LATHAM & WATKINS LLP

Seminar Series: Startup Law 101 for Entrepreneurs

Idea to Liquidity & Beyond: Formation & Founder Issues

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How Lawyers Can Help

Lawyers are not just the people you call when you get in trouble.

A business lawyer:

- is familiar with legal issues faced by start-up and small businesses.
- can help you create contracts and other agreements that protect your business interests.
- can help you ensure you are complying with the law.
- can help you think through issues and alternatives faced by your business.

When Thinking about Starting a Company…

Choice of Entity	Intellectual Property Strategy
Founder Stock and Equity	Employment
Compensation & Benefits	Financing

Typical Start-Up Scenario

- One or more entrepreneurs or scientists from university, research center or larger company
- Small, focused laboratory/incubator-type setting, working efficiently and quickly to develop technology that may lead to products with commercial application
- Access to university innovations and consulting
- Possession of cutting-edge technology
- Founders have no business experience; no capital

Conditions Precedent to Financing: Technology Ownership

- Must have ‘clear and unambiguous’ rights to relevant technology/products
  - Founders generally believe that, although a university or former employer may own the results of their work, they should be able to direct where the commercial rights to their inventions go—this perception is often correct
- In certain industries, early patent protection is necessary to justify the risk of investment
- Additional technology is often necessary to assure successful commercialization

Conditions Precedent to Financing: Technology Ownership

- Differences among assignments and exclusive / non-exclusive licenses
  - Ownership often not available
  - License may be insufficient if founders personally own the technology or have reversionary rights in the technology
- CMU Technology Transfer Offices
  - Each institution has its own expectations
  - Trust and conflicts of interest may complicate negotiations

Conditions Precedent to Financing: Employment Contract Considerations

- Employees are often subject to IP assignment clauses in employment contracts
  - Any IP created while acting in scope of employer is automatically assigned to the employer
- Key exception: CA Labor Code §2870
  - Certain inventions exempt from IP assignment clauses
  - Invention must be created by employee entirely on their own time without using any of the employer’s equipment, supplies, facilities, or trade secret information
  - Invention must not relate to area of business of employer, or anticipated research and development of employer
- Non-compete provisions are generally unenforceable in CA
  - Exceptions: mergers & acquisitions, severance agreements

Conditions Precedent to Financing: Committed, Full-Time Founders

- Founders often want to maintain contacts with former employer, university or research center
- Founders remaining with previous employer full or part-time must make arrangements to define what work they may and may not perform for employer
- Generally, one or more founders must commit to spend full-time with company—investors often decide on basis of people rather than technology

The First Legal Element…

What Entity Should We Form?

Which Entity to Form?

	Advantages	Disadvantages
C Corporation	✓ Limited liability for shareholders ✓ Preferred investment vehicle for VCs ✓ Investor familiarity ✓ Liquidity ✓ Continuity of existence ✓ Established body of law in Delaware ✓ Equity award flexibility	× Double taxation – on income at the entity and shareholder levels × Cannot deduct business losses against personal income × Burden of corporate formalities and state/ federal rules and regulations
S Corporation	✓ Limited liability for shareholders ✓ Pass through tax treatment	× Single class of stock × Allocation of profits/losses strictly according to ownership × Limited number of shareholders (100) × Restriction on identity of shareholders (foreign share ownership is prohibited)
LLC	✓ Limited liability for members ✓ Pass through tax treatment ✓ Members can apply losses to income ✓ Unlimited number of members ✓ Can issue multiple classes of ownership interests ✓ Can distribute appreciated property to members tax-free (certain exceptions)	× Not preferred for IPO or sale × VC investment issues × Converting to a c corp can be expensive × Complicated tax reporting and compliance × Different structuring of traditional equity awards × Tax-exempt members may derive "unrelated business taxable income" × Non-US members may be required to pay US income tax

Our Scenario

Two Founders, each with 50% ownership

Tax Treatment of C Corporations

Annual Company Sales = **$500,000**
- General Company Expenses, Salaries, etc. = **$300,000**
Taxable Income to the C Corporation = **$200,000**

Taxable Income to the C Corporation of $200,000

- **$200,000**

- 35% C Corporation Entity Tax

- 65% of $200,000 = **$130,000**

Each Shareholder's Income

- 50% of $130,000 = **$65,000**

- 40% Personal Income Tax

- **$39,000 each for Sergei and Larry**

Tax Treatment of LLCs

Annual Company Sales = **$500,000**
- General Company Expenses, Salaries, etc. = **$300,000**
Taxable Income to the C Corporation = **$200,000**

Taxable Income to the C Corporation of $200,000

- **$200,000**

~~- 35% C Corporation Entity Tax~~

- ~~65% of $200,000 = **$130,000**~~

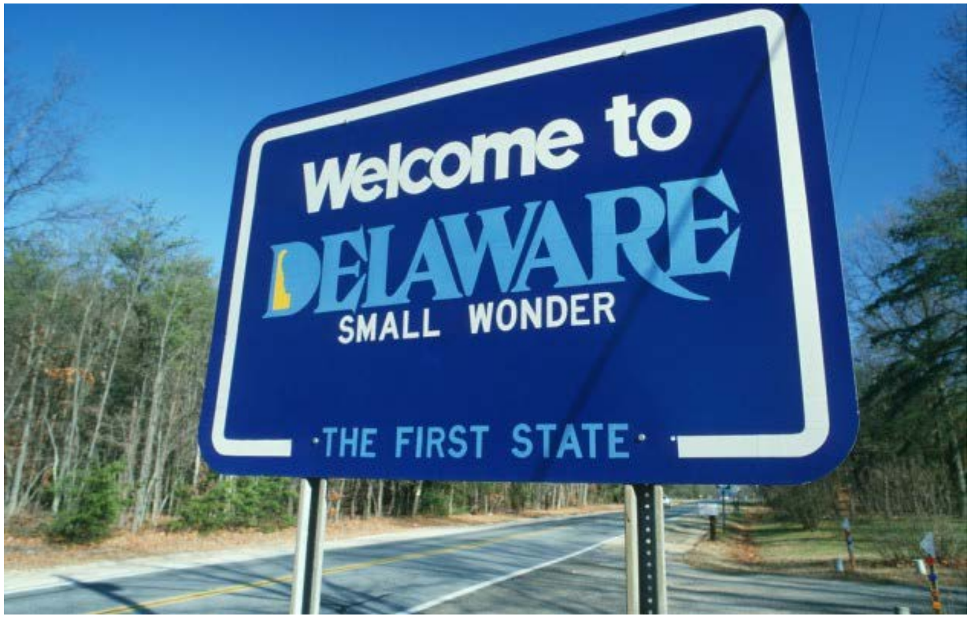
Each Shareholder's Income

- 50% of $200,000 = **$100,000**

- 40% Personal Income Tax

- **$60,000 each for Sergei and Larry**

Where to Incorporate?



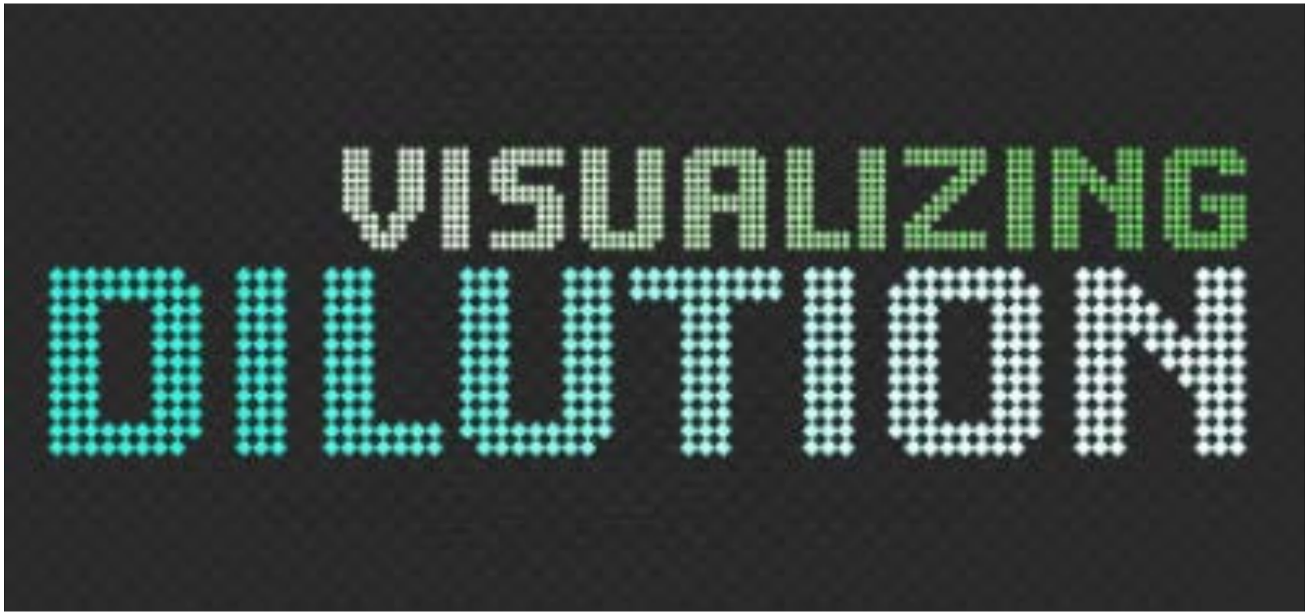
- Business-friendly (easy filings)
- Qualify as foreign corporation in other states
- Other jurisdictions are generally discouraged

Why and When to Officially Incorporate

Protect	• Protect yourself and other stakeholders against personal liability
Prevent Founder Issues	• Formalize founder agreements to prevent any misunderstandings about equity splits in the future
Intellectual Property	• Creating the entity allows you to assign IP to it
Hiring	• The entity can hire employees and third party contractors
Stock Options	• The entity can issue stock options
Tax Benefits	• Start the clock on the capital gains holding period in the event of a stock sale
Raising Funding	• The entity can receive outside funding from angels, VCs, etc.

Understanding Founder Stock

Valuation Model and The Concept of Dilution



Sample Valuation Model – *The Founders*

- Two Founders Jack and Jill
- Jack and Jill each purchase 2,000,000 shares of **common** stock at a purchase price of $0.001 per share

Entity	# of Shares	% of Shares	Value
Jack	2,000,000	50%	$2,000
Jill	2,000,000	50%	$2,000
Total	4,000,000	100%	$4,000

Sample Valuation Model – The Founders + *Option Pool*

- To recruit key talent and attract employees, the company establishes an option plan and reserves 2,000,000 shares of common stock for issuance under the plan – note that the founder equity % decreases

Entity	# of Shares	% of Shares	Value
Jack	2,000,000	33.33%	$2,000
Jill	2,000,000	33.33%	$2,000
Option Pool	2,000,000	33.33%	$2,000
Total	6,000,000	100%	$6,000

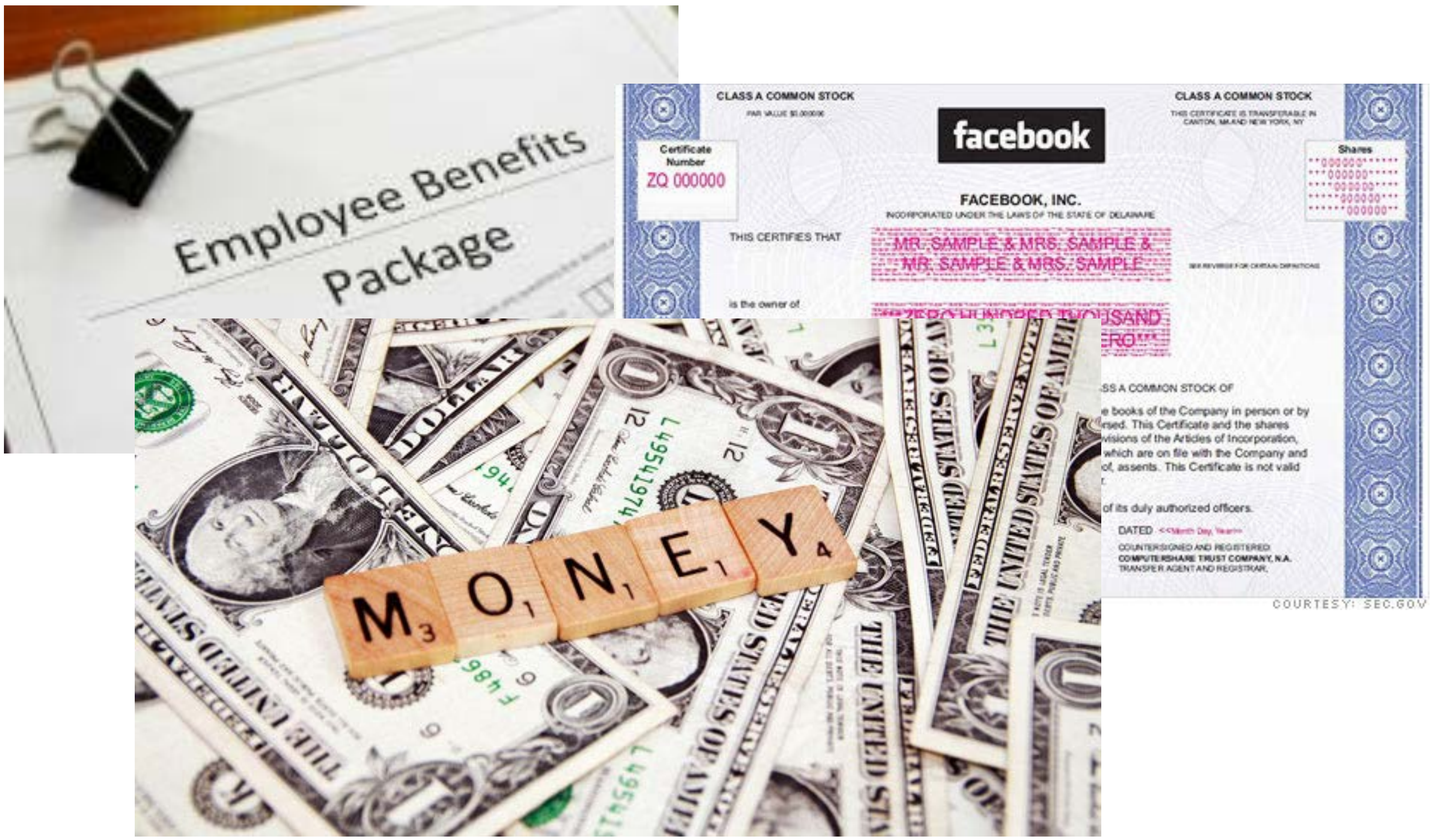
Sample Valuation Model – The Founders + Option Plan + *First Two Rounds of Preferred Funding*

- The company successfully completes a $4,000,000 Series A **Preferred** Stock Financing at a purchase price of $1.00 per share. The pre-money valuation is $1.00 x 6,000,000 = $6,000,000. The post-money valuation is pre-money valuation + amount invested = $6,000,000 + $4,000,000 = $10,000,000. Pretty typical for option pool to be 20% of the fully diluted capitalization.
- The company successfully completes a $15,000,000 Series B **Preferred** Stock Financing at a purchase price of $2.50 per share. The pre-money valuation is $28,750,000. Pretty typical of VCs to request option pool to be 20% of the fully diluted capitalization.

Entity	# of Shares	Pre-Series A % of Shares	Post-Series A / Pre-Series B % of Shares	Post-Series A / Pre-Series B Value	# of Shares	Post-Series B % of Shares	Post-Series B Value
Jack	2,000,000	33.33%	20%	$2,000,000	2,000,000	11.43%	$5,000,000
Jill	2,000,000	33.33%	20%	$2,000,000	2,000,000	11.43%	$5,000,000
Option Plan	2,000,000	33.33%	20%	$2,000,000	3,500,000	20%	$8,750,000
Series A Investors	4,000,000	0%	40%	$4,000,000	4,000,000	22.85%	$10,000,000
Series B Investors	0	0%	0%	$0	6,000,000	34.29%	$15,000,000
Total	10,000,000	100%	100%	$10,000,000	17,500,000	100%	$43,750,000

Other Legal Elements…

Stock, Options, Cash and Financing



Founders' Stock

- Common stock issued at formation of new company at low price relative to prices of later issued stock
- Founders will generally seek large percentage of company in common stock when company is established, giving founders initial control
- But founders' ownership and control will be diluted as investors purchase stock

Founders' Stock

- Founders' stock may be 'purchased' in various ways, including in consideration for technology transfer, for cash, or by promissory note
- Vesting arrangements (commonly 4-5 years), especially where founder will be employee
  - Protection against founders leaving company after financing
  - Percentage of a founder's stock, decreasing over time, is subject to repurchase by company—at a founder's cost—if founder terminates his/her employment
- May sometimes negotiate immediate vesting for some portion of a founder's stock, especially where he or she transfers technology to company

Allocation of Founders' Stock: Common Equity Percentage Ranges

Allocated to:	% Allocated	Stock Type	Vesting
Founders	10 – 40	Common	Yes
VC Investors	40 – 70	Preferred	No
Employee Pool	10 – 20	Options	Yes

Stock Options

- Options for period of 5 – 10 years to purchase common stock at price equal to fair market value of common stock on the date the option is granted
- Acts as recruiting tool and, due to vesting provisions, a retention tool
- Effective compensation device to supplement low salaries
- Usually granted to employees, directors, consultants, advisors

Considerations for Founder Stock Agreements

Before Venture Financing

- Typically same general vesting terms as what one would expect after a venture financing
- Acceleration of vesting upon termination? Probably not best for remaining founders.

Post Series A Financing

- Typically, four-year vesting with a one-year cliff = 25% of the shares vest one year from the vesting commencement date, and 1/48 of the total shares vest each month thereafter
- Vesting upon change in control – single trigger or double trigger?

Questions?

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