

Legal Issues for the Entrepreneur

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I. Choosing the Form of Business Organization. One of the first decisions that will need to be made by a start-up enterprise is to choose a form of business organization. In order to make such a determination, an entrepreneur will need to focus on the likely capital structure of the organization (i.e., who are the likely or targeted equity owners of the business) and the exit strategy. The following is a general description of the advantages and disadvantages of the three major business entities.

A. The C Corporation

The primary advantages of a C corporation are that they have very flexible capital structures and investors are very familiar with them. C corporations also offer certain exit strategy advantages. If the exit strategy is a sale of the business, C corporations can participate in tax-free reorganizations. If the exit strategy is an IPO, no significant structural changes will need to be made to consummate the IPO.

The most significant disadvantage of a C corporation is that it is taxed as an entity distinct from its owners, thereby preventing its losses from flowing through to its shareholders, and causing its income to be subject to double taxation. The income of the C Corporation is taxed, and, upon the distribution of earnings to its owners, there is a second level of tax to the shareholders. The sale of a C corporation in taxable transactions will generally need to be structured as a stock sale, and, due to the adverse impact on the buyer (unable to obtain a step-up basis in the assets of the seller), the sale price of the C corporation may be negotiated downward.

B. The S Corporation

The primary benefit of the S Corporation is that it generally is taxed only once on its earnings. Its income and losses flow through to the shareholders, who are taxed on the income at their individual rates.

S corporations also have certain advantages with respect to exit strategies. Unlike C corporations, because S corporations are generally only subject to one level of tax, a taxable sale of an S corporation can generally be structured in a tax efficient manner that delivers a stepped-up basis to the buyer with only one level of tax imposed on the seller. Finally, an IPO of an S corporation can generally be accomplished with minimal restructuring.

The primary disadvantage of an S corporation is its limited flexibility with respect to its capital structure. Among other requirements, the S corporation can have only one class of stock, and no more than seventy-five shareholders. Subject to certain limited exceptions, its shareholders must be individuals which prevents many potential investors from being shareholders in an S corporation, including most institutional investors and venture capitalists.

C. The LLC

The LLC has many of the advantages of the other forms of business entities and few of the disadvantages. Like S corporations, the earnings of an LLC are generally taxed only once at the owner level, and taxable dispositions can be structured in a tax-efficient manner; however, unlike S corporations, an LLC has greater flexibility with respect to its capital structure.

The primary disadvantage of the LLC is the complexity of the governing documents and their relative newness to the market and potential investors. Additionally, although there is flexibility with the capital structure and the type of shareholders, many VCs would prefer not to invest in pass-through entities.

D. The following chart provides a brief comparison of the business and tax considerations of the three entities discussed above.

Factor	Limited Liability Company	S Corporation	C Corporation
A. Business considerations			
1. Limited Liability	Limited liability for Members even if they participate in management	Same as C Corporation	Limited Liability for shareholders even if they participate in management
2. Management	By all Members, unless Manager(s) appointed	By Board of Directors	By Board of Directors
3. Continuity of life	Permitted	Permitted	Permitted
4. Free transferability of interests	Permitted	Permitted	Permitted
5. Types of owners	No restrictions	No corporations, pension plans, nonresident aliens, partnerships; generally no trusts (except certain trusts)	No restrictions
6. Number of members	No maximum, but requires at least two (2) (one as of 1/1/00)	Maximum of 100	No maximum
7. Difference classes of interests	Permitted	Except for voting rights, only one class permitted	Permitted
8. Limited liability in all states	Uncertain	Yes	Yes

Factor	Limited Liability Company	S Corporation	C Corporation
B. Tax considerations			
1. Taxability of income	No tax at entity level, if it qualifies as nonpublicly traded partnership; undistributed income taxed to Members	No tax at entity level, except on certain passive income, capital gains, and built-in gains; undistributed income taxed to shareholders	Entity-level tax is imposed; undistributed income generally not taxed to shareholders
2. Certainty of tax status	Yes	Yes; relief available if technical violation of certain rules	Yes
3. Distributions to owners and compensation payments	Generally not taxable, unless a guaranteed payment (IRC Section 707)	Payment of salaries deductible by corporation and taxable to recipient; Distributions generally not taxable	Payment of salaries deductible by corporation and taxable to recipient; payment of dividends not deductible and generally taxable to shareholders
4. Special allocations of taxable income and loss to owners	Permitted subject to IRC Section 704(b) and (c)	Not allows; one class of stock required	Permitted (via disproportionate dividends)
5. Deductibility of losses	Members may deduct their allocable share of the LLC's losses only to the extent of their tax basis in their LLC Interest, which includes their allocable share of LLC debt. (At-risk and passive activity rules also apply)	Shareholders may deduct their allocable share of the S corporation's losses only to the extent of their tax basis in the S corporation shares and loans they have made to the S corporation (not loans they have guaranteed). (At-risk and passive activity rules also apply)	Not applicable.
6. Basis adjustment available to entity assets	Upon death and sale of interest of a Member (IRC Section 754)	None	None
7. Flexibility in structuring retirement payments	Yes (under IRC Section 736)	No	No
8. Taxation upon distribution of appreciated property	No (but see IRC Section 704(c))	Yes	Yes

Factor	Limited Liability Company	S Corporation	C Corporation
9. Insolvency exception to discharge of indebtedness of income provisions (IRC Section 108)	Determined at the member level	Determined at the entity level	Determined at the entity level
10. Accounting method	Cash or accrual, but an LLC with C corporate members (having more than \$5 million in gross receipts) and “tax shelters” may not use cash method	Cash or accrual, but a “tax shelter” may not use the cash method	Accrual, but cash available to C corporations with \$5 million or less gross receipts
11. Taxable Year	Can elect fiscal year in certain circumstances	Can elect fiscal year in certain circumstances	Generally, any year permissible upon adoption; changes require business purpose
12. Ability to do tax-free reorganization	No	Yes	Yes
13. Self-employment tax to members	Services subject to self employment tax, but treatment unclear	No, but FICA on salary	No, but FICA on salary

II. Avoiding Common Mistakes. Compliance with governmental and other regulatory constraints is a critical but often overlooked step by inexperienced entrepreneurs. Among many other issues, a start-up must make sure to comply with securities laws and tax laws and to secure its rights to intellectual property.

A. Securities Laws

(i) The offer and sale of securities in the United States is regulated by the federal Securities and Exchange Commission (“SEC”) and by each state under what are commonly known as the “blue sky” laws. There are two overarching principals to remember prior to issuing securities of your company to any party, including friends, family and investors:

(a) **Registration/Exemption.** Every offer or sale of a security must be registered with the federal and appropriate state agency unless the offering is subject to an exemption from registration. While registration is a viable exit strategy for a more mature business enterprise, it is a very time consuming and expensive process that typically involves conducting a public offering through underwriters and the preparation of a prospectus. Therefore, registration should be avoided by early-stage start-ups, if possible, by issuing stock pursuant to an exemption from registration.

- (b) **Disclosure.** Anti-fraud rules apply to all transactions involving the exchange of securities, whether or not the offering is exempt from compliance with federal and state law. Anti-fraud rules require that the persons offering securities disclose (without omitting or misstating) any material information about the business. “Material” information is anything that a reasonable investor would want to know prior to making an investment decision.

- (ii) **California’s Private Placement Exemption - 25102(f).** Section 25102(f) provides the most widely used private placement exemption in California. The major statutory elements of Section 25102(f) are summarized below:

 - (a) Sales of the security are not made to more than 35 persons including persons not in this state;
 - (b) As a general rule, there is no limit on the number of offerees.
 - (c) All “counted” (described below) purchasers either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or by reason of their business or financial experience or the business or financial experience of their “professional advisors” who are unaffiliated with, and who are not compensated by the issuer or any affiliate or selling agent of the issuer directly or indirectly, could be reasonably assumed to have the capacity to protect their own interest in connection with the transaction;
 - (d) Each purchaser represents that the purchaser is purchasing for the purchaser’s own account (or a trust account if the purchaser is a trustee) and not with a view to or for sale in connection with any distribution of the security;
 - (e) The offer and sale of the security is not accomplished by the publication of any advertisement; and
 - (f) The issuer must file a notice with the Department of Corporations as provided by rules of the commissioner.

- (iii) **Analysis of Certain Provisions of Section 25102(f).**

 - (a) **Number of Purchasers.** The maximum number of counted purchasers is limited to 35 and this includes purchasers outside the State of California. The following purchasers are not “counted” with respect to the limit of 35:
 - (b) Certain institutional investors.
 - (c) Officers, directors or affiliates of the issuer.

- (d) Any person who occupies a position with the issuer with duties and authority substantially similar to those of an executive officer of a corporation.
- (e) An individual who is a “promoter” of the issuer.
- (f) Any person who purchases \$150,000 or more of the securities offered in the transaction, provided each such purchaser meets any one of the following, or who the issuer reasonably believes comes within any one of the following:
 - 1. Such person, or such person’s professional advisor, has the capacity to protect such person’s own interests in connection with the transaction.
 - 2. Such person is able to bear the economic risk of such person’s investment in the transaction.
 - 3. The investment (including mandatory assessments) does not exceed 10% of such person’s net worth or joint net worth with that person’s spouse.
- (g) A person who comes within one of the categories of an “accredited investor” in Rule 501(a) of Regulation D of the Securities Act of 1933. The following are some of the more commonly used categories of “accredited investors”:
 - 1. A natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000.
 - 2. A natural person who had “Individual Income” in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.
 - 3. A broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934, as amended.
 - 4. An investment company registered under the Investment Company Act of 1940 or a business development company as defined in Section 2(a)(48) of that Act.
 - 5. A Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958.

6. A director or executive officer of the Company.

(h) Advertising.

1. Section 25102(f)(4) provides that the offer and sale of the security is not accomplished by the publication of any advertisement.
2. “Advertising” and “publish” are words of art under the California Securities Laws and, unless care is exercised, the exemption can be inadvertently lost.
3. “Advertisement” is defined as any written or printed communication, or any communication by recorded telephone messages, or spoken on radio, television or similar communications media, published in connection with the offer and sale of a security. Thus, a private placement memorandum, if published, constitutes an advertisement.

“Publish” is defined to mean publicly to issue or circulate by newspaper, mail, radio or television, or otherwise to disseminate to the public. Private placement memoranda, offering circulars and similar disclosure documents are not disseminated to the public for the purposes of Section 25102(f) if the issuer limits such circulation (i) to persons reasonably believed to be interested in purchasing the securities or (ii) to persons whom the issuer believes may meet the qualifications required of purchasers under the statute, provided with respect to clauses (i) and (ii) that neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including but not limited to, the following:

- a. Any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio; and
- b. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

(iv) Regulation D. Under certain conditions, Regulation D allows a company to sell securities to not more than 35 “non-accredited” investors (e.g., friends and family) and an unlimited number of accredited investors (e.g., financial institutions, venture capital funds, individuals with a certain level of income) if the company does not engage in advertising or promotion of the sale. The general solicitation and other guidelines are substantially similar to those as described above under 25102(f).

B. Taxation of Equity Based Compensation. As more fully described under Section IV below, due to the scarcity of financial resources of a start-up, stock options and other types of equity-based compensation for founders, employees, directors and consultants are a standard form of compensation. There are, however, significant tax and accounting implications on the use of such equity-based compensation.

(i) **Founder's Stock.** Founder's Stock is generally sold upon the organization of a company for an insignificant amount of consideration. If the fair market value of such stock at the time of its issuance exceeds the nominal consideration, and if the purchaser provides services to the company, then the difference between the fair market value and the price paid will be taxed as ordinary compensation income. Accordingly, an entrepreneur should not delay in forming and organizing the company until the time that he or she may receive a term sheet from an outside investor. If, for example, the founders paid \$.01 per share for their Common Stock and one month later the Company sells Common Stock at \$.50 per share, then the Internal Revenue Service may deem that the founder have received taxable income in the amount of \$.49 per share.

(ii) **Cheap Stock.** Cheap stock is stock sold for a very low price per share any time after the company has obtained outside financing. Low valuations may be justified when issuing stock to founders and initial key employees prior to obtaining outside financing because the company is just beginning to develop its business. However, the sale of cheap stock with valuations that are too low in relation to the value of senior securities may bring a challenge from the Internal Revenue Service as well as the SEC at the time of a company's initial public offering. The key to avoiding or minimizing cheap stock problems is to evidence the value of any stock or stock option grants at the time they are made and be able to explain why that value subsequently increased. For example, common stock of start-up companies is often valued at a discount to the price that senior securities are sold. While there is no standard criteria for determining the appropriate discount price of common stock, the following factors should be analyzed: (1) earnings prospects, (2) book value of stock, (3) prices paid for stock in prior financing rounds, (4) prices paid for other classes of stock of the company in prior financing rounds, (5) the presence of proprietary technology and (6) prices paid for similar stock in companies of comparable development. To avoid creating tax problems for its purchasers, cheap stock should be justifiable, in part, on the above criteria and should not be sold shortly before or after a venture financing at a higher price.

C. Protecting and Securing Rights to Proprietary Information and Intellectual Property

(i) **Employee/Consultant Agreements.** Prior to investing in a company, sophisticated investors will require that all employees and consultants of the company have executed certain agreements that provide the company with various rights relating to employee-developed inventions and certain protections in connection with the company's inventions and trade secrets. In the absence of

such agreements, the owner of employee or consultant-developed inventions may in fact be the individual inventor and not the company. Investors are wary to invest in a company that has not properly secured and or protected the intellectual property key to its business. Accordingly, a start-up company should institute a policy requiring, at a minimum, that technical and management employees and consultants sign some type of Employment, Consulting and/or Proprietary Information and Inventions Rights Agreement. Such agreements assign to a company all of the employee's or consultant's rights to all inventions and intellectual property created during their employment as well as prohibit employees and consultants from disclosing any proprietary information of the company in consideration of their employment with the company.

- (a) **Express Agreements.** If an employee or consultant signs an agreement specifically assigning his or her rights in any invention to the company, the company owns it. These agreements are strongest if they are executed by all new employees and consultants at the time they are hired and as a condition to their employment. A written agreement to assign intellectual property executed *after* the employee or consultant begins may not be enforceable. Therefore, a company should take full advantage of its leverage at the time of hiring and obtain a written assignment of all present and future rights to all inventions and intellectual property as a condition to the employment relationship. During the course of employment, a number of benefits which the employee or consultant is not otherwise entitled to could be used to provide adequate consideration for the assignment of intellectual property. Examples include bonuses, promotions, incentive programs and even separation agreements.
- (b) **Hired to Invent/Contract-in-fact.** If an employee is specifically hired for the purpose of inventing, then any resulting invention belongs entirely to the employer. Thus, even when no express contract exists, the circumstances surrounding the employment relationship may provide the company with all of the rights to an employee's inventions. However, each case is decided on its own facts and depends upon the conditions and requirements of employment. These issues are critical when a former employee joins a competitor and attempts to use inventions that the prior company claims to be its own. Absent an express agreement, these issues may only be resolved through prolonged and costly litigation.
- (c) **Shop Right Doctrine.** Absent an express written contract to the contrary, if an employee is not specifically hired to invent, then, under certain circumstances, the inventions created by the employee may belong to the employee. In such circumstances, the "shop right" doctrine grants to employers a nonexclusive, nontransferable royalty-free license to use the invention. However, a company should not rely on this doctrine as a means for obtaining rights to an employee's invention because there are no restrictions on who the employee may license to or the number of licenses the employee may grant to use the invention. Even competitors

can be licensed and they may use the patented technology in competition with the employer.

(ii) **Types of Intellectual Property.** The following is a brief description of the types of intellectual property that companies should be concerned with protecting, as well as the protection they afford.

(a) **Trademark.** Trademark law is designed to prevent confusion among the consuming public regarding the source of goods or services. A trademark may consist of a name, phrase or symbol. A person or business who has trademark rights may prohibit others from using the same or a similar trademark in connection with the sale of goods or services under circumstances that could result in confusion of consuming public. Having a URL does not automatically give you trademark rights to the name.

1. **Classifications of Marks.** The more unique the name that you give your product or company, the higher the degree of protection that the mark will be afforded. Fanciful marks such as “Kodak” are entitled to the highest degree of protection, and it is unlikely that a later user will be allowed to use the mark in connection with its product. Marks that are merely descriptive (such as “Quality”) are not entitled to protection unless it can be shown that the mark has acquired “secondary meaning” and that customers actually associate the mark with a company’s goods or services.

2. **Policing Your Mark.** Rights in a trademark arise upon its first use in commerce in connection with the sale of goods or services. Once you have established your mark, you must protect it by registering the mark with federal and state agencies. State registration extends protection to the geographic area in which the mark is used. Federal registration extends protection throughout the U.S. You also must maintain a state of constant vigilance and be on the lookout for potential infringers of your company’s mark.

3. Short of registering your mark, you should place the symbols “TM” or “SM” next to the mark in advertisements and the like to demonstrate your claim to its trademark rights. Federally registered trademarks are distinguished by use of the ® symbol.

(b) **Patent.** A patent is an exclusive right granted by a country to an inventor, allowing the inventor to exclude others from making, using or selling his or her invention in that country during the life of the patent, although this right is subject to any prior rights that others may have to related inventions.

1. **United States Patents.** Patents are issued to the individual inventor (although employees typically assign inventions to their

employer). An individual can obtain patent protection for any product, process or design that meets certain standards of novelty, nonobviousness and utility. Patent protection is available for most inventions for 20 years from the earliest date of filing, and for 14 years for design patents. A patent application must be filed with the U.S. Patent and Trademark Office within one year after a description of the invention is published or publicly disclosed or the invention is first offered for sale or offered for commercial use.

2. **Foreign Patent Issues.** Although patent applicants in the United States are protected by the one year period for filing, in almost all foreign countries, patent protection is not afforded to inventions that are publicly disclosed before the inventor files a patent application. Further, the “first to file” a patent application in most foreign countries will prevail in a dispute among inventors (in the U.S., the “first to invent” would win such a dispute). Consider filing in the U.S. before publicly disclosing the invention, because this will preserve your ability to obtain foreign patents within one year of the date of the U.S. filing. Foreign patent filings are typically made under one of two international treaties: the Patent Cooperation Treaty or the European Convention. Those who file under these treaties preserve their rights and limit the upfront filing fees required; however, the applicant will eventually be required to pay the patent filing fees for each county or each regional patent office in which the applicant wants to obtain a patent.
3. The patent application process in the United States usually takes 18 to 24 months. It is well worth your time to hire a patent lawyer that specializes in patent prosecution (that is, obtaining patents) in the technical area that the invention covers. A patent lawyer with experience in your field of technology can be invaluable in this process because he or she can draft the patent application in anticipation of new developments in the field.

(c) **Copyright.** Under federal law, copyright protection is available for original works of authorship, such as written works (books, manuals, etc.) computer programs, databases, dramatic works, and audio and video works. Copyright protects only the way in which the idea is expressed, not the actual idea.

1. Copyright owners have the exclusive right to copy, publicly perform and distribute the copyrighted material and to prepare derivative works. Copyrights can be transferred and/or licensed.
2. Registration of a copyright with the Library of Congress is no longer required, but before you can bring an action for copyright

infringement, you must register the copyright in order to prove the damages incurred as a result of the infringement.

3. **Copyright Notice.** It is no longer necessary to put a copyright notice on a work in order to preserve a copyright in the work. However, you should still use a copyright notice as a matter of course. The following copyright form is sufficient: “Copyright 200__ (Owner’s name) All Rights Reserved.”
 4. Generally speaking, the author of the work is the owner of the copyright, but an employer is the copyright owner where the work was created by an employee within the course and scope of his or her employment.
 5. **Term of Copyright.** Where an individual has copyrighted material, the copyright applies during the life of the individual plus fifty years. Works copyrighted by a business entity, on the other hand, are protected by 75 years from the publication of the work or 100 years from its creation, whichever expires first.
- (d) **Trade Secrets.** The law of competitive business practices often deals with the protection of a company’s trade secrets. A trade secret is confidential knowledge or proprietary information that enables one to obtain a competitive advantage over another and typically include formulas, systems, processes, techniques, designs, developments, plans, know-how, and customer lists. Restatement of Torts §757. Although not always as easily definable as the other forms of intellectual property set forth above, a technology-based company’s trade secret and proprietary information is often critical to the company’s success. One of the several factors to be considered in determining whether information is a trade secret is the extent of measures taken by the company to guard the secrecy of the information. Accordingly, although many believe that a Confidentiality or Non-Disclosure Agreement is “not worth the paper it is written on,” it will be difficult for a company to later claim that a company has misappropriated a trade secret in the absence of any evidence that a company attempted to protect such information.

III. Equity Based Compensation for Employees.

- A. **Use of Stock Options.** Due to the scarcity of financial resources of a start-up. Stock options for employees, directors, and consultants have become a standard form of compensation. They are a cost-effective form of compensation to incentive employees. An option is the right to purchase a company’s stock at a given price. The holder of an option does not actually own the underlying stock and does not have the same rights as a stockholder. As opposed to rewarding employees with shares of stock and the resulting income tax consequences, the granting of options to an employee generally does not result in the recipient having any taxable income when they receive the options.

- (i) **Incentive Stock Options (“ISOs”).** ISOs can only be granted to employees and must be granted under a stock option plan approved by the company’s stockholders. ISOs also must have an exercise price equal to the fair market value of the stock on the date the ISO is granted. ISOs must vest within 10 years from the date of issuance. An employee will not be taxed on the grant or exercise of an ISO. Upon the sale of the underlying stock, the employee will be taxed on the differences between the price of the stock as sold and the exercise price. This spread is taxed as ordinary income if sold before the later of two years from grant or one year from exercise and as capital gains if after these disqualifying time periods.
- (ii) **Non-Qualified Options (“NQOs”).** All other types of options are NQOs. Non-employees, outside directors and consultants necessarily receive NQOs. NQOs do not have to be granted at fair market value. An employee will not be taxed on the grant of an NQO, but does realize ordinary income on the date of exercise if the fair market value of the stock is greater than the exercise price. Upon the sale of the stock, the proceeds of the sale that exceed the value of the stock upon exercise is taxed as a capital gain.
- (iii) **Vesting/Exercisability.** Generally, an employee’s ability to exercise his or her stock option, will be tied to a vesting schedule described below. When a stock option vests, the employee’s option to purchase stock at the option price is triggered.
- (iv) **Milestone Vesting.** Milestone vesting allows for the vesting of options based solely upon the achievement of individual or group goals such as the completion of alpha testing of a product, the shipment of a beta product to the consuming public for testing or the achievement of a certain level of gross annual revenue. Milestone vesting is not common because it is extremely difficult to set definitive milestones and because a company’s “milestones” are often in flux. Additionally, a vesting schedule that is tied solely to performance without a calendar schedule described below can create significant accounting issues for a company.
- (v) **Calendar Vesting.** Allows for vesting if the employee is still employed by the company on a given date. This model has the advantage of tying vesting to the employee’s longevity, and presumably addition of significant value, to the company. Calendar vesting is usually accomplished within a three to five year period. Calendar vesting is typically done on an annual, quarterly or monthly basis.
- (vi) **Acceleration of Vesting.** Vesting schedules typically have a provision for the partial acceleration of a portion the vesting of options upon the occurrence of specified events, such as an initial public offering (“IPO”) or the acquisition of the company.

B. Determining How Much Stock/Options to Set Aside for Employees. In order to answer this question, you must first ask yourself why you are paying your employees in stock/options in the first place. Is it because market salaries are unaffordable? Is it for motivation or as a risk premium for a venture in a new area of business/technology? It is important to answer these questions and develop a strategy for making awards of stock/options.

(i) **Pre Venture Capital Investment.** Here, set asides typically fulfill multiple obligations like compensating for lower salaries, adjusting for risk and motivation.

(ii) **Post First Round Venture Capital.** Companies may set aside 10-20% of stock after the venture capital investment for future stock or option grants. The exact set aside will vary based on perceived need for stock. For example, more will be set aside if stock is needed for an upcoming critical hire of an executive. Post venture capital set asides are primarily used for motivational purposes.

(iii) **Long Term Planning.** Use your long term business plan and project forward to determine which critical positions may need to be filled in the near term.

IV. Valuation. Once the entrepreneur has determined his capital needs and has selected (or been selected by) the right source of financing, the entrepreneur and the funding source must determine a valuation of the company. Valuation is essentially a process to determine the present value of the company, taking into account its future worth at the time when the investor can realize a return on its investment (*i.e.*, when the investor's equity in the company becomes liquid).

A. Pricing of Initial Rounds of Financing, i.e., How Much Equity to Give Up? From the entrepreneur's prospective, valuation determines how large of a share of the new venture he or she must relinquish in order to receive the funding needed by the venture. From the investor's prospective, valuation determines how large of a share of the new venture the investor must receive in order to justify the risks of making the investment. With these competing interests in mind, a higher valuation will mean that the entrepreneur will have to relinquish a smaller share of his company to obtain the funding he or she needs.

As briefly discussed above, in order to understand how much equity to give up in early rounds of financing, the entrepreneur should understand that the venture financing industry operates under the concept of staged financing. The essential question for the entrepreneur is how much capital he or she will need to get the company to the next stage of its development. For example, the entrepreneur might determine how much funding is necessary to move from concept to development to beta testing to full scale development to product launch and expansion. A company will generally have a lower valuation at its earlier stages of development than at later stages of development. As a result, the pricing of an earlier stage company's equity will generally be lower than a more developed company, and more equity will have to be relinquished in order to raise capital in the early stages as opposed to the later stages. Thus, as a general rule, entrepreneurs should

determine the need for capital in order to realistically get to the next significant stage of the company's development, because at such time a higher valuation may be obtained.

It is important to note also that valuation is recomputed at each round of financing, and a favorable valuation at one stage does not guarantee an acceptable valuation later on if the company has not performed as expected. As such, the entrepreneur should also set realistic goals in determining the future prospects of the company. In addition, it is also important to note that it is ultimately the absolute value of the entrepreneur's ownership of the company that matters, and not necessarily his percentage of ownership. Thus, if relinquishing a certain percentage of the company increases its value significantly, the entrepreneur may nevertheless have a much bigger pie to share with investors.

B. Critical Terms Related to Understanding Valuation

- (i) **“Pre-Money” and “Post-Money” Valuation.** Pre-money valuation refers to the value of a company prior to the infusion of cash from a proposed financing. Post-money valuation refers to the value of a company immediately after the infusion of cash from a proposed financing. It is important to know when an investor discusses making an investment based on a certain valuation, whether that valuation is intended as a pre-money or post-money valuation, as it ultimately affects the percentage of the company the investor will receive. For example, if an investor is willing to invest \$5 million based on a pre-money valuation of the company of \$10 million, the investor will receive 33% of the company (\$5 million divided by \$15 million since the \$10 million figure does not include the added value of the cash investment). If an investor is willing to invest \$5 million based on a post-money valuation of \$10 million, then the investor will receive 50% of the company (\$5,000,000 divided by \$10,000,000, since the \$10,000,000 is assumed to include the added value of the cash investment).
- (ii) **Fully Diluted.** “Fully-diluted” essentially means the assumed conversion and/or exercise of all rights, options and warrants to acquire the common stock of the company. Valuation, and the ultimate percentage the investor will own of the company, is determined on a fully-diluted basis.
- (iii) **Rules of Thumb.** Entrepreneurs should generally approach valuation based on a realistic, defensible projection of the company's future performance. An overly aggressive projection may indicate that the entrepreneur has not seriously considered the challenges faced by the new venture, and may make suspect other representations as to the company.

V. Structure of Financing

A. Angels

- (i) **Bridge Loan with Warrant Coverage.** Entrepreneurs often approach angel investors because an angel investment can usually be made much faster than professional venture investments. A bridge loan with warrant coverage is often

the fastest method of getting money into a company, often as a precursor to obtaining equity investment from other sources. Under this structure, an angel makes a short term loan (often 6 months or less) to the company in the form of a promissory note. At the maturity of the loan, the angel can choose to collect on the note, or to convert the loan into shares of the company at a predetermined price per share or at a price per share based upon the price per share at which the venture raises capital at its next financing (or some predetermined discount thereto). A new venture may also require that the loan become automatically converted into the shares of the company upon certain events, such as the raising of a certain amount of additional capital or the accomplishment of certain milestones, in order to avoid having to spend cash to repay the loan. Angels benefit from this type of structure because it allows them additional time to gauge the potential success of the company prior to making an equity investment. The investor may perform additional due diligence during this time, or simply observe the development of the company. The new venture benefits from this structure because it can obtain and begin to use the cash from the angel in a relatively short period of time.

- (ii) **Preferred Stock.** Angels may require that they receive preferred stock as opposed to common stock. Preferred stock ordinarily provides the holder a number of preferences and rights over common stockholders, including the founders. What those additional rights and preferences are depends on negotiation between the company and the investor, which in turn is often dictated by current market standards.

New ventures will often want to issue preferred stock instead of common stock in order to preserve a lower exercise price for stock options. Certain requirements under the internal revenue code and securities laws require that stock options be granted at the fair market value of the company's common stock. Because the price in which an outside investor pays for a company's common stock is often a key determinant of the stock's fair market value, a sale of the common stock at a price acceptable to the company may inadvertently set a high exercise price for stock options. Companies may avoid this problem in some situations by selling preferred stock instead, which arguably commands a higher price than the fair market value of common stock because of the additional rights and preferences given to its holders. Furthermore, if, as is typically the case in new ventures, founders and key employees have recently bought and are buying the Company's common stock at a low price and contemporaneously therewith, or soon thereafter, the Company acquires outside financing based upon a higher price, the founders and key employees may be faced with the inadvertent tax issues.

- (iii) **Common Stock.** New ventures may also simply issue to angel investors common stock, essentially putting them on the same footing as the founders, subject to the relative percentage ownership of the company. However, as discussed above, issuing common stock has the primary drawback of setting an unintended high exercise price for stock options. Moreover, because angel investors often invest

shortly after the founders have received their own shares, the price paid by angels may create unexpected taxation problems.

B. Venture Capital Funds

(i) **Convertible Preferred Stock.** Venture capital funds will often insist on having substantial rights and preferences to other stockholders that reduce the risks of their investment. Preferred stock may be converted into common stock upon a liquidity event (e.g., sale of the company or an IPO) so that preferred holders can enjoy the same benefits as common stockholders. In general, preferred rights will include the following:

(a) **Dividend Preference.** If the company pays dividends to its stockholders, preferred stockholders are entitled to a certain percentage per share prior to the common stockholders receiving their distributions.

(b) **Liquidation Preference.** If the company is liquidated, merged or sold, the preferred stockholders will be entitled to a predetermined amount (often 3 times their initial investment) prior to any distribution to the common stockholders.

(c) **Pro-Rata Participation Rights.** If the company issues additional stock of any kind, the preferred holders have a right to purchase such additional number of shares of the company in order to maintain their percentage ownership of the company.

(d) **Anti-Dilution Rights.** In the event that the company issues additional securities below the investor's purchase price, the rate upon which the investor may convert preferred stock into common stock (initially on a 1-to-1 basis) is adjusted so that the investor will receive more shares of common stock upon conversion. The net effect is that the investor will ultimately receive a higher percentage of the company. Anti-dilution rights is a form of price protection for the investors, since additional issuances of securities below the investor's purchase price has the effect of lowering the valuation of the company.

(e) **Other Rights.** The preferred stock may entitle the holders to other additional rights, including the right to elect directors and the right to veto certain actions by the company (such as a sale of the company for less than a certain price).

(f) **Redeemable Preferred Stock with Warrant Coverage.** In addition to the other rights and preferences that preferred stock may have, investors may insist upon the stock being redeemable at their election. Pursuant to the redemption right, the preferred stockholders may require the company to buy back their shares at the original purchase (plus any unpaid dividends) after a certain number of years. The right assures the investor

that if there has not been a liquidity event in a certain amount of time, the investor essentially can “walk away” from the investment. In addition, investors may request a warrant right to purchase additional shares of the company’s stock at a pre-determined price (usually the price per share of the investment). The warrant right essentially gives the investor an additional ability to share in the upside of the company, without immediately bearing the risk of additional capital investment.

C. Look at Every Task or Event with an Eye to Its Effect on a Liquidity Event. As a start-up company grows, the decisions it makes along the way can and will impact its ability to employ certain exit strategies.

(i) Registration Rights Agreement. Venture capital funds usually begin plotting their ultimate exit strategies at the time of their initial investment. Indeed, contracts signed at the time of the fund’s initial investment may give investors future rights to control the exit event. Venture funds typically insist at the front end that a company and its other stockholders sign an investor rights agreement. Such an agreement may give the investors control over the timing of a future IPO, priority over other stockholders in the public resale of its stock, and rights to additional SEC registrations subsequent to the IPO. The following are a few of the provisions that investors may insist be included in an investor rights agreement.

(a) Demand Registration Rights. A demand registration right allows the demanding stockholders to cause a company, subject to negotiated limitations, to effect a registration statement at a time chosen by such stockholders. Even though demand registration rights are seldom used, they may give stockholders the power to force a company to register their shares prior to the company’s own IPO. There are major negotiating points, however, that may lessen the effect of such rights if stockholders desire to make such a demand. First, a company may include provisions that prohibit the use of demand rights for a period of several years or until after the company’s IPO, giving the company the right to plot its own course during the formative stages of its development. The company may also insert a provision to give its board of directors the right to delay a demand registration for a period of time if it determines in good faith that registration would be seriously detrimental to the company or its stockholders. A provision may also require that the demand be made by a certain percentage of stockholders or cover a certain threshold value of securities. The company may also limit the number of demands that may be requested. The number of demands given to the investors may have a significant effect on the percentage in interest the investors will want to specify: as a general rule, from the investors’ point of view the larger the number of demands given, the lower the percentage in interest required to effect the demand.

- (b) **Piggyback Registration Rights.** Piggyback registration rights allow investors to “piggyback” their shares in a public offering initiated by a company. Since the investors are merely along for the ride, the company is entitled to determine the timing of the registration and, indeed, whether to complete it at all. In addition, companies regularly include “cut-back” provisions that allow the company to exclude the stock of existing investors from registration if underwriters determine that market factors so dictate.
 - (c) **S-3 Registration Rights.** A company may grant a particular form of registration right when the company becomes eligible to register securities for resale on Form S-3. Form S-3 is available for secondary offerings if: (i) the company is organized under the laws of the United States, (ii) the company is and has been a reporting company for at least 12 months, (iii) during the past year it has filed all reports required by the SEC and such reports have been timely, and (iv) the company has not defaulted on certain obligations since the end of its prior fiscal year. A registration on Form S-3 does divert management time, carry moderate costs, and expose the company to liability under the Securities Act. Therefore, companies often require that such offerings achieve certain minimum aggregate price thresholds (e.g., aggregate price to the public of \$2,500,000), limit the number of S-3 demands in a given time period (e.g., one per year), or restrict the time in which such demand may be made (e.g., must be effected within five years of the company’s IPO).
 - (d) **Expense Provisions.** There are many variations on the allocations of expenses between the company and investors. The agreed upon allocation depends upon the relative bargaining power of the investors and the company. These provisions may require that the company pay the registration expenses for all registrations. If the company has more leverage, it may require that the selling stockholders pay for S-3 registrations or pay for the second demand registration, but not the first.
- (ii) **Acceleration of Stock Options.** Stock options for employees, directors and other “insiders” have become a standard form of compensation offered by start-up companies, because options provide a seemingly cost-effective way to “incentivize” employees. Stock options typically vest on a calendar time schedule. Implicit in this is that the employee will be motivated over that period of time to applying his or her skill set to help the company achieve “success”.

Certain “success events”, like the acquisition of the company, often trigger acceleration of the vesting schedule of the options. Many options plans are drafted to provide for automatic acceleration upon a change in control of the ownership of a company. For example, if a company agrees to a five year linear vesting for its employees and agrees to acquire the company for an outrageous premium on the price per share of the company’s stock, this is “success” and it would appear to make sense to accelerate the vesting of the employee’s stock

options. However, rigid acceleration provisions may actually prove harmful. Since a substantial part of the “assets” of a technology company are the employees, the acceleration of the vesting of all options may cause an acquirer concern that the employees may elect to “cash-out” and leave the company following the closing.

To avoid the pitfalls of automatic acceleration, companies may adopt provisions in their option plans that provide for acceleration only if the acquiring company does not adopt the target companies option plan on substantially similar terms. This, however, may strain employee relations by preventing key employees from cashing out if and when the founders and principals they agreed to work are displaced by the acquiror. It also makes it difficult for a company to attract key employees. As a compromise, many start-up companies adopt option plans that provide for some form of modified acceleration upon a change in control. For instance, a modified acceleration clause might provide that upon a change in control the vesting of unexercised options accelerate for an additional two year period. While such a modified acceleration clause only works where options are granted with calendar vesting schedules, these acceleration clauses have become standard in the option plans of today’s start-up enterprises. Additionally, the plan may be structured so that acceleration would occur for any given employee upon (i) a change of control and (ii) the termination of such employee without cause within a certain period of time following the closing.



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