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# Nuts & Bolts: Critical Steps to Building a Successful Start-Up

A CMU & Morgan Lewis  
Collaboration

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Entity Formation &  
Other Start-up Issues



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# Introduction

- What should we do first?
- What's the best legal structure?
- How many shares should each of us receive?
- What agreements do we need?
- Who should be on the board?

# Preliminary Matters

- Market research
- Define business objectives
- Develop business plan

# Entity Formation

- Types Of Entity
  - Sole proprietorship
  - C corporation
  - S corporation
  - Limited liability company
  - Partnership

# C Corporation

- Advantages
  - Limited liability
  - Simple structure
  - Tax-free reorganization permitted
  - Incentive stock options permitted
  - Preferred by most venture funds
- Disadvantages
  - Double taxation
    - Corporation pays taxes on income
    - Stockholders pay tax on dividends received

# S Corporation

- Advantages
  - Same as C corporation, plus
  - Pass-through entity
    - No double taxation
    - Income and losses “pass through” to individual stockholders
    - Business losses can be offset against other income
- Disadvantages
  - No more than 75 stockholders
  - One class of stock
  - Restrictions on stockholders
    - No non-resident aliens
    - No corporations, partnerships or LLCs

# Limited Liability Company

- Advantages
  - Limited liability
  - Pass-through entity
  - NO incentive stock options
  - No restriction on number and type of members
  - No restriction on classes of equity
- Disadvantages
  - NO tax-free reorganization
  - NO incentive stock options
  - Complex equity compensation issues
  - Tax issues for tax-exempt and non-U.S. investors
  - Increased costs of organization and administration

# Choice of Entity

## Summary

- Restrictions on ability to deduct “pass-through” losses
- S corporation or LLC may be preferable initially; however
  - corporations not practical for many companies over long term due to limitations under tax laws
  - LLCs offer tax efficiency but
    - Not favored by venture capital funds
    - Complex equity compensation issues
    - Complicates tax-free exit strategy

# Choice of Entity (cont'd)

## Summary (continued)

- C corporations are the principle vehicle for venture capital investments
- Bottom line:
  - Choice of entity depends on
  - Business objectives
  - Funding needs

# Organizational Checklist

- Incorporation/organization
  - Delaware vs. Pennsylvania
  - Basic documentation
  - Certificate of incorporation and bylaws (corporation)
  - Certificate of formation and operating agreement (LLC)
  - Organizational resolutions
  - Stockholder agreement (corporation)

# Organizational Checklist (cont'd)

## **Other documents**

- Equity compensation plan and related documentation
- Form of offer letter
- Nondisclosure and assignment of inventions agreement

# Capital Structure

- Initial capitalization
  - Founder contributions
    - Cash
    - Intellectual property (patents, etc.)
    - NO services rendered or to be rendered Personal loans
  - Personal loans
  - Research grants
- No outside professional investors
  - Low valuation
  - Potential for dilution
  - Tax issues
- Limit number of stockholders

# Capital Structure (cont'd)

- Tax Issue

|                          | <u>Investor</u> | <u>Founder</u>      |
|--------------------------|-----------------|---------------------|
| Amount invested in Newco | \$100,000       | F's future services |
| Newco common stock       | 40 shares       | 60 shares           |

- Risk

- Receipt of property in connection with performance of services is taxable

# Capital Structure (cont'd)

- Solution
  - Receipt of stock in exchange for “property” can be tax-free if
    - “Property” does NOT include past services
    - “Property” does NOT include promise to perform future services
  - Period of time between founder’s receipt of stock and subsequent investment in Newco
  - Issue investor more valuable securities

# Capital Structure (cont'd)

- Ownership issues
  - Basic concepts
    - Allocation of equity
    - Authorized stock
    - Avoid deadlock situations
    - Issued stock
    - Common stock issued and outstanding on a fully diluted basis
  - Allocation of equity
    - Avoid deadlock situations
    - Written agreements
    - Option plan [15-20%]

# Capital Structure (cont'd)

- Control issues
  - Restrictions on transfer
  - Permitted transfers (family members, etc.)
  - Rights of first refusal
  - Co-sale rights
  - Rights of first offer
  - Repurchase right (termination, death, disability, etc.)
  - Drag-along rights
  - Tag-along rights
  - Voting agreements (supermajority votes)

# Capital Structure (cont'd)

- Control issues
  - Consider founder restricted stock (typically imposed by VCs)
    - Each founder owns and votes the shares
    - Shares earned by continued employment
    - Standard “vesting” four years
    - Unvested shares subject to repurchase by company at cost on termination
    - Vested shares subject to other restrictions
    - Section 83(b) election

# Management and Board of Directors

- Management team
  - Experienced management
  - Develop and implement business plan
  - Budgeting process
  - Business and technical expertise
  - Prior employers

# Management and Board of Directors (cont'd)

- Board of Directors
  - Active outside directors
  - Business experience
  - Complement strengths and weaknesses
  - Outside consultants and advisors

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# Compensating Your Employees: Equity Compensation

Presented by:  
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Employee Benefits & Executive  
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# Introduction

- IS EQUITY COMPENSATION DEAD? NO!!!!
- Dot-com bust restored reality: options do not mean guaranteed riches
- However, options and other equity compensation remain critical for start-ups
- Accounting rule changes may have some impact, but mostly on design – more choices

# Importance of Equity Compensation

- Benefits of equity compensation:
  - No cash outlay/positive cash flow
  - No accounting expense (currently)
  - Potential for capital gains treatment
  - Provides incentive to employees; ties interests of employees and shareholders together
- Primary downside: dilution

# Basic Terminology

- Restricted stock
- Exercise
- Stock option
- Grant date
- Exercise price/strike price
- Vesting date(s)
- Option term
- Exercise
- Capital gains vs. ordinary income
- Alternative minimum tax (AMT)
- Accounting charge

# Design Issues

- WHAT TYPE(S) OF EQUITY COMPENSATION SHOULD WE PROVIDE?
  - Restricted stock for founders
  - Options (ISOs/NQOs)
  - For most start-ups, other forms of equity compensation (phantom stock, SARs, performance units) are neither necessary nor practical (possible exceptions: LLCs; no liquidity event expected)

# Design Issues (cont'd)

- HOW MANY SHARES SHOULD WE RESERVE?
  - Rule of thumb: 15-20% of common
  - Investors (and, eventually, underwriters) will have something to say
  - Balance between desire to have sufficient options available vs. dilution concerns

# Design Issues (cont'd)

- WHO GETS OPTIONS/HOW MANY?
  - Key employees vs. all or nearly all
  - Must accurately project future hiring needs, gauge recruiting market for particular positions and functions (consultant input)
  - Don't want to run low later – key hires (professional management), investor resistance to pool increases (consider an evergreen)

## Design Issues (cont'd)

- WHAT TYPE OF OPTIONS SHOULD WE GRANT?
  - ISOs vs. NQOs
  - ISOs better for employees (capital gains treatment, but beware the AMT)
  - NQOs better for employer (potential tax deduction, more flexibility – can offer early exercise for capital gains)

# Design Issues (cont'd)

- WHAT SHOULD THE EXERCISE PRICE BE?
  - Default is “fair market value” (ISO requirements, accounting charge, common sense)
  - Issues re determining FMV: no market for stock; valuation typically based on most recent financing/discount for preferred vs. common
  - Premium/discounted options; “underwater” options – bottom line: in a start-up, option price should be a minor issue for employees

# Design Issues (cont'd)

- WHAT VESTING REQUIREMENTS?
  - Standard: time vesting – 25% cliff after one year; ratably thereafter (monthly/quarterly)
  - Performance triggers – currently, acceleration only, may change under FAS 123
  - Special vesting events (change of control, termination w/o cause)

# Design Issues (cont'd)

- WHAT SHOULD THE OPTION TERM BE?
  - General default: 10 years (ISO requirement)
  - Truncated for terminated employees (30-90 days; one year for death or disability; immediate forfeiture if terminated for “cause”)
  - If new accounting rules adopted, terms may become shorter (lower earnings charge)

## Design Issues (cont'd)

- ANY SPECIAL RIGHTS RE EXERCISE?
  - Early exercise for restricted stock
  - Exercise with note/loan – issues re full vs. partial recourse; loan forgiveness

# Wrap-up Thoughts

- Plan should be well-designed and drafted, as should ancillary documents – litigation risk; demands of investors
- Equity grants must be carefully and appropriately administered – documents accurately completed and executed; grants and exercises tracked
- Tax issues complicated – beware of giving employees tax advice

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Coming to Terms:  
Negotiating Early Stage Deals



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# Overview

- Current market trends
- What is an angel investor?
- Basic terms in an angel round

# Current Trends in Venture Capital

- Pace of venture financing still falling in the wake of the overall technology market decline
- Public market debacle has severely impacted valuations
- VCs continue to raise the bar

## Current Trends in Venture Capital (cont'd)

- There is plenty of money available . . . but this may not last forever
- Decrease in the number of funds . . . but increase in the quality of funds
- % of money going into early stage investments (seed/1st round) beginning to stabilize after huge decline

# Considering Angel Investment – Why Angels?

- Fills the “gap”
  - Finalize “research” or “beta product”
  - Build out management team
  - Find early customers
- Friendly terms
  - Less negotiation (valuation, founder’s share)
  - Less “control” requirements

# Who are Angels?

- Old-line business owner looking to learn something new and mentor
- Successful new economy entrepreneur (or employee) that doesn't want day-to-day involvement
- Risk taker looking for high risk/high return investments

# Key Decision Making Criteria For Angels

- Credibility of the entrepreneur
  - Personal integrity
  - Willingness to seek advice
- Familiarity with industry or desire to be involved with industry
- Attractiveness of deal – afraid to be shut out later on

**SUMMARY OF TERMS OF  
COMMON STOCK/PREFERRED STOCK INVESTMENT**

Set forth below is a summary of the material terms of an investment in XYZ Corp. (the "Company"). In this offering shares of the Common Stock/Preferred Stock are being offered by the Company to investors ("Angel Investors").

Type of Security: Common Stock or Preferred Stock (circle one)

Total Capital to be Raised (before expenses): \$ \_\_\_\_\_ million

Pre-Money Valuation: \$ \_\_\_\_\_

| Post-Financing Ownership:   | <u>Shares</u>           | <u>% Ownership</u>    |
|---|-------------------------|-----------------------|
| Founder:  | _____                   | _____ %               |
| Reserved for Option Pool:   | _____                   | _____ %               |
| New Angel Investors   | _____                   | _____ %               |
| <small>(% = Total Capital to be Raised + Pre-Money Valuation)</small> |                         |                       |
| <b>TOTAL</b>  | <b><u>1,000,000</u></b> | <b><u>100.00%</u></b> |

Material Provisions of the Common Stock/Preferred Stock:

(1) Dividend Provisions. No dividends shall currently be paid.

(2) Voting Rights. All shares shall vote as one class, except as otherwise required by law.

Information Rights: Stockholders will receive annual financial statements and a semi-annual update letter.

Use of Proceeds: Obtain BSU license, recruit management team, file patents, further clinical research.

Other: Purchasers will sign a Stock Purchase Agreement (which incorporates the terms of this Term Sheet) and an Accredited Investor Questionnaire.

# Common Stock or Preferred Stock?

## SUMMARY OF TERMS COMMON STOCK/PREFERRED STOCK INVESTMENT

|                   |                                 |
|-------------------|---------------------------------|
| Type of Security: | Common Stock or Preferred Stock |
|-------------------|---------------------------------|

- Common
  - Generally, no “bells and whistles”
  - Can provide basic contractual rights
    - Information, participation, but no blocking
- Preferred
  - Can provide many protections, but these are often illusory
  - Greater say in future financings, basic operations

# Capital Raise

## SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

Type of Security: \$\_\_\_\_\_ million  
(before expenses):

- What do you know you need to do?
  - License technology/file patents
  - Attract first management team
  - Get first customers
- What cushion do you need?
  - Trade-off is low valuation

# Valuation

## SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

Pre-Money Valuation: \$\_\_\_\_\_

- Very difficult at early stage
  - Few true metrics
  - Often shoot too high
- Run preliminary DCF, using projections
- Can look at comparables, outside sources
  - EDGAR
  - Venture Source

# Founder's Share

## SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

| Post-Financing Ownership   | <u>Shares</u>    | <u>% Ownership</u> |
|--|------------------|--------------------|
| Founder:   | _____            | _____%             |
| Reserved for Option Pool:  | _____            | _____%             |
| New Angel Investors<br>(& = Total capital to be Raised<br>+ Pre-Money Valuation) | _____            | _____%             |
| TOTAL  | <u>1,000,000</u> | <u>100.00%</u>     |

- Value in invention creation, balanced by where company is in the process
- Dilution can be dramatic in future venture round, regardless of angel round “protections”

# Option Pool

## SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

| Post-Financing Ownership   | <u>Shares</u>    | <u>% Ownership</u> |
|--|------------------|--------------------|
| Founder:   | _____            | _____%             |
| Reserved for Option Pool:  | _____            | _____%             |
| New Angel Investors<br>(& = Total capital to be Raised<br>+ Pre-Money Valuation) | _____            | _____%             |
| TOTAL  | <u>1,000,000</u> | <u>100.00%</u>     |

- 15-20% probably customary
- Avoid front loading too much vesting

# A Note on Notes

- For angel rounds or in-between rounds, mandatory convertible notes can work very well
- Protect early investors, don't dissuade institutional funders
- Not discussed in-depth here, but used frequently

# Summary

- VCs are beginning to return
- Angels take cue from VCs – but invest for different reasons
- Keep terms as simple as possible

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# Securing Your Future: Understanding Intellectual Property Rights

Presented by:

**Peter M. Watt-Morse**  
Partner, Business Transactions

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# Introduction

- IP – A START-UP'S ESSENTIAL ASSET
  - Primary asset – limited capital, employees, reputation
  - Protect IP – prevent theft, obtain license revenues, David-Goliath negotiations
  - Defend IP – departing employees, cease and desist letters

# Importance of Intellectual Property

- UNIVERSITY INTELLECTUAL PROPERTY VS. COMMERCIAL INTELLECTUAL PROPERTY
  - Base patents vs. patent portfolios
  - Copyright protection – academic vs. commercial software
  - Limited trade secret and trademark protections

# Importance of Intellectual Property (cont'd)

- VITAL TO GROWTH OF COMPANY
  - Requirement for financing
  - Licensing revenues
  - Strategic partnerships – leverage
  - Independent value – not mere licensee

# Importance of Intellectual Property (cont'd)

- FOUNDER/EMPLOYEE INVOLVEMENT
  - Invention disclosures/prior art
  - Create/protect trade secrets
  - Don't just "leave it to the lawyers"
  - Data Rights Chapter – Encyclopedia of Software Engineering

# The Four Basic Rights

## 1. TRADE SECRET

- *Protecting against use of confidential information*

## 2. PATENT

- *Protection against use of inventions*

## 3. COPYRIGHT

- *Protection against copying of “writings”*

## 4. TRADEMARK

- *Protection against use of substantially similar names*

# Trade Secret

- DEFINITION

- *“Information that derives economic value from not being generally known that the owner takes reasonable steps to retain in secrecy.”*

- PROTECTION

- Breach of confidential relationship (employees)
- Breach of non-disclosure agreement (NDA)
- Unfair competition (burglary or espionage)

# Trade Secret (cont'd)

- Creation
  - Select trade secret (“Company Jewels”)
  - Confidentiality agreements
    - Corporate partners
    - Independent contractors
    - Employees
  - Documenting oral disclosures
- Restrictions on access
  - Physical
  - Electronic
- Copies
  - Restrictions
  - Cataloging
- Legends

## Trade Secret (cont'd)

- *“THIS DOCUMENT CONTAINS CONFIDENTIAL INFORMATION THAT IS OWNED BY ABC, INC. AND MAY NOT BE COPIED, DISCLOSED OR OTHERWISE USED WITHOUT THE EXPRESS WRITTEN CONSENT OF ABC, INC.”*

# Trade Secret (cont'd)

- PREVENTING INFRINGEMENT
  - Independent development – documentation
  - Retain legends and other notices
  - New employees – agreement/acknowledgement to prevent former employer disclosures
  - Clean room – isolating employees and computers

# Patent

## 1. DEFINITION

- *“Whoever invents or discovers any new and useful process, machine, manufacturer or composition of matter, or any new and useful improvement thereof, may obtain a patent thereof.”*
- Novelty (objective standard)
  - Bars for publication and public use or sale – (one year grace period)
  - First to invent (U.S. – others first to file)
  - Interaction with foreign filings (no grace period)

# Patent (cont'd)

- Non-obvious (subjective “invention” standard)
  - Prior art
  - Ordinary skills vs. spark of invention
- PROTECTION
  - Prevents unauthorized manufacture, use, or sales of patented inventions – prevents imports
  - Current term: 20 years from filing

# Patent (cont'd)

- CREATION
  - Generate idea and “reduce to practice”
    - Invention disclosure
  - Patentability review
    - Prior art
    - Usefulness
    - Disclosure issue
  - Patent drafting (inventor’s participation)
  - Enforcement (identify infringement)

# Patent (cont'd)

- INTERNATIONAL FILINGS
  - PCT
  - Japan / European Union
- PREVENTING INFRINGEMENT
  - Knowledge of prior art
  - “The best defense is a strong offense”

# Copyright

- DEFINITION

- *“Original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device.”*
- Includes:
  - Software (source or object)
  - Literary works (documentation)
  - Audiovisual works and sound recordings
  - Pictorial and graphic works

# Copyright (cont'd)

- PROTECTION
  - Author given sole right to:
    - Make copies
    - Distribute copies
    - Make derivative works
  - Narrow protection
    - Protects expression – not ideas
    - Substantial similarity

# Copyright (cont'd)

- CREATION
  - Automatic
  - Copyright notice
    - “© ABC , Inc., 2003, All Rights Reserved.”
  - Registration
    - Presumed valid, attorneys fees and statutory damages, transfers recorded, initiate litigation

# Copyright (cont'd)

- PREVENTING INFRINGEMENT
  - Independent development – documentation
  - Do not copy internet and bulletin boards
  - Segregate third party code and documentation (copy restrictions)
  - Clean room – isolating employees and computers

# Trademark

- IMPORTANCE
  - Lotus, Excel
- DEFINITION
  - Designation of origin
    - Quality/consumer information
    - Protection of goodwill
  - Types
    - Product or service
    - Company name
    - Domain name

# Trademark (cont'd)

- PROTECTION
  - Prevents use of marks that create “a likelihood of confusion” with original mark
  - Actual confusion
  - Competitive/related goods
  - Same channel of trade
- Federal and state protections
  - U.S. Lanham Act
  - State unfair competition laws
  - Common law

# Trademark (cont'd)

- CREATION

- Selecting mark

- Prior marks
    - Advantages
    - Strength of mark  
(arbitrary/descriptive)
    - Use – develop secondary meaning/value

- Registration

- U.S.
      - Legal protections
      - Practical protections
    - International – CTM

- Notice

- Prior marks
  - ™ vs. ®

# Trademark (cont'd)

- PREVENTING INFRINGEMENT
  - Use
    - Use of other trademarks – fair use
  - Use of new trademarks
    - Searching
    - Internet