



Structuring Founder Equity And Relationships



The Capital Network - Expert Lunch Series

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- Partner and Deputy Chair of Foley Hoag’s Business Department
- Board Member of The Capital Network.
- Practice focuses on venture capital financings, mergers and acquisitions, strategic alliances and related business transactions.
- Clients range from start-up and venture-backed portfolio companies to well-established public companies
- Clients operate in a wide array of industries, including networking, computer security, information technology, enterprise software, and life sciences.
- Have helped clients raise hundreds of millions of dollars in angel and venture capital, and has advised clients through several dozen acquisitions in the aggregate amount of over \$2.8 billion.

- Cutting up the pie; Division without Divisiveness
- “Restricted Shares”
- The Founders’ Agreement; getting it down on paper

Critical Questions Facing Co-Founders

- Definition: Who should my co-founders be?
- Equity Distribution: How will we divide the equity among ourselves?
- Control: How will decisions be made, and who will make them?
- Succession: What happens when one of us leaves?
- Forced Departure: Can one of us be fired? By whom, and for what reasons?
- Cash Contributions: Will any of us be investing cash in the company? How will this be treated?

Choosing Your Co-Founders

- Use care in who you choose; founders are to a startup as location is to real estate.
- Ability is a necessary but not sufficient condition.
- Character and commitment are even more important than ability.
- Work hard to maintain the relationship; your co-founder is more than just a co-worker.
- You haven't seen someone's true colors unless you've worked with them on a startup.
- The success of a startup is almost ALWAYS a function of its founders.

“Why not just split everything equally?”

The “Rule of N Approach.”

N= total number of founders, and each founder gets $1/N$ of equity.

- It's simple and quick
- We're all equals, so our equity stake should be too
- There's no “right” answer, so might as well divide it equally
- We want everyone to have skin in the game
- Debating over equity will kill the company
- If future events require, we can always adjust later

Metrics for dividing equity:

- Past contributions
- Future contributions
- Opportunity cost
- Your relationship with co-founders

– (Note: Don't confuse equity with income)

What do I pay for my Founders' Stock?

- Address this EARLY!
- Everyone should pay fair market value for the stock.
- Everyone should pay at least par value in cash.
- Cash is sometimes augmented by contribution of intellectual property, but this is tricky:
 - Difficult to define scope of transfer
 - Difficult to properly perfect the transfer
 - Difficult to value the assets assigned
 - Potential tax ramifications (Section 351 of IRC)

What if I paid “more” than FMV?

- Need to balance control over company (relative percentage of company held) with company’s need for capital.
- In extreme cases, consider issuing junior preferred stock with a liquidation preference.

Equity - take aways

- Address the “splitting the pie” issue as early as possible
- Pay attention to tax issues (get appropriate advisors)
- Dividing equally is often sub-optimal (Apologies to King Solomon)
- Choose metrics that are appropriate for your business
- Co-Founder’s equity position should reflect his/her true value
- “Skin in the game” means different things to different people
- Don’t avoid the issue; this only gets harder (and more expensive) over time

Should Founders' Stock be Restricted?

- “Restricted Stock” –shares subject to forfeiture
- The company has the right to repurchase the shares if the founder leaves the company for any reason.
- Vesting
- Acceleration
- Determining repurchase price
- Critical Tax Considerations – 83(b) election
- Timing- When to impose restrictions

What is “Vesting”

- Vesting = Company’s right to repurchase shares lapses over time or upon certain events
- “Vested Shares” – shares that are no longer subject to repurchase right.
- “Unvested Shares” - shares that are still subject to repurchase right.
- Note: Time based vesting vs. Performance based vesting

Vesting Schedule

- Standard Vesting Schedule: Four year vesting, with 25% vesting after one year, remainder vests monthly over next 36 months (i.e. 1/48 vests each month).
- Referred to as “cliff” vesting.
- Vesting commencement date – credit for past service?
- “Re-vesting” at a financing event

Timing: Restrictions on Day 1?

- **Primary reasons for imposing vesting even before VC financing:**
 1. If multiple co-founders, each is benefited if company is able to repurchase unvested shares of a departing co-founder.
 2. If the terms are reasonable, they might survive the venture financing.

Acceleration Upon Change of Control

- Standard Approach - allow some period of accelerated vesting (6-12 mos.) upon Change of Control
- “Double Trigger” - acceleration tied to the termination of the founder (usually without “cause”) within a certain period of time (12 mos.) after the Change of Control.
 - Difficult to implement if cash only consideration.
- Note: Founders and Investors have adverse interests

Acceleration Upon Termination

- Accelerate upon termination without “cause” or “constructive termination”?
 - Difficult to define “cause” and “constructive termination”
 - Difficult to implement
 - Almost always results in regret (except for the departing founder).
- Acceleration should be treated like severance (3-6-12 mos.)

■ Two Common Approaches:

- 1) Company repurchases unvested shares at the nominal price paid by the founder.
- 2) Company repurchases unvested shares at a price equal to the fair market value (FMV) at the time of the repurchase.
 - Board usually determines FMV
 - Problem #1- Investors often view the founders as having not yet “earned” the stock, and so they resist allowing founder to benefit from an increase in equity value.
 - Problem #2- the Company might not have the \$.
 - Possible Compromise: Differentiate the purchase price based upon the reason for the departure.

83(b) Election

- **General Rule:** If service-based vesting is imposed up on founder's stock, founder recognizes income (the difference between fair market value and the price paid) as the stock vests.
- **83(b) Election:** If founder elects within 30 days of the issuance of the stock to be taxed on the value of the stock at the time of issuance (less anything paid for the stock, which can include the value of IP contributed to the business), then no income recognized upon vesting.
- **30 Day Limit** – Strictly Enforced. (Being close doesn't count.)
- **Election is voluntary** - Can't unwind if shares are forfeited.

The Shareholders Agreement

- Standard Provisions in Shareholders' Agreement:
 - Structure of company and equity distribution
 - What are the vesting provisions?
 - Are Co-Founders allowed to pledge their shares?
 - Who is on the Board?
 - Any restrictions on new issuances by the company? (anti-dilution, pre-emptive rights)
 - How are disputes to be resolved?
 - How are sales by Co-Founders handled? (e.g. right of first refusal, tag along rights, drag along rights)
 - What are Co-Founders' obligations and commitments?

When do I involve the Lawyers?

- As early as possible!
- Organization of company (charter, bylaws, stock incentive plans)
- Stockholders Agreement
- Any agreement containing equity feature or right of first refusal
- Financing transactions (both debt and equity)

- Choose your co-founders wisely.
- Choose your attorney wisely, and early!
- Always involve your attorney before issuing equity or entering into shareholder agreements.

Sources and References

- www.onstartups.com
- www.founderresearch.blogspot.com
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- “Startups that Work” by Joel Kurtzman
- “Business Basics for Engineers” by Michael Volker

Questions?

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