FENWICK & WEST LLP

THE ENTREPRENEUR WORKSHOP SERIES

Founders and Formation Issues

Fenwick & West LLP

Fenwick & West LLP
Silicon Valley Center
801 California Street
Mountain View, CA 94041
Phone: 650.988.8500

www.fenwick.com

A1. Formation Issues and Considerations

Form the Company Early

- Type of entity
  - Corporation
  - Other entities (LLC, partnerships)
  - Key Considerations
    - Tax treatment
    - Flexibility
    - Venture investment/Liquidity Path
- Where: Delaware/California/Other?

A1. Formation Issues and Considerations

Formation Issues

- Limit liability
  - Prior to formation – Operating like a sole proprietorship or partnership?
- Ownership of IP
  - IP created outside of the company
  - IP committed to the Company once contributed

A1. Formation Issues and Considerations

- Founder Issues
  - Allocation of equity
  - Contributions of Property or not
  - Valuation and Tax issues
- Going Forward ➔ Observe Corporate Formalities
  - Form board of directors; Appoint officers
  - Observe Corporate Formalities
  - Properly capitalize (fund) the company, proper documentation of founder contributions

A2. Early Stage Issues

Key Issue 1: Informal Promises of Equity for Services

- o Company needs services performed but is short of cash
- o Contractors will work for equity (less popular today)
- o Issues:
  - What is the agreement?
  - Valuation, accounting and tax issues for consultants/ employees
  - Capitalization issues to consider
  - Securities laws concerns
  - Impact on future financing

A2. Early Stage Issues

Key Issue 2: Founder Contribution of IP

- o Founder who wants to avoid possibility of losing IP if the company does not succeed
- o IP is licensed into the Company (vs. a contribution or assignment of IP)
- o Considerations:
  - Financing issues
  - Tax issues for the licensor founder
  - May not avoid creditor challenges on dissolution

A2. Early Stage Issues

Key Issue 3: Founder Vesting

- Right of repurchase, at cost, on termination that lapses over time. Economically identical to vesting on options.
- Why impose vesting pre-financing?
- 83(b) election
  - If vesting on issuance – typically want to file 83(b). Election to be taxed at the time of filing
  - *Tip:* Must be filed within 30 days – If not, Founder will have ordinary income on the spread between purchase price and fair market value AS THE SHARES VEST
  - Potentially massive phantom income and no cash to pay the taxes

A2. Early Stage Issues

- When Does Right to Repurchase Attach?
  - On termination of employment (or service)
  - Typically, doesn’t matter if founder is fired (with or without cause), or resigns. (Exceptions in acceleration situations – Usually only in acquisition context.)
- <u>What</u> is the right of vesting schedule for founders?

A2. Early Stage Issues

- o Acceleration of Vesting – How Much Acceleration?
- o What Triggers Events?
  - Termination without Cause or Constructive Termination
    - o Terminated without “cause”
      (Narrowly defined – does not typically include poor performance)
    - o “Constructive Termination”
      - » Reduction of salary
      - » Being required to move
      - » Sometimes, material reduction in duties – Problem with this definition

A2. Early Stage Issues

- Acquisition – Single/Double Trigger – How Much Acceleration?
  - Full acceleration – Rare
  - 50% acceleration – More common
  - Reasonable/Middle of the Road – Double trigger; 12 months is not uncommon
- Considerations:
  - Founder wants protection
  - Acquirer needs founder's efforts going forward, concern is that founder is not sufficiently motivated.

A2. Early Stage Issues

Key Issue 4: Founders Who Advance Funds to the Company During Start-up

- o Deferred salary; Cash advanced to the company
- o Treatment on financing?
  - Paid back on the closing
  - Converted into financing stock or common stock
  - Contributed (forgiven)

B1. Pre-Financing Capitalization Structure

Common Stock

- What founders and employees typically get. Last in line in a liquidity event (except IPO)
- Lowest price per share
- Take care to whom you issue common stock

B1. Typical Pre-Financing Capitalization Structure

Preferred Stock

- What investors typically buy
  - Higher price per share (which is key to keeping CS price low) rationale – special rights
    - Liquidation preference (still junior to debt)
    - Participation with CS after liquidation preference (often capped)
    - (Price Based) Antidilution Protection on down rounds
    - Veto powers over key corporate transactions
    - Rights to Board seats
    - Redemption
    - Registration Rights
    - Convertible into CS – initially one for one

B1. Typical Pre-Financing Capitalization Structure

Stock Options

- Rights granted to employees and other service providers to purchase Common Stock at a later date
- Basic features:
  - Vesting based on continued service to company
  - Exercise price equal to FMV of common stock on date of grant
- Key benefit to employee is investment decision is deferred
- Key benefit to company is that, if employee doesn't work out and is let go, employee doesn't walk away with significant stock
- Unusual for founders to get options

B1. Typical Pre-Financing Capitalization Structure

Warrants / Other Rights to Acquire Stock

- Rights granted to third parties to purchase either Common Stock or Preferred Stock, typically at an exercise price set now. (This can also be in the form of convertible debt.)
  - Sometimes vesting, but can raise accounting issues
  - Benefit is ability to defer investment decision
  - Typically granted to services providers, lenders and leasing companies (somewhat less prevalent now)
  - Be careful about valuation – can create issues for pricing of your common stock

B2. Stock Options for Employees

Stock Option Plan / Equity Incentive Plan

- Major form of compensation for employees and, in some circumstances, consultants – aligns interest of employees with stockholders
  - Tax/Securities law compliance reasons
  - It's the norm and expected
- How many shares to reserve – Depends on stage of company
  - Founders – enough to get you financed
  - Financing – 15%-30% is typically the range (shares will be treated as outstanding for purposes of valuation)

B2. Stock Options for Employees

Stock Options – Key Issues

- How many shares to grant?
  - CEO – 5%-15%
  - CTO – 2%-10%
  - CFO – 1%-5%
- What is the appropriate vesting ranges?
  - Typical: Four-year vesting (one year cliff, monthly thereafter) standard
  - No acceleration on acquisition or on termination (unless executive officer, then sometimes)

B2. Stock Options for Employees

- Key issue agree to specific number of options
  - Exercise price per share – FMV of the common stock (for large holders different rules apply)
  - The failure of an award to be priced at FMV can result in such awards being taxable and subject to a 20% excise tax upon vesting new federal legislation)
- What is the FMV of common stock?
  - Generally a percentage of the price of the preferred stock (typically 10% of PS)
  - Keep pricing of common stock consistent; Selling common stock to investors can create pricing problems

B2. Stock Options for Employees

- Key differences between ISOs and NQs
  - Non-qualified options (NQOs)
    - Ordinary income on spread at time of exercise. Can be tough if you don't have any cash.
    - Taxed again at time of sale on spread between sale price and tax basis.
  - Incentive stock options (ISOs)
    - Employees only (numerous limitations)
    - No ordinary income at time of exercise – but beware alternative minimum tax.
    - Taxed on disposition for spread between exercise price and sale price.
    - Disqualifying disposition – sale of stock less than one year from date of exercise or two years from date of grant – treated like NQOs.

B2. Stock Options for Employees

Early option exercise issues

- Popular in dotcom era to offer early exercise of options.
- Advantage was perceived to be starting the capital gains holding period running early so that, if you sold, you pay less tax.
- Disadvantage for optionholder
  - You give up main advantage of option – deferring investment decision.
  - Have to come up with purchase price – OR pay with full recourse note.
  - You also risk alternative minimum or ordinary income tax in the year of exercise if FMV of stock has gone up between date of grant and date of exercise.

B2. Stock Options for Employees

- Disadvantage for company of early exercise-
  - Proliferation of shareholders
  - Greater Administrative Burdens