

# Engineering Entrepreneurship: Forming your team

ENGR 4302/5302; EE 4302



**WHAT EVERY ENGINEER  
SHOULD KNOW ABOUT  
STARTING A  
HIGH-TECH  
BUSINESS  
VENTURE**

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# Creating your founding team

- ▶ “A players hire A players; B players hire C players. Great people hire great people. On the other hand, mediocre people hire candidates who are not as good as they are, so they can feel superior to them.”  
–Guy Kawasaki, CEO

**Remember: You are like a coach—do not try to compete with the players!**

## WHAT ARE INVESTORS LOOKING FOR FROM YOUR FOUNDING TEAM?

Here are some of the potential questions that an outside investor will want to know about a new business:

- Has the team worked together previously? How do we know that they can?
- Does the team seem capable of adapting as the venture and the needs change?
- Does the team have the required technical experience?
- Does the team have the necessary business expertise?
- What is the team dynamic? Is there a natural leader in the group and do the others listen to him or her?
- Does the team accept criticism and challenge each other in a positive and helpful way?
- Can the team recruit and retain top talent?
- Does the team seem willing to adapt to changes in the team dynamic as the need for outside talent arises?

# How big should the team be?

- ▶ Often you begin with a 3–person founding team:
  - President/Chief Executive Officer
  - Vice President of Marketing/Sales
  - Vice President of Engineering/Chief Technical Officer
- ▶ In this class, we think a team of 3 enrolled students is about right.
- ▶ For the MavPitch contest, a team that includes both engineering and business students will typically be seen to be stronger than a monochromatic team.

## WE'VE FORMED OUR TEAM. ARE WE READY TO INCORPORATE NOW?

### What could happen

We've got a founding team in place for our new startup. When is the right time to incorporate the business?

### Watch out for

There are different schools of thought on when the "right" time is to incorporate. Some founders have decided to wait until just before they are to receive funding, whereas others have formed their corporation after a meeting of the minds of the founders. Even so, keep in mind that waiting to incorporate until immediately before your Series A investment round may raise a number of tax issues for the founders because of the increased valuation at the time of this investment.

Incorporation is necessary for certain aspects of the business, and the expense is relatively minimal. If you are still in the "research and discussion" phase, deciding whether the idea and concept have legs, there is likely little need to formally incorporate. Instead, the founders should plan the timing of your incorporation based on factors including the timing for extracting themselves from their current employers, the need to transfer existing intellectual property to the company, the need to enter into contracts for the business (with customers or vendors), the formalization of agreed on founders terms (ownership levels, intellectual property matters, etc.), the need to grant options to employees, and receipt of investment funding.

The lesson here is you can incorporate too quickly (creating potential problems for a founder still employed elsewhere) and too slowly (creating potential tax problems for the founders).

**TIP:** Don't wait too long to incorporate, but also avoid rushing to incorporate and making a rash decision on your entity structure.

# What should you look for in cofounders?

- ▶ Founders often liken their experience with their cofounders to a marriage!
- ▶ Key traits to look for:
  - Compatibility
    - Individual you're comfortable having in your inner circle
  - Mixture of new and old
    - Diverse perspectives
  - Entrepreneurial experience
    - Experienced entrepreneur is ~15% more likely to be a success
    - Seasoned entrepreneur increases company's valuation at funding
    - 1 member with doctoral degree increases valuation



# What should you look for in cofounders? (continued)

- ▶ Key traits to look for:
  - Top-tier technical experience
    - Outstanding technical background
    - Wealth of contacts in their field
  - High integrity and strong ethics
    - Nature of startup is that you're without procedures and protocols
  - A "true" equal
    - Team that can collaborate as equals and peers
    - 1-person team with support staff is rarely the answer



# Recruitment

- ▶ Stock to the founders
- ▶ Stock options to other management members
- ▶ At this stage of your “meeting circuits,” you should not make finding a cofounder the focus of any of your meetings—often the choice is natural
- ▶ Look for conversations, meetings, and lunches to develop a personal network

# Agreement among the founders

- ▶ 1<sup>st</sup> meeting most often rosy, focused on good times ahead
- ▶ 1 or more original business founders will leave the venture within the first 3 years
  - Unable to stay while waiting for funding
  - Conflicts resulting in frustrations or even firing

# Key discussion points to address

- ▶ Personal goals of each founder
- ▶ Where will you locate the business
- ▶ Leaving your current employer
- ▶ Employment
- ▶ Company titles and job responsibilities
- ▶ Salary and benefits
- ▶ Contractual terms of employment (for example, vacation time, title, severance, noncompetition, and nonsolicitation)
- ▶ Termination of a founder
- ▶ Cash investments into the business

# Key discussion points (continued)

- ▶ Ownership of stock
- ▶ Vesting of stock (and acceleration terms)
- ▶ Departing the company
- ▶ Transfer restrictions
- ▶ Future stock issuances
- ▶ Day-to-day decision-making
- ▶ Major decision-making
- ▶ Death or disability
- ▶ Proprietary information
- ▶ Confidentiality
- ▶ Nonnegotiable changes to the business

# Important discussions

- ▶ Stock purchase agreements/stockholders' agreement/limited liability corporation (LLC) operating agreement
- ▶ Vesting
- ▶ Stock transfer restrictions
- ▶ Employment issues (offer letters):
  - Salaries, termination, titles, vacation, severance, noncompetition, nonsolicitation
- ▶ Confidentiality, invention assignment, IP filings (employment agreement)

## DOES IT MATTER WHERE WE “START UP”?

### What could happen

You are starting a high-tech business. You live in Nebraska (or name any other city/state of your choice). Does it really matter where you start up your business?

### Watch out for

In the same way that New York City is the fashion capital and Los Angeles is the film capital, so is Silicon Valley the startup capital in the United States. Does that mean you shouldn't consider starting up a business if you don't live in that area of California? Absolutely not. However, you should recognize that certain cities are known as places where startups prosper and be sure your business is located in an area that can provide tools for success.

Your startup location matters because you want to be in a place that has the right type of talent for your organization, the partners and joint ventures for your business, the support services and resources, the capital and investment options, and the attitude that promotes and enhances startups. Cities such as Silicon Valley, Boston, Seattle, Austin, San Diego, and Denver have those qualities, and each have produced their own share of successful startup companies. A Kauffman Foundation report listed Massachusetts, New Jersey, Maryland, Washington, and California as the top states in its rankings of locations transitioning to new economy in February 2007.

So if you live in Detroit or Boise or Houston or Tucson, should you scrap the whole idea or move to another city? No. However, be sure that the city you choose will have the right talent and support you'll need. For example, Tucson is known as a leader in the optics space, so choosing it for your optics (or related) business would make perfect sense.

**TIP:** Locate your startup in a city that has the right combination of resources (talent, competitors, collaborators, and investors).

## MOONLIGHTING IN YOUR NEW VENTURE

### What could happen

You and several coworkers have decided that you could run your current employer's business better than they're doing now if given the chance. So rather than wait to become the next CEO of that company, you are going to open up your own business in the same or similar markets as your current employer.

### Watch out for

Running (or starting up) a competing business as your current employer raises a number of issues. Numerous court cases have ruled in favor of the employer in these scenarios, especially if the employee was managing those operations or was a key employee. You could even be at risk if you incorporate the business while still employed.

Review your company's policies and your employment documentation before acting formally on behalf of your new business venture. In some circumstances, employees have found that disclosing your business plans before beginning this venture has been met with greater support than expected (but use your judgment on whether or not you should disclose!). Perhaps your employer may be able to reassign you so as not to raise competition issues. No matter how you plan to handle the scenario, you should not misstate or misrepresent the activities of the new business.

Don't risk litigation for your new venture. When in doubt, check with the appropriate parties. Your attorney may be able to provide some guidance for this transitional period.

**TIP:** Beware of problems that arise from starting and operating your new venture while still employed in your current job.



## HOW DO WE MAKE OUR (DIFFERENT) CONTRIBUTIONS EQUAL?

### What could happen

The four cofounders have all agreed that Joe will work full-time on their new startup and the others will only work part-time on the startup and continue drawing a salary from their current jobs. How do we make this fair?

### Watch out for

First, be sure to discuss this arrangement from the outset. Contributions will differ, but if one party feels his or her contributions are not equal, then the relationship could quickly become strained. Discuss it up front rather than wait for tensions to boil over.

Misunderstandings in the role each founder will play, the salary each individual will expect, and the time each founder is expected to contribute are very common. To the extent that the founders will each make part-time contributions to the business, set forth the expectations in terms of number of hours per week or per month each founder is expected to contribute. If one founder will continue to work full-time and the rest will work exclusively for the business, discuss how different contributions shall be treated within the company.

For example, if Joe works full-time on the business, perhaps the other founders should each agree to contribute 40 hours per month (10 hours per week) to the startup. In addition, these founders could agree to each contribute \$500 per month to help Joe pay his living expenses or could agree to take less equity than Joe will receive.

**TIP:** Discuss founding arrangements such as hours expectations, equity ownership percentages, and ongoing capital contributions.

## WHOSE INVENTION IS IT ANYWAY?

### What could happen

You and your cofounder have invented a better mousetrap, which you are convinced should revolutionize the vermin trap industry. Your coinventor isn't quite sold on the idea so decides not to found the business with you. The rights to the invention are still owned by the business since you are part inventor, right?

### Watch out for

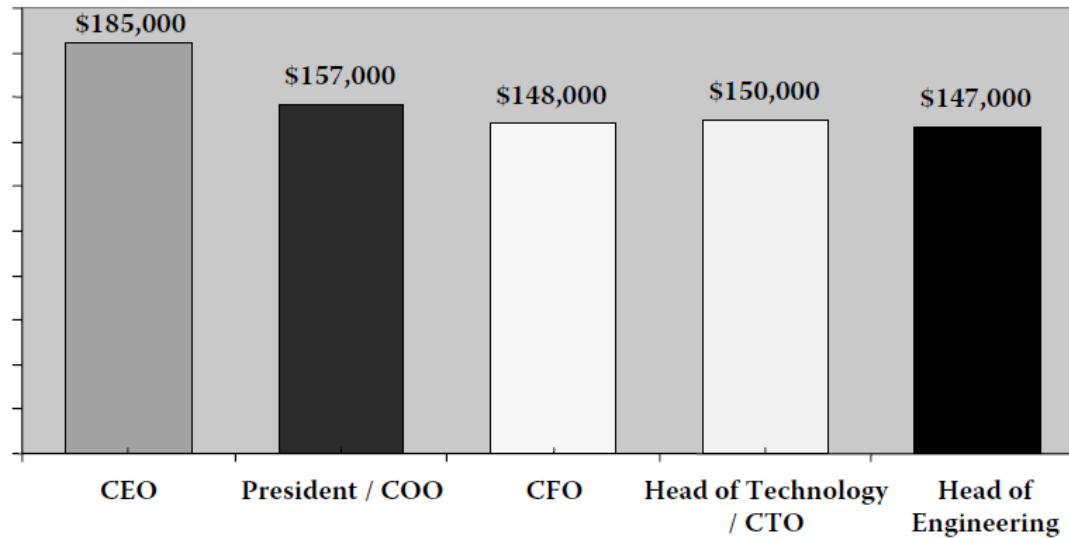
No. Under most state laws, an invention is the property of the inventor or inventors. In this case, you and your coinventor have equal rights to the invention. However, when you start the business, this doesn't mean that your half of the invention is automatically assigned to the business. Instead, you will need to assign your rights to your startup company, which is oftentimes done in exchange for your founders stock.

You also have another problem: your cofounder. You both have rights in the invention even if you decide to be the one to invest the time to start the business. So, be sure to have your coinventor assign his or her rights to the invention to the business. In some cases, a coinventor may assign them for minimal consideration (perhaps a couple hundred bucks or perhaps some nominal royalty rate down the road) or you may give the coinventor a small part of the equity of the company in exchange for assigning his rights.

Don't forget that forming a business isn't enough to assign the rights to an invention produced before you started the business. Furthermore, if you coinvented the business with others, be sure to find out how the coinventors would feel about assigning their rights to the business. In many cases, because the technology might be very early stage, you won't have to give up too much for those rights.

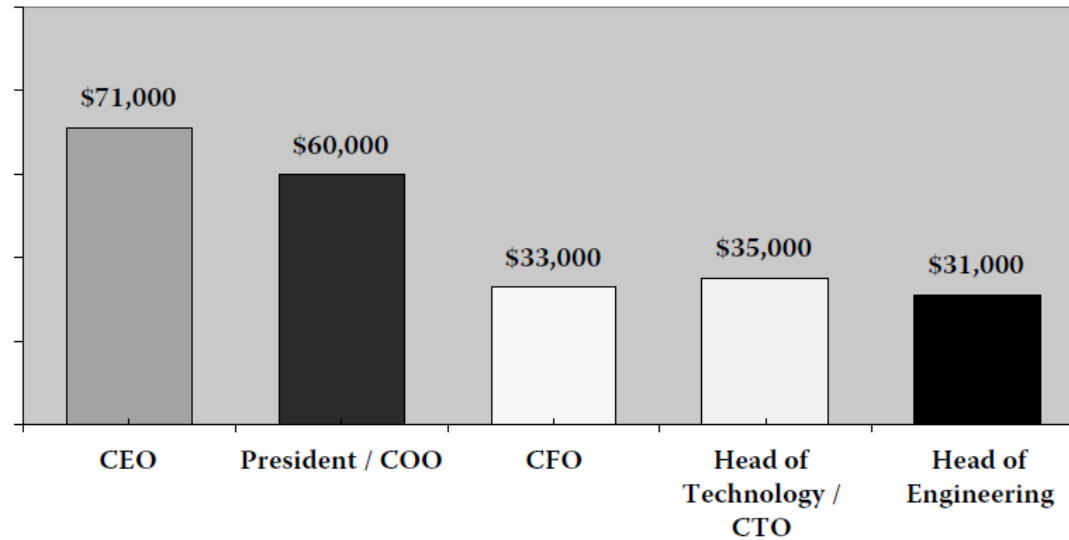
**TIP:** Inventions are initially the property of the inventor, not the business. Don't forget to assign all inventions to the company early on.

### I.T. Founders: Cash Compensation



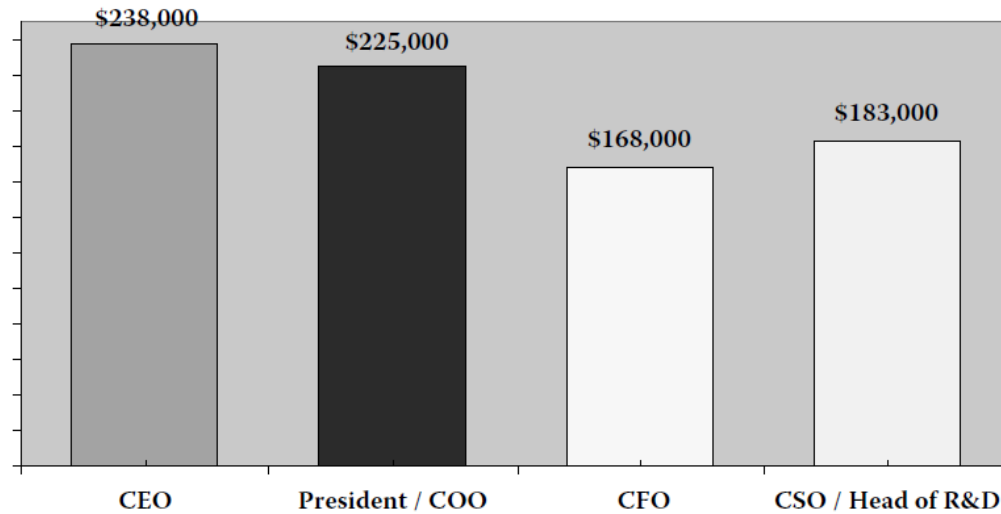
Source: 2006 Compensation & Entrepreneurship Report in Information Technology.

### I.T. Founders: Annual Bonuses



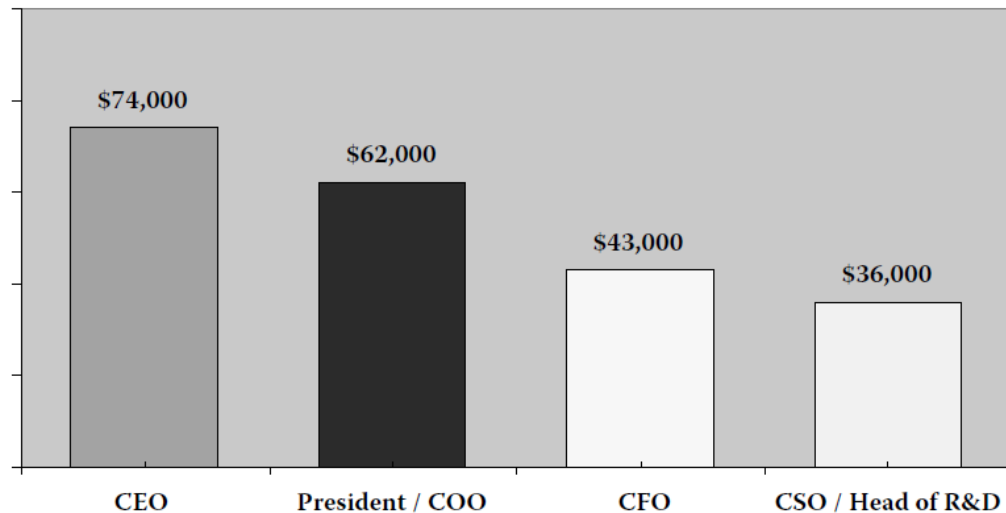
Source: 2006 Compensation & Entrepreneurship Report in Information Technology.

### Life Sciences Founders: Cash Compensation



Source: 2006 Compensation & Entrepreneurship Report in Life Sciences.

### Life Sciences Founders: Annual Bonuses



Source: 2006 Compensation & Entrepreneurship Report in Life Sciences.

# Contractual terms of employment

- ▶ Noncompetition agreements
- ▶ Nonsolicitation agreements

## CREATING A “CHEAP STOCK” PROBLEM

### What could happen

The company has waited to incorporate until funding is imminent. Now they'd like to issue stock to the founders immediately before the infusion of funding.

### Watch out for

This could create a “cheap stock” tax problem for the company. By waiting to issue this founders stock and then issuing inexpensive stock to the founders while selling more expensive stock to your investors, you may raise tax problems for the company and the founders. The IRS may consider this difference in stock price (between the price paid by the founder and the price paid by the investor) as income for the founder.

**TIP:** Don't wait too long before issuing founders stock.



## EVEN FOUNDERS' STOCK STILL MUST COMPLY WITH SECURITIES LAW

### What could happen

### A good time to talk to an attorney

You've decided to give away a single share of stock in your new company to all the members of your alumni association to "spread the word." Could this cause a problem? Perhaps. Before undertaking any sale of stock, you should ensure that sale (or gift in the case above) will not require you to register the securities or will be in violation of securities laws. For most private company startups, your stock sales can be exempted from federal and state securities laws, but this requires you to be cautious in your issuance and sale of stock. Simply because your company is small, new, and you aren't selling for large dollar amounts, you cannot forget about the applicable securities laws and your compliance.

### Watch out for

For each issuance of stock, or any other security, be sure to check that this sale or issuance does not violate any federal or state securities laws. Each issuance should be made under an applicable federal and state exemption; usually these are not difficult for startups but require continued diligence.

**TIP:** Private companies must comply with securities laws, so make sure each issuance is reviewed for compliance with applicable laws.

## DISAPPEARING FOUNDER

### What could happen

One of the founders received 50% of the founders stock and then left the company after six months.

**Vesting! A critical consideration or you'll be sorry later.**

### Watch out for

In many cases, it is advisable for founders to include vesting provisions on the stock issued to all of the founders. Then, in the event one of the founders leaves before the stock is vested, the company can repurchase the stock at the initial purchase price. As time passes, more of the stock is “released” to the founder and cannot be repurchased. This helps ensure that the individuals who remain as productive members of the founding team will have their shares vest and are rewarded with a higher amount of stock owned outright. This way, if one of the founders leaves, the company can recover the unvested stock (which would be repurchased at par value, which will likely be priced at \$0.01 to \$0.0001 per share).

What is an appropriate time period for vesting? It depends. However, many venture capital firms or other investors will require a minimum of three to four years of monthly vesting on founders stock. You may also consider a one year cliff on vesting. In this case, no stock will vest until after one year. At the one year mark, the founder will have a portion of their stock become vested (say 25% or one-quarter if the stock vests over four years).

**TIP:** Founders should consider having vesting terms on the initial stock issued to founders.



## TYPES OF VESTING

There are numerous ways to structure vesting restrictions on founders stock, including the use of time-based vesting, milestone-based vesting, and a combination approach.

- **Time-based** (straight line)
  - Stock is released from vesting in equal amounts each month over a particular time period (say monthly, quarterly, or annually over a number of years, usually between two and five years).
  - As an example, a founder has straight monthly vesting over a three year period. After being employed for 12 months, the founder leaves the company. At this point, the departed founder would only own one-third of the original stock issued to him or her. The rest of his or her shares (two-thirds of the original amount issued) would then be repurchased by the company at the par value.

## TYPES OF VESTING (CONTINUED)

- **Time-based (cliff)**
  - No vesting for a particular time period (for instance, the first six months or first year or until financing occurs). Then, once that initial period is completed, the company will then release a certain portion from vesting. Once the cliff period has passed, the rest will typically vest on a straight-line basis afterward (monthly, quarterly, or annually).
  - As an example, a founder's stock is vested over three years. The vesting will be a one year cliff, followed by straight-line monthly vesting over the remaining two years. If the founder departs after six months, he or she will have no shares vested and the company will repurchase the entire amount of original shares issued. However, if the founder departs after 18 months, then one-third will have vested after the cliff and six more months of vesting would have occurred. So the founder would have 50% of his or her stock vested at that time.

## TYPES OF VESTING (CONTINUED)

- **Milestone-based**
  - Stock will be released on the achievement of particular milestones rather than based on time periods.
  - As an example, a certain portion of unvested stock will be released from vesting when (1) the company receives at least \$1 million in funding (to incentivize fundraising efforts), (2) the company reaches \$250,000 in annual revenue (to incentivize sales), and (3) when the company releases its second-generation product (to incentivize product development).
- **A combination-based approach**
  - Stock will be released on a combination of milestone-based and time-based vesting.
  - As an example, half of the stock will vest monthly over a three year period and the other half will vest based on achievement of certain milestones.

## THE DISGRUNTLED FORMER FOUNDER

### What could happen

One member of your original founding team left before the company got any traction. A year later, the company received funding (or years later is undertaking an IPO) and that former founder is back and is requesting equity in the company.

### Watch out for

This founder isn't likely to be entitled to anything unless a binding contract was formed. However, this situation could have been avoided if the company had incorporated and issued stock to the founders (subject to certain vesting terms) earlier. In this case, the former founder would have had stock in the company and knew he'd given it up all or part of it by leaving.

**TIP:** Don't wait too long before incorporating your startup and consider applying vesting provisions to founders stock.

## SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS

Name: \_\_\_\_\_

Personal goals with company: \_\_\_\_\_

Expectations: \_\_\_\_\_

When do you plan to “start up”? \_\_\_\_\_

### **Business**

Name of the company: \_\_\_\_\_

Business form (Corporation/LLC/Partnership; State): \_\_\_\_\_

Purpose and aims of the company: \_\_\_\_\_

\_\_\_\_\_

Initial location of the business: \_\_\_\_\_

- Would you be open to considering relocating the business? Y / N

What milestones do you have for the business? \_\_\_\_\_

What is the fundraising strategy for the business? \_\_\_\_\_

**SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS**  
**Roles in the Company** **(CONTINUED)**

Business lead (i.e., CEO/President): \_\_\_\_\_

Financial lead (i.e., CFO/Controller): \_\_\_\_\_

Technical lead (i.e., Chief Technology Officer): \_\_\_\_\_

Marketing/sales lead: \_\_\_\_\_

Initial directors: \_\_\_\_\_

Will any positions be full-time initially? Y / N

- When do you expect to have or be full-time employees? \_\_\_\_\_

What are the salaries? \_\_\_\_\_

- Do you expect to defer payment? Y / N
- Vacation, severance, health insurance? \_\_\_\_\_

Decision-making

- What decisions require unanimity among the founders? \_\_\_\_\_
- Who is responsible for day-to-day decisions? \_\_\_\_\_
- What are typical day-to-day decisions? \_\_\_\_\_



## **SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS** **(CONTINUED)**

### **Current Status**

Current job: \_\_\_\_\_

Have you discussed the new business with your current employer? Y / N

Have you shared all the employment agreements with your cofounders? Y / N

Is there any overlap between the activities of the new company and your employer? Y / N

Average hours worked: \_\_\_\_\_

Current employment salary and benefits: \_\_\_\_\_

How many hours per week do you expect to contribute to the business initially?

\_\_\_\_\_



## SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS (CONTINUED)

### Ownership Interest

Do you expect to contribute any cash initially? Y / N

- If yes, how much? \_\_\_\_\_

Do you expect other founders to contribute any cash initially? Y / N

- If yes, how much? \_\_\_\_\_

How will future cash contributions be handled? \_\_\_\_\_

\_\_\_\_\_

How do you expect the equity and ownership of the company to be structured?

\_\_\_\_\_

Do we have vesting on the ownership? \_\_\_\_\_

- If yes, what are the terms? \_\_\_\_\_

## **SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS**

**(CONTINUED)**

### **Founder Financial Status**

Assets: \_\_\_\_\_

Liquid assets: \_\_\_\_\_

Liabilities: \_\_\_\_\_

Credit history: Excellent / Good / Fair / Poor

Expected money to be contributed to the business in year one: \_\_\_\_\_

Any other personal tax planning issues to consider for company structure? \_\_\_\_\_

**SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS**  
**Exit Strategy** (CONTINUED)

How do you value the shares/units on exit of a founder? \_\_\_\_\_

Transfer:

- Can you transfer part of your ownership or only the entire stake? Y / N
- Can you transfer to your spouse/children? Y / N

Departure of a founder:

- “Shoot out” provision (party receiving notice must elect to either purchase shares of other party or sell its shares to that party)? Y / N
- Staggered exit provision (party leaving may be “bought out” over a period of time for cash flow and tax purposes)? Y / N
- “Bring-along” provision (if either party is transferring shares, they must require third party purchaser to offer to buy also the other party’s interest at the same price per share)? Y / N
- “Drag-along” provision: (if selling party has at least a certain percentage being purchased [80%+], they can obligate the other party to also transfer its shares to the same purchaser)? Y / N

What happens in the case of:

Death/serious illness: \_\_\_\_\_

Divorce: \_\_\_\_\_

Sale of the business: \_\_\_\_\_

What happens in the case of a deadlock or unresolved dispute (last resort: the right of either party after a minimum deadlock period for either party to call for liquidation of the company)? \_\_\_\_\_

## SAMPLE KEY TERM DISCUSSION GUIDELINE FOR FOUNDERS

### Other Matters

(CONTINUED)

Intellectual property

Contributing intellectual property to the company? \_\_\_\_\_

Entering invention assignment agreements? Y / N

Will the founders execute noncompetition agreements? Y / N

What terms? \_\_\_\_\_

Will the founders execute nonsolicitation agreements? Y / N

What terms? \_\_\_\_\_

Will the founders execute confidentiality agreements? Y / N

What terms? \_\_\_\_\_

Life insurance policies for the founders? Y / N

**NOTE:** Remember, these are just a sample of some of the issues founders should discuss. Some early-stage discussions might not involve some of these questions, whereas other companies might have other issues not contemplated here.

# High-Tech Startup Inc.

Initial Capitalization

Capitalization Table as of =>

1/1/2009

## Assumptions:

Authorized Shares	10,000,000
Founders Stock – To Be Issued	8,000,000
Option Pool – To Be Reserved	2,000,000

Remaining shares available for issuance

CLASS	RECIPIENT	SHARES	% of Series	Fully Diluted
<b>FOUNDER SHARES</b>				
	Sally Founder	4,000,000	50.0%	40.0%
	Mike Techie	2,400,000	30.0%	24.0%
	Jane Designer	800,000	10.0%	8.0%
	Mark Angel	800,000	10.0%	8.0%
	[TBD]			
	<i>Issued Founders /Executive</i>	<b>8,000,000</b>	<b>100.0%</b>	<b>80.0%</b>
<b>2009 STOCK PLAN</b>				
	Total Options Reserved	2,000,000	100.0%	20.0%
	Total Options Granted			
	Options Exercised			
	Cancelled/Expired Options			
	Options Outstanding			
	Options/Shares Available for Future Issuance			
<b>TOTAL (fully diluted)</b>		<b>10,000,000</b>	<b>100.0%</b>	<b>100.0%</b>

Total Common Stock (Including Shares Issued under Plan):	8,000,000
Total Options:	2,000,000
Shares Issued on Exercise of Options and Purchase Rights:	0
Reserved but Unissued under Plan:	2,000,000