

Corporate Start-up Fundamentals

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Why am I here?

- If you are establishing a business based on IP, you will need to know the basics on how to structure the corporate side of the business.
- This discussion will provide you the business and legal vocabulary that are fundamental to new businesses (often used in discussions, newspapers)
- This discussion will also provide a framework on basic business set-up

Corporate Start-up Fundamentals

Topics:

- Entity Selection
- Corporate Formation
- Founder Ownership
- Equity for Employees
- Securities Law Basics
- Pre and Post-Money Calculations
- Bridge Notes

Entities

Using an Entity

- What is an entity? – legal “person”
- Why use an entity? – limited liability
- What types of entities are there?
 - ▶ corporation
 - ▶ partnership
 - ▶ limited partnership
 - ▶ limited liability company
 - ▶ S corporation

Entities

Using an Entity

- Corporation
 - ▶ Most common
 - ▶ VCs and other investors understand
 - ▶ Negatives
 - Two levels of tax
 - Cannot realize losses
 - Limited flexibility

Entities

Using an Entity

- Other entities (other than S corporation)
 - ▶ Partnership – not limited liability
 - ▶ Limited partnership – need a general partner
 - ▶ VCs – most cannot fund pass through entity
 - ▶ Difficult to implement option plan
- S corporation
 - ▶ Pass through
 - ▶ Limitations (# and type of shareholders)
 - ▶ Easy transition to regular (“C”) corporation

Corporation

The Corporation – *structure*

- Where to incorporate? Delaware?
Washington?
- Structure
 - ▶ Owners = stockholders
 - ▶ Overall management = board of directors
 - ▶ Day to day management = officers
- Governing documents
 - ▶ Certificate of incorporation
 - capital structure
 - fundamental rights
 - ▶ Bylaws
 - operating manual

Corporation

The Corporation – *directors*

- Duty to manage affairs
- Power to do all necessary things to accomplish
- May delegate
- Required level of care
 - ▶ good faith (loyalty)
 - ▶ reasonableness (ordinary prudent person)
 - ▶ reasonably believe in best interests of corporation
 - ▶ business judgment rule – no second guessing

Corporation

The Corporation – *issuing stock*

- What is stock
 - ▶ Types of stock
- Where does it come from
 - ▶ authorized stock
 - ▶ issued stock
- How to issue stock

Securities Laws

Securities Laws

- Federal and state laws
- Every offer or issuance of a security
- Registration requirement
- Register *OR* find an exemption
- Disclosure, *NOT* merit review
 - ▶ authorized stock
 - ▶ issued stock

Founder Ownership

Founder Ownership

- How do founders get stock?
- What consideration is paid?
- Vesting or not vesting?
 - ▶ investors often require
 - ▶ avoid free-loading
 - ▶ need the equity to replace departing founder
- Tax issues for vesting stock
 - ▶ 83(b) election
- Options for founders?

Founder Ownership

Founder Ownership

- Do it early
- Value is low
 - ▶ tax issues
 - ▶ accounting issues
- Avoid disputes as to ownership

Founder Ownership

Founder Issues

- Avoid informal promises of equity
- Avoid promising percentages
- Advanced expenses
- Paying back wages
- Avoid 50/50 partnerships

Employee Equity

Why give employees a stake?

- Motivation – the potential big payoff
- Team spirit – “skin in the game”
- Compensation – tie compensation to collective success
- Conserve cash – cash is king for startups

Employee Equity

What is a stock option?

- Most prevalent employee equity
- Contract
- Right to purchase stock
- # shares
- Purchase price
- Term

Employee Equity

Why options?

- Lock in low price
- Upside with no downside
- No current out of pocket expense
- Delay income tax

Types of Stock

Types of Stock

- Preferred stock vs. Common stock
 - ▶ Preferred = special rights/preferences
 - ▶ Common = plain vanilla
- Why the distinction?
 - ▶ Outside investors demand special rights
 - ▶ Justifies lower price for common – avoid...
 - Tax problems
 - Accounting problems
 - ▶ Size of the gap

Bridge Financing

Bridge Financings

- Convertible promissory notes
- “Bridge” the company to an event (i.e. next equity financing)
- Convertible
 - ▶ Convert into what?
 - ▶ When convert?
 - ▶ What terms to convert under?

Bridge Financing

Bridge Financings

- Kicker for added risk
 - ▶ Early = risky
 - ▶ Less money = risky
 - ▶ Warrants
 - ▶ Warrant “coverage”
- Secured vs. unsecured
- Advantages
 - ▶ Quick
 - ▶ No valuation established

Startup Horror Stories

- Unaccredited investors in the angel round
- Founder who's gone but owns a large chunk of the company
- Promised payment of back salaries to executive team/employees
- Paying employees equity only versus minimum wage (WA state gotcha)
- Founder deadlock
- Poor corporate records that kill the deal

Questions?


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