STARTUP LEGAL PLAYBOOK

Everything you need to know about startup equity

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Read this if: you are a founder looking to leverage equity to attract investors and talent to your startup

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Offering ownership in your company can help you attract the capital and talent you need to scale. We share how equity works below.

Types of startup equity

Equity is the name given to the ownership you, or others, have in your startup. Your level of ownership is dictated by the number of shares you have. Shares are usually given in exchange for investment or employment in your company.

There are two kinds of shares that are usually issued in startups—common and preferred. Founders and employees are typically issued common shares or options to purchase common shares. Depending on your articles of incorporation, you may be authorized to issue multiple classes of common shares. It is not uncommon for startups to incorporate with two classes of common share: voting and non-voting. Founders are typically issued voting common shares, however, depending on approvals set out in your documents of incorporation, you can amend the authorized share classes at any time by holding a special shareholder meeting or resolution.

A class of preferred shares, on the other hand, is usually only created and authorized for issuance under the startup's articles during later stage deals, if requested by sophisticated investors. These preferred shares will typically also include the right to vote, as well as other economic and governance-related protections. All classes of preferred shares are generally senior to classes of common shares when it comes to the payment of dividends and return of capital, meaning they will be paid first in priority to the holders of common shares.

Ordinary rank-and-file employees, advisors and consultants are often given options instead of being issued shares directly. Options, as the name suggests, provide holders with the option to purchase a specific number of shares, typically at the fair market value at the time of grant, after a certain amount of time has passed. While options generally grant a right to purchase common shares, to the extent a separate class of non-voting common shares exist, it is common for rank-and-file employees, advisors and consultants to be issued options to purchase non-voting common shares instead of shares that give them voting rights. Options are typically subject to a “vesting schedule”, meaning that the holder’s option to purchase those shares slowly vests over time in accordance with a specified timeline. We discuss this in greater detail below.

The idea behind creating a non-voting class of common shares is to do as the name suggests—take away the voting rights that would otherwise accompany common shares. As your startup grows, you will likely start to issue many stock option grants to your team. The goal is to let your team participate in the economic upside as the value of your startup grows. However, founders will generally try to avoid giving their employees and advisors governance and voting rights. This is partially accomplished by granting non-voting common shares to those stakeholders.

Regardless of the kinds of equity you are allocating, it should always be clearly expressed as absolute share numbers instead of percentages because using percentages can make it difficult to identify the actual amount being measured.

Splitting equity with a co-founder

If your startup has multiple founders, then you will all likely want equity in it. To save future disagreements or legal disputes, it is important that the equity split is agreed upon and clearly tracked. Having a well-thought-out equity package will also ensure that founders are properly incentivized.

Equity is generally not split equally amongst co-founders (e.g., 50/50) as those with a more active role in the operations of the startup, such as the CEO, or those who invest more of their own money upfront, will usually receive a bigger share. This is, of course, case-specific and up to the co-founders to negotiate. The equity split, plus a breakdown of roles and responsibilities, should be agreed upon and documented early on.

Structuring initial share issuances

Your organizational documents, such as subscription and stock restriction agreements, etc., should, among other things, set out how much equity each founder holds and how it is treated. Once your startup is incorporated, shares in this new legal entity will be issued based on these agreements. They will also dictate how shares are granted, managed and accessed. A common issue that these agreements often address is what to do with a co-founder’s shares if they exit the company.

Offering equity to employees

Many startups offer equity to employees as part of their compensation package. This not only incentivizes employees to stay with the company, but also gives them a stake in the company’s success. An equity distribution plan lays out how much equity in the startup an employee will receive in exchange for their work at the company. This is usually in addition to monetary compensation which, when the startup first launches, can be on the lower side due to limited funds. Having equity as an additional employment benefit can help your company remain competitive in the hiring market. When drawing up the equity distribution plan, it is important that you limit the number of shares that will be made available.

Vesting

When someone receives equity in a startup, whether they are a founder, employee, contractor or advisor, those shares or options are typically granted subject to a vesting schedule. A vesting schedule dictates how much time must pass before owners of shares or options can access and cash in on those shares or options. The goal of implementing a vesting schedule is to incentivize people to stay and contribute to the company's success. Vesting is done one of two ways: reverse vesting, usually tied to founders' initial issuance of common shares, or standard vesting, usually tied to option grants provided to employees and advisors.

Reverse vesting

Reverse vesting means that the person owns their shares in the startup upfront, but there are restrictions in place that stop them from walking away with those shares before the vesting end date. This is especially important for founders because, if a founder leaves or is terminated shortly after incorporation and there is no vesting mechanism in place, the company can't take back shares from that founder, which means they will continue to own a company they are no longer contributing to. With reverse vesting, if the founder or key employee is terminated or decides to leave the company before the agreed-upon vesting period has passed, then they can be forced to sell the balance of their restricted shares at face value (i.e., making no profit) back to the startup. This is known as the repurchase right.

The typical reverse vesting period for a founder involves monthly, pro-rata vesting over a period of four years, subject to a one-year cliff. What this means is that 25% of the founder's shares would be free of restriction on the one-year anniversary of his or her subscription date and then continue to vest on a monthly, pro-rata basis after that. Prior to the one-year anniversary of the founder's subscription date, all the founder's shares would remain restricted, and it is only after the fourth-year anniversary of the subscription date that all of the founder's shares would be free and clear of all restrictions. While restricted, the shares cannot be transferred to a third party, pledged to a bank or acted on in certain other ways and remain subject to the previously mentioned repurchase right of the company.

Reverse vesting is different from the standard vesting approach taken with respect to option grants. Where options are subject to standard vesting, employees do not actually own any shares until they've exercised their option to purchase those shares under the terms of their option grant and cannot do so until their options have vested after a certain amount of time has passed. In this sense, the employees must earn their right to purchase their shares at their legacy fair market value price through time spent, rather than receiving them upfront.

Vesting schedules

Similar to founder reverse vesting timelines, a standard option vesting schedule for employees is a four-year vest and one-year cliff—meaning their right to purchase up to 25% of the shares subject to their option only materializes after their first full year of service, after which, they'll receive incremental options to purchase their pro-rata number of shares on a monthly or quarterly basis until all of their options have been received by the fourth anniversary of the vesting start date.

For advisors and contractors, there can be shorter vesting schedules for their options, for example a two or three-year monthly vest, as their relationship with the startup is usually based around specific periods in the company's growth/operations.

Vesting schedules not only show people what the expectation on their commitment to the startup is, but also protect the company from having a significant shareholder on its cap table who does not make any active contributions to the company.

There are certain situations where the options and shares subject to these vesting restrictions can be lifted or "accelerated". It is common for founders' or key employees' equity to be subject to acceleration provisions that accelerate the vesting of their equity upon certain conditions being met. These often come in two different varieties: single-trigger acceleration and double-trigger acceleration provisions.

Single-trigger acceleration

The most common construct of single-trigger acceleration typically ties to the sale of the business and would result in the founder or key employee receiving the balance (or some portion thereof) of their equity immediately before the sale as a thank-you for all their hard work getting the business to that point.

Double-trigger acceleration

The most common form of double-trigger acceleration builds off the former provision and requires that, in addition to the startup selling its business, the person must be involuntarily terminated within a specified window of time following the sale of the business. This gives key employees who are transitioning with the company some additional protection and comfort that they will not be terminated immediately following the closing of the deal. There are several different considerations when deciding to include single- or double-trigger acceleration provisions in an equity agreement, so it is important to map out all scenarios with legal counsel first.

The capitalization table

A cap table details who owns what in your startup. It is vital that you clearly track, in writing, all the equity in your company. This not only helps you avoid misunderstandings around what number of shares have been promised to whom, but also gives you a clear snapshot of how many shares have been allocated, so that you aren't in danger of overdistributing equity.

Founders, especially in the early days, tend to promise equity to people in return for advice, introductions, etc., so a common issue in the startup space is that too many people have been promised shares when there aren't enough shares to go around. You should be careful about who you promise shares to, and when you do offer equity, you must clearly document what was agreed upon.

If the cap table doesn't reflect all the people or entities who own a part of your startup, or it lists an indeterminate amount of ownership, then it can be a major red flag to investors. An inaccurate cap table could impact the equity return your investors are expecting in exchange for their investment, lead to the startup being in breach of certain share purchase agreement representations and warranties, and other negative consequences.

Offering equity to investors

Investors will provide funding to your startup in exchange for equity in it. How they are granted this equity is dependent on the way in which they invest the money. These investment agreements are called instruments. Learn more about investment instruments in our startup funding guide.

To discuss these issues, please contact the author(s).

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Learn the ins and outs of the commonly used terms in the startup and VC ecosystem.