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Vesting Incentive Equity: Time vs. Milestone Vesting Schedules

One of the defining features of the Silicon Valley model of high-risk/reward startups is the allocation of incentive equity to pretty much every member of the startup's team. Sharing the upside with the team is a great way to build esprit de corps, reduce cash compensation expense, and provide an incentive for employees to stick around as the startup grows.

Historically, incentive vesting schedules have mostly been time-based. While there are no "rules" for time-based vesting, probably the most common vesting formula for new employees is a four-year vesting period with one-quarter of the equity vesting after one year of service and the remaining three-quarters vesting monthly over the remaining thirty-six months of the four year period.

Alternatively, there have always been those who preferred vesting formulas based on milestones, whether job-specific (e.g. a CTO meeting milestones on a product roadmap) or company-wide (e.g. the startup obtaining a valuation milestone). While never the conventional wisdom, milestone vesting has always had a place in the startup universe, and there is probably a bit more of it going on today than in the past.

So, which, finally, is the better approach?

Time-Based Vesting: The Virtue of Simplicity

The origins of time-based vesting are lost in the mists of time. It is just "the way it has always been done," and inertia is a powerful thing. I, for one, in thirty plus years in the high-risk/reward entrepreneurship and investing space, have never really (well, until now) given it a whole lot of thought. As with convertible preferred stock as the standard vehicle for venture capital investments, it just is what it is.

Having now thought about it, there are some pretty good reasons the conventional wisdom favors time-based vesting. It is simple in concept, easy to implement and leaves little room for argument (time, at least in our velocity-limited world,

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being for all practical purposes absolute and universal). In a big picture sense, it just works.

Still, however certain the measurement of time may be, it is hard to argue that its mere passage correlates in any predictable and consistent way with value creation in a business. All kinds of internal and external variables, variously controllable and less so, influence startup value creation. The ticking of the clock, though, is not one of them. Which suggests that vesting based on keeping track of sand flowing through the hour glass isn't actually such a good idea, even if mostly everyone does it.

Milestone-Based Vesting: What's Not to Like?

And so we come to milestone-based vesting: vesting based on checking off value-creating achievements rather than arbitrary periods of time.

It sounds pretty good. The overarching purpose of vesting is to incent team members to get the job done sooner rather than later. What could make more sense than vesting based on accomplishing discrete value-building milestones?

Alas, as good as the theory, the practice can be quite problematic. The biggest issues are rooted in the reality that value-enhancing milestones (unlike units of time) are often neither fixed nor objective. In the startup environment, milestones are constantly shifting, and all too often ambiguous. Shifting sands, so to speak, just don't provide a solid foundation for vesting structures, as milestones become millstones.

Startup business plans are notoriously fluid. Even discounting basic business pivots, important milestones are variously scratched, modified, and rescheduled as the realities of markets, technology, talent, finance and such weigh on startup objectives and resources. These are the same considerations that make milestone-triggered financing events problematic. See my previously published article: Of Milestone and Millstones.

Consider the two examples previously mentioned: a CTO with vesting based on achieving four discrete milestones of a product development plan; and a more generally applicable vesting milestone for members based on the company achieving a valuation of say $10 million pre-money.

In the CTO example, what, realistically, are the chances that today's product roadmap will remain static, in terms of target delivery dates and target specs, for any prolonged length of time? If (when) changes are made, do you renegotiate the impacted vesting schedules? (Does that depend on who/what is at "fault?") Or, do you leave the old schedules in place – in effect incenting the vesting-impacted employees to work towards the old milestones and schedule rather than the new (or just give up)?

There is also the problem of how well defined milestones are (and the more well-defined, the less likely they are to be static). How do you handle the situation where milestones are arguably, but not necessarily certainly, achieved?

Consider next our $10 million valuation vesting milestone. What if once set, the market gets much hotter – making the $10 million target a no-brainer. Or, a lot softer – making the $10 million target unrealistic. Or, the company becomes cash flow positive and decides to skip the next round altogether. And how do you determine what constitutes a $10 million pre-money valuation if you get an attractive "clean" $9 million pre-money offer that you prefer over a covenant-laden $10 million pre-money offer that includes a punitive liquidation preference?

The bottom line on milestone-based vesting is that the theory is compelling, but the reality is confounding. The more specific the milestone, the less likely it is to survive intact for the vesting period. The more general the milestone, the more likely there will be disagreements about what constitutes achieving it.

And the Winner Is …

There is a lot to be said for milestone-based vesting. Achieving business milestones surely seems a better measure of “value add” than the simple passage of time, and after all, the whole idea of vesting is to reward folks for adding value, not for passing time. And yet, time-based vesting is still the norm in the startup world.

Why is that? Mostly, I think, for the same reason that Churchill favored democracy as the basis of government: it was not altogether attractive, but it was more attractive than the alternatives.

As lacking in theoretical virtue as it may be, time-based vesting avoids the very real practical problems of milestone vesting – evolving and ambiguous milestones. Even more important, it puts management in charge of dealing with the uncertainties of the startup world as they relate to vesting – but without giving management seemingly capricious power over vesting decisions.

How? By confronting management with a simple – but weighty – decision at each vesting point: is the particular employee still a valuable member of the team worthy of the equity incentive still in play? Or should the employee be terminated, and the unvested equity incentive reacquired for better uses?   Given the real costs of terminating an employee, all the more so a key employee (financial, management distraction, morale, schedule, etc.), management has every incentive to get this decision right.

For me, than, the answer to the vesting schedule conundrum is pretty straightforward: stick with the tried and true; stick with time-based vesting. There’s a reason the conventional wisdom here is conventional. It works. Well, better than the milestone alternative. Usually.

Addendum: For Every Rule, an Exception

Rules, of course, are made to be broken. Particularly by entrepreneurs. And my rule favoring time-based vesting schedules is no exception. There are situations where milestone-based vesting can make sense. These situations most often involve a team member with a narrow, well defined area of responsibility (and authority) together with a shorter term, easily definable objective. Situations, that is, that minimize the problematic aspects of the milestone-based vesting model.

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