The Low Down on Start-Ups

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A successful company always starts with a good idea. Development teams then take the idea and work on proposals for startup. After careful deliberation, the best start-up plan is put into action, and a successful business is born. This is, of course, a vast oversimplification of what really happens. Before any business gets to the start-up phase, the developers have to answer quite a few questions: When is the right time to form the company? What is the best choice of entity? Where should the entity be organized? How should the company be capitalized? Is an equity incentive plan a good idea for this particular business? Would there be any advantage in trying to get "angel" financing? And how should the company go about hiring its staff? This guide discusses some of the basic answers to these and the other questions that are critical to a successful start-up.

When to Form the Company

Business development teams are often somewhat fluid, and likely to change before the company is actually launched. There may even be some question about whether the company will be launched at all. As a result, the team members may not be ready to incur the costs of forming the company, and even if they were willing to do that, they might not be comfortable making decisions regarding equity allocation among the founders at such an early stage. While these are legitimate concerns, there are several good reasons to form the company as early as possible.

Holding Periods

The earlier the company is formed, the sooner the stock can be issued and the capital gains holding period begins to run. Upon a liquidity event, stock that has been held for one year or more will be taxed at the long-term capital gains rate, which is generally 20 per cent. Gains on stock held for less than one year are taxable at an individual's ordinary income tax rate, which can be significantly higher than the long-term capital gains tax rate.

Cheap Stock Issues

Founders of companies often make the mistake of waiting until they have received a strong indication of interest from an investor before they decide that it is time to incorporate. Forming a company so close in time to raising capital can create a significant tax issue. This issue may be summarized as follows. If founders issue themselves stock at the time of formation for one cent per share (for example), and then within a short period of time outside investors pay $1 or more per share (for example), it might appear upon an IRS audit that the founders issued themselves stock at significantly below the fair market value per share. The difference between what the founders paid for their stock and the fair market value of that stock based on the sale to outside investors may be characterized as compensation income, resulting in what could be significant tax liability to the founders. If, on the other hand, founders' stock is issued with some lead time before investor commitment, and certain significant milestones are achieved in the interim, this risk decreases substantially.

Ability To Contract

The founders may want to establish certain relationships with third parties that require contracts. As an example, there may be an independent contractor that is going to be developing some software code. For the company to own this code, it needs to enter into a work for hire agreement with the contractor. This obviously cannot be done until the company is formed. Non-disclosure agreements, or NDAs, raise a similar issue. Founders are often in contact with potential strategic partners, advisors, employees, and others at the very earliest stages. Although the individual

founders could, and often do, enter into these types of agreements with third parties before the formation of the company, this arrangement is not ideal and raises issues regarding enforceability and personal liability for the founders.

Limited Liability
Perhaps the most fundamental benefit of incorporating is the protection of the corporate shield. Individual stockholders are generally not liable for the liabilities of the company in which they hold stock. Until a company is formed, the individuals are acting in their personal capacity, and may be personally liable. To enjoy the benefit of the corporate shield, certain corporate formalities must be adhered to, including the maintenance of separate corporate records and accounts, the holding of annual meetings of the stockholders and directors, and the execution of documents in the name of the company.

Choice of Entity

One of the initial decisions founders must make is the form of entity to use for their new company. On the whole, C corporations tend to be the entity of choice for most startups that plan to raise money from the venture capital ("VC") community.

C Corporation
For a company that is going the traditional VC route, it may make the most sense to simply form the company as a C corporation because C corporations are generally preferred by VCs. In addition, by forming the business as a C corporation, the founders position themselves best to take advantage of Internal Revenue Code ("Code") section 1202, which permits the exclusion of up to 50 percent of the gain on sales of stock in certain types of C corporations held for more than five years.

Limited Liability Company
If the founders or investors want to be able to deduct early losses from the business on their personal tax returns, however, they might be tempted to organize the business as an S corporation or limited liability company ("LLC"). S corporations have very strict limitations on who can be stockholders (for example, non-resident aliens, corporations, and partnerships cannot own stock in S corporations). Perhaps more significantly, stock issued while the corporation was an S corporation can not qualify for the favorable treatment of Code section 1202. Thus, if the founders or investors want to be able to deduct early losses from the business and preserve their ability to take advantage of Code section 1202, they may be better off forming the business as an LLC and then converting it to a C corporation at the time of the VC investment. Of course, certain Code provisions may limit the founders' and investors' abilities to use their shares of the company's losses anyway. In addition, LLCs can be cumbersome when it comes to awarding equity participations to employees and consultants.

State Of Incorporation

There are basically two states of incorporation that startups based in Massachusetts consider — Massachusetts and Delaware. Although some founders feel a connection to Massachusetts, and will incorporate in Massachusetts for that reason, incorporating in Delaware is the more common practice, for two primary reasons: maturity of Delaware corporate law, and relative ease of taking stockholder actions.

Maturity of Delaware Corporate Law
First, VCs tend to be comfortable with Delaware corporations, regardless of where the venture capital is based. This is because the corporate law of the State of Delaware is generally considered to be the most sophisticated, comprehensive, and well defined. For this reason, many Fortune 500 companies are incorporated in Delaware, even though their primary office location is in another state. Since VCs serve on the board of directors of their portfolio companies, they generally prefer Delaware because the laws regarding fiduciary duties and other matters involving directors are well understood and delineated.

Stockholder Actions
The second benefit to incorporating in Delaware, as opposed to Massachusetts, has to do with the legal mechanics of stockholder actions. In both Delaware and Massachusetts, stockholder action can be taken either at a meeting at which a quorum of the stockholders vote in person or by proxy, or by circulating what is called a written consent that is signed by the stockholders. It is generally preferable to take actions by written consent if possible because stockholders' meetings typically require prior written notice of at least seven days. The Delaware laws generally authorize action by consent with a simple majority of the stockholders' signatures. However, in Massachusetts consents can only be accomplished with the signatures of all of the stockholders. As a result, it is often much easier to obtain stockholder approval if the company is based in Delaware. In fact, Massachusetts companies often later reincorporate in Delaware for precisely this reason.

Founders' Equity

The subject of founder's equity is one of the more involved aspects of organizing a start-up. Matters to consider include capitalization at time of formation, division of shares among founders, stock restriction agreements, the dilutive effect of the employee stock pool required by the VCs, and equity budgeting.

Basic Definitions
Basic definitions for understanding the choices facing the founders include the following:

- Authorized stock is the total number of shares of capital stock, whether common or preferred, that the company is authorized to issue at any given time;

- Issued and outstanding stock is the total number of shares of capital stock that have actually been issued pursuant to financings, stock options or otherwise, and that are still owned based on the corporate records of the company at any time;

- Issued and outstanding common stock on an as-converted basis is the total number of shares of common stock that are issued and outstanding at any time, plus that total number of shares of common stock that the issued and outstanding preferred stock (and other convertible securities) would convert into at that point in time were it to convert;

- Issued and outstanding common stock on an as-converted, fully diluted basis is the total number of shares of issued and outstanding common stock on an as-converted basis, plus the total additional number of shares that would be issued and outstanding if all options and warrants were exercised.

Capitalization at Time of Formation
The total number of authorized shares, and the total number of issued and outstanding shares, at the time of formation of the company is largely arbitrary; and in the end not of high importance. What really matters is the relative allocation of the equity among the founders. The numbers of shares authorized and outstanding can, and often are, adjusted upward through stock splits. Notwithstanding this, there are a couple of guiding factors.

Ability To Make Awards of Large Blocks of Shares
Prospective hires often focus more on the total number of shares awarded to them (either outright as restricted stock or by the grant to them of options to purchase the shares) rather than the percentage of the company that such shares represent. As a result, the company should consider putting in place an equity incentive plan that has a significant number of shares, often between one million and two million shares. At the high end of the range, this will allow the company to make awards in the market range in terms of both percentage and raw numbers (i.e. two percent to three percent for a VP of Business Development, at 50,000 to 70,000 shares). In addition, this allows the company to establish a low issuance (in the case of restricted stock) or exercise (in the case of options) price.

Venture Capital Ranges
VCs often have an opinion about what number of shares of common stock should be issued and outstanding at the time of their investment. They usually run numbers based on an assumed purchase price in the range of $1 per share for a first or "Series A" round. Some VCs are more concerned about the initial purchase price than others, and will dictate what the capital structure of the company will look like before funding. For the sake of discussion, if we assume that a VC firm is going to put $5 million into a company with a pre-money valuation of $5 million in exchange for 50 percent of the stock of the company, and require that 20 percent of the stock be allocated to an employee pool, the founders would need to own three million shares in aggregate for the purchase price in the Series A round to be $1.

Division of Shares Among Founders
The issuance of stock among the founding group is for the founders to determine, and is typically based on relative contributions to the formation of the company, including:

- The conception of the business idea;
- Leadership in promoting the idea;
- Assumption of risk to launch the company;
- Sweat equity;
- Writing the business plan; and
- The development of any underlying technology.

In addition to pre-formation contributions, the potential for future success in commercializing the business idea may also be a factor, including the background and experience that each person brings to the task.

Founder Status
There is much confusion over what makes someone a founder, and whether it has any legal significance. "Founder" is really nothing more than a designation that the original promoters of an idea bestow on one another to identify to the outside world who is credited with getting the company off the ground. A key hire may come in well after the company has been formed, and in the end be described as a founder. The expression has no legal significance per se. However, VCs do distinguish founders from other employees for certain reasons. For example, VCs often require the founders to make certain representations and warranties individually at the time of the first round of investment. In addition, VCs might want to impose certain vesting restrictions on the stock of founders, but might not be so concerned with the other employees on the theory that the founders really constitute the brain trust. (Nonetheless, late hires, especially late executive management hires, are often treated like founders by VCs for such purposes).

Allocations Based on Relative Contributions
If three people jointly conceive of an idea that is based on a business model rather than a technology, it would not be surprising for them to split the company evenly at formation. However, if one person conceived of the idea, wrote the business plan, and assembled the team, a 50-25-25 percent split might be more appropriate. In addition, it is often the case that when the business plan is based on a proprietary technology, the developer of the technology receives a significantly higher percentage of the company. However, if the technologist is fortunate to attract as a co-founder a CEO with established industry credentials and connections, the business experience of this person might level the playing field and suggest a more equal split of founders' equity.

Importance of Team Cohesiveness
If you are the lead promoter of an idea, and are faced with making the initial proposal regarding the division of equity, keep in mind that nibbling around the edges of a prospective cofounders' equity position may not inspire the level of trust and cohesiveness so essential among the members of a founding team. The objective is to reach an allocation that is perceived to be fair and that leaves all of the founders feeling properly motivated to do what is necessary to make the business a success.

Stock Restriction Agreements
To ensure that stock issued to founders is properly "earned" by each founding stockholder, it is advisable for each founder to sign a stock restriction agreement. The primary purpose of this agreement is to give the company a right to purchase shares held by a founder in the event that the founder leaves the company for any reason. This purchase option generally applies only to shares that are unvested at any given point in time, with shares becoming vested over a predetermined, usually time-based, schedule.

Tax Consequences of Stock Restriction Agreements
Stock restriction agreements can have significant tax consequences. The founder must make an election under Code section 83(b) within 30 days after receiving shares subject to the restriction agreement. If not, the founder is subject to tax as the shares vest on the amount by which the value of the vested shares at the time they vest exceeds the amount paid by the founder for the vested shares. If the founder makes a section 83(b) election upon receiving the shares, he is taxed upon receiving the shares on the amount by which the value of the shares at the time of receipt exceeds the amount paid for the shares. If it is expected that the founder's shares will appreciate significantly in value, therefore, it may be a good idea to make a section 83(b) election.

Basic Elements Regarding Vesting
There are five essential elements to address in a stock restriction agreement regarding vesting:

- Duration of vesting schedule;
- Up-front vesting;
- Cliff vesting;
- Acceleration upon termination; and
- Acceleration upon change of control.

VCs have established certain acceptable ranges for these elements, and they serve as the best guide for determining what vesting should be self-imposed by the founders. By self-imposing restrictions before VC funding, the VCs might satisfy themselves that what is in place is acceptable, and as a result, the founders may end up with slightly more favorable terms than they otherwise would receive. The following are some ranges for these elements, which tend to change from time to time due to the labor market and can vary by industry.

Vesting Period
Founders stock generally vests over three to five years. You rarely see five-year vesting requirements any more. Founders with significant bargaining leverage may be able to get a three-year vesting schedule. Four-year vesting seems to be the most common.

Up-Front Vesting
It is fairly common in VC transactions for founders to have some percentage of their stock vested up front. VCs will often agree to this if there has been a significant amount of effort put into the company before funding. The range of up-front vesting typically falls between 10 percent and 25 percent.

Cliff Vesting
Vesting is said to be on a "cliff" basis when a certain minimum period of time must elapse before any additional shares of stock vest. Six and 12-month cliff vesting is fairly common, with the current trend toward the shorter end of that range.

Termination
Any number of circumstances could lead to the termination of a founder's employment. VCs often take the position that the equity must be earned, and that if the founder leaves for any or no reason, no additional stock vests. There are four basic circumstances in which a founder might leave the company:

- Resignation (for no reason and for good reason);
- Termination (for cause and without cause);
- Death; and
- Disability.

In the event the employee resigns voluntarily or is terminated for cause, no additional stock vests. However, an argument can be made that if the founder is terminated without cause, or

resigns for good reason (in other words, is "forced out"), there should be some compensation to the founder; both out of fairness and as a means of keeping the board of directors honest. While VCs resist any acceleration under these circumstances, occasionally founders are able to negotiate for partial or even full acceleration, with an additional six to 12 month's acceleration being the most common. In the event of a founder's death or disability, six-month acceleration is fairly common, presumably as a good will gesture in a time of hardship.

Change of Control
VCs will generally permit either an additional one-year vesting or 50 percent vesting upon a change of control. A founder can make certain assumptions about when the change of control for the company would be most likely to occur, and determine which of these two options appears preferable. For example, if the vesting duration is three years, and the founders anticipate a sale of the business after the first year, the founder would be better off with one-year acceleration, as it would always result in more acceleration than 50 percent after the first year. Occasionally founders are able to obtain full acceleration upon change of control, and it is not always an unreasonable starting point for negotiation. After all, if the company is sold, the founders who are still with the company likely made significant contributions to put the company in a position to be bought. VCs, however, are very reluctant to allow for full acceleration upon change of control. Their primary argument is that the value of the company diminishes if the founders stock vests fully upon change of control because the founders have less incentive to work for the acquirer after the acquisition. If the VCs do not permit for full acceleration, an alternative is to request that they agree to provide for full acceleration if the founder is let go or resigns for good reason within one year following a change of control. This is sometimes called "double trigger" acceleration. However, this compromise position is only appropriate when the change of control calls for the founders to receive "replacement" equity. The double trigger concept does not make sense in a cash-out merger.

Dilutive Impact of Employee Pool Required by VCs
Every VC term sheet includes a requirement that the company put in place an equity incentive plan equal to between 15 percent and 25 percent (sometimes higher) of the common stock of the company on an as converted, fully diluted basis, including for this purpose the entire employee pool even though no awards may have been made at the time of the closing of the venture investment. The more key hires the VCs perceive will be necessary to fill out the executive management team, the higher will be the proposed employee pool. Very few first-time founders understand the important implication that this percentage has for their equity stake in the company. A brief description of the pricing of equity in VC deals illustrates the point.

Pre-Money Valuation
VCs place a pre-money valuation on the company, which is the negotiated value of the company before putting their money in. For sake of discussion, let's assume that this number is $5 million. The VCs then specify how much they are willing to invest, which number, when added to the pre-money valuation, yields the post-money valuation.

Let's assume that the amount of the investment is $5 million, yielding a post-money valuation of $10 million. For this $5 million, the VCs will demand 50 percent of the company, on an as-converted, fully diluted basis, including for this purpose the entire employee pool specified in the term sheet. Let's assume that the term sheet requires an employee pool of 20 percent. Assume further a $1 price per share for the VCs' 50 percent of the company, for a total of 5 million shares. For these 5 million shares to equal 50 percent of the company on an as-converted, fully diluted basis, including for this purpose the employee pool, the founders must own 3 million shares immediately before the closing, and the employee pool must have 2 million shares reserved for issuance. Immediately after the closing of the financing, the capitalization will be as follows:

- VCs own 5 million shares of preferred stock (convertible one-to-one into common stock);
- Founders own 3 million shares of common stock; and
- There are 2 million shares of common stock reserved for issuance under the equity incentive plan.

The point of the illustration is to show that the shares that fund the employee pool come directly out of the founders' ownership, and the VCs are not diluted at all by issuance from the pool. In this example, the founders are diluted 50 percent after the first round, assuming that all of the shares in the employee pool are put to use, and even more if not all of the shares are put to use.

Recent Increases in Employee Pool Sizes
There seems to be a trend to increase in the size of the employee pool required by the VCs. This is in part a result of upward pressure on the amount of shares available for issuance from the pool resulting from the labor shortage in the startup community.

Another explanation might be that the VCs are trying to reduce the net effect of escalating pre-money valuations by requiring larger employee pools. The dilutive effect of the employee pool as described in the previous paragraph is, after all, less well understood than the

relatively simple notion of pre-money valuation. The size of the employee pool is very much a pricing term, and should be thought about as such.

Effective Valuation Assigned to Founders Stock

One useful tool for sorting all of this out in the context of reviewing a VC term sheet is the calculation of the effective pre-money valuation being assigned to the founders' shares. Using the numbers in the example above, the effective pre-money valuation assigned to the founders' shares is $3 million, determined by subtracting from the pre-money valuation the per share price paid for the preferred multiplied by the number of shares required for the employee pool. This calculation can be very useful in comparing two VC offers, when one is at a higher valuation than the other, but requires a larger employee pool.

For example, a pre-money valuation of $5,500,000 on its face sounds better than $5 million. However, if the employee pool requirement for the $5,500,000 valuation is 25 percent, the effective pre-money valuation is $2,875,000 ($5 million - ($1 X (.25 X 10,500,000)). While this calculation may be useful for drawing comparisons, founders should not place too much of an emphasis on it. It is always of prime importance to consider the other things that a VC can bring to the company, and a perceived preoccupation with valuation and ownership tends to drive VCs off.

Equity Budgeting

Many companies find it useful to put together a spreadsheet that, based on certain assumptions, projects out the founders' stock ownership in the company through several rounds of financing. Such a budget can be a helpful tool for thinking about the dilutive effect that financings will have on the founders' equity stakes. Statistics show that founders as a group have done well if they retain between 15 and 20 percent of the company at IPO. This statistic suggests that founders should expect 80 percent dilution at minimum before going public. The first round of financing itself often results in 50 percent or more dilution when the employee pool is factored in.

Equity Incentive Plans

There are two basic types of equity incentives used by start-up companies—stock options and restricted stock. Stock options come in two forms—incentive stock options and non-qualified stock options. These basic forms of incentives differ primarily in the tax consequences to the recipient.

Stock Options Generally

A stock option is a contract between the company and the recipient that gives the recipient, usually an employee, the right to purchase a certain number of shares of common stock at an exercise price per share specified in the option grant agreement. This right to "exercise" the option applies only to that portion of the stock subject to the option that has vested, and the underlying stock typically vests over a period of time—three or four years, usually in equal monthly or quarterly installments, although often there is an initial "cliff" of six months to one year.

Incentive Stock Options

Incentive stock options ("ISOs") are a common type of equity currency used by start-up companies. Only employees are eligible to receive ISOs. ISOs must, among other things, have an exercise price at least equal to the fair market value of the stock at the time of grant (or 110 percent of the fair market value if the grantee is a 10 percent owner). In addition, the value of shares (as of the date of grant) for which an ISO may first become exercisable in any year may not exceed $100,000. The advantage to an ISO is that the employee is not taxed until he sells the shares acquired upon exercising the option. Upon sale, if the requisite holding periods have been met, the amount by which the sale price of the shares exceeds the exercise price of the ISO is taxed as a long-term capital gain. This is, however, subject to two caveats:

> The first caveat is that the exercise of an ISO can have an alternative minimum tax (or "AMT") consequence (A discussion of this is beyond the scope of this article);
>
> The second caveat is that the employee must hold the stock received upon exercising the ISO for at least a year after exercising (and until the date that is at least two years after being granted the ISO). A disposition that is made before the required holding periods have expired is referred to as a "disqualifying disposition." A disqualifying disposition generally results in ordinary income to the employee at the time of the disposition. Disqualifying dispositions are very common upon liquidity events for emerging technology companies.

Non-qualified Stock Options

Non-qualified Stock Options (or "non-quals") are often used when ISOs are unavailable, such as when the grantee is not an employee. The grantee of a non-qual recognizes ordinary income upon exercising the non-qual in the amount by which the value of the shares received upon exercise (measured at the time of exercise) exceeds the exercise price of the non-qual. The grantee then takes a fair market value basis in the stock, and his holding period for tax purposes begins, upon exercising the non-qual.

Restricted Stock

Restricted stock, as already explained in concept above, is stock that is held outright, but subject to the company's op-

tion to buy back unvested stock at the time the employee leaves the company. Restricted stock is desirable to the recipient because, if the recipient makes an election under Code section 83(b) upon receiving the stock, any appreciation in the value of the stock after receipt is taxable at long-term capital gain rates when the stock is sold if the recipient has held the stock for more than one year. Thus, the tax issues generally associated with options are avoided. Restricted stock also entitles the holder to voting rights, a benefit that may make a key employee feel more involved in the ownership of the company.

Equity Incentive Ranges

Companies often ask us to comment on what percentage ownership interest would be appropriate for an executive hire. Although there are ranges that can be helpful as points of reference, the amount of equity that a person can command as a condition of employment is a very fact-specific question. The answer depends in part on how much risk the prospective employee is being asked to take, and what the individual's background is. In determining the level of risk, relevant considerations include whether:

- The company has been venture funded;
- The prospective employee is being asked to forgo salary in exchange for equity;
- The company is far along in validating its product, service, or technology (i.e. are there any customers or partners lined up); and
- The management team is largely in place.

As is always the case in a hiring situation, the individual's credentials, and the resultant supply and demand forces for such individual's services, are major factors. In addition, the nature of the company and its hiring needs weigh heavily into the equation, as a technology company may pay more in equity for a technology officer than a marketing person, whereas a consumer product business idea may be the other way around. Finally, the size of the opportunity is also relevant, as the greater the potential for the company, the less the company may have to pay the individual in equity.

Although these and other factors make it difficult to generalize about equity participation levels, there are certain ranges that are recognized as "market":

- CEO—six to 10 percent;
- VP Technology—two to six percent;
- VP Marketing—one to three percent;
- VP Business Development—one to three percent; and
- VP Finance and Operations one-half of one percent to two percent.

These numbers are determined as of the closing of the first VC round, and are not subject to dilution by the grant of options out of the employee pool. For example, if there is a 20 percent employee pool, a CTO receiving five percent would be granted options or receive restricted stock for 25 percent of the shares in the employee pool. If offers are being extended to prospective hires before VC funding but after the founders' interests are established, the company might offer one of these key persons an amount which, after the first round, would bring the person into the appropriate range. For example, the VP of Business Development might be offered six percent before the first round, which would result in three percent after first round, assuming a 50 percent dilution.

Angel Financings

As a company gets into initial fundraising efforts, it may find that it either needs to or prefers to raise money from "angel" investors rather than through traditional venture capital firms. An angel is generally a wealthy individual who invests in his or her individual capacity. Recently, groups of angels have gotten together and formed alliances. Examples of these are the Band of Angels in Silicon Valley, and the Common Angels and the Walnut Group in the Boston area. By aligning, angels are able to pool their resources for purposes of screening suitable investments. These alliances can also benefit the company seeking to raise money, because once one angel in one of these groups has decided to invest, others may be more inclined to follow.

One potentially significant downside of working with a group of angels is that because they pool their collective knowledge base, they tend to be more sophisticated than individual angels. This can result in terms that are more demanding on the company than might otherwise result.

Type of Security Sold

Angels will typically be expecting one of two types of securities in exchange for their money—preferred stock or debt convertible into preferred stock. Preferred stock gives the holder certain preferences and privileges relative to the holders of common stock.

Preferred Stock

Preferred stock was the standard vehicle until it was supplanted by convertible notes as the instrument of choice over the last several years. The preferences associated with preferred stock purchased by angels are, these days with a more sophisticated angel investor base, essentially the same that VCs would obtain.

Liquidation Preference
Most fundamental to preferred stock is what is called a liquidation preference. A liquidation preference gives the holder of the stock the right to receive its original investment back upon liquidation or dissolution of the company before any distributions to holders of common stock. Once the preferred stockholders have gotten their original investment back, the common stockholders typically get whatever is remaining. The liquidation preference typically includes declared or accrued but unpaid dividends. In today's financing climate, the liquidation preference is often a multiple (two or three times) of the original investment.

Dividend
Some preferred stock may also have a dividend associated with it, which is usually a fixed annual percentage return on the original purchase price—much the way interest works on a loan. This dividend may be:

- Cumulative (which means that if it is not paid in one year, it will continue to build until it is eventually paid); or
- Non-cumulative (which means the dividend does not carry over from one year to the next if not declared by the company);
- Automatic (which means that the company must declare it every year or at some other predetermined time such as on or before a sale of the company); or
- Discretionary (which means the dividend is payable only if and when declared by the company's board of directors); and
- Be subject to capitalizing (which means any unpaid amount gets added to the total original purchase price against which the dividend rate is applied) or not.

In the event of a liquidation or dissolution, preferred stockholders are generally entitled to receive any dividends they are owed before the common stockholders would be entitled to anything.

Conversion and Anti-Dilution Protection
Preferred stock is typically convertible into common stock. Usually the conversion ratio at the time the preferred stock is issued is one-to-one – that is the preferred stockholder may convert each share of preferred stock into one share of common stock at any time. The preferred stockholder typically has protection that results in an increase in the conversion ratio in the event that the company sells any of its stock at below the price paid for it by the preferred stockholder – so-called anti-dilution protection.

Conversion Price
The "conversion price" is a key concept for understanding the mechanics of anti-dilution protection. Upon issuance, preferred stock typically converts into a number of shares equal to the original purchase price per share of the preferred stock divided by the conversion price. Before any adjustment, the conversion price usually equals the purchase price, and therefore the original conversion rate is one share for one share. The conversion price, and as a result the number of shares into which each preferred stock may be converted, changes when the stock is sold at a price below the price per share paid by the preferred stockholder and an antidilution adjustment results. The calculation of the "new conversion price" depends on the nature of the anti-dilution protection.

Full Ratchet
The most favorable kind of anti-dilution protection for a preferred stockholder is called "full ratchet" protection. In full ratchet protection, the "conversion price" equals the most recent price per share of common stock sold by the company. To take a simple example, assume there were 300 shares of common stock held by the founders on January 1, 2001. Assume also that the company sold 100 shares of preferred stock to investors at $1 per share on that date, convertible one-to-one into 100 shares of common stock, or 25 percent of all common stock. Then assume that 100 shares of common stock were subsequently sold at 50 cents per share. The new conversion ratio would be $1 divided by fifty cents, or two, and the preferred stock would then be convertible into 200 shares of common stock, which on an as converted basis would equal 33 percent of all common stock.

Typically full ratchet anti-dilution protection is applied without regard to how many shares of stock are subsequently sold at the lower price. In the above example, if just one share of common stock were sold at 50 cents, the result would have been much more favorable to the preferred stockholder, who would still have the benefit of the two-to-one conversion ratio. With that ratio, the preferred stockholder would then own stock convertible into 200 out of a total of 501 shares of common stock, or nearly 40 percent of the common stock!

Weighted Average
A type of anti-dilution protection more favorable to the company is called "weighted average" protection. Weighted average protection gives effect to the dilutive effect that the subsequent issuance has, and typically results in a much less dramatic change in the conversion ratio. To take a simple example, assume there were 300 shares of common stock held by the founders on January 1, 2001. Also assume that the company sold 100 shares of preferred stock to investors at $1 per share on that date, convertible one-to-one into 100 shares of common stock, or 25 percent of all common stock. Then assume that 100 shares of common stock were subsequently sold at 50 cents per share. The new conversion ratio would be $1

÷ ((300 + 100) ÷ (300 + 200)), or 1.2, and the preferred stock would then be convertible into 120 shares of common stock, which on an as converted basis would equal 24 percent of all common stock.

Conversion vs. Liquidation Preference
Often times preferred stockholders have one of two options upon the sale of the company in the form of an asset sale or a stock merger. The preferred stockholder may opt either to:

Treat such sale or merger as a liquidation, and get the liquidation preference back before the distribution of the proceeds to any of the common stockholders; or
Convert to common stock before the sale and be entitled to receive what the other stockholders are getting.

A preferred stockholder has to decide which of these two options makes the most economic sense. Under an alternative method of calculating the liquidation preference, a preferred stockholder will be entitled to both the liquidation preference and the consideration that common stockholders are entitled to. This is sometimes referred to as "participating preferred", and more disparagingly as the "double dip."

Issues Associated with Preferred Stock
Although preferred stock is a widely accepted security for early stage financings, relative to convertible notes, it has certain shortcomings.

Fixing Fair Market Value
Issuing preferred stock to angel investors requires the company and the prospective investors to establish a pre-money valuation of the company without the benefit of someone in the business of determining such valuations (such as a VC). The company and the angel investors might not be entirely comfortable placing a valuation on the company at this stage. They might fear that the valuation will turn out to be substantially different (even after taking into account the development of the company between the two rounds of financing) than that established in the next, VC round of financing.

Blocking Rights
Once a series of preferred stock has been issued, the company would typically need the consent of the holders of the preferred to approve future issuances of preferred stock, including the issuance of stock to VCs. This can occasionally result in problems with the angels, who might, for example, disagree with the valuation being offered to the VCs.

VC Concerns
Founders often ask whether having angels that hold preferred stock will somehow make it difficult to raise VC funding. There are two potential causes of this concern. The first is that angels typically have pre-emptive rights but often do not participate in the next round alongside VCs because:

- The bump-up in value is significant enough to make further investment impractical from an economic perspective;
- The next round is large enough that it has become too "rich" for angels, who frequently invest $100,000 or less;
- The next round is a so-called down round, meaning that the value of preferred stock has gone down as a result of slower-than-expected progress in executing the company's business plan.

The second potential cause of this concern is that angels can complicate votes and other decisions that are made by preferred stockholders as a class. Feedback received from the VC community does not support these concerns, provided that the VCs will own a significant majority of the preferred stock post-financing, and the angels do not have any preferential or blocking rights (a fact VCs will make certain of before investing). VCs may hesitate to invest in a company where there is known to be one or more difficult stockholders on the basis that "life is too short," but as long as a company is working with either passive or value-added angel investors, this should not be a problem.

Convertible Debt
Instead of issuing preferred stock to angels, early stage companies may issue notes that convert into whatever the company issues in the future, presumably to VCs, but at a discount. The single most attractive benefit of this is that the valuation of the company can be deferred until the VCs, who are generally professional investors, make their investment. The tax consequences of an issuance of convertible debt may be more complicated than those associated with preferred stock financings, and should be considered carefully by the company and the investors. The basic terms of a convertible note offering are discussed below.

Promissory Note
The security sold in a convertible debt offering is a promissory note that automatically converts into preferred stock at some future time. The intent of the company and investors is that the preferred stock into which the note will convert will be whatever is negotiated between the company and the VCs in the first venture financing —typically Series A Preferred Stock. The debt typically converts at some discount—usually in the 15 percent to 30 percent range from the price paid by the VC investors. Companies occasionally try to come up with complicated discount matrices in which the discount may vary as a function of:

The VC valuation. (The higher the valuation, the steeper the discount in

order to align the interests of the note holder and the company); and
The duration that elapses between the time of the sale of the convertible note and the closing of the VC round. (The longer the duration, the steeper the discount, on the theory that the venture must have been riskier at such an early stage).

These complicated structures are something to avoid. They are very difficult to explain and they confuse investors. Convertible debt financings seem to work best when they are kept clean and simple.

Default Preferred
In the event that there is no subsequent VC financing within a certain period of time, the notes convert (usually automatically, but sometimes at the option of either the company or the investors) into a pre-defined class of preferred stock, at a pre-determined pre-money valuation. This type of default conversion allows the company to remove the debt from its books.

Hiring Basics

Once the issues of formation and capitalization have been addressed, the founders can begin to think about filling personnel positions.

Offer Letters
Offers of employment are typically extended to new hires using simple offer letters. These simply serve to outline the key terms of the offer, including the position of employment, the base pay, the options package and benefits. They also attach a form of employee agreement that each new hire must sign as a condition precedent to becoming an employee.

Employee Agreement
An employee agreement is for the benefit of the company, not the employee. It has four basic provisions:

- A confidentiality agreement whereby the employee agrees not to disclose or misappropriate the confidential information of the company during or after the period of employment;
- An assignment of rights provision, whereby the employee assigns any and all rights in any work product resulting from or related to the employee's services, to the company;
- A non-solicitation provision whereby the employee agrees not to solicit the employees or customers of the company for a period of time (usually one year) after the termination of employment; and
- A non-compete provision whereby the employee agrees not to compete with the company for a period of time (again, usually one year) after the termination of the employee's employment.

The company should require prospective hires to sign this agreement before they begin employment with the company; otherwise it may be difficult to enforce. In addition, in certain companies, it may be best to remove the non-compete provision for lower level employees who will not be privy to proprietary information.

This agreement is not to be confused with an employment agreement, which provides protection for the employee, including severance, acceleration of vesting upon termination, and other similar provisions. Employment agreements are typically reserved for very senior management people who have significant negotiation leverage coming into the company.

Personnel Resource Issues
With hiring comes a range of human resource issues, including payroll administration, health insurance, 401k plans, and other benefits. Many start-up companies outsource these functions. The service providers for these functions, through the aggregation of client employee bases, say they are able to buy benefits at group discounts. This seems to be a very valuable service, and one that a lot of our clients use.

Conclusion

Although a company will never succeed without a strong business vision, the return that founders ultimately realize on their investment in building the company depends in part on certain key decisions that are made in the earliest days of the company, some of which may seem mechanical and inconsequential at the time. From timing the formation of the company, through the complex choices of capitalization, to the common-sense aspects of hiring personnel, the practical choices made at the beginning can be the most important. For the founders, and their advisors, there is good news: These things can be planned and controlled at the beginning. And the right choices can help to steer the business toward future success.

Appendices

A. *Choosing the Proper Form of Entity for a New Business Venture*
B. *Tax Considerations in Buying or Selling a Company*

If you would like to discuss any aspect of this process, please email Jonathan Gworek at *jgworek@mbbp.com.*