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Tying Down Your People

Today’s article will discuss tying down the other main asset of a venture company: its people. The people of a venture startup not only hold its IP (other than that which has been otherwise captured by law), they are also the heart of the company. From an investor’s perspective, it is extremely important, in fact imperative, that the key people in an investee company be identified, properly incentivized, and, to the extent possible, “tied down” through the operation or the threat of the operation of legal sanctions against their leaving the company or ceasing to work diligently for the investee company.

Obviously, this is very difficult to accomplish, given that indentured servitude is illegal, and given the nature of bright people, who are both free to move to another company, and free to come up with new ideas, which they may feel to have a brighter future than their current reality.

There are legal techniques which have been developed in Silicon Valley, home of arguably some of the best and the brightest in the world, that are being used to "tie down" the people of a startup, usually for a period of four years. Why four years? It generally takes that long for a company to ripen to exit (which is the concern of the investor, after all). Also, this has become customary over time, and has come to be expected, and acceptable, to engineers and other bright folks in the Valley.

The mechanisms generally used are as follows:

The Employment Contract, which generally is reserved for the key people of the company, as it's advisable to keep all others on an "at-will" employment basis, which means that you can fire them at any time. An Employment Contract, on the other hand, gives the employee more rights under the contract. Obviously, these rights are negotiated, and the key provisions that should be addressed are the acceleration of options and restricted stock buyback lapsing as well as the termination provisions of the contract. Typical sticking points on the negotiations will be what happens when the employee can be terminated when the employee is not "at-fault" and what that term legally means for this contract.

The Proprietary Information & Assignment Agreement, which obligates the holder of any valuable intellectual property to identify and transfer it to the company. Once the IP is transferred, the former holder is incentivized to stay with the new holder of his or her IP, which is now the company itself. This agreement also serves to protect the company with respect to the confidentiality and ownership surrounding the technology developed at the company during the employee's tenure.

The confidentiality of the information and other secrets, which could include marketing lists or other purely “business” information, is further protected by the Confidentiality Agreement. This also serves the double purpose of becoming another "weapon" against an employment relationship gone bad. This means that the employee is further incentivized to remain at the company for as long as he or she is "needed" by the investors.

Restricted Stock Purchase Agreements govern the purchase and holding of common stock by the founders of the company. These agreements contain lapsing schedules with respect to the repurchase right of the company vis a vis the common stock held by the founder. In other words, if the founder leaves too early, he or she loses his or her stock in the company. This is scheduled on a four year basis, usually, and mirrors the vesting schedule on the options held by the founders and employees.
The vesting schedule on the options (also on common stock) usually contains a one-year "cliff" with one forty eighth of the option grant's vesting on a monthly basis after the one year period. If the employee or founder leaves before the "cliff" is overcome, he or she gets nothing. This at least incentivizes that person to stay at least for a year and a day... These provisions are described in the Option Plan of the company as well as in the Option Agreements under which the employees hold the options.

Finally, the employees and founders are "tied down" by anti-competition clauses in the various agreements described above. There may also be a separate document for this clause, which essentially tries to prevent that person from moving to a competitor or from starting up his or her own company in the same field and/or region (both figuratively and geographically) as the investee company. In California, these are generally held by the courts to be unenforceable. In New York, they have been more favorably viewed.

In Korea, the aforementioned agreements have yet to be used, but I'm sure that there will come a day when something like them will develop. We have already had several well-publicized instances of IP theft and industrial espionage. It's a matter of time before Korea develops its own technology, in terms of laws, to combat this problem, as we have entered a period where it's in the interests of populace to capture as much of the IP of the nation as possible domestically, as well as maximize its value.

Without such technology, our venture industry is doomed. Why invest in a company if you know that its most valuable assets walk out the door every night, with no guarantee of their return in the morning?