

University of Washington

The Legal Side of Things
Corporate Start-up Fundamentals

Craig Sherman

Wilson Sonsini Goodrich & Rosati

CORPORATE START-UP FUNDAMENTALS

Topics:

- Entity Selection
- Corporate Formation
- Founder Ownership
- Equity for Employees
- Securities Law Basics
- Pre and Post-Money Calculations
- Bridge Notes

ENTITIES

Using an Entity

- **What is an entity? – legal “person”**
- **Why use an entity? – limited liability**
- **What types of entities are there?**
 - *corporation*
 - *partnership*
 - *limited partnership*
 - *limited liability company*
 - *S corporation*

ENTITIES

Using an Entity

■ Corporation

- *Most common*
- *VCs and other investors understand*
- *Negatives*
 - Two levels of tax
 - Cannot realize losses
 - Limited flexibility

ENTITIES

Using an Entity

■ Other entities (other than S corporation)

- *Partnership – not limited liability*
- *Limited partnership – need a general partner*
- *VCs – most cannot fund pass through entity*
- *Difficult to implement option plan*

■ S corporation

- *Pass through*
- *Limitations (# and type of shareholders)*
- *Easy transition to regular (“C”) corporation*

CORPORATION

The Corporation – *structure*

- **Where to incorporate? Delaware? Washington?**
- **Structure**
 - *Owners = stockholders*
 - *Overall management = board of directors*
 - *Day to day management = officers*
- **Governing documents**
 - *Certificate of incorporation*
 - capital structure
 - fundamental rights
 - *Bylaws*
 - operating manual

CORPORATION

The Corporation – *directors*

- **Duty to manage affairs**
- **Power to do all necessary things to accomplish**
- **May delegate**
- **Required level of care**
 - *good faith (loyalty)*
 - *reasonableness (ordinary prudent person)*
 - *reasonably believe in best interests of corporation*
 - *business judgment rule – no second guessing*

CORPORATION

The Corporation – *issuing stock*

- **What is stock**
 - *Types of stock*
- **Where does it come from**
 - *authorized stock*
 - *issued stock*
- **How to issue stock**

SECURITIES LAWS

Securities Laws

- Federal and state laws
- Every offer or issuance of a security
- Registration requirement
- Register *OR* find an exemption
- Disclosure, NOT merit review
 - *authorized stock*
 - *issued stock*

FOUNDER OWNERSHIP

Founder Ownership

- **How do founders get stock?**
 - **What consideration is paid?**
 - **Vesting or not vesting?**
 - *investors often require*
 - *avoid free-loading*
 - *need the equity to replace departing founder*
 - **Tax issues for vesting stock**
 - *83(b) election*
 - **Options for founders?**
-

FOUNDER OWNERSHIP

Founder Ownership

- **Do it early**
- **Value is low**
 - *tax issues*
 - *accounting issues*
- **Avoid disputes as to ownership**

FOUNDER OWNERSHIP

Founder Issues

- **Avoid informal promises of equity**
- **Avoid promising percentages**
- **Advanced expenses**
- **Paying back wages**
- **Avoid 50/50 partnerships**

EMPLOYEE EQUITY

Why give employees a stake?

- **Motivation – the potential big payoff**
- **Team spirit – “skin in the game”**
- **Compensation – tie compensation to collective success**
- **Conserve cash – cash is king for startups**

EMPLOYEE EQUITY

What is a stock option?

- Most prevalent employee equity
- Contract
- Right to purchase stock
- # shares
- Purchase price
- Term

EMPLOYEE EQUITY

Why options?

- Lock in low price
- Upside with no downside
- No current out of pocket expense
- Delay income tax

TYPES OF STOCK

Types of Stock

■ Preferred stock vs. Common stock

- *Preferred = special rights/preferences*
- *Common = plain vanilla*

■ Why the distinction?

- *Outside investors demand special rights*
- *Justifies lower price for common – avoid...*
 - Tax problems
 - Accounting problems
- *Size of the gap*

BRIDGE FINANCING

Bridge Financings

- **Convertible promissory notes**
- **“Bridge” the company to an event (i.e. next equity financing)**
- **Convertible**
 - *Convert into what?*
 - *When convert?*
 - *What terms to convert under?*

BRIDGE FINANCING

Bridge Financings

- **Kicker for added risk**
 - *Early = risky*
 - *Less money = risky*
 - *Warrants*
 - *Warrant “coverage”*
 - **Secured vs. unsecured**
 - **Advantages**
 - *Quick*
 - *No valuation established*
-

STARTUP HORROR STORIES

- **Unaccredited investors in the angel round**
- **Founder who's gone but owns a large chunk of the company**
- **Promised payment of back salaries to executive team/employees**
- **Paying employees equity only versus minimum wage (WA state gotcha)**
- **Founder deadlock**
- **Poor corporate records that kill the deal**

STARTUP ISSUES

Questions?