Idea to Exit:
Formation & Founder Issues

Patrick Pohlen and Ben Potter, Latham & Watkins LLP
October 2, 2014
START A START-UP

live in the future, ahead of your time
what is missing in the world?
write it down and bounce ideas around
make a prototype
show the prototype to 100 people

launch - let everyone know you have made something
look for funding and build version one at the same time
register your C-corp, split equity
find a co-founder
iterate on the prototype until it makes sense

1,000
get to 1,000 users
grow 5% a week (hard, but proven possible)
keep growing for another 4 years, and at that rate you will reach 25 million users

success

LATHAM & WATKINS LLP
When Thinking about Starting a Company…

**The Business Elements:**

<table>
<thead>
<tr>
<th>Clarity of Purpose</th>
<th>✓</th>
<th>A simple and easy to understand value proposition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Markets</td>
<td>✓</td>
<td>A large existing market poised for rapid growth or change.</td>
</tr>
<tr>
<td>Rich Customers</td>
<td>✓</td>
<td>Customers who will move fast and pay a premium for your product/service</td>
</tr>
<tr>
<td>Talent and Team Chemistry and DNA</td>
<td>✓</td>
<td>Team members who are the smartest or most clever in their domain and work well together – high quality talent attracts more high quality talent</td>
</tr>
<tr>
<td>Agility</td>
<td>✓</td>
<td>Speed and flexibility to help you out-maneuver the competition and larger companies</td>
</tr>
<tr>
<td>Frugality</td>
<td>✓</td>
<td>The know-how to spend only on the priorities and what’s critical and to maximize profitability</td>
</tr>
<tr>
<td>Discipline and Focus</td>
<td>✓</td>
<td>The basic tenets of discipline and focus which can get a team/company pretty far down the road with little money</td>
</tr>
</tbody>
</table>

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
• 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

A Few Things Before Starting a Company…
What Entity Should We Form?
## Which Entity to Form?

<table>
<thead>
<tr>
<th>Entity</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
</table>
| **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
Annual Company Sales = $500,000
- General Company Expenses, Salaries, etc. = $300,000
Taxable Income to the C Corporation = $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
Annual Company Sales = $500,000
- General Company Expenses, Salaries, etc. = $300,000
Taxable Income to the C Corporation = $200,000

- 35% C Corporation Entity Tax
  • $200,000
  • 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
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

**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
• 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

<table>
<thead>
<tr>
<th>Entity</th>
<th># of Shares</th>
<th>% of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jack</td>
<td>2,000,000</td>
<td>50%</td>
<td>$2,000</td>
</tr>
<tr>
<td>Jill</td>
<td>2,000,000</td>
<td>50%</td>
<td>$2,000</td>
</tr>
<tr>
<td>Total</td>
<td>4,000,000</td>
<td>100%</td>
<td>$4,000</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Entity</th>
<th># of Shares</th>
<th>% of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jack</td>
<td>2,000,000</td>
<td>33.33%</td>
<td>$2,000</td>
</tr>
<tr>
<td>Jill</td>
<td>2,000,000</td>
<td>33.33%</td>
<td>$2,000</td>
</tr>
<tr>
<td>Option Pool</td>
<td>2,000,000</td>
<td>33.33%</td>
<td>$2,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>6,000,000</strong></td>
<td><strong>100%</strong></td>
<td><strong>$6,000</strong></td>
</tr>
</tbody>
</table>
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.

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

<table>
<thead>
<tr>
<th>Entity</th>
<th># of Shares</th>
<th>Pre-Series A % of Shares</th>
<th>Post-Series A % of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jack</td>
<td>2,000,000</td>
<td>33.33%</td>
<td>20%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Jill</td>
<td>2,000,000</td>
<td>33.33%</td>
<td>20%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Option Plan</td>
<td>2,000,000</td>
<td>33.33%</td>
<td>20%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Series A Investors</td>
<td>4,000,000</td>
<td>0%</td>
<td>40%</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>$10,000,000</td>
<td></td>
</tr>
</tbody>
</table>
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

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

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

Partner, Silicon Valley

T  +1.650.463.3067
E  patrick.pohlen@lw.com

Associate, Silicon Valley

T  +1.650.470.4809
E  benjamin.potter@lw.com