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The $60M Exit Where Founders Got $0

A White Paper on Capital Architecture, Liquidation Mechanics, and Founder Protection

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Executive Summary

Welcome to the $60M exit where the founders got nothing.

This white paper explains the mechanics that decide who gets paid when a venture-backed company is acquired. It is built around an anonymized case study: a $60M acquisition of a medical device company in which a founder held 22% fully diluted ownership and still received zero net proceeds. Not a small payout. Not a disappointing payout. Zero.

The arithmetic seems impossible. Twenty-two percent of $60M should yield approximately $13.2M. But venture capital financing does not work on simple arithmetic. Between the founder's ownership percentage and the founder's actual payout stands a series of contractual mechanisms—liquidation preferences, participation rights, anti-dilution provisions, cumulative dividends, option pool dynamics, and management carve-outs—that determine the order and magnitude of payments in any exit. These mechanisms are negotiated at each financing round, typically when the founder has less leverage than the investor, and they compound across the life of the company.

The core insight is simple but routinely ignored: ownership percentage does not equal payout percentage.

Your cap table tells you what fraction of the company you own. It does not tell you what fraction of the exit proceeds you will receive. Those two numbers can diverge dramatically, and in the case we examine here, they diverged completely.

This paper provides:

- A detailed case study showing, step by step, how $60M in exit proceeds resulted in zero founder payout
- Technical analysis of the four terms that most significantly impact founder outcomes in any financing
- A framework—the "three machines"—for understanding how payout, control, and employment interact to determine who captures value
- Practical protection architecture for founders at each financing stage, from seed through late-stage and recapitalizations
- Negotiation frameworks and specific language for investor conversations that position founder interests as aligned with company success
- A founder-CEO transition framework addressing what happens when founders lose operating control but retain equity exposure
- Analysis of why hired executives routinely out-earn founders in exit scenarios, and how to close that gap

This is not a document about edge cases or rare disasters. The mechanics described here are present in virtually every venture financing. They are described as "standard" and "market" because they are. The question is not whether you will encounter them—you will—but whether you will understand them well enough to negotiate effectively and protect your outcome before the terms are locked.

Executive Takeaways

What Every Founder Must Understand Before the Next Term Sheet or Exit

1. Ownership Percentage Does Not Determine Payout. In venture-backed companies, exit proceeds are not distributed proportionally to ownership. They flow through a contractual waterfall defined by preferred stock terms, participation rights, dividends, option pools, transaction costs, and board-approved carve-outs. A founder can hold a substantial equity stake and still receive no proceeds in an acquisition. Ownership percentage is a legal metric; payout is an economic outcome governed by contract.

2. Liquidation Preferences Reshape Outcomes Far Beyond 'Downside Protection'. Liquidation preferences are often framed as investor protection in failed or distressed exits. In practice, they materially affect outcomes across a wide range of exits, including moderate and seemingly successful acquisitions. Participating preferred stock, seniority stacking, cumulative dividends, and conversion mechanics can consume the majority of proceeds long before common shareholders are paid. These terms must be modeled, not assumed.

3. The Option Pool Quietly Transfers Value Away from Founders. Pre-money option pool expansions shift dilution almost entirely onto existing shareholders, primarily founders, while preserving new investor ownership targets. Over multiple financing rounds, this 'option pool shuffle' can erase meaningful founder value without appearing as a discrete concession. Pool size, timing, and treatment must be negotiated deliberately and tied to an explicit hiring plan.

4. Hired Executives Optimize Economics; Founders Often Optimize Only Ownership. Founders typically focus on legal ownership and control. Hired executives optimize economic outcomes through employment agreements, transaction bonuses, acceleration provisions, and retention packages. Boards, operating at the governance layer, approve these mechanisms. As a result, executives with far less equity can outperform founders in exit outcomes. Focusing solely on ownership leaves founders exposed to asymmetric downside risk.

5. Founder Protection Is an Architecture, Not a Single Clause. No individual provision protects founder outcomes. Protection requires coordinated attention across four categories: economic terms, governance rights, employment protections, and exit mechanics. Weakness in any one layer undermines the others.

6. Negotiating Leverage Exists Primarily Before the Term Sheet Is Signed. The meaningful window to align risk, control, and reward is before the term sheet is executed. After signing, leverage declines rapidly, and outcomes become governed by document mechanics rather than intent. Founders who defer structural negotiations until later stages often discover too late that protections cannot be retrofitted.

7. Structural Literacy Is a Core Founder Competency. The mechanisms described in this paper are not edge cases. They appear in nearly every venture financing and determine real exit outcomes. Founders who understand them can ask better questions, negotiate more effectively, and design incentives that remain aligned under uncertainty. Those who do not often learn the rules only after the exit, when outcomes are irreversible.

Bottom line: A successful company does not guarantee a successful founder outcome. Structural literacy determines whether the value you create is the value you capture

Why This Matters Now

In a bull market, a lot of sins get forgiven. In a normal market, structure decides outcomes.

The venture financing environment has shifted materially over the past several years, and the shift matters for every founder currently raising capital or approaching an exit. Three trends deserve particular attention.

Down Rounds and Flat Rounds Are No Longer Rare

According to PitchBook data, flat and down rounds reached approximately 24% of all US venture financings in 2024, a decade high. This is not a temporary blip. The zero-interest-rate environment that fueled valuations in 2020-2021 is over, and many companies raised capital at valuations they have not yet grown into.

When a company raises a flat or down round, anti-dilution provisions activate, converting ownership away from common stockholders (including founders) and toward protected preferred holders. The founder who owned 25% before a down round may own 18% after it, without selling a single share.

Exit Multiples Have Compressed

Median IPO valuation-to-revenue multiples declined from approximately 17x in 2021 to roughly 4x by 2025. These are public market signals, but private market terms follow public market reality, typically with a lag.

When exit multiples compress, the same company sells for a lower price. And when the price is lower, the liquidation preference stack consumes a larger percentage of proceeds. A preference stack that seems manageable at a $200M exit can be catastrophic at a $60M exit.

Consider the math. If a company has raised $50M in preferred stock with a 1x liquidation preference and is subsequently sold for $200M, the preference consumes 25% of the proceeds, leaving $150M for common shareholders. If the same company sells for $60M, the preference consumes 83% of the proceeds, leaving $10M for common shareholders. The preference amount did not change. The outcome changed completely.

Investor Protections Are Stacking

In recent quarters, only approximately 17% of new venture financings were structured pari passu, meaning on equal footing, with existing preferred stock. The corollary is striking: roughly 83% of new money is negotiating senior liquidation preference over prior rounds.

Each new financing adds another layer to the preference stack. By Series C, a company may have three or four layers of preferred stock, each with its own liquidation preference, potentially with participation rights, and potentially with accruing dividends. The common stockholders: founders, employees, early supporters—sit beneath all of it.

The Implication for Founders

Founder ownership tends to fall sharply through successive financing rounds. A founder who starts with 100% will typically own 50-60% after seed, 30-40% after Series A, and 15-25% after Series B. These percentages are not unusual; they reflect the reality of dilution in venture-backed companies.

But when your ownership percentage is small, the terms that govern how that ownership converts to payout matter more than the headline percentage itself. The time to protect your downside is before the stress arrives: in the term sheet and definitive documents of each financing, and then revisited and renegotiated before each subsequent round. Once the documents are signed, your leverage is minimal.

Every battle is won or lost before it is ever fought. Protect the outcome before you need it.

The Three Machines

When you raise venture capital, you are not simply selling equity. You are plugging your company and yourself into three interlocking systems that will run whether you understand them or not. I call these the three machines. Each machine has its own logic, its own documents, and its own winners and losers. The founder who optimizes for only one machine will be surprised by the other two.

Machine One: The Payout Machine

The payout machine determines who gets paid when there is money to distribute, in what order, and how much. This is the machine most founders think about when they think about equity. But ownership percentage is only one input to the payout machine. The other inputs include:

- **Liquidation preferences:** Who gets paid first, and what multiple of their investment do they receive before others see anything?
- **Participation rights:** After taking their preference, do investors also participate pro rata in the remaining proceeds?
- **Seniority:** Among different series of preferred stock, who gets paid before whom?
- **Dividends:** Is there accruing interest on preferred stock that grows the preference stack over time?
- **Anti-dilution adjustments:** In a down round, how much additional ownership transfers from common to preferred?
- **Carve-outs and retention pools:** Are there management incentive payments that come off the top before the waterfall runs?

The payout machine is defined primarily in the Certificate of Incorporation (for the rights of each share class) and the financing documents (for the specific terms of each round). Once these documents are signed, the machine is set. It will run according to its programming when an exit occurs, regardless of who deserves what or who contributed most.

Machine Two: The Control Machine

The control machine determines who makes decisions, who can block them, and how power shifts as the company evolves. Founders often assume that owning a significant percentage of a company means controlling that company. This assumption is wrong.

Control is determined by:

- **Board composition:** Who sits on the board, and what decisions require board approval?
- **Protective provisions:** What actions require investor consent regardless of board composition?
- **Voting rights:** How do different share classes vote on major corporate actions?
- **Drag-along rights:** Can a majority of shareholders force a sale over the objection of minority holders?
- **Information rights:** Who has visibility into company operations and financial performance?

The control machine matters because it determines who can force outcomes. A founder who loses board control may be unable to block a sale at an unfavorable price. A founder subject to drag-along provisions may be forced to sell shares in a transaction that benefits preferred holders but wipes out common. Control and ownership are related but distinct. You can own 30% of a company and control nothing. You can own 15% of a company and control the board.

Machine Three: The Employment Machine

The employment machine determines who stays, who goes, and what happens to equity and compensation when roles change. This is the machine founders think about least, but it is often the machine that determines their personal outcome.

The employment machine includes:

- **Role and authority:** What is the founder's position, and what decisions can the founder make unilaterally?
- **Compensation:** Salary, bonus, equity grants, and how these compare to market rates for similar roles.
- **Vesting and acceleration:** What happens to unvested equity if the founder is terminated or the company is sold?
- **Severance:** If the founder is terminated, what payments and protections apply?
- **Cause definition:** What conduct justifies termination without severance or acceleration?
- **Change-of-control provisions:** What happens to founder equity and compensation if the company is acquired?

The employment machine matters because founders are not just shareholders; they are also employees. A founder can be fired. A founder can be demoted. A founder can be replaced by a professional CEO hired by the board. When any of these things happen, the founder's equity typically continues to vest according to the original terms, which often means the founder loses unvested shares. Meanwhile, the replacement CEO negotiates a full executive package with acceleration, severance, and transaction bonuses.

The three machines interact. The control machine determines who can fire the founder. The employment machine determines what happens when the founder is fired. The payout machine determines what the founder's remaining equity is worth. A founder who optimizes for payout (negotiating a high ownership percentage) while ignoring control (losing board seats) and employment (having no severance protection) may end up with nothing.

The rule to remember: Ownership percentage does not equal payout percentage. Your payout is what remains after all three machines have run.

Part I: The Case Study

The following case study is based on a real company. Details have been changed to protect confidentiality, the industry has been generalized, names removed, and certain figures rounded, but the financial mechanics are accurate. This is not a hypothetical. This happened.

Company Profile

Attribute	Details
Industry	Medical Technology
Founded	2016
Product	FDA-cleared surgical guidance platform
Total Capital Raised	$47M across Seed, Series A, Series B
Employees at Exit	85 (R&D heavy, regulatory team, small commercial)
Series B Investment	$32M at senior liquidation preference with full participation
Series B Ownership	Approximately 64% on as-converted basis
Founder Ownership at Exit	22% (fully diluted basis)
Exit Type	Strategic acquisition
Exit Value	$60M
Exit Year	2023
Founder Payout	$0 (effectively)

At first glance, the arithmetic seems straightforward. The founder owned 22% of the company. The company sold for $60M. Twenty-two percent of $60M is $13.2M. The founder should have received approximately $13.2M.

The founder received nothing. Less than his VP of Engineering. Less than his head of Regulatory Affairs.

The reality of venture capital deal structures tells a different story than simple multiplication.

The Waterfall: How $60M Disappeared

When a venture-backed company is acquired, the proceeds do not flow proportionally to ownership. Instead, they flow through a "waterfall"—a priority-ordered payment structure defined by the company's preferred stock terms and the acquisition agreement. Understanding the waterfall is essential to understanding founder outcomes.

Order of Operations

In this transaction, the waterfall operated as follows:

1. Transaction costs, escrows, and debt repayment reduce gross proceeds to net proceeds available to equity.
2. Senior preferred stockholders receive their liquidation preference before any other equity holders.

3. If preferred stock is participating, preferred holders receive their pro-rata share of remaining proceeds.
4. Any management carve-out or retention pool is funded (either from remaining proceeds or off the top).
5. Residual proceeds, if any, flow to common stockholders on a pro-rata basis.

Here is how the waterfall ran in this case:

Step 1: Senior Liquidation Preference

The Series B investors had invested $32M with a 1x senior liquidation preference. "Senior" meant their preference was paid before Series A and Seed investors received anything. "1x" meant they were entitled to receive their full investment amount $32M before any other equity holders saw a dollar.

The Series B investors held approximately 64% of the company on an as-converted basis, meaning if they converted their preferred stock to common, they would own 64% of the outstanding shares. The investors did not convert. At a $60M exit, taking the preference was more valuable than converting.

Starting proceeds: $60M → After senior preference: $28M remaining

Step 2: Participating Preferred

The Series B preferred stock was "participating." This is the term that often surprises founders.

Non-participating preferred forces investors to choose: take your liquidation preference OR convert to common and share proportionally with everyone else. Participating preferred gives investors both: take your preference AND share proportionally in whatever remains. This is sometimes called the "double-dip."

The Series B investors received their $32M preference. Then they also participated in the remaining $28M as if they were common stockholders holding 64% of the company. Sixty-four percent of $28M is approximately $18M.

Remaining: $28M → After participation: $10M remaining

Step 3: Transaction Costs, Escrows, and Management Carve-Out

Every M&A transaction has friction costs: investment banking fees, legal fees for buyer and seller, accounting fees, escrow holdbacks for indemnification, and, in many cases, a management incentive pool designed to motivate key employees to close the deal and support the transition.

In this transaction, these items totaled approximately $4M. The specific allocation was:

- Transaction costs (legal, banking, accounting): ~$1.5M
- Escrow holdback for indemnification obligations: ~$1.5M
- Management carve-out pool: ~$1M

Remaining: $10M → After costs and carve-outs: $6M remaining

Step 4: Distribution to Common Stockholders

Now we reach the common stockholders: founders, employees with vested options, early angels, and anyone else holding common shares or exercised options.

The founder's 22% ownership was calculated on a fully diluted basis, meaning it included all outstanding shares assuming all preferred stock converted and all options were exercised. But the $6M remaining for common was not distributed on a fully diluted basis. It was distributed among actual common stockholders.

The option pool represented approximately 18% of the fully diluted share count. Some of those options were vested and exercised; some were unvested and worthless; some were unallocated.

When the remaining $6M was distributed among common shareholders, the founder's actual share was approximately 15% of the common pool, not 22% of the fully diluted total.

Founder's share of remaining proceeds: ~$900K (before taxes and deductions)

Step 5: Taxes and Final Deductions

The $900K was not cash in the founder's pocket. It was a gross amount subject to federal and state capital gains taxes (approximately 35% combined in the relevant jurisdiction), legal fees for the founder's personal representation in the transaction, and a portion of the escrow holdback allocated to selling shareholders.

The founder's share of the escrow was never released because the acquirer made IP indemnification claims that consumed the holdback.

After taxes, fees, and escrow non-release, the founder's net proceeds were effectively zero.

Final result: $60M exit. 22% ownership. $0 founder payout.

What the Numbers Reveal

This outcome was not the result of fraud or malfeasance. Every step in the waterfall was governed by documents the founder signed. The Series B term sheet specified senior liquidation preference with participation. The Certificate of Incorporation defined the rights of each share class. The acquisition agreement allocated proceeds according to those rights. The lawyers did their jobs. The math ran correctly. The founder got nothing.

The numbers reveal several structural realities that founders must understand:

Reality 1: Participating preferred is a double-dip. The Series B investors received $32M in preference PLUS $18M in participation, for a total of $50M on a $32M investment—a 1.56x return. Not a home run for them, but a positive outcome. The founder, holding 22% of the company, received nothing.

Reality 2: Seniority compounds across rounds. The Series B was senior to Series A, which was senior to Seed. In a modest exit, senior investors get paid; junior investors and common may not. This creates a perverse dynamic: early investors who took the most risk (seed stage) may receive less than later investors who took less risk (Series B) because of stack position.

Reality 3: Fully diluted ownership is misleading. The founder "owned" 22% of the company, but that percentage was calculated assuming all preferred converted to common. When preferred holders take their preference instead of converting, the founder's percentage of actual payout is much lower.

Reality 4: Transaction costs matter at low exits. At a $500M exit, $4M in transaction costs is a rounding error. At a $60M exit, $4M is 6.7% of total proceeds. In a compressed exit, every dollar of friction cost comes disproportionately from common stockholders, who are already at the bottom of the waterfall.

Part II: The Four Terms That Decide Outcomes

If you remember nothing else from this paper, remember these four terms.

The case study outcome—$60M exit, 22% ownership, $0 payout—was determined by specific contractual terms negotiated years before the acquisition. These terms appear in virtually every venture financing. They are described by lawyers and investors as "standard" and "market" because they are genuinely common. But their impact on founder economics is profound, and most founders do not understand what they have agreed to until it is too late to change it.

The four terms that most significantly impact founder outcomes are: liquidation preference, participation rights, anti-dilution protection, and cumulative dividends. Each deserves detailed attention.

Term 1: Liquidation Preference

What it is: A liquidation preference is a contractual right that determines who gets paid first, and how much, in a "liquidation event." Liquidation events typically include a sale of the company, a merger, or a wind-down, any event where proceeds are distributed to shareholders.

How it works: Investors with preferred stock receive their liquidation preference before common stockholders receive anything. The preference is typically expressed as a multiple of the original investment amount. A "1x preference" means investors receive their full investment back before common sees a dollar. A "2x preference" means investors receive twice their investment back before common participates.

Why it exists: From the investor's perspective, liquidation preferences are downside protection. Venture capital is a hits-driven business; most investments fail or return modestly, while a few outliers generate the bulk of returns. Preferences ensure that investors at least recover their capital in a modest exit before founders and employees benefit.

Market standard: According to the NVCA model term sheet, 1x non-participating preference is the default for US venture deals. However, in difficult fundraising environments, competitive auctions, later-stage rounds, or deals with strategic investors, preferences of 1.5x, 2x, or higher become more common.

Impact on founders: The math is unforgiving. If a company raises $32M with a 1x preference and sells for $32M, investors receive 100% of proceeds and founders receive nothing, regardless of the percentage of the company they own.

Founder Moves: Liquidation Preference

- **Model payout at a modest exit (2-4x capital raised), not just a home run.** Ask your lawyer or CFO to run a waterfall analysis showing founder proceeds at $50M, $75M, $100M, and $150M exit values. If the modest-exit numbers shock you, address the terms before signing.
- **Prefer 1x non-participating.** Treat any multiple above 1x, or any participation, as a major concession that requires compensation elsewhere.
- **Ask for an explicit waterfall model before signing definitive documents.** Do not accept "we'll figure it out later" or "it's standard." Standard terms still produce non-standard outcomes. See the math.

Term 2: Participation Rights

What it is: Participation rights determine whether preferred stockholders "double-dip" by receiving both their liquidation preference AND a pro-rata share of remaining proceeds as if they had converted to common stock.

Three variants exist:

Non-participating preferred forces investors to choose: take the liquidation preference OR convert to common and share proportionally. Investors will take the preference when the exit price is low and convert when the exit price is high. This is the most founder-friendly structure because investors cannot benefit twice.

Fully participating preferred allows investors to take the preference AND participate in remaining proceeds. This is the double-dip: investors receive their preference off the top, then share in whatever remains as if they were common stockholders. Fully participating preferred maximizes investor returns and minimizes common stockholder returns in all but the highest exits.

Capped participating preferred allows investors to participate until they reach a specified total return (for example, 3x their investment). Once the cap is reached, the participation stops and the investor is treated as having converted to common. Capped participation is a compromise that limits but does not eliminate the double-dip.

Why participation matters: In our case study, the Series B had fully participating preferred, meaning the investors received their $32M preference, then participated in the remaining $28M at their 64% ownership level, receiving an additional $18M. Total Series B recovery: $50M. If the Series B had been non-participating, the investors would have faced a choice: take $32M in preference, or convert and receive 64% of $60M ($38.4M). They would have converted, because $38.4M is greater than $32M. The remaining $21.6M would have flowed to other shareholders. The founder's share would have been materially higher.

Founder Moves: Participation Rights

- **Treat participation as a double-dip that must be capped or avoided.** If an investor insists on participation, negotiate a cap at 2x or 3x total return.
- **Understand when participation hurts most.** Participation transfers the most value from common to preferred in moderate exits—precisely the exits that are most common.
- **Run the waterfall with participation on and off.** Ask your counsel to model the exit waterfall under both scenarios. If the difference is material, and it usually is, address participation in the negotiation.

Term 3: Anti-Dilution Protection

What it is: Anti-dilution provisions protect investors from ownership dilution if the company raises a subsequent financing round at a lower valuation than the investor's round. This situation is called a "down round."

How it works: When a down round occurs, anti-dilution provisions adjust the conversion price of existing preferred stock, giving those investors more shares when they eventually convert. The adjustment effectively reprices the earlier investment to reflect the lower valuation, transferring ownership from common stockholders to the protected investors.

Two mechanisms dominate:

Full ratchet adjusts the conversion price as if the investor had invested at the lower price. If an investor paid $10 per share in Series A and the company later raises at $5 per share, full ratchet reprices the Series A to $5, doubling the investor's share count. Full ratchet is severe and relatively rare in institutional venture deals.

Weighted average adjusts the conversion price based on a formula that accounts for the relative sizes of the original round and the down round. Broad-based weighted average (which includes all outstanding shares in the calculation) is more founder-friendly than narrow-based weighted average. Broad-based weighted average is the industry standard.

Why anti-dilution matters in the current market: When down rounds were rare (during bull markets), anti-dilution provisions were largely theoretical. In the current environment, down rounds are common. When anti-dilution triggers, ownership shifts silently—founders do not sell shares, but their percentage decreases.

Founder Moves: Anti-Dilution Protection

- **Push for broad-based weighted average and avoid full ratchet.** Broad-based weighted average is fair and standard. Full ratchet is punitive and should be resisted.
- **Understand that anti-dilution transfers ownership silently.** You will not receive a notice that your ownership has decreased. The adjustment happens automatically when the down round closes.
- **Force the model.** Before signing any term sheet, ask: "Show me my ownership and payout in a flat round and in a 50% down round."

Term 4: Cumulative Dividends

What it is: Cumulative dividends are an accruing return, typically 6-8% annually, that accumulates on preferred stock and is paid out before common stockholders receive anything in a liquidation event.

How it works: Unlike regular corporate dividends, cumulative dividends on venture preferred stock usually do not pay out annually. Instead, they accrue, accumulating year after year, and are paid only when a liquidation event occurs. At exit, the accumulated dividends are added to the liquidation preference, increasing the amount that must be paid to preferred stockholders before common stockholders receive proceeds.

The compounding effect: An 8% cumulative dividend on $32M in preferred stock, held for 7 years, adds substantially to the preference stack. With simple interest, the addition is $32M × 8% × 7 = $17.9M. With compound interest, the addition is larger: $32M × (1.08^7 - 1) = $22.8M. The original $32M preference becomes approximately $50-55M before common stockholders see anything.

> *Note on the case study: The company in our case study did not have cumulative dividends on its Series B preferred stock. If it had, the founder outcome would have been even worse. We include cumulative dividends in this analysis because they appear in many financings and founders should understand and model their impact.*

Founder Moves: Cumulative Dividends

- **Do not dismiss dividends as harmless or standard.** An 8% accruing dividend sounds small. Compounded over a typical venture timeline of 5-7 years, it meaningfully increases the preference stack.
- **Clarify the mechanics in the term sheet.** Is the dividend simple or compound? Does it accrue before or after the liquidation multiple? These details matter.
- **Model the impact at realistic timelines.** Run the waterfall at 3, 5, and 7 years post-investment. If dividends are accruing, the exit hurdle for common stockholders grows every year.

Part III: The Option Pool Shuffle

Beyond the four core liquidation terms, there is another mechanism that systematically transfers value from founders to investors: the option pool shuffle. Unlike liquidation preferences, which operate at exit, the option pool shuffle operates at financing. It is built into the structure of how pre-money valuation is defined, and it affects founder ownership from the moment the round closes.

The Setup

When negotiating venture financing, investors typically express their investment in terms of pre-money valuation and investment amount. If a company has a $20M pre-money valuation and an investor puts in $5M, the post-money valuation is $25M, and the investor owns 20% ($5M / $25M). Simple enough.

But there is a complication. Companies need equity to hire employees. Investors want to ensure there is sufficient equity available to attract talent through the next financing milestone. This is why investors typically require the company to have an option pool, a reserve of shares set aside for future employee grants, before the financing closes.

The question is: who bears the dilution from expanding the option pool?

Pre-Money vs. Post-Money Pool Expansion

Post-money pool expansion would mean the option pool is created after the new investment, so the dilution is shared proportionally by all shareholders, including the new investor. This is fair in the sense that if the new investor is requiring the pool, the new investor should share in its cost.

Pre-money pool expansion means the option pool is created before the new investment is calculated, so the dilution comes entirely from existing shareholders, primarily founders and early employees. The new investor's ownership percentage is calculated on a post-money basis that already includes the expanded pool.

Standard market practice is pre-money pool expansion. This is so common that many founders do not realize there is an alternative. But the economic effect is significant: founders pay for the option pool that benefits the investor by enabling future hiring.

The Math: An Illustrative Example

Consider a company approaching its Series B with the following cap table:

Shareholder	Pre-Series B Ownership
Founders	35%
Seed Investors	15%
Series A Investors	35%
Option Pool (existing)	15%
Total	100%

The Series B investor wants 32% of the company and requires that the option pool be expanded from 15% to 22% post-money, a 7 percentage point increase, to support hiring through the next milestone.

Under pre-money pool expansion, the pool is increased before the Series B investment is made. Here is how the math works:

Step 1: Pool Expansion (Pre-Money)

Shareholder	Before Expansion	After Expansion
Founders	35%	32% (↓3%)
Seed Investors	15%	14%
Series A Investors	35%	32%
Option Pool	15%	22% (↑7%)
Total	100%	100%

The founders have already lost 3 percentage points, from 35% to 32%, before the Series B investor has written a check. The dilution from the pool expansion came entirely from existing shareholders.

Step 2: Series B Investment (32%)

Shareholder	After Expansion	After Series B
Founders	32%	22% (↓10%)
Seed Investors	14%	9%
Series A Investors	32%	22%
Series B Investors	0%	32%
Option Pool	22%	15%
Total	100%	100%

The dollar impact: At a $60M exit, 3% of proceeds equals $1.8M. That is $1.8M in value transferred from founders to the option pool before the Series B closed, simply because of how the pool expansion was structured.

How to Negotiate the Shuffle

- **Build a bottom-up hiring plan.** Investors ask for large pools because they do not know how much equity you actually need. If you can present a specific hiring plan, you can justify a smaller pool.
- **Ask for post-money or split pool treatment.** Propose that the pool expansion be post-money, so the new investor shares the dilution. This is a fairness argument.
- **Use the pool as a negotiating chip.** If the investor insists on pre-money pool expansion, ask for something in return: a higher pre-money valuation to offset the dilution.
- **Track unused pool shares.** At exit, unallocated option pool shares typically do not participate in the waterfall. A smaller, tighter pool benefits all shareholders at exit.

Part IV: The Three Structural Layers

To understand why executives often outperform founders in exit economics—sometimes dramatically—we need to examine how value is structured at three distinct layers within a company. Each layer has different rules, different documents, and different winners.

Layer	What It Governs	Who Optimizes Here
Legal Layer	What the documents say: ownership percentages, share classes, contractual rights	Founders (typically)
Economic Layer	How money actually flows: cash compensation, acceleration, bonuses, carve-outs	Executives
Governance Layer	Who decides: board composition, committee authority, consent rights	Investors and Board

Founders typically focus on the legal layer. They negotiate ownership percentages, fight for valuation, and pay attention to their position on the cap table. This makes sense, ownership feels like the foundation of economic value. But ownership is not payout. The legal layer tells you what you own. The economic layer determines what you receive.

Executives optimize for the economic layer. They negotiate cash compensation, equity grants with acceleration provisions, transaction bonuses triggered by acquisition, severance protection, and inclusion in management carve-out pools. A skilled executive joining a growth-stage company will negotiate a package that protects them across multiple scenarios.

The governance layer sits above both and can override them. The board controls whether to approve a sale, whether to create a management incentive pool, whether to grant acceleration to specific individuals, and how to allocate proceeds in ambiguous situations.

Why Executives Win in Exit Scenarios

In our case study, the VP of Regulatory Affairs, holding approximately 1.5% ownership, received a larger total payout than the founder holding 22% ownership. This result seems impossible, but it follows directly from how each party optimized across the three layers.

The VP's payout came from four mechanisms:

6. **Carve-out pool.** The board approved a $1M management incentive pool funded from exit proceeds. The VP was allocated a significant portion based on her criticality to the acquirer. The carve-out came off the top—before the waterfall ran.
7. **Transaction bonus.** The VP's employment agreement included a change-of-control bonus equal to 6 months of salary, payable in cash at closing regardless of what her equity was worth.

8. **Double-trigger acceleration.** The VP's equity grant included double-trigger acceleration: if the company was acquired AND she was terminated within 12 months, her unvested equity would vest immediately.
9. **Retention package.** The acquirer offered a separate retention package, cash and equity, to ensure she would stay post-close.

The founder had none of these protections. His compensation was his common stock, sitting at the bottom of the waterfall, subject to full liquidation preferences and participation.

Founder vs. Executive: A Side-by-Side Comparison

Protection	Typical Founder	Typical Executive
Liquidation preference position	Bears full stack (common stock)	N/A or less exposed
Equity acceleration	None or single-trigger	Double-trigger standard
Transaction bonus	Rare	Common (3-12 months' salary)
Severance protection	None or minimal	6-12 months standard
Change-of-control benefits	Rare	Standard package
Carve-out pool inclusion	Usually excluded	Usually included
Retention package from acquirer	Rare	Common for key roles

This is not a criticism of executives. Executives negotiate these protections because they have leverage—the company needs them to stay. The question is why founders do not negotiate equivalent protections when they have even more at stake.

A Note on Exogenous Risk

The case study founder executed well by any reasonable measure. The company achieved FDA clearance, a significant milestone in medical devices. The team built a functioning regulatory infrastructure. The product worked. The company attracted a strategic acquirer willing to pay $60M for the technology, team, and regulatory pathway.

The founder's zero payout was not the result of incompetence or failure. It was the result of structural terms compounded by factors beyond anyone's control: a market environment where exit multiples compressed, where acquirer appetite shifted, where the transaction that was available was not the transaction that was planned.

Venture outcomes are shaped by forces no founder or management team can predict. Macroeconomic conditions shift. Interest rates rise. Regulatory environments change. The question is not whether exogenous risk will affect your outcome; the question is how the documents allocate that risk when it does.

When founders bear the full downside of exogenous events while investors are protected by preferences, participation, and anti-dilution, the incentive structure inverts. A founder with nothing to gain from an exit because liquidation preferences will consume all proceeds has no rational economic reason to optimize for an exit.

Smart investors understand this dynamic. Founder alignment in downside scenarios is not charity; it is portfolio protection.

Part V: Founder Protection Architecture

Protecting founder economics is not a single negotiation, it is an architecture that must be built across multiple financing events and maintained through the life of the company. Effective protection requires attention to four distinct categories of rights and provisions.

1. Economic Protections

Economic protections ensure that founders participate in value realization regardless of how the three machines run. Key mechanisms include:

- **Acceleration triggers.** Single-trigger acceleration vests equity upon a change of control. Double-trigger acceleration vests equity upon a change of control AND a qualifying termination. Founders should negotiate for at least single-trigger acceleration at Series A.
- **Transaction bonus.** A change-of-control bonus pays out in cash regardless of equity value. This ensures founders receive something even if preferences consume all proceeds.
- **Carve-out inclusion.** When boards create management incentive pools at exit, founders are often excluded on the theory that their equity provides sufficient incentive. This is wrong. Founders should negotiate explicit inclusion.
- **Founder secondary rights.** The ability to sell a portion of founder shares in later funding rounds provides liquidity and reduces concentration risk.

2. Governance Protections

Governance protections ensure that founders retain influence over major decisions even as ownership dilutes. Key mechanisms include:

- **Board composition.** The founder's ability to influence outcomes depends on board representation. At seed stage, founders should control the board. At Series A, a balanced structure is reasonable.
- **Protective provisions.** Certain decisions such as issuing senior securities, increasing the option pool, approving management carve-outs, should require founder consent, not just board approval.
- **Information rights.** Founders who lose day-to-day control should retain robust information rights: regular financial reporting, cap table updates, strategic planning visibility.

3. Employment Protections

Employment protections address what happens when the founder's role changes. Key mechanisms include:

- **Severance terms.** Founders should negotiate severance provisions comparable to what executives receive: 6-12 months of base salary and benefits continuation.
- **Cause definition.** A broad cause definition is dangerous. A narrow definition (limiting cause to felony conviction, fraud, or gross negligence) protects founders from pretextual removal.
- **Notice periods.** Founders should require reasonable notice before termination, typically 30 to 90 days, to allow time for negotiation and transition planning.

4. Exit Protections

Exit protections address founder optionality when liquidity events occur. Key mechanisms include:

- **Tag-along rights.** If other shareholders sell their shares, founders should have the right to participate on the same terms.
- **Drag-along thresholds.** Founders should negotiate for reasonable thresholds (majority of each share class) and minimum price floors.
- **Treatment in recapitalizations.** If the company restructures its capital, founders should negotiate for explicit treatment that preserves some economic participation.

Part VI: Leverage Timing

Leverage is perishable. Use it before it expires.

One of the most important concepts for founders to internalize is the time-decay of negotiating leverage. The founder who understands when to negotiate what can protect their position effectively. The founder who tries to negotiate after the window closes will be disappointed.

The Four Stages of Leverage

Stage	Leverage Level	What Can Be Negotiated
Pre-Term Sheet	MAXIMUM	Everything: valuation, preferences, participation, board composition, founder protections
Term Sheet Signed	HIGH	Most economic terms, some governance terms; major changes still possible
Closing / Definitive Docs	MODERATE	Minor adjustments; commercial terms largely set
Post-Close	MINIMAL	Almost nothing; renegotiation requires new leverage

Why Leverage Decays

Leverage derives from alternatives. Before you sign a term sheet, you can walk away. You can pursue other investors. You can decide not to raise this round. Your leverage is real because the investor knows you might not do the deal.

Once you sign a term sheet, the calculus changes. You have made a commitment, usually not legally binding, but reputationally significant. Walking away after signing a term sheet damages your reputation. The investor knows this. Your alternatives have narrowed, and your leverage has decreased.

At closing, the documents are being finalized. Your lawyers and the investor's lawyers are negotiating specific language, but the commercial terms are set. Trying to renegotiate liquidation preferences at closing is like trying to renegotiate the purchase price after you've agreed to buy a house.

Post-close, the documents are signed. The terms you agreed to will govern your payout at exit, potentially years in the future.

The Critical Window

Key insight: If you are unwilling to walk away from a deal over a term, you do not have leverage, and investors will price that accordingly.

Before signing a term sheet is the only time you have genuine alternatives. Use that window to negotiate the terms that will determine your outcome.

This does not mean you should be adversarial or unreasonable. It means you should be deliberate. Before signing, identify the three or four terms that matter most to your economic outcome and governance position. Negotiate those terms explicitly. Do not assume they are "standard" or that you can fix them later. Later does not come.

Part VII: Negotiation Language

These are not tricks. They are frames.

Negotiating with investors requires language that positions founder interests as aligned with company success. The scripts below are not manipulative, they work because they are true. Founder alignment benefits investors. Protecting founders in downside scenarios reduces moral hazard and preserves motivation.

For Transaction Bonuses

Instead of: "I want a transaction bonus."

Say: "How do we make sure the team that gets this company to exit is still motivated to close the deal?"

Why this works: You have reframed your personal interest as a team alignment issue. The investor cares about closing transactions successfully. Demotivated founders cause deals to fail.

For Founder Protections Generally

Instead of: "What protections do I get?"

Say: "What is the standard founder protection package in your portfolio companies?"

Why this works: You have shifted from asking for special treatment to asking for standard treatment. Most institutional investors do have standard packages they offer, they just do not always volunteer them.

For Downside Scenarios

Instead of: "I'm worried about a downside scenario."

Say: "How do we structure this so everyone's aligned if the exit is smaller than we hope?"

Why this works: You have acknowledged that exits do not always meet expectations. By asking how to align everyone in downside scenarios, you invite discussion of the very mechanisms that determine founder outcomes.

For CEO Transition Scenarios

Instead of: "What happens to me if you hire a new CEO?"

Say: "If you replaced me tomorrow, what package would you offer the new CEO? Let's use that as the benchmark for my role if I stay."

Why this works: You have anchored the negotiation to market rates for professional CEOs. This frame exposes the inconsistency of asking founders to carry CEO responsibility without CEO protection.

For Control/Risk Mismatch

Instead of: "I'm worried about losing control."

Say: "If I am no longer in control, what protections will we put in place so my risk matches my rights?"

Why this works: You have articulated a principle, risk and control should be aligned, that investors themselves apply in their own deals.

The Common Structure

These scripts share a common structure. They invite the investor to solve a problem collaboratively rather than defend against founder demands. They ask questions rather than make statements. They assume alignment rather than adversarial positioning. They appeal to principle and precedent rather than emotion.

The goal is not to trick investors. The goal is to have productive conversations about real issues that affect founder outcomes.

Part VIII: Founder-CEO Transition and Risk-Control Alignment

Here is the founder paradox: you often have the most equity and the least protection.

A board would rarely hire a professional CEO without offering a market salary, an employment agreement with severance, explicit performance expectations, equity incentives with acceleration, and change-of-control protections. These are standard terms for hired executives.

Yet founders—who typically carry more risk, have more at stake, and have been with the company longer—often have none of these protections. The founder paradox arises because founders do not think of themselves as employees. They are owners. They are builders. They feel uncomfortable asking for employment protections when they are simultaneously asking investors to fund their vision.

This discomfort is understandable but economically irrational. The founder's equity is not protection; it is exposure. The founder's common stock sits at the bottom of the preference stack, worth something only if there is value left after the machines run.

If the Founder Stays CEO: Benchmark the Hired-CEO Package

The simplest framework for founder-CEO compensation is to benchmark against the CEO the board would hire if the founder left. If the founder continues to carry CEO-level responsibility, the founder should receive the same market-grade CEO package:

- **Market salary.** Founder salaries are often below market because founders "have equity." But below-market salary is a transfer of value from the founder to the company.
- **Employment agreement.** Founders should have written employment agreements specifying role, compensation, severance, and termination provisions.
- **Written performance expectations.** Ambiguity about performance creates risk of pretextual termination. Written goals protect against termination-for-convenience.
- **Equity refresh grants.** Founder equity typically vests over four years from founding. Refresh grants sized to the CEO role maintain incentive alignment.
- **Change-of-control protections.** Double-trigger acceleration, transaction bonuses, and severance should be standard for founder-CEOs.

If the Founder Is Replaced: Convert Risk and Protection to Match Control

When the board decides to replace a founder-CEO, the founder's role and risk profile changes fundamentally. The founder no longer controls strategy, hiring, capital allocation, or the timing and structure of an exit. Yet the founder typically remains exposed through common equity that sits under the entire preference stack.

In valuation theory, lack of control increases risk and reduces value. Private equity firms apply discounts of 20-35% for lack of control when valuing minority positions. The same principle should apply to founders who lose operating control: if your control decreases, your protection should increase.

From a governance perspective: A founder who loses operating control should negotiate a board seat or observer rights, a defined list of reserved matters requiring founder consent, and explicit treatment in any transaction bonus or carve-out plan.

From an economic perspective: A founder who loses operating control should negotiate preference-like protection for a portion of founder equity where feasible, clear inclusion in management incentive plans, pro-rata rights in future financings, and protective provisions against major actions.

Critically, this is a question of alignment rather than entitlement. The objective is not to give founders special treatment, it is to preserve engagement, fairness, and constructive behavior during a leadership transition. A founder with nothing to gain from a modest exit has no incentive to support one.

Conclusion: Structural Literacy as Founder Competency

The mechanics described in this white paper—liquidation preferences, participation rights, anti-dilution provisions, cumulative dividends, option pool dynamics, the three structural layers, and founder protection architecture—are not obscure edge cases or rare disasters. They are present in virtually every venture financing. They determine outcomes in virtually every exit.

The terms are called "standard" and "market" because they are genuinely common. The National Venture Capital Association publishes model documents that include these terms. Startup lawyers draft thousands of financings using these structures. Investors expect them.

This ubiquity is precisely why founders must understand them. You cannot avoid these terms; you can only negotiate them well or poorly.

> *A note on scope: This paper draws heavily from one anonymized case study in medical devices. Many founders do achieve strong outcomes, and this paper is not intended to suggest otherwise. The venture ecosystem has created enormous value and life-changing wealth for founders who navigate it successfully. The point of this paper is preparation, not despair.*

Founders who understand these structures can negotiate more effectively. They can ask the right questions when reviewing term sheets. They can model their payout at realistic exit values. They can insist on protection mechanisms that align their interests with those of investors.

Founders who do not understand these structures will continue to fund outcomes like our case study: $60M exits where founders receive nothing, where the VP hired three years after founding out-earns the founder who took seven years of risk, where the documents everyone signed worked exactly as designed, but the founder never understood the design.

Structural literacy is not about becoming an expert in corporate law or mastering every clause in a Certificate of Incorporation. It is about understanding enough to ask the right questions, hire the right advisors, and negotiate with full awareness of what is at stake.

The rule is simple: Ownership percentage ≠ Payout percentage.

Your cap table shows what you own. The waterfall determines what you receive. The gap between those two numbers can be zero, or it can be everything.

The question is whether you learn this before or after it costs you.

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About AEIOU Academy

The Academy of Entrepreneurial Innovation, Opportunity & Understanding (AEIOU) was co-founded by Christopher J. Velis and Dr. Christos Kelepouris to deliver structured, venture-grade training for founders and management teams.

AEIOU exists to close the repeat-player knowledge gap. The venture ecosystem is dominated by repeat players: investors who do dozens of deals per career, lawyers who draft hundreds of term sheets, executives who negotiate multiple compensation packages. Founders, by contrast, typically negotiate one or two term sheets in their entire careers. They do not have pattern recognition. They do not know what is truly "standard" versus what is negotiable. They learn the systems that govern capital, governance, and incentives only through loss.

AEIOU's mission is to give founders the structural literacy that determines whether they capture the value they create. Founders do not lose outcomes because they are not smart. They lose outcomes because capital, governance, and incentives operate as systems—and most people only learn those systems after the documents are signed and the outcome is locked in.

This white paper is designed to be useful as a standalone tool. It covers the mechanics that matter most. But mechanics alone are not enough. Implementation requires practice, feedback, and guided application.

If you want structured, implementation-focused guidance across the full spectrum of founder competencies—psychology and resilience, brand and market position, capital architecture, negotiation, governance, systems for scale, and exit orchestration—AEIOU provides the path.

Learn more: aeiouacademy.org

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