Corporate & Commercial

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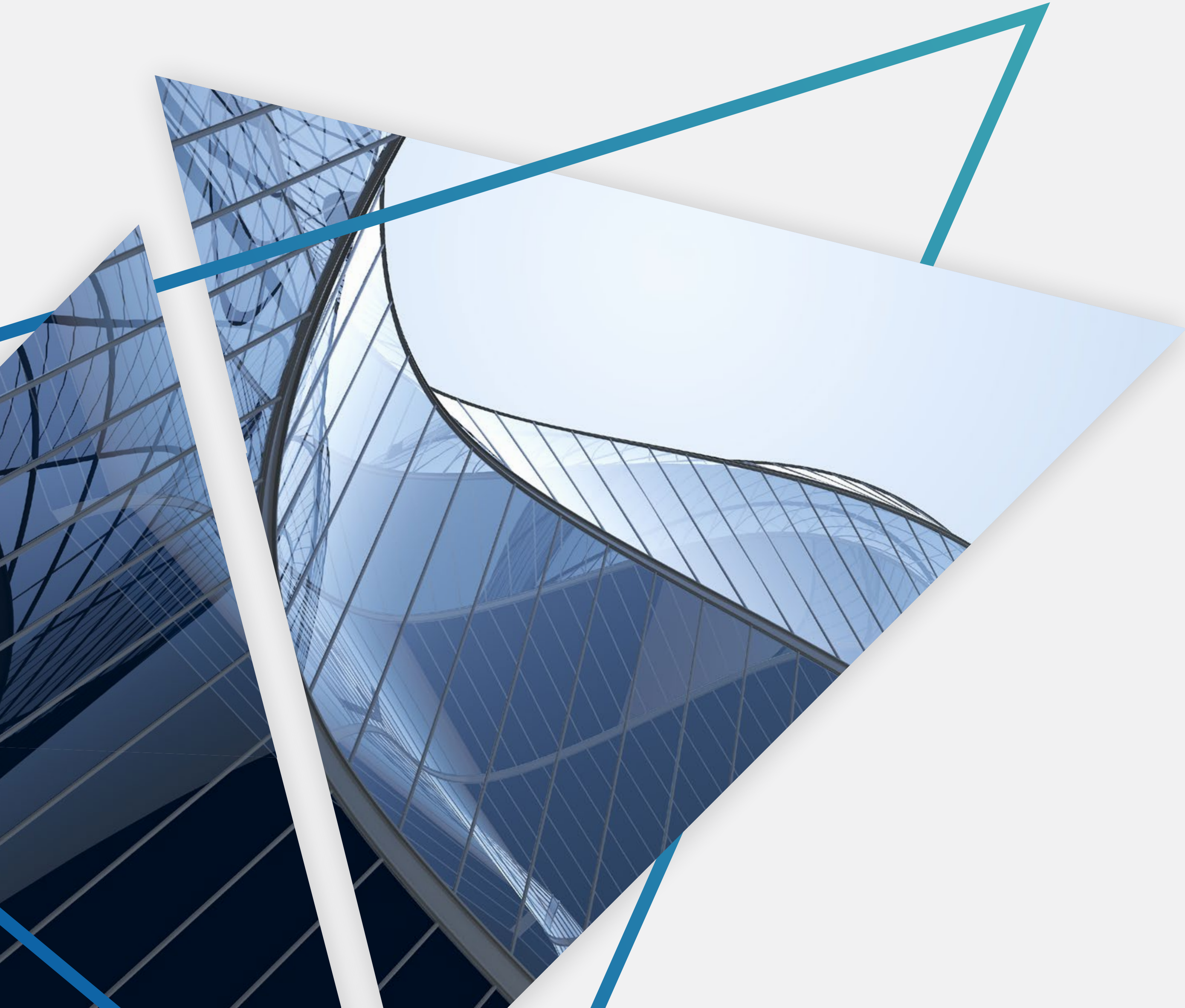
CDH INCORPORATED



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Optimising founder vesting clauses for a successful investment

Investor confidence is intricately tied to a team's unwavering dedication to the company's long-term success. Founder vesting, a key component in this journey, not only provides investors with the assurance that their significant investment is geared towards a fruitful outcome but also secures the founders' commitment for the long haul. This long-term commitment is a crucial factor that reassures investors about the potential success of their investment.

What is founder vesting?

Founder vesting refers to the process through which founders gradually earn ownership of their shares. Co-founders can sign a vesting agreement on incorporation to ensure all founders are committed to the venture. Additionally, investors are encouraged to insist on including a vesting schedule as part of the terms of the investment to deter founders from potentially walking away with their full ownership rights, leaving the company vulnerable. A typical vesting clause would stipulate a five-year vesting period, with a one-year cliff and thereafter, vesting on a monthly or quarterly basis.

Drafting of a vesting provision

Founder vesting terms are negotiated between founders and investors under a founder vesting agreement or in the shareholder's agreement.

Investors should ensure there is a comprehensive vesting schedule in place to mitigate the risks associated with founders departing the company early. Key elements in a vesting clause include:

- **Vesting period:** This is the period before the founder gains full ownership. Investors will want to insist on longer periods to ensure founders actively participate long enough for a successful return on investment.
- **Vesting schedule:** Outlines when and how founders will gain ownership of the shares. Investors benefit from longer vesting schedules as founders are encouraged to commit for longer before realising significant value from their shares.

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- **The cliff** refers to a specified period at the beginning of the vesting schedule when no shares are being vested. After the cliff period, the founders start earning ownership of the shares as per the vesting schedule. A longer cliff period strengthens investor protection by ensuring founders are committed to the company beyond the initial stages.
- **Vesting scheme:** This details how shares vest. For example, in a five-year vesting period, after the cliff period, a percentage of shares vest every month or quarterly until all shares are fully vested.
- **Treatment upon termination:**
  - **Bad leaver:** Involves a situation where the founder intentionally hurts the company's interest. This can be through a breach of a material obligation such as gross misconduct, infringement of intellectual property rights, theft, fraud or breaching a non-compete. To protect the investor's interests, the clause should insist that in this scenario, the founder loses both vested and unvested shares. Though harsh, it acts as a deterrent as founders who cause damage to the company will not get any value from the company.
  - **Early leaver:** This includes situations where the founder voluntarily terminates the working relationship or is asked to leave under a situation that is not covered under the bad leaver clause. In this situation, the founder loses their unvested shares but keeps the vested ones. This approach rewards the founder for their contribution while mitigating the risk of equity dilution for the investor.
  - **Good leaver:** The good leaver clause should be drafted widely to catch all other situations where a leaver does not leave under bad situations or as an early leaver. It can include illness, resignation due to relocation, or termination for reasons other than a bad leaver situation. Usually, the departing founder keeps the vested shares, with the unvested shares being offered back to the company at a lower price than the market value. This ensures that the departing founder is compensated, and the company can purchase the shares at a reasonable price.

Vesting provisions go beyond merely delaying ownership. They often include provisions for repurchasing unvested shares by the company if a founder departs prematurely. Investors will not want shareholders with significant ownership stakes on the cap table if they are not actively participating in the development of the company. This buy-back option prevents founders from leaving with a significant ownership stake and ensures active participation

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from founders. These elements work to secure the investment by motivating founders to build a thriving company. Therefore, the vesting clause should provide that unvested shares are made subject to repurchase by the company with the founder giving pre-authorisation to the repurchase in the vesting clause.

Acceleration triggers

A special term can be included providing for early vesting of shares in the event of a sale of the company or exit before the vesting period. In this scenario, the clause can provide for the immediate vesting of unvested shares so that the founders and investors benefit from the sale. For investors, this is beneficial as it incentivizes founders to perform so that shares are worth more and further gives them a good exit strategy. The clause should be customised to outline the exact events that will trigger the acceleration provisions and how many shares will vest when triggered.

Importance for investors

- **Incentivising commitment:** The ownership stake is tied to continued involvement. The founders are motivated to stay and work towards the company's success.
- **Protection of interests:** If a pivotal team member leaves, they can take a huge piece of the company. Founder vesting ensures that only members committed to the success of the company are onboard and making decisions for the company.
- **Investor confidence:** A vesting schedule is a key indicator that the company's main players are committed to the long haul. As such, investors are confident of their return on investment as the risks associated with leadership changes are reduced.

Challenges and considerations

- **Founder motivation:** If a vesting schedule is not well structured, it can lead to misaligned objectives between the founders and investors. For instance, if the vesting period is too long, it will not drive the desired the level of performance from the founders at the beginning as the rewards for their efforts are delayed. As such, when negotiating the clause, investors should strike a fair balance to ensure the employees are motivated.
- **Legal and administrative:** Managing a vesting schedule requires significant legal and administrative responsibilities, including monitoring the vesting process, handling paperwork and ensuring compliance with its terms. Further, a founder's departure has the potential to trigger complex legal and financial negotiations that could lead to tensions and difficult decisions on equity distribution.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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