Incorporation Stage Issues and Seed Financings Overview

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Presentation Overview

- **What are we going to cover today?**
  - Key considerations and issues at the incorporation stage
  - Overview of the seed financing stage – key considerations and possible structures

Incorporation Stage Issues

Why Should You Form An Entity?

- Limit liability
- Allocate economic interests and control
- Create a vehicle for transactions and acquisitions

Types of Entities

- Sole proprietorship
- Partnership
- Limited liability company
- Corporation
  - S Corporation
  - C Corporation

CAVEAT
LLCs and LPs Can Be Good Options Too

- This presentation assumes that the new entity will be incorporated as a (Delaware) C-corp, as this is the entity of a choice for +98.5% of all venture-backed technology companies.
- But, LLCs (and, most likely LPs) have a lot going for them too.

Where to Incorporate?

- **California**
  - Difficulty of dealing with bankrupt regulatory authorities. Filings (for financings, mergers, etc.) are much harder and take longer
  - But, pro = only one state to deal with, and lower cost.
  - Inevitable reincorporation to Delaware at financing event or IPO.
- **Delaware (very highly recommended)**
  - Very business-friendly (easy filings).
  - More flexibility in the law and more precedent in corporate law.
  - Strong investor preference.
  - If operate in CA, also need to qualify as foreign corporation in CA and pay taxes in CA.

Incorporation Forms

- **Incorporation Documents include:**
  - Initial Articles of Incorporation (California) or Certificate of Incorporation (Delaware)
  - Organizational Resolutions (first action of Board of Directors)
  - Bylaws
  - Restricted Stock Purchase Agreement
  - Equity Incentive Plan established

Post-Incorporation

- Select management and hire first employees
- Qualify to do business for corporate and tax purposes in necessary states
- Get business license (city or county level)
- File with IRS, FTB, etc.

Equity Incentive Plan

- **Stock Options**
  - Rights granted to employees and other service providers to purchase Common Stock at a later date.
  - Often used as incentive to "service providers" (employees, consultants and even directors) to align interests with the company.
  - Number of shares reserved depends upon stage of the company but, generally, should be enough to get the company to its next fund raising event; at incorporation, usually reserve 15-20% of founder shares
  - 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. However, holding period for capital gains treatment does not start until exercised.
  - Key benefit to company is that, if employee doesn't work out and is let go, employee doesn't walk away with significant stock ownership.
  - Tax treatment differs depending on whether ISO or NQ option.

Intellectual Property (IP)

- **Get the IP basics right – Investors will carefully investigate**
  - Clean break from prior employers. Working completely outside an employer's premises and not using an employer's resources may not be enough
  - On-going responsibilities to prior employer. Founder is likely bound by agreements with former employer which impose on-going confidentiality obligations and limit ability to solicit employees and customers.
- **Position the company for investment**
  - Consider using provisional patents to start creating a proprietary advantage. This will protect U.S. and global rights to patent.
  - NDAs and other trade secret protections.
  - Consider appropriate trademark protection.

Assignment of Intellectual Property

- **Pre-Incorporation.** The IP created by the founders prior to incorporation is assigned into the Company as (partial) consideration for the founders' stock.
- **Post-Incorporation.** The IP created by the founders and employees/consultants following the incorporation is assigned to the Company under invention assignment agreements, which are part of the employment/consulting relationship.

Control Issues

- **Board**
  - At the first preferred financing, the board will be changed to be, most likely, one common, one preferred and one “independent”
- **Stockholders**
  - Also at the first preferred financing, the founders’ control at the stockholder level will be reduced by (1)an overall reduction in percentage ownership, and (2)preferred stock protective provisions.

Founder Allocation

- **<u>The Founding Team</u>.** When allocating the founders' shares, remember that the founders are likely not all equal. Ask, *"What makes sense given roles/contribution? "*
- **<u>Number of Shares</u>.** 4-6M shares of Common Stock is the likely number of shares to be allocated to the founders. (Variance depends on number of founders.)
- **<u>Form of Payment</u>.**
  - Cash to help capitalize the company
  - Assignment of IP/Technology. *Company must own its technology and IP to raise outside investment.*

Founders' Vesting

- **What is stock vesting?**
  - In case of founder stock, right to repurchase "unearned" shares, at original purchase price, on termination, that lapses over time. The longer the founder stays with the company, the more stock earned.
  - Right is exercisable if founder stops providing services to the company. Typically doesn't matter if founder is terminated or resigns. But see acceleration below.
  - 83(b) filing/consequences
- **Why impose vesting pre-financing?**
  - Provides incentive for founder to continue to provide services to the company
  - Avoids "free-rider" problem if a founder leaves
  - Sophisticated investors will require.
- **How much vesting up front for founders?**
  - Work done in past. Keep any "up-front" vesting defensible.
  - Value of IP/other contributions
  - Stickiness
- **Time vesting**
  - Typical schedule: 4 years vesting, 1 year cliff (sometimes no cliff for founders)
  - Monthly after the cliff

Vesting Acceleration

- **Vesting acceleration –**
  - Possible Trigger events
    - Acquisition of the company
    - Termination without “cause” or for “good reason” (outside of an acquisition)
  - What is a “double trigger”?
    - Trigger One - Company acquired
    - Trigger Two – Termination within 12 months (or other period)
  - What is a “single trigger”?
    - Could be either just an acquisition (more likely) or just termination (less likely but still possible).

Seed Financings Overview

Introduction to Seed Financings

- Change in angel/seed financing environment
- Products can be developed and introduced to market quicker and with less resources, particularly for internet/software based start-ups
- Traditional venture capital harder to obtain
- So, larger percentage of professional angels, seed funds, VC funds willing to invest smaller amounts of capital

Convertible Notes or Series Seed Preferred?

- **Convertible Notes**
  - **Pros**
    - Doesn't require that a company valuation be negotiated (but may need to negotiate a "valuation cap")
    - Quick and cheap to paper, not many terms to negotiate
    - Most common for raises of < $2M
  - **Cons**
    - Valuation uncertainty (for investors)
- **Series Seed Preferred**
  - **Pros**
    - Clearer definition around rights, more stability
    - Potential long term capital gains treatment if early exit
  - **Cons**
    - Requires negotiations around valuation
    - More complexity in documents and more terms to negotiate, takes longer

Convertible Promissory Notes

- **Summary of Terms**
  - Financing amount to be raised
  - Interest Rate
  - Term/maturity
  - Qualified Financing: size of future financing in which note converts
  - Economics:
    - Conversion Price discounts
    - Valuation Cap
    - Warrants
  - Treatment on Change of Control:
    - Premium
    - Right to convert at agreed upon valuation
    - Neither
  - Amendment – majority-in-interest controls?
  - Others – no prepayment, etc.

Convertible Notes Continued

- **Documents**
  - Note purchase agreement
    - Reps and warranties by company
    - Purchaser reps for securities laws
  - Individual promissory notes

Series Seed Preferred Stock

- Documents
  - Series Seed structure (www.seriesseed.com)
    - Certificate of Incorporation
      - No preferential dividends
      - No price-based anti-dilution
    - Investment Agreement
      - No ROFR over founder sales
      - No registration rights
      - Slimmed downs reps and warranties for company
      - Investors get benefit of any better rights in next round
  - More traditional structure
    - Certificate of Incorporation
    - Stock Purchase Agreement
    - Right of First Refusal & Co-Sale Agreement
    - Investors' Rights Agreement
    - Voting Agreement

Questions?

I look forward to hearing from you!

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Check out Kristine's bio!