Double Trigger Acceleration:

Neat in Theory, Messy in Practice

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The founders and other employee stockholders of a company seeking venture capital will likely be required to subject their shares to vesting as a condition precedent to funding. The vesting period is typically four years, with the stock vesting on a monthly or quarterly basis over this period. Once the stock is vested, the founder retains the stock even if he or she leaves the company. But if the founder leaves the employment of the company before this time period has elapsed, the founder forfeits the unvested portion of the stock.

Many venture backed companies are acquired before the four year vesting period has elapsed. This raises the question of what should happen with respect to the unvested shares of common stock upon an acquisition.[1] One common approach is to provide for the unvested shares to fully vest, or “accelerate”, after the acquisition if the stockholder is terminated without “cause”[2] by the acquiring entity within a certain time period, often one year. This approach is commonly referred to as “double trigger” acceleration upon an acquisition. It is so named because two events must occur before the employee stockholder will be treated as the outright owner without any risk of forfeiture-one, the company must be acquired, and two, the employee must be terminated.[3]

While the parties may agree that this is a neat solution that strikes a reasonable compromise between the interests of the common stockholder, the company and the investors, this double trigger approach can result in misunderstandings and confusion in practice. This stems from the fact that the double trigger approach presumes that the stockholder either retains his or her unvested stock, or receives replacement buyer stock of substantially equivalent value. If either of these is not the case, then there is no stock to vest upon the second trigger. But many acquisitions are not structured in such a way that the stockholders’ unvested common stock survives the acquisition either literally or in the form of replacement stock of substantially equivalent value. The most obvious situation in which this is the case is an acquisition in which the target company stockholders receive cash rather than stock. This is a very common deal structure.

The parties should anticipate this possibility and agree in advance as to what should happen to the unvested stock should this occur. One possibility is to provide that in such a scenario the common stockholder forfeits all unvested stock. This is obviously in the best interests of the investor stockholders as they would benefit from such a forfeiture through increased ownership percentages and a higher level of ownership at the time of closing. The common stockholder is arguably penalized as he or she is deprived of the ability to earn the unvested stock, a right that was seemingly implied in the double trigger arrangement.

A second approach would be to recognize that in such a situation the stockholder is effectively denied the opportunity to earn the unvested stock, and to therefore accelerate the unvested stock fully upon the acquisition. This is in the best interests of the common stockholder, but arguably a windfall to such stockholder as he or she does not have to put in the agreed upon service time to earn the unvested stock.

There is a third approach that would seem to strike the best balance and have a result that best approximates that which would have occurred if there were in fact replacement stock. This third approach would provide that an amount of cash consideration equal to that which would have been paid on the unvested stock be escrowed at the time of the closing, with the cash released to the employee on the same schedule as the underlying stock would have vested. Should the employee be terminated without cause within one year of the acquisition thereby tripping the second “trigger”, all of the cash would be released to the employee. While this third approach would seem to be the most equitable, it is not without its own challenges in practice. In a transaction in which there are many target company stockholders, there would need to be many separate escrow accounts set up and administered. The tax consideration to the recipients also would have to be closely examined.

As described above, there is more to the double trigger approach than may initially meet the eye. The issue highlighted, and the mechanics for dealing with the issue, are manageable provided that the parties recognize them in advance and address them in the agreement. The failure to carefully do so has the potential to result in open questions and confusion at the time of an acquisition. The following is a representative provision from a stock restriction agreement that recognizes the need for double trigger language that contemplates the situation in which there is no surviving or replacement stock in an acquisition.

“In the event of an Acquisition, the consideration paid or exchanged for any Unvested Shares in the Acquisition, (i) if paid in the form of equity securities of the acquiror, shall remain subject to this Agreement as Unvested Shares hereunder, or (ii) if paid in cash or in property other than the equity securities of the acquiror, shall be held in escrow until the Unvested Shares in exchange for which such consideration was paid would have vested pursuant to this Agreement if such Unvested Shares had continued to be held by the Stockholder (for construction of the terms of this Agreement following an Acquisition, the term “Company” shall thereafter be deemed to include the successor entity of the Acquisition).”

For more information on double trigger acceleration, please contact **Jonathan D. Gworek**.

Footnotes:

1. The purpose of this article is not to discuss acceleration generally. For a discussion of vesting, see “Founders’ Equity,” by Mary Beth Kerrigan and Shannon S. Zollo, VC Spotlight, Q3 07. Neither is the purpose of the article to discuss the theory behind what should happen to unvested stock upon a change of control. For background discussion on the change of control acceleration, see “The Making of a Winning Term Sheet: Understanding What Founders Want”, Part II, by Jonathan Gworek, VC Spotlight, Q4 07.

2. The definition of “cause” in this context is extremely critical. Such definitions can vary considerably. It is also worth noting that many double trigger agreements contain an alternative “second trigger” commonly referred to as resignation for “good reason”. Such a provision would allow the stockholder to get the benefit of the second trigger acceleration upon voluntary resignation under certain circumstances without being terminated by the company.

3. There are a number of possible outcomes upon an acquisition. They include but are not limited to: 1) full vesting automatically upon an acquisition, 2) partial vesting upon an acquisition with provision for additional vesting upon termination following an acquisition, 3) partial vesting upon an acquisition with no provision for additional vesting upon termination following an acquisition , and 4) no vesting upon an acquisition with no provision for any acceleration post-acquisition.