

Venture Financing: Forming an Emerging Company Laying the Foundation for VC Investment



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Forming an Emerging Company

- ❑ Selecting the Right Entity and Jurisdiction
- ❑ Structuring Company Ownership
- ❑ IP Issues & Hiring Employees
- ❑ Common Pitfalls During Formation
- ❑ Q&A

Selecting the Right Entity and Jurisdiction

- ❑ Limitation of liability for owners
 - Limited liability vs. unlimited liability
- ❑ Tax treatment of entity and owners
 - Pass-through of profits and losses to owners
 - Impact on exit strategies and liquidity options
- ❑ Formality and centralization of management structure and decision-making
- ❑ Choice of formation jurisdiction
 - Delaware versus state of residence
- ❑ Industry, Exit Event Considerations

Selecting the Right Entity and Jurisdiction

<u>Entity Type</u>	<u>Liability</u>	<u>Entity Level Taxation</u>	<u>Management</u>
Sole Proprietorship	Unlimited	No	Direct
General Partnership	Unlimited	No	Decentralized
Limited Partnership	Limited for LP, Unlimited for GP	No	Centralized
Limited Liability Company	Limited	Elect Yes or No	Either
Corporation (C or S Corp)	Limited	Yes for C Corp, No for S Corp	Centralized

Selecting the Right Entity and Jurisdiction

- ❑ Venture capitalists prefer C corporations
 - Investor familiarity with centralized management structure and formalities
 - Some private equity funds are precluded from investing in pass through entities for tax reasons
 - Full range of exit strategies or liquidity options not available to other entity types
 - Lower organizational costs than an LLC or LP
- ❑ Venture capitalists prefer Delaware
 - Well-formed body of corporate law, including long-established principles in case law and ease of filing
 - Increased flexibility under Delaware law with respect to Board composition and corporate administration
 - National understanding of Delaware law among practitioners

Structuring Company Ownership

- ❑ Types of equity interests
 - Common stock versus preferred stock
- ❑ Allocating ownership among the founders
 - Contribution of IP and past services vs. future services to be rendered
- ❑ Valuing stock and options issued to founders and employees

Founder's Issues

- ❑ Founder's Stock
- ❑ Vesting – General Structure
 - 4 years on a monthly, quarterly or annual basis
 - Can be shortened in certain instances
 - Buy back at cost upon termination of employment prior to the end of the vesting period
 - 83(b) Election
 - Acceleration Issues: Termination & Change of Control
- ❑ Right of first refusal for sale to third parties
- ❑ The role of employment/severance agreements; vesting accelerators
- ❑ Setting expectations and roles

Structuring the Company: Capitalization Plan

	<u>Formation</u>		<u>Series A Preferred (\$5 Million Pre-Money \$5 Million Invested)</u>		<u>Series B Preferred (\$15 Million Pre-Money \$7.5 Million Invested)</u>		<u>Series C Preferred (\$50 Million Pre-Money \$10 Million Invested)</u>	
	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>
Common (Founders)	2,500,000	100%	2,500,000	25%	2,500,000	14%	2,500,000	12%
Option Pool	---	---	2,500,000	25%	4,464,285	25%	5,000,000	20%
Series A Preferred	---	---	5,000,000	50%	5,000,000	28%	5,000,000	23%
Series B Preferred	---	---	---	---	5,892,857	33%	5,892,857	28%
Series C Preferred	---	---	---	---	---	---	3,613,945	17%
Total	2,500,000	100%	10,000,000	100%	17,857,142	100%	21,258,503	100%

IP Issues & Hiring Employees

- ❑ Non-compete/non-solicitation agreements with previous employer
 - Does one exist? If so, what is the “scope” of the restriction?
 - Is it enforceable?
 - Should you attempt to notify/negotiate right away?
- ❑ Continuing non-disclosure obligations from previous employer
 - Agreements with previous employer may restrict transfer of certain know-how and trade secrets?
 - Even without an agreement, common law trade secret obligations exist
 - What is the employee bringing with him? Files, computers, storage media, etc. spell trouble
- ❑ Note regarding incorporation of prior software code, etc.

IP Issues & Hiring Employees (cont.)

- ❑ Obtain a signed proprietary information and invention assignment agreement before commencing employment
 - Don't ignore any carve-outs – have someone technical review them
 - Get is as of “Day 1”
 - Consider appropriate, enforceable non-compete
 - Beware of contractors who become employees – good time to clean up IP ownership

IP Issues & Hiring Employees (cont.)

- ❑ Beware of the “Inevitable Disclosure” doctrine
 - Under the “Inevitable Disclosure” Doctrine, a former employee of one company may be prohibited from working for a competitor of the previous employer based on the theory that the employee could not perform the duties of the new position with the competitor without relying on trade secrets obtained from the previous employer
 - Not all states apply the Doctrine
 - Application of the Doctrine does not require the former employee to have executed a non-compete agreement
- ❑ Trademarks, URLs and pre-formation IP assignments

Common Pitfalls During Formation

- ❑ Do it right the first time...your deal will follow the Company until it goes public or gets acquired
 - Failure to incorporate soon enough
 - Creating tax issues with equity
 - Failure to subject founders shares to vesting
 - Angel/friends & family financings
 - Failure to adequately protect IP
 - Failure to seek or receive adequate NDAs
 - Hiring employees without regard to prior employer agreements
 - Inadequate agreements with employees and contractors
 - Failure to maintain proper documentation
 - Fundraising errors
 - Choosing the wrong attorney for venture (or not using one)

A Focus on Emerging Growth

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Matt Lyons is an Austin partner with Andrews Kurth, where he specializes in representing private and public emerging growth companies and entrepreneurial interests. He advises on all aspects of forming new businesses, raising capital, M&A, and securities laws & regulations. He also regularly counsels companies and their boards on corporate governance and executive compensation. Matt represents and maintains relationships with a number of prominent venture capital, private equity and investment banking firms.

Matt has consistently been named as one of the leading lawyers in Texas for the area of Technology: Corporate and Commercial in the Chambers USA Rankings, in which his strategic advice was noted. He also has been Martindale-Hubbell "Peer Review Rated" for Ethical Standards and Legal Ability. Matt has been named a "Texas Rising Star" in the area of Securities and Corporate Finance by Texas Super Lawyers and Texas Monthly Magazine. Matt received his undergraduate and law degrees from the University of Texas at Austin.

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