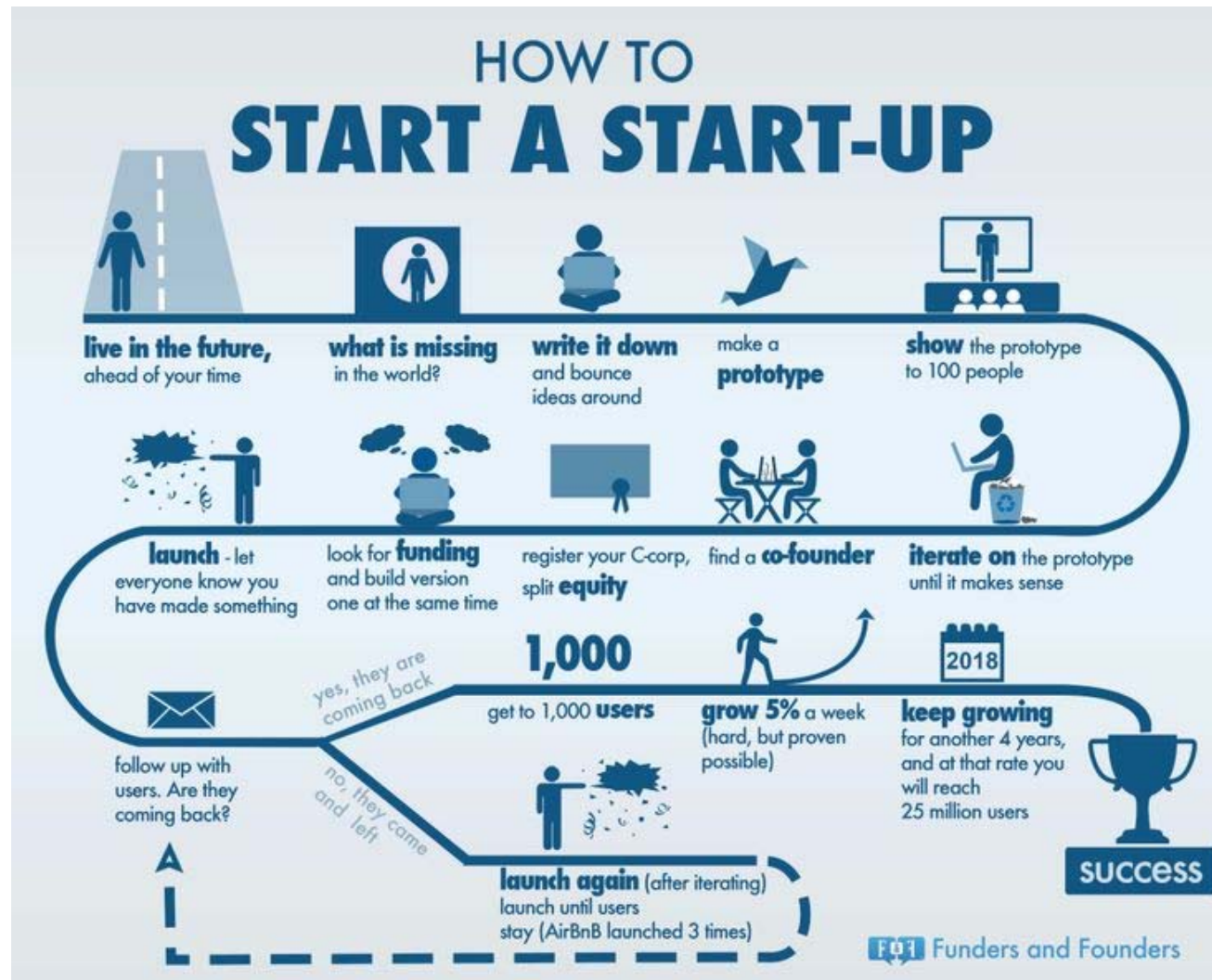


# Idea to Liquidity & Beyond: Formation & Founder Issues

**Patrick Pohlen and Ben Potter, Latham & Watkins LLP**

**October 8, 2015**

# Starting a Company



# When Thinking about Starting a Company...

- **The Business Elements:**

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**Clarity of Purpose** ✓ A simple and easy to understand value proposition

**Large Markets** ✓ A large existing market poised for rapid growth or change.

**Rich Customers** ✓ Customers who will move fast and pay a premium for your product/service

**Talent and Team Chemistry and DNA** ✓ Team members who are the smartest or most clever in their domain and work well together – high quality talent attracts more high quality talent

**Agility** ✓ Speed and flexibility to help you out-manuever the competition and larger companies

**Frugality** ✓ The know-how to spend only on the priorities and what's critical and to maximize profitability

**Discipline and Focus** ✓ The basic tenets of discipline and focus which can get a team/company pretty far down the road with little money

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*Source: Sequoia Capital*

# When Thinking about Starting a Company...

## The Legal Elements

Choice of  
Entity

Intellectual  
Property  
Strategy

Founder  
Stock and  
Equity

Employment

Compensation  
& Benefits

Financing

# A Few Things Before Starting a Company...

- If you have a current employer, review all agreements with your current employer
  - Pay close attention to the following provisions:
    - Confidentiality
    - Invention Assignment
    - Invention Disclosure
    - Non-Compete
    - Non-Solicit of Customers and Vendors
    - No Moonlighting
    - No Conflicting Stock Ownership or Directorships
  - Return any confidential information to your employer
  - Limit pre-resignation activities
  - Prepare for the exit interview
  - Stay on good terms
  - Stock options and benefits from your employer – check on when your options expire and whether or not you want to exercise
  - Talk with your attorney

# The First Legal Element...

What Entity Should We Form?



# Which Entity to Form?

|                      | Advantages  | Disadvantages  |
|----------------------|---|--|
| <b>C Corporation</b> | <ul style="list-style-type: none"> <li>✓ Limited liability for shareholders</li> <li>✓ Preferred investment vehicle for VCs</li> <li>✓ Investor familiarity</li> <li>✓ Liquidity</li> <li>✓ Continuity of existence</li> <li>✓ Established body of law in Delaware</li> <li>✓ Equity award flexibility</li> </ul>   | <ul style="list-style-type: none"> <li>× Double taxation – on income at the entity and shareholder levels</li> <li>× Cannot deduct business losses against personal income</li> <li>× Burden of corporate formalities and state/federal rules and regulations</li> </ul>   |
| <b>S Corporation</b> | <ul style="list-style-type: none"> <li>✓ Limited liability for shareholders</li> <li>✓ Pass through tax treatment</li> </ul>  | <ul style="list-style-type: none"> <li>× Single class of stock</li> <li>× Allocation of profits/losses strictly according to ownership</li> <li>× Limited number of shareholders (100)</li> <li>× Restriction on identity of shareholders (foreign share ownership is prohibited)</li> </ul>   |
| <b>LLC</b>           | <ul style="list-style-type: none"> <li>✓ Limited liability for members</li> <li>✓ Pass through tax treatment</li> <li>✓ Members can apply losses to income</li> <li>✓ Unlimited number of members</li> <li>✓ Can issue multiple classes of ownership interests</li> <li>✓ Can distribute appreciated property to members tax-free (certain exceptions)</li> </ul> | <ul style="list-style-type: none"> <li>× Not preferred for IPO or sale</li> <li>× VC investment issues</li> <li>× Converting to a c corp can be expensive</li> <li>× Complicated tax reporting and compliance</li> <li>× Different structuring of traditional equity awards</li> <li>× Tax-exempt members may derive “unrelated business taxable income”</li> <li>× Non-US members may be required to pay US income tax</li> </ul> |

# Our Scenario

Two Founders, each with 50% ownership



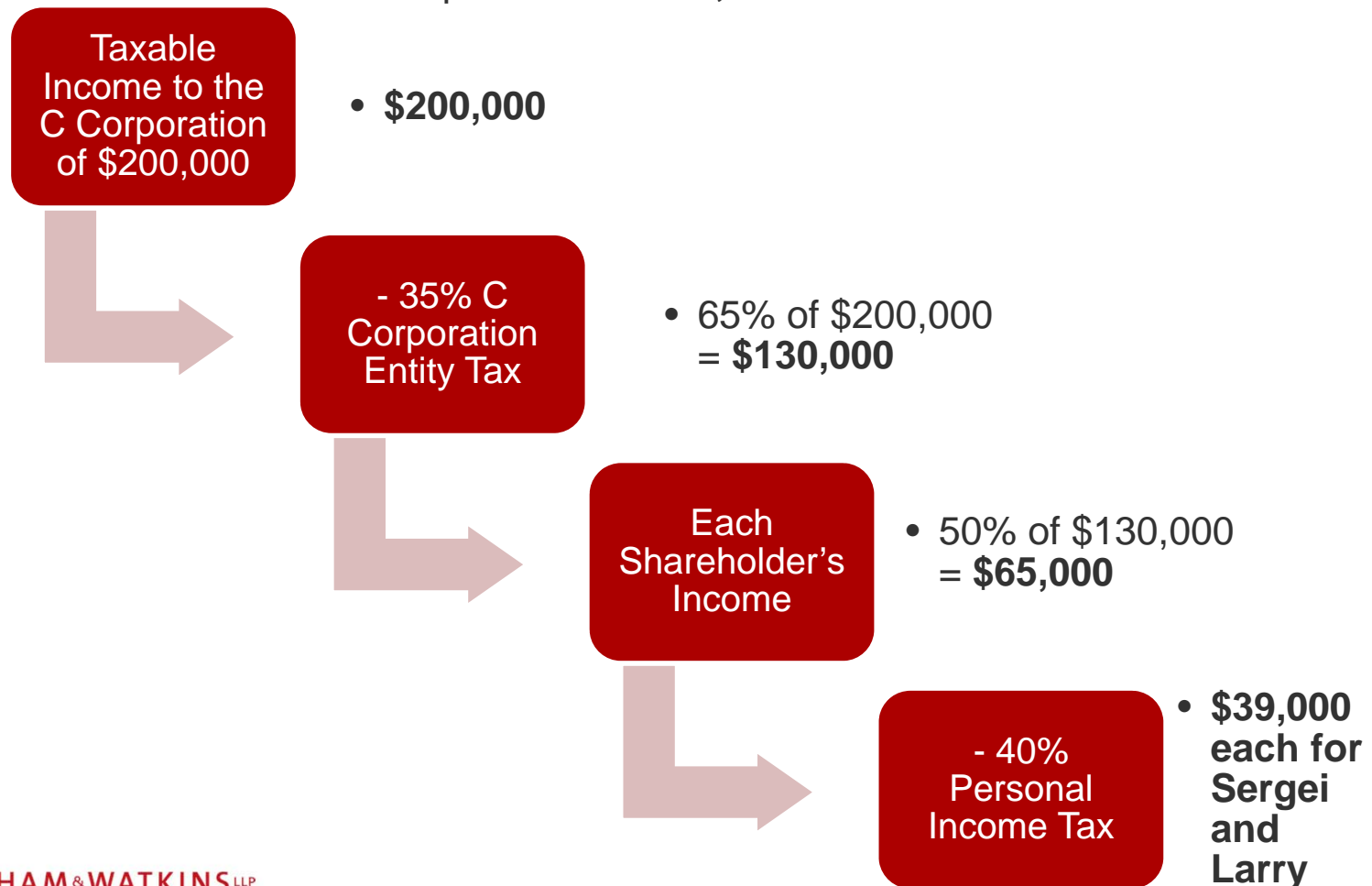


# Tax Treatment of C Corporations

Annual Company Sales = **\$500,000**

- General Company Expenses, Salaries, etc. = **\$300,000**

Taxable Income to the C Corporation = **\$200,000**

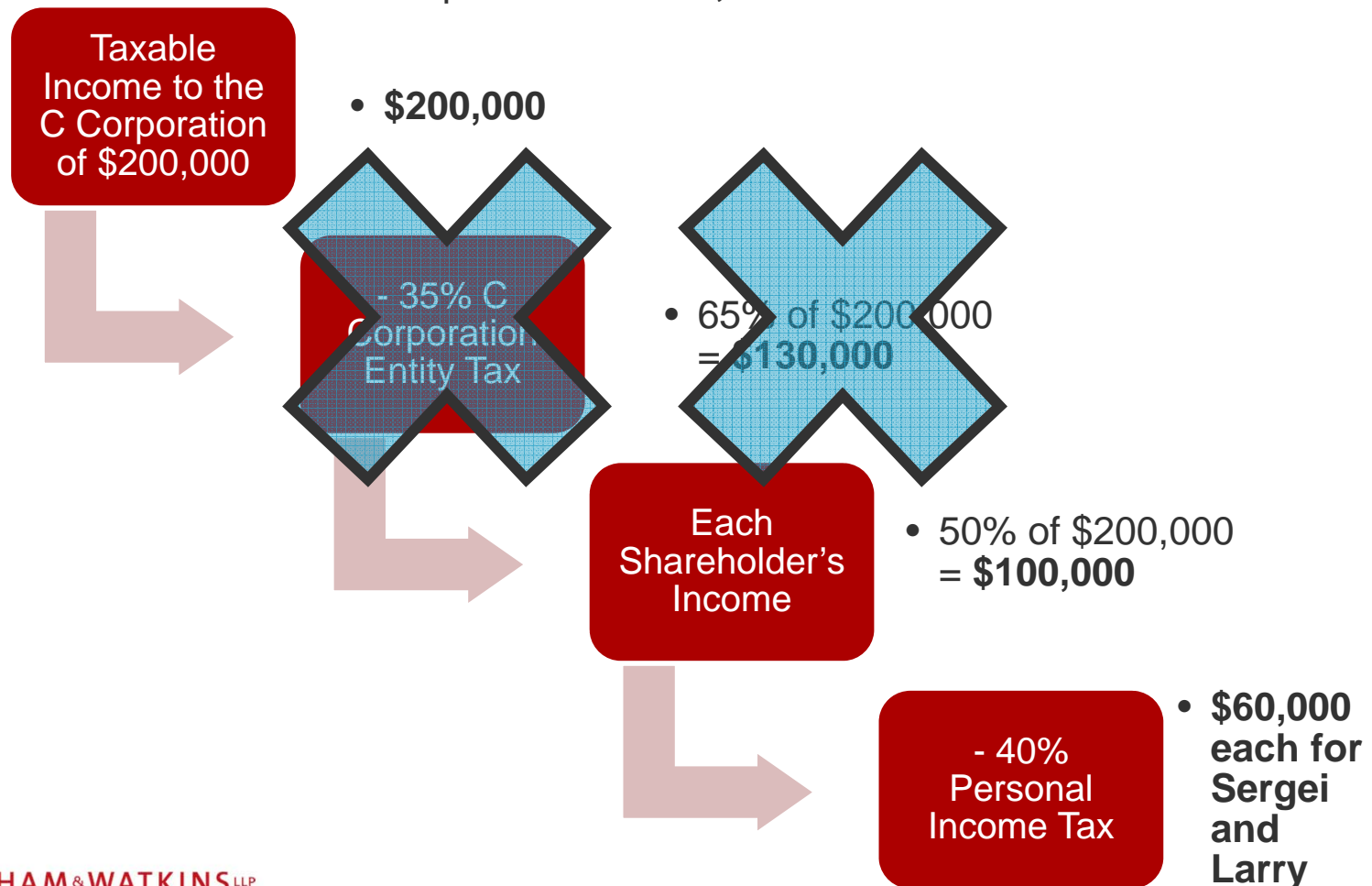


# Tax Treatment of LLCs

Annual Company Sales = **\$500,000**

- General Company Expenses, Salaries, etc. = **\$300,000**

Taxable Income to the C Corporation = **\$200,000**



# Where to Incorporate?



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

# Tips for Founders



**Choose co-founders carefully and understand each co-founder's expectations** about work hours, funding or not, exit or not, decision-making, etc. – choose as wisely as you would in marriage



**Choose your advisors carefully** – advisors may expect compensation in the form of equity in the company



**Discuss and determine the roles of each founder and business advisor and the allocation of equity amongst founders and remaining pool of common stock** (more on this later)



**Get any IP and Technology into the company ASAP**

# Why and When to Officially Incorporate

|                               |   |
|-------------------------------|---|
| <b>Protect</b>                | <ul style="list-style-type: none"><li>• Protect yourself and other stakeholders against personal liability</li></ul>                              |
| <b>Prevent Founder Issues</b> | <ul style="list-style-type: none"><li>• Formalize founder agreements to prevent any misunderstandings about equity splits in the future</li></ul> |
| <b>Intellectual Property</b>  | <ul style="list-style-type: none"><li>• Creating the entity allows you to assign IP to it</li></ul>   |
| <b>Hiring</b>                 | <ul style="list-style-type: none"><li>• The entity can hire employees and third party contractors</li></ul>                                       |
| <b>Stock Options</b>          | <ul style="list-style-type: none"><li>• The entity can issue stock options</li></ul>  |
| <b>Tax Benefits</b>           | <ul style="list-style-type: none"><li>• Start the clock on the capital gains holding period in the event of a stock sale</li></ul>                |
| <b>Raising Funding</b>        | <ul style="list-style-type: none"><li>• The entity can receive outside funding from angels, VCs, etc.</li></ul>                                   |

# 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 Round 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
- Pre-money valuation is  $\$1.00 \times 6,000,000 = \$6,000,000$
- 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

| Entity                | # of Shares | Pre-Series A<br>% of Shares | Post-Series A<br>% of Shares | Value        |
|-----------------------|-------------|-----------------------------|------------------------------|--------------|
| Jack                  | 2,000,000   | 33.33%                      | 20%                          | \$2,000,000  |
| Jill                  | 2,000,000   | 33.33%                      | 20%                          | \$2,000,000  |
| Option<br>Plan        | 2,000,000   | 33.33%                      | 20%                          | \$2,000,000  |
| Series A<br>Investors | 4,000,000   | 0%                          | 40%                          | \$4,000,000  |
| Total                 |             | 100%                        | 100%                         | \$10,000,000 |

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

- The company successfully completes a \$15,000,000 Series B **Preferred** Stock Financing at a purchase price of \$2.50 per share
- 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 B % of Shares | Post-Series B % of Shares | Value        |
|--------------------|-------------|--------------------------|---------------------------|--------------|
| Jack               | 2,000,000   | 20%                      | 11.43%                    | \$5,000,000  |
| Jill               | 2,000,000   | 20%                      | 11.43%                    | \$5,000,000  |
| Option Plan        | 3,500,000   | 20%                      | 20%                       | \$8,750,000  |
| Series A Investors | 4,000,000   | 40%                      | 22.85%                    | \$10,000,000 |
| Series B Investors | 6,000,000   | 0%                       | 34.29%                    | \$15,000,000 |
| Total              | 17,500,000  | 100%                     | 100%                      | \$43,750,000 |

# Other Legal Elements...

## Stock, Options, Cash and Financing



# Stock

- A security that signifies ownership in a corporation
- Represents a claim on part of the corporation's assets and earnings
- Types
  - Common
    - Founders and employees will purchase/own this type of stock
  - Preferred
    - Class of stock with additional rights
    - Typically may be converted into common stock
    - Investors will purchase this type of stock

# Options

- A right to purchase a defined number of shares of stock at a predetermined purchase price (exercise price)
- Allows employees and others to participate in the growth of the corporation without immediately putting up cash or paying tax
- Types
  - Incentive stock options
  - Nonqualified stock options
- Often subject to vesting

# Considerations for Founder Stock Agreements

- Vesting
  - Standard practice for two or more founders
  - Standard term: 1 yr cliff followed by monthly vesting for 3 years.
  - 83(b) Elections – very important for each individual founder to file individually on this
- IP Assignment

# 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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