My General Counsel Group

Legal Organization of Technology Start Ups

By Michael Prozan

650 348-1500

mike@mgcgroup.com

My General Counsel Group

When Do You Need a Lawyer?

- When you have more than one founder
  - Get equity arrangements straight from the beginning.
  - Establish vesting in case things do not work out.
- When you have anyone other than a sole shareholder working on Company IP
  - Ensure that the Company owns all of its IP in the event of a separation.

My General Counsel Group

What to Look for In a Lawyer

- Experience in establishing pre public technology companies.
  - This is the only absolute recommended in selecting an attorney at this stage of Company development.
- Good Personal Fit.
  - You will be receiving a lot of advice regarding how to handle your affairs and spending a lot of time with your lawyer on important matters. At a minimum, you should respect your lawyer and preferably you should like your lawyer.
- Big Firm v. Small Firm v. Sole Practitioner
  - At this stage of your development, this is a matter of personal preference.

My General Counsel Group

What Are the Risks of Not Seeing an Experienced Lawyer in a Timely Manner?

- Letting a founder leave the Company prematurely with too much equity, severely hampering incentives for remaining founders.
- Failing to secure ownership of intellectual property needed by the Company.

My General Counsel Group

Vesting

- In the founder context, vesting is the right of the Company to repurchase shares that have been issued to the founder.
- As contrasted with stock options, many of which do not permit purchase until vesting has occurred, this is sometimes called reverse vesting.

My General Counsel Group

Vesting Issues

- Founders A and B each own 1,000,000 shares (50%) of Tech Co with no vesting.
- Founder A leaves the Company before the end of the first year.
- Founder B sells 50% of the Company to secure venture capital and reserves 20% of the Company for the Employee Pool.
- Founder A and Founder B now own 15% of the Company but Founder A is on to a new venture *and* has equity in Tech Co.

My General Counsel Group

Vesting Issues

- Founders A and B each own 1,000,000 shares (50%) of Tech Co with standard 4 year vesting 25% one year cliff.
- Founder A leaves the Company before the end of the first year and Tech Co buys shares.
- Founder B sells 50% of the Company to secure venture capital and reserves 20% of the Company for the Employee Pool.
- Founder B now owns 30% of the Company and Founder A is still able to get equity in a new venture.

My General Counsel Group

What are the risks of not seeing an experienced lawyer in a timely manner?

- Creating significant and unintended tax liabilities for the founders.

My General Counsel Group

Unintended Tax Consequences

- Founders purchase share subject to vesting and file a Section 83(b) Election.
- Founders buy 1,000,000 shares each for $0.001 for $1,000, the fair market value on the date of the purchase, with standard vesting, and file an 83(b) election.
- They pay no tax until sale.

My General Counsel Group

Unintended Tax Consequences

- Same facts, except that no 83(b) is filed.
- Six months later, a VC round is closed and stock is now worth $0.10 per share.
- One year from date of purchase, 25% of stock, or 250,000 shares vest.
- Founder now pays tax on $0.099 per share (difference between $0.10-$0.001), or $22,500 (250,000 x $0.099) with NO CORRESPONDING INCOME.

My General Counsel Group

Getting Started: Basic Documents

- Articles of Incorporation
- Action of Sole Incorporator
- Bylaws
- Minutes of First Meeting

My General Counsel Group

The Important Stuff: The Founder's Stock Purchase Agreement

- Sets the terms of the stock purchase for the Founders
  - Price. Generally a small amount of cash plus assignment of all pre incorporation intellectual property.
  - Vesting. Ensures that one founder does not unduly benefit from the work of the other founders by leaving early.

My General Counsel Group

The Important Stuff: Founder’s Stock Purchase Agreement

- Right of First Refusal. Enables the Company to repurchase stock if the founder attempts to sell to a third party.
- Market Standoff Agreement
- Tax Planning Form 83(b)
- Confidentiality of Shareholder Materials

My General Counsel Group

The Important Stuff: Officer's Confidentiality and Inventions Assignment Agreement

- Assigns all work done by officers to the Company.
- Requires officers to keep Company and third party information confidential.

My General Counsel Group

The Important Stuff: Officers Confidentiality and Inventions Assignment Agreement

- Limits competitive activities of officers during relationship with Company.
- Limits competitive activities of officers after separation from Company.
  - Employees

My General Counsel Group

The Important Stuff: Officers Confidentiality and Inventions Assignment Agreement

- Ensures that officers do not have conflicts with previous employers
- Ensures that officers do not wrongfully bring third party of information of others to the Company.

My General Counsel Group

THANK YOU