LATHAM & WATKINS LLP

Seminar Series: Startup Law 101 for Entrepreneurs

Idea to Exit: Formation & Founder Issues

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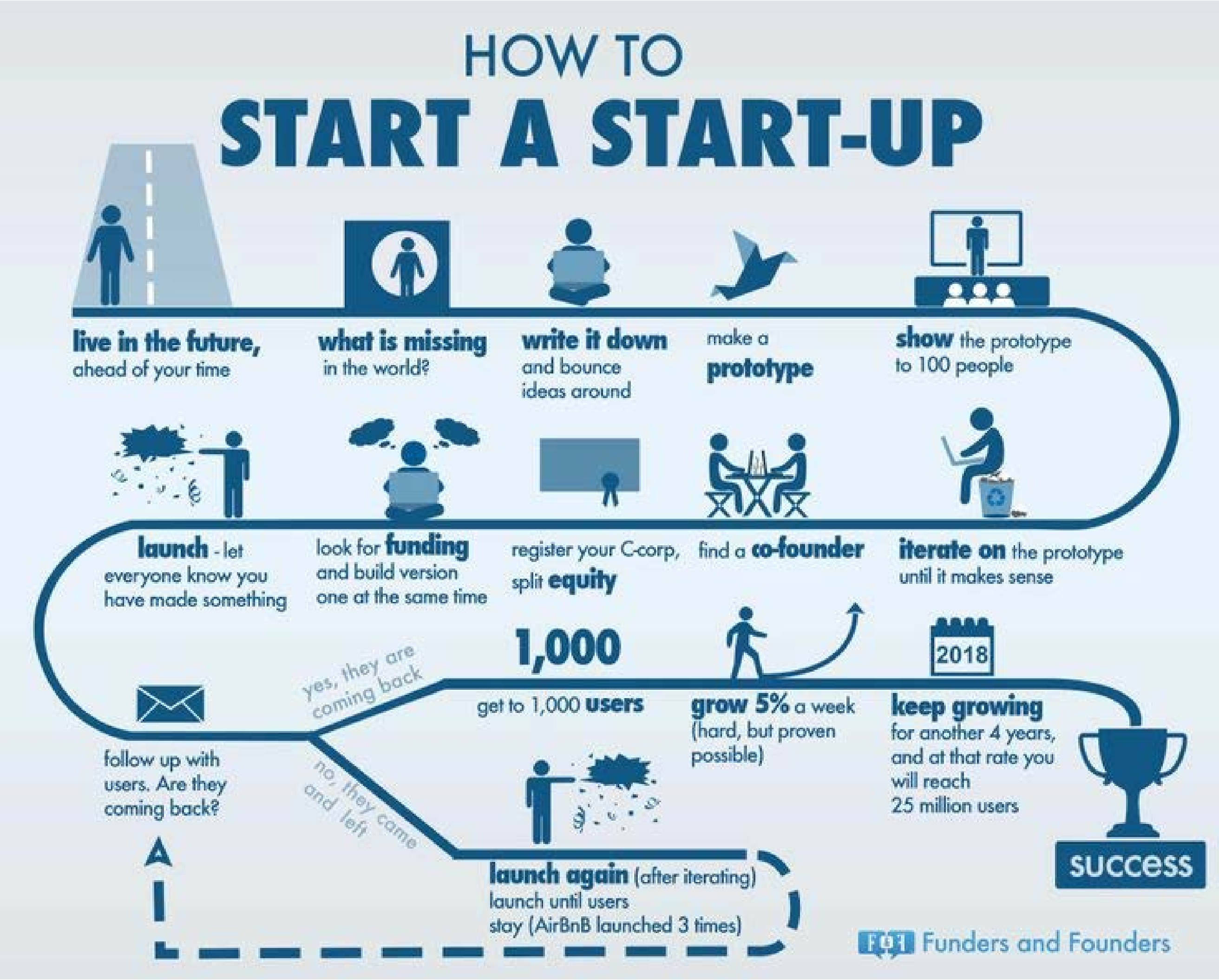
Starting a Company



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When Thinking about Starting a Company…

- ## The Business Elements:

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-maneuver 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

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
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

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

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 x 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 % of Shares	Post-Series A % of Shares	Value
Jack	2,000,000	33.33%	20%	$2,000,000
Jill	2,000,000	33.33%	20%	$2,000,000
Option Plan	2,000,000	33.33%	20%	$2,000,000
Series A 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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