

# Legal Perspectives on Forming and Financing an Emerging Company

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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
- ❑ Seed Angel Financing Strategies
- ❑ Common Seed Financing Pitfalls
- ❑ Do It Right from Inception
- ❑ Q&A / Discussion

# 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 vs. state of residence
- ❑ Choice will depend on expected investment source and exit strategy

# 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	May 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

- ❑ ***Institutional investors*** prefer C corporations
  - Investor familiarity with centralized management structure and formalities
  - Many venture and private equity funds are precluded from investing in “pass through” entities for tax reasons
  - Full range of exit strategies or liquidity options (e.g. stock for stock) not readily available to other entities types
  - Lower organizational and ongoing administrative costs
  
- ❑ ***Institutional investors*** 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

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

# Structuring Company Ownership: Founder's Stock

- ❑ Founder's Stock
- ❑ Vesting – General Structure
  - 4 years on a monthly, quarterly or annual basis; one-year cliff
  - Can be shortened in certain instances
  - Buy back at cost upon termination of employment, death or marital dissolution 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 agreements

# IP Issues & Hiring Employees

- ❑ Consider obligations to prior employer
  - Non-disclosure, non-compete, non-solicitation
  - Even without an agreement, common law trade secret obligations exist
  - Did you or another develop idea while employed?
  - Any employer files, documents, computers, smartphone, storage media, etc. spell trouble
  
- ❑ 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
  - Application of the Doctrine does not require the former employee to have executed a non-compete agreement

# IP Issues & Hiring Employees (cont.)

- ❑ Hiring Employees and Contractors
- ❑ Obtain a signed PIIA on Day 1 of service
  - Include non-compete/non-solicitation restrictions (note state by state enforceability)
  - Consider their restrictions from prior employment
  - Include contractors who (will) become employees
- ❑ Trademarks, URLs and pre-formation IP assignments

# Common Pitfalls During Formation

- ❑ Do it right the first time ... issues at formation will follow the Company until it goes public or gets acquired
- ❑ Failing to maintain adequate organizational records and capitalization
- ❑ Giving away the company – “too many promises”. E.g. Equity with guaranteed percentage or antidilution rather than specific number of shares
- ❑ Failure to file 83(b) election; “cheap stock” issues; “phantom tax” issues
- ❑ Employment Agreement
- ❑ Awarding preferred stock to service providers
- ❑ Failing to ensure proper ownership of the IP (consulting agreements, PIIAs)
- ❑ Creating new venture while remaining with employer and other prior employer issues

# Angel Investors

- ❑ Angel Investors:
  - Typically individuals; active/former entrepreneurs; often form networks
  - Generally invest \$25,000-\$250,000
  - May provide guidance and advice to founders/CEO
  - Many have become leery of deals that require institutional (VC) funding
- ❑ Angels want to “**lock in**” value of the investment or discount commensurate with risk while companies want to **defer** valuation until higher price can be justified (and want to do so using investors’ dollars)
- ❑ Often request participation on the Board and/or in business oversight
- ❑ Want to maintain rights & preferences in future VC rounds of financing
- ❑ Finding them...
  - Angel Networks
  - Individuals
  - “Super angels”

# Friends & Family Financings

- ❑ Beware of sales to non-accredited investors
- ❑ Often overpriced
  - Creates barriers to future rounds
  - Dilution and disappointment
  - “Dumb money”
  - Option pricing issues when common stock sold
- ❑ Inadequate resources to continue to invest and “protect” prior investment
- ❑ Administrative hassles
  - Expensive to administer and may deter VCs
  - Complex Structures for small dollars

# Accredited Investors

- ❑ No **offer or sale** of sale of securities may be made without registering unless offering qualifies for an exemption
- ❑ Can have unlimited number of accredited investors and still qualify for exemption
- ❑ Definition of **Accredited Investor**:
- ❑ Income: Individual: \$200k/yr for 2 years with expectation to continue; \$300k if married.
- ❑ Net worth: \$1MM (*excluding* value of principal residence)
- ❑ Executive officers and directors qualify
- ❑ Founders exemption
- ❑ Generally presumed to be more sophisticated in business matters; at least able to bear risk of loss and hold investment indefinitely
- ❑ No specific information / prospectus requirements
- ❑ As few as one non-accredited investor can trigger prospectus requirements

# Seed and Angel Financing Structures: Equity

## ❑ Common Stock

- simplest structure with minimal transaction costs
- requires an implied valuation
- “taints” option price (i.e. company required to grant options with exercise price equal to common sale price)
- Offers no investor protection, so rarely used by sophisticated angels

## ❑ Preferred Stock

- “Seed” Preferred: simple liquidation preference and other terms to permit some “discounting” of options
- Standard Preferred: standard “venture capital” formula preferred stock favored by more experienced angel investors but entails substantially higher transaction costs
  - Use varies with size of investment
- Equity allows investors to begin holding period for **long-term capital gains**
- Equity qualifies for **Section 1202 Qualified Small Business Stock treatment**

# Seed and Angel Financing Structures

- ❑ Series Seed and Series AA Preferred Stock
  - Simpler form of preferred stock touted as alternative to convertible notes
  - Allows investor to “price” the investment while keeping transactional costs down
  - Structure:
    - Simple Purchase Agreement (fewer representations, no legal opinion)
    - Standard Preferred Stock terms (perhaps with fewer protective provisions)
    - Simplified Investor Rights Agreement (with basic information and preemptive rights, perhaps board seat, and requirement to be granted rights to next round investor)
  - Costs somewhat higher than typical convertible note but substantially lower than standard preferred stock round
  - Generally economical (as compared to bridge notes) with \$500,000 investment

# Common Seed Financing Pitfalls

- ❑ **Not bootstrapping enough (or long enough)**
- ❑ Selling common stock instead of preferred stock (setting option price), but granting options at lower price
- ❑ Selling stock instead of bridge notes
- ❑ Investment by too many (or the wrong) friends, family and angel investors (administrative and management burden)
- ❑ Violations of state securities laws (especially sales to non-accredited investors); rescission rights
- ❑ Unrealistic expectations of inexperienced early investors (perhaps caused by optimistic projections -> potential fraud claims if investment sours)
- ❑ Previous unsupportable valuations (resulting in “down” round when VC invests)
- ❑ Unique or non-standard terms in seed financings that can require significant revisions
- ❑ Unequal deals among investors in same round
- ❑ Using brokers and finders





# Do it Right: AK Start-Up Package

## ▪ Incorporation, Organization and Qualification

- Reservation of corporate name
- Preparation and filing of Delaware Certificate of Incorporation
- Preparation of Bylaws and Certificate of Secretary
- Preparation of Action by Incorporator
- Preparation of Organizational Board Consent regarding various organization and corporate governance matters
- Preparation and filing of Form SS-4 Application for Employer Identification Number
- Preparation and filing of qualification to do business as foreign corporation
- Preparation and organization of corporate records and minute book
- Preparation of Stockholder Consent
- Preparation of form Indemnification Agreements for directors & officers

## ▪ Capitalization matters

- Entry of capitalization data and corporate records into capitalization tracking software and corporate records database
- Preparation of Founder's Restricted Stock Purchase Agreement for up to four Founders
- Preparation of Stock Certificates for up to four Founders
- Preparation of Memorandum re 83(b) Elections for Founders
- Preparation and filing of state securities filings for stock issuances to Founders
- Preparation of Stock Option/Stock Issuance Plan
- Preparation of forms of Early and Standard Exercise Stock Option Agreement
- Preparation of form of Stock Issuance Agreement
- Preparation/filing of Form U-2 Uniform Consent to Service of Process

# Do it Right: AK Start-Up Package

- **Employment and Consulting Matters**

- Preparation of form of At-Will Employment Offer Letter
- Preparation of form of Proprietary Information and Inventions Agreement
- Preparation of Form of Independent Contractor Services Agreement

- **Intellectual Property Matters**

- Preparation of form of Unilateral Nondisclosure Agreement
- Preparation of form of Mutual Nondisclosure Agreement
- Preparation of Assignment of Intellectual Property from Founders to the company
- Preparation of Memorandum re Trademark Matters for a new company

- **Consultations**

- One hour of advice on employment matters
- One hour of advice on employee benefits matters
- One hour of advice on protecting intellectual property
- One hour of advice on venture capital term sheets

# A Focus on Emerging Growth

## **ANDREWS KURTH LLP** **Technology and Emerging Companies**

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We represent clients in the areas of semiconductors, telecommunications, computers and electronics, enterprise software, life sciences, aerospace, Internet and e-commerce, consumer products and retail. We also represent and have extensive contacts with market leading investment banking, private equity and venture capital firms from coast-to-coast.



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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. 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.