Forming Startup Companies

Presented by:

Greg Kim
Partner, Virtual Law Partners

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Choosing the Entity

Entity Types You Don’t Want to Use to Form a Fundable Startup:

- Sole Proprietorships
- General Partnerships
- Limited Liability Partnerships (LLPs)
- Subchapter S corporations

Limited Liability Companies

- Limited liability for members and managers
- Taxed as partnership—profits and losses flow through to members
- Can have single member LLC
- Flexibility in management process
- Can be costly to establish
- Likely scenarios: cash flow businesses, closely held

Corporations (C)

- Limited liability/developed body of case law
- Double taxation (corp pays tax, and so do shareholders on distributions)
- Predetermined management and ownership structure
- Likely scenarios: high growth companies, public companies

Creating a Fundable Startups

It’s all about adding REAL credibility and REALLY mitigating risk to investors.

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It starts with a good idea, which can be given credibility over time. You can't REALLY mitigate your way out of a bad idea.

(And it's a bad idea to fake it.)

Key Questions at the Startup Stage

Who Are the “Founders”?

- They are there at the start and receive shares for the cheapest price (hopefully)
- Are they the “right” people?
- There is no such legal title as “Founder” but it indicates status in the company
- They are usually the original team that launches the company

What are everyone’s titles?

- Take a “Built to Last” approach.
- Hard to “demote” officers and directors.
- Give folks titles that not only match what they do but the level they can provide post-funding.
- Will they measure up to investors?

Does it help to have "brand name" advisors and directors at the early stage?

- Yes, but only if it REALLY adds credibility.

Do you own your company name?

- How important is the name to your business?
- It’s very expensive to ensure worldwide ownership and even then there are no guarantees (e.g. iPhone dispute)
- Most startups should assume that they may have to change their name at some point because of conflicts.
- Some easy checks: google search, dcca name search, www.uspto.gov

What is the Equity Allocation?

- More valuable founders should receive more equity.
- Initially equity is your currency to attract and retain key personnel. Will you create an equity reserve for future consultants, employees, founders, advisors, directors, etc.?

How do you define "Sweat Equity"?

- If someone quits, how much, if any, equity do they get to keep?
- Standard for rank and file is 4 year vesting and one year cliff.
- Consider special acceleration clauses for founders, e.g. upon a termination following a change of control, but don't overdo it.

Are you planning to seek traditional venture capital?

- If yes, then best to incorporate as a Delaware C corporations to mitigate risk to investors.
- If no, LLC is likely the right choice for cash flow businesses.
- No sense in starting as a LLC and convert to a Corporation later. Venture investors don’t’ care about taking early losses.
- Need to structure your company in accordance with Silicon Valley standards and templates.

What is your Pre-Money Valuation?

- Always project to the next round and beyond. Don’t just think in the present.
- Use spreadsheet to project multiple rounds, if all goes well. Adds credibility to what you are doing.
- Anticipate giving up 30-40% of your company in the first round, and majority after the second round. Is not directly dependent on amount of money you seek, so seek more not less.

Who Owns the Intellectual Property?

- Former employer issues?
- Are IP assignments/license in place?
- Do you use a NDA when disclosing your ideas?
- Is your idea patentable? Have you discussed with a good patent attorney?

HYPO: Tom and Tammy want to form a new software company. Tammy is the key founder, and, between Tammy and Tom, Tammy will have 60% of the outstanding common shares, and Tom will have 40%. They will create a stock pool for employees that will be 20% of the total shares. They need to raise $1.5 million to complete the development of their enterprise software product, but would be more comfortable raising $2,000,000 for a cushion. They contemplate a pre-money valuation of $3 million, and will be hiring employees once the financing is in place.

Name	Shares	Percentage
Common Stock		
Tammy	X	X
Tom	X	X
Option Pool	X	X
Series A Preferred	X	X
TOTAL	**10,000,000**	**100.0%**

1. Construct the cap table below for Tom and Tammy and guide them through the process. Insert a number or percentage where there is an “X” above.
2. Based on this cap table, what is the Series A price per share?
3. What is the Common Stock price per share?

1. Establish stock pool share number based on %.
    1. Decide if 20% is pre or post-money
    2. In our example it will be post-money (not diluting the investors)
2. Select a pre and post money valuation based on amount raised:
   $4.5mm vs. $5MM ($5MM better)
3. Establish Series A number based on % = 40% ($2MM out of $5MM)
4. Calculate total shares for founder = 800,000
5. Calculate number of shares for founders based on %:
    1. Tammy = 60% of 4,000,000 = 2,400,000
    2. Tom = 40% of 4,000,000 = 1,600,000

6. Calculate the Series A price per share = $2 million divided by 4,000,000 Series A shares = $0.50 per share

7. Calculate the Common Stock price per share. Possibilities are appraisal (IRC Section 409A) or apply a rule of thumb. For example, if common shares are discounted by 90%, the common price per share based on a preferred price of $0.50 would be $0.05. Note that this does not qualify for the 409A safe harbor.

Name	**Shares**	**% of Total Shares**
Common Stock		
Tammy	2,400,000	24%
Tom	1,600,000	16%
Option Pool	2,000,000	20%
Series A Preferred	4,000,000	40%
TOTAL	**10,000,000**	**100.0%**

And now . . .

The Top Ten Maxims for Startup Founders. . .

Maxim #10

Don’t Get Hung Up on Valuation or Control.

Without investment it’s worth NOTHING.

Maxim #9

Companies are not democracies

(discriminate in favor of value)

Maxim #8

Founders Can Get “Up Front” Special Treatment

(e.g. double trigger acceleration clauses)

Maxim #7

Go to Delaware or Go Home

Maxim #6

Share your company to grow it.

Maxim #5

Smaller is Better

(when it comes to your board and officers and titles)

Maxim #4

It’s all about sequence.

Maxim #3

Sacrifice Personal Interests for the Good of the Company

(Be Spock)

Maxim #2

Realize you have a limited useful shelf life to the Company.

(Avoid founder’s syndrome)

Maxim #1

Mantra trumps planning

(Business Plans are Fiction)

Thank you for your time!

Greg Kim
gkim@virtuallawpartners.com
780-2495 (cell)