



A Founders' Tale: Organizing and Running a Start-up Company

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PREFACE

- We will cover
 - Some basic concepts regarding forming a business
 - The story of two founders and the business they create
 - The legal structure of the business
 - Typical equity incentives
 - How capitalization changes with the arrival of new contributors and investors



The Basics--Starting a Business

- If you start a business
 - Alone, it is automatically a Sole Proprietorship;
 - With someone else, it is automatically a General Partnership.
- In both cases, no separate tax entity, no protection against personal liability, no easy means for passive investment



The Basics--Choosing an Entity

- Limited Partnership -- partial limited liability, tax flow-through, flexible but complex
- Limited Liability Company -- full limited liability, tax flow-through (but in Cal, separate gross receipts tax), flexible but complex
- Corporation -- full limited liability, with either modified tax flow-through (S corp) or no tax flow-through (C corp); rigid, standard structure



Why Do Start-ups Incorporate?

- Most high-growth start-ups incorporate because:
 - Straightforward structure is comfortable to investors (VCs won't invest in other forms)
 - Enables use of stock as tax-optimized incentive to employees (ISOs) without K-1s
 - Relatively easy to add (or subtract) shareholders
 - Investors in growth companies want long-term capital gains, not short-term profits and ordinary income taxes
 - Best vehicle for going public



Our Story Begins:

- Archie – Has an MBA and therefore feels fully qualified to run a company
- Babs – An engineer with a brilliant concept for allowing people to access each other’s digital music files over the Internet—for free! She describes it as a “peer-to-peer” network, and calls it “Babster”
- Babs first ran her business off a server in her den, then asked Archie to help with marketing and raising capital. They visited a lawyer, and now want to form a corporation.



Contributions and Responsibilities

Archie -- will be CEO and will contribute \$50,000

Babs --will be CTO and will contribute IP

- Both agree their initial contributions are equal in value
 - Authorize 10,000,000 shares common stock (be careful of Delaware!)
 - Archie and Babs receive 2,500,000 shares each @ 2 cents per share, set aside employee pool of 1,000,000 shares (20% of 5M outstanding) for others.



Founders

- Tax Issues
 - The shares are issued for property (cash or IP), BEWARE of issuance for services—taxable, and may not be valid.
 - Neither Archie nor Babs recognizes income on receipt of shares
- Vesting
 - Should the founders' shares be subject to vesting?
 - Preempt the VCs, lock in co-founders



Founders

- Vesting (continued)
 - Normal -- three or four years, first-year cliff with monthly vesting in subsequent years (vesting start date usually pegged to when recipient started work)
 - Often, “double-trigger” vesting acceleration—if the company is sold and the founder is terminated without cause within several months thereafter, all or a portion of the remaining unvested shares vest.



Founders

- Vesting (continued)
 - File the Section 83(b) election!
 - Normal rule—if property is subject to a substantial risk of forfeiture that will lapse in future, then no tax now, but taxed at FMV when restriction lapses.
 - 83(b)—taxpayer elects to be taxed now without regard to the risk of forfeiture.
 - Only 30 days to file after receipt of property!



Founders

- Other Features

- Right of First Refusal

- If a founder wants to sell, Company can buy shares

- Stock escrow and assignment of shares to company

- 180-day Lock-up

- Spouse's consent



Founders

■ Cash Compensation

- Founders will often go without salary or will accept reduced or deferred salary
- Deferred salary will create a corporate liability, for which board is personally liable if not paid.
- Founder cash contribution to Company so it can pay salaries to founders is bad tax planning (@40% cash drain)
- Consider paying small salary, and founders lending money to pay other expenses



Founders

- Employment Agreements
 - Do founders need these?
 - Duties, benefits, termination, noncompete, severance, invention assignment and nondisclosure
- Asset Transfers
 - Locking in the corporate IP
 - Technical and business intangibles



Founders

- Shareholders' "Buy/Sell" Agreement
 - Often used in closely held or family businesses
 - Provides for control of transfers, limited liquidity
 - Voluntary transfers -- right of first refusal
 - Involuntary transfers -- termination, death, divorce, disability, debt -- stock valuation issues
 - Not often used in high-growth start-ups.



Six Months -- New Team Members

- Two New People join Babster
 - Camille--CFO
 - Dilbert -- VP of Engineering
 - Founders? If not, equity comp usually limited to <5%.
 - Employees or Consultants? Many different tests with many factors; control/supervision = employment.
- Employment/Consulting Agreements
 - More important for later hires; critical for independent contractors who will contribute IP
 - Probably will provide for current cash, but less equity than the founders received, often in the form of options.



Six Months -- New Team Members

- Equity Compensation -- Grants or Stock Options?
 - Direct grant would trigger income (and withholding); as price rises, tax cost of stock grant increases
 - Options:
 - Require payment of exercise price (eventually)
 - Don't vote; can't be transferred
 - C.G. holding period doesn't start until stock is purchased
 - Assume each receives option to purchase 100,000 shares at \$.05 (2%)--If Camille's an independent contractor, not eligible for Incentive Option.



Six Months -- New Team Members

- Vesting
 - Three-year or four-year vesting periods
 - One-year cliff and subsequent monthly vesting still common
 - Company right of first refusal on any proposed sale of stock
 - For Camille – key engineering objectives -- consider milestone vesting



Nine Months -- Dilbert Leaves

- Departure of Early Team Member
 - After just three months on the job, Dilbert becomes convinced there are some copyright problems with Babster, and leaves
 - Quitting or getting fired -- does it make a difference?
 - For Dilbert--vesting, unemployment, reputation, severance
 - For Company--liability for wrongful termination or “constructive termination”?



Nine Months – Dilbert Leaves

- Vesting to the rescue!
 - Lapse of Option Rights
 - Repurchase rights for prior stock grants (but must execute repurchase within stated period--usually 90 days!)



12 Months -- More Staff

- 12 Months Go By -- Babster Expands Its Staff
 - Two new sales reps, an office manager and a bookkeeper
 - Independent contractor or employee?
 - Compensation and equity, vesting
 - Payroll obligations or commissioned sales personnel?
 - Employment agreements, proprietary info agreements, stock options with vesting
 - Assume each receives option to purchase 20,000 shares at \$.10 per share (0.3%).



15 Months -- VC Investment

- After 15 Months, Major New Investment
 - Babster has sufficient product development, customer commitments, revenue or profits to attract outside professional investors
 - Gets some Silicon Valley law firm to tell investors the copyright infringement issue is “no problem.”
 - Surrenders some ownership and autonomy, but gains expansion capital and VC contacts/expertise



15 Months -- VC Investment

- Due Diligence
 - Does Babster own all of its IP?
 - Is Babster in good standing? Filed all tax returns?
 - Has Babster paid all employment taxes and withholding? Are employees terminable at will?
 - Is capitalization accurately stated?
 - Has Babster issued its stock and stock options in accordance with applicable securities laws?



15 Months -- VC Investment

- Babster's Capital Structure
 - Babster has issued 2,500,000 shares to Archie and 2,500,000 shares to Babs
 - Babster has issued aggregate stock options covering 280,000 shares (100,000 each for Camille and Dilbert and another 20,000 for each of the four recent hires).
 - Dilbert's stock option lapsed, so there are 5,000,000 shares outstanding and 280,000 shares subject to outstanding stock options



15 Months -- VC Investment

- VC Valuation and Dilution
 - Assume there are 1M shares reserved for issuance under the Babster stock option plan (5M outstanding shares + 1M shares reserved = 6M “fully diluted” shares)
 - The VCs believe Babster is currently worth \$6,000,000. They are willing to invest \$2,000,000.
 - Based on 6,000,000 fully diluted shares, the VCs will purchase 2,000,000 shares of the stock of Babster, in the form of Series A Preferred Stock at \$1.00 per share.
 - Impact on common stock price.



15 Months -- VC Investment

- Results of the VC Investment
 - There are 7M shares outstanding (5M common, 2M preferred) and 1M shares reserved for issuance under the Babster stock option plan. 8M shares fully diluted.
 - Archie and Babs each now own 2.5M shares of Babster-- 31.25% each
 - VCs own 2M shares of Babster—25%
 - Employee plan represents 12.5% reserved for issuance, at a new common price of 15 cents per share.
 - Babster has \$2,000,000 in the bank