

# CRITICAL LEGAL ISSUES FOR EARLY STAGE COMPANIES

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# Overview



- Pre-Formation Issues
- Stockholders' Agreement / Vesting
- Capitalization
- Incentivizing Employees
- Final Thoughts/Pitfalls

# Key Pre-Formation Issues

- **Why start a business?**
  - Control?
  - Growth?
  - Revenue?
- Structure of Entity?
- Who are the owners?
- What are the founders' responsibilities?

# Entity Types

- C-Corporation

- Common structure, with well defined governance regulations
- Not very flexible
- Tax disadvantages

- Limited Liability Company

- “Pass-through” entity for tax purposes
- Difficult to provide equity incentives
- Not favored by investors

- S-Corporation

- “Pass-through” entity
- Particular requirements must be met

# Where to Incorporate

- Why does everyone love Delaware so much?
- What's wrong with Massachusetts?
- Is Nevada the new Delaware?

# Stockholders Agreement

- Goal: Keep shares in the hands of those continuing to add value
  - Vesting relating to term of service (83b's)
  - Right of first refusal
  - Restrictions on the transfer of stock
  - Voting for specified directors
  - Process for breaking deadlocks

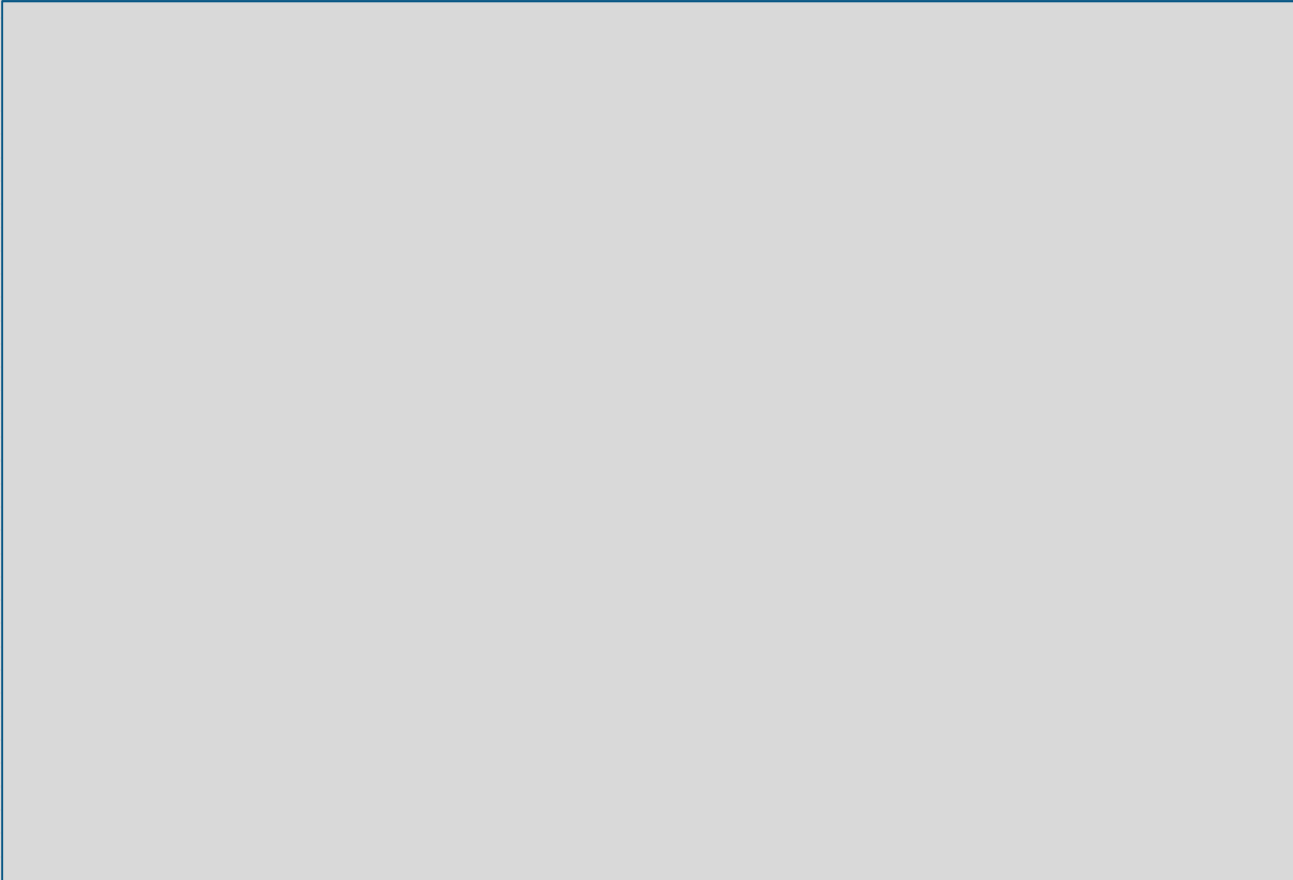


# Capitalization

- Equity / Cap Table
  - Need to get this right up front, and keep meticulous records going forward.
  - Construct a pro-forma capitalization, showing how the stock is to be allocated among founders, employees, expected investors, etc.
- Who is investing? How much? Type of investment (cash, services, property)?
- Think in terms of “shares” not percentages

# Start-Up - At Formation

Holder	Original Issue Shares	Percent of Total
<b>Founders</b>		
Founder 1	755,760	48.0%
Founder 2	535,330	34.0%
Founder 3	283,410	18.0%
<b>Consultants</b>		
Tech Consultant		
Investor Consultant		
Management Consultant		
<b>Investors</b>		
F&F1		
F&F2		
<b>Note Holder 1</b>		
Note Holder 2		
Noteholder 3		
Noteholder 4		
<b>Option Holders</b>		
OptionHolder 1		
OptionHolder 2		
OptionHolder 3		
OptionHolder 4		
Expanded Option Pool		
<b>Series A Investors</b>		
<b>Total</b>	<b>1,574,500</b>	<b>100.0%</b>
Price per share	0.001	
Company valuation	par	



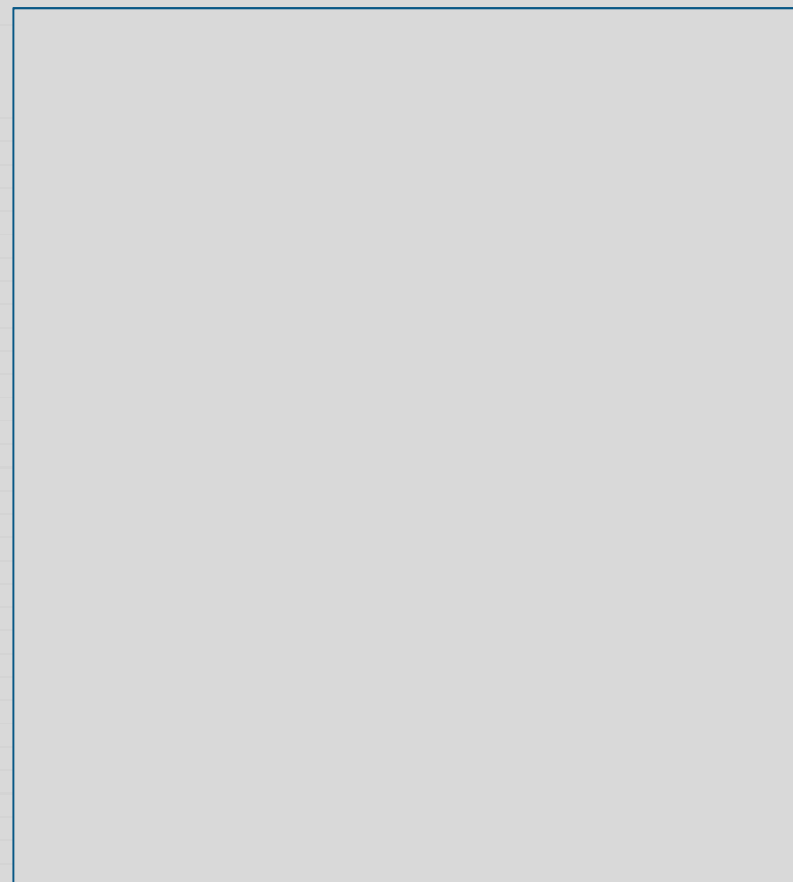


# Start-Up - Product Development

Holder	Original Issue Shares	Percent of Total	Developer/Investor Issuances	Total	Percent of Total
<b>Founders</b>					
Founder 1	755,760	48.0%		755,760	41.12%
Founder 2	535,330	34.0%		535,330	29.13%
Founder 3	283,410	18.0%		283,410	15.42%
<b>Consultants</b>					
Tech Consultant			85,790	85,790	4.67%
Investor Consultant			41,186	41,186	2.24%
Management Consultant			7,500	7,500	0.41%
<b>Investors</b>					
F&F1			15,250	15,250	0.83%
F&F2			113,700	113,700	6.19%
<b>Note Holder 1</b>					
<b>Note Holder 2</b>					
<b>Noteholder 3</b>					
<b>Noteholder 4</b>					
<b>Option Holders</b>					
<b>OptionHolder 1</b>					
<b>OptionHolder 2</b>					
<b>OptionHolder 3</b>					
<b>OptionHolder 4</b>					
<b>Expanded Option Pool</b>					
<b>Series A Investors</b>					
<b>Total</b>	<b>1,574,500</b>	<b>100.0%</b>		<b>1,837,926</b>	<b>100.00%</b>
Price per share	0.001		0.5588964		
Company valuation	par		\$1,000,000		

# Start-Up - Initial Fund Raising

Holder	Original Issue Shares	Percent of Total	Developer/Investor Issuances	Total	Percent of Total	Notes Issued	Conversion
<b>Founders</b>							
Founder 1	755,760	48.0%		755,760	41.12%		
Founder 2	535,330	34.0%		535,330	29.13%		
Founder 3	283,410	18.0%		283,410	15.42%		
<b>Consultants</b>							
Tech Consultant			85,790	85,790	4.67%	\$ 25,000	18,379
Investor Consultant			41,186	41,186	2.24%	\$ 50,000	15,316
Management Consultant			7,500	7,500	0.41%		
<b>Investors</b>							
F&F1			15,250	15,250	0.83%		
F&F2			113,700	113,700	6.19%		
<b>Note Holder 1</b>						\$ 40,000	29,407
<b>Note Holder 2</b>						\$ 50,000	36,759
<b>Noteholder 3</b>						\$ 20,000	14,703
<b>Noteholder 4</b>						\$ 25,590	18,813
<b>Option Holders</b>							
OptionHolder 1							
OptionHolder 2							
OptionHolder 3							
OptionHolder 4							
Expanded Option Pool							
<b>Series A Investors</b>							
<b>Total</b>	<b>1,574,500</b>	<b>100.0%</b>		<b>1,837,926</b>	<b>100.00%</b>		<b>133,377</b>
Price per share	0.001		0.5588964			1.36	
Company valuation	par		\$1,000,000			\$2,500,000	



# Start-Up - Employees Hired

Holder	Original Issue Shares	Percent of Total	Developer/Investor Issuances	Total	Percent of Total	Notes Issued	Conversion	Option Issued	Strike Price
<b>Founders</b>									
Founder 1	755,760	48.0%		755,760	41.12%				
Founder 2	535,330	34.0%		535,330	29.13%				
Founder 3	283,410	18.0%		283,410	15.42%				
<b>Consultants</b>									
Tech Consultant			85,790	85,790	4.67%	\$ 25,000	18,379		
Investor Consultant			41,186	41,186	2.24%	\$ 50,000	15,316		
Management Consultant			7,500	7,500	0.41%				
<b>Investors</b>									
F&F1			15,250	15,250	0.83%				
F&F2			113,700	113,700	6.19%				
<b>Note Holder</b>									
Note Holder 1						\$ 40,000	29,407		
Note Holder 2						\$ 50,000	36,759		
Noteholder 3						\$ 20,000	14,703		
Noteholder 4						\$ 25,590	18,813		
<b>Option Holders</b>									
OptionHolder 1								9,190	\$ 2.24
OptionHolder 2								2,297	\$ 2.24
OptionHolder 3								1,378	\$ 2.24
OptionHolder 4								40,371	\$ 2.24
Expanded Option Pool									
<b>Series A Investors</b>									
<b>Total</b>	<b>1,574,500</b>	<b>100.0%</b>		<b>1,837,926</b>	<b>100.00%</b>		<b>133,377</b>	<b>53,236</b>	
Price per share	0.001		0.5588964			1.36		2.17636575	
Company valuation	par		\$1,000,000			\$2,500,000		\$4,000,000	

# Start-Up - Series A Round

Holder	Original Issue Shares	Percent of Total	Developer/Investor Issuances	Total	Percent of Total	Notes Issued	Conversion	Option Issued	Strike Price	Series A Investment	Series A Pro Forma
<b>Founders</b>											
Founder 1	755,760	48.0%		755,760	41.12%						
Founder 2	535,330	34.0%		535,330	29.13%						
Founder 3	283,410	18.0%		283,410	15.42%						
<b>Consultants</b>											
Tech Consultant			85,790	85,790	4.67%	\$ 25,000	18,379				
Investor Consultant			41,186	41,186	2.24%	\$ 50,000	15,316				
Management Consultant			7,500	7,500	0.41%						
<b>Investors</b>											
F&F1			15,250	15,250	0.83%						
F&F2			113,700	113,700	6.19%						
<b>Note Holder 1</b>						\$ 40,000	29,407				
<b>Note Holder 2</b>						\$ 50,000	36,759				
<b>Noteholder 3</b>						\$ 20,000	14,703				
<b>Noteholder 4</b>						\$ 25,590	18,813				
<b>Option Holders</b>											
OptionHolder 1								9,190	\$ 2.24		
OptionHolder 2								2,297	\$ 2.24		
OptionHolder 3								1,378	\$ 2.24		
OptionHolder 4								40,371	\$ 2.24		
Expanded Option Pool											341,024
<b>Series A Investors</b>										\$1,000,000	591,391
<b>Total</b>	1,574,500	100.0%		1,837,926	100.00%		133,377	53,236			932,415
Price per share	0.001		0.5588964			1.36		2.17636575			
Company valuation	par		\$1,000,000			\$2,500,000		\$4,000,000			

# Start-Up - Product Launch

Holder	Original Issue Shares	Percent of Total	Developer/Investor Issuances	Total	Percent of Total	Notes Issued	Conversion	Option Issued	Strike Price	Series A Investment	Series A Pro Forma	Total	Percent of Total	Fully Diluted Total	Percent of Fully Diluted Total
<b>Founders</b>															
Founder 1	755,760	48.0%		755,760	41.12%							755,760	31.11%	755,760	25.56%
Founder 2	535,330	34.0%		535,330	29.13%							535,330	22.04%	535,330	18.10%
Founder 3	283,410	18.0%		283,410	15.42%							283,410	11.67%	283,410	9.58%
<b>Consultants</b>															
Tech Consultant			85,790	85,790	4.67%	\$ 25,000	18,379					85,790	3.53%	104,169	3.52%
Investor Consultant			41,186	41,186	2.24%	\$ 50,000	15,316					41,186	1.70%	56,502	1.91%
Management Consultant			7,500	7,500	0.41%							7,500	0.31%	7,500	0.25%
<b>Investors</b>															
F&F1			15,250	15,250	0.83%							15,250	0.63%	15,250	0.52%
F&F2			113,700	113,700	6.19%							113,700	4.68%	113,700	3.85%
<b>Note Holder 1</b>						\$ 40,000	29,407							29,407	0.99%
Note Holder 2						\$ 50,000	36,759							36,759	1.24%
Noteholder 3						\$ 20,000	14,703							14,703	0.50%
Noteholder 4						\$ 25,590	18,813							18,813	0.64%
<b>Option Holders</b>															
OptionHolder 1								9,190	\$ 2.24					9,190	0.31%
OptionHolder 2								2,297	\$ 2.24					2,297	0.08%
OptionHolder 3								1,378	\$ 2.24					1,378	0.05%
OptionHolder 4								40,371	\$ 2.24					40,371	1.37%
Expanded Option Pool											341,024			341,024	11.53%
<b>Series A Investors</b>										\$1,000,000	591,391	591,391	24.34%	591,391	20.00%
<b>Total</b>	1,574,500	100.0%		1,837,926	100.00%		133,377	53,236			932,415	2,429,317	75.66%	2,956,955	80%
Price per share	0.001		0.5588964			1.36		2.17636575							
Company valuation	par		\$1,000,000			\$2,500,000		\$4,000,000							

# Incentivizing Employees

- Pay Minimum Wage (Really!)
- Types of equity incentives
  - Stock Grant
  - Restricted Stock
  - Options
- Beware Contractors and Interns





# Protect Your IP!!

- Employee/Consultant Assignment Agreements
- Non-Disclosure Agreements
- Domain Names
- Trademark
- Patents

# Financings

- Other People's Money
- Investors are helpful, but are not your friends
- Understand financing terms
  - Ask questions
  - Think about impact on future rounds
  - Be realistic



# Final Thoughts

- Founders - Don't assume you're all in it together.
- Consultants - Beware anti-dilution requests
- Employees - Don't let it get out of control
- Investors - Don't get bullied

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