performing services for their employer. It is also standard to impose a 1-year 'cliff' on such awards. A 'cliff' is simply a date before which, if the employee is terminated, then none of that employee's equity will be vested. However, once the 'cliff' date is reached, then all of the stock that *would have been* vested had there been no 'cliff' vests immediately (*ie*, 25% of an employee's total equity award will vest once the 'cliff' date is reached if four-year vesting and a one-year 'cliff' is chosen).

This '4/1' standard is underpinned by the incentives at play with employees: companies typically give employees equity in order to encourage them to stay with the company longer and to work harder to generate company value. However, given the time and resources that it takes for a company to onboard and train employees, it makes sense that if employment is terminated quickly, then that employee's equity should be forfeited as his/her contribution to the company is offset to a greater extent by the significant onboarding and training costs. The company also needs the equity that was previously set aside for the early departing employee to provide appropriate equity incentives to that employee's replacement.

The four-year period reflects an employment retention horizon that is generally accepted as reasonable: a shorter period would force the company to start thinking sooner about budgeting additional equity awards for that employee once the prior award is fully vested; longer and it becomes more likely that the employee's role will have materially changed and/or that a significant change will have occurred for the company.

Advisor vesting

Standards for vesting advisor equity awards are similarly influenced by the incentives at play in advisor relationships. First, because advisors often receive *only* equity awards as compensation, and they understandably want to be compensated from the first day they provide services, advisor equity is typically *not* subject to a 'cliff'. Second, the vesting period tends to track the expected tenure of an advisor, which is often 1-2 years. Last, because advisors are often advising on big picture company strategies and tactics to help the company chart a course toward growth, revenues, and a possible exit (*ie*, rather than getting involved in the nuts-and-bolts of day-to-day business matters), in the event that the company is purchased, merges with another company or goes public (or other 'exit' event), then any vesting that remains on the advisor's equity award is typically accelerated in full so that the advisor can reap the full benefit of their advisory services.

Independent contractor vesting

Independent Contractors and consultants are perhaps the most diverse group in terms of the factors that can drive their equity arrangements. Contractors are often compensated in cash but are able negotiate an equity award as a kicker.Some contractors may even go further and discount their services (sometimes significantly) in exchange for an equity award concomitant with that discount. Other contractors may forgo cash payment altogether in favor of receiving *only* equity compensation in hopes of a big payday on an exit. In each of the foregoing cases, the specifics of a contractor's particular mix of cash and equity compensation will impact the size of their equity award. However, vesting itself will depend primarily upon the nature of the services that the contractor is performing and how and when such services are delivered to the company.

The first thing to point out about contractor equity vesting is that contractor equity is typically *not* subject to any 'cliff'. The first reason for this is because, in contrast to employees, there is no long-term retention incentive for the company in a typical contractor relationship. In fact, contractors by nature perform their services only for a set term.Putting in place a mechanism like a one-year 'cliff' might give rise to a perception that the contractor is really a misclassified employee. Founders who have faced misclassification scenarios before can attest to the fact that this is something to be avoided. For more about the risks associated with employee/contractor misclassification, see our article.

The second reason that contractor equity is typically not subject to 'cliffs' is because—as with advisors—contractors expect to be 'paid' as they deliver their services to the company and their compensation is thus earned. However, 'delivery' is key here.

Broadly speaking, the vesting interval and total vesting period for a contractor equity award should reflect how the contractor's services are delivered to the company. For example, if a contractor is engaged to perform extra coding support for the company over the course of a six-month period and the contractor delivers their work-product regularly, then vesting that contractor's equity monthly (or even weekly) over six months makes perfect sense. However, often a contractor will deliver their work product in two or more significant milestones. In such a case, it may make sense for the company to impose milestone-based vesting instead, where the contractor's equity award is released from vesting in large chunks upon the achievement of each such milestones (and the portion of total equity award released upon a given milestone is reflects the relative importance of that milestone). The nature of the engagement may also call for a hybrid scenario, where a consultant performs and delivers regular work for the company over a set period but also has one or more key milestones to hit. In such a case, it may make sense to use a combination of time-based and milestone-based vesting. Combinations abound, but the overall takeaway is that companies should consider vesting scenarios for contractors that reflect the contractor's expected deliveries and keep the contractor appropriately motivated and compensated.

Conclusion

Vesting service providers' equity awards is something about which we receive lots of questions. Although there are some standards and rules of thumb that companies should be mindful of, it is always helpful when thinking about service provider vesting to take a step back and think about the larger context of the service provider relationship, why equity is being awarded in the first place, and how it is being used.

DLA Piper is a global law firm operating through DLA Piper LLP (US) and affiliated entities. For further information please refer to www.dlapiper.com. Note past results are not guarantees of future results. Each matter is individual and will be decided on its own facts. Attorney Advertising. Copyright © 2024 DLA Piper LLP (US). All rights reserved.