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?

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

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

Each Shareholder’s Income
- 40% Personal Income Tax
  • 50% of $130,000 = $65,000

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

- $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

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
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.

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<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. The pre-money valuation is $1.00 \times 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.

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

<table>
<thead>
<tr>
<th>Allocated to:</th>
<th>% Allocated</th>
<th>Stock Type</th>
<th>Vesting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>10 – 40</td>
<td>Common</td>
<td>Yes</td>
</tr>
<tr>
<td>VC Investors</td>
<td>40 – 70</td>
<td>Preferred</td>
<td>No</td>
</tr>
<tr>
<td>Employee Pool</td>
<td>10 – 20</td>
<td>Options</td>
<td>Yes</td>
</tr>
</tbody>
</table>
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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