CHAPTER 1

START-UP PHASE

FOUNDERS' CONTRACTUAL ARRANGEMENTS AND MECHANICS OF THE INCORPORATION PROCESS

Entrepreneurs who want to start a business are extremely diverse. They range from college dropouts (e.g., Bill Gates) to so-called serial entrepreneurs or those who have started multiple businesses in the past and always seem to want to do so again (e.g., Steve Jobs), even though many are wealthy beyond imagination. The issues surrounding the organization of start-ups differ little in these cases and do not really depend very much on the type of technology or business.

Lawyers are sometimes asked by those intending to start a business when to hire a lawyer. I like to compare the situation to when you should see a doctor. Many people dread the idea and want to put it off (particularly as they get older). But the conventional wisdom in both cases is that going early may be a bit painful, but going too late can be deadly. If the entrepreneurial idea is just coming together and the founders are short of funds, it is probably not necessary to hire a lawyer at that point. If the founders are beginning to get serious about starting the business and are beginning to devote substantial time to their idea, then going to a lawyer is essential. Believe it or not, it is not unprecedented for five founders to come in for a first interview with a lawyer thinking each is getting 50 percent of the equity.

The fundamental deal among the founders of a business is that the business entity itself owns the business idea and the associated intellectual property (IP)—trade secrets, patents, copyrights, and the like. This point is crucial. The overriding concept here is that the company is like a hub, and the spokes are all of the contributors of time, talent, energy, IP, and capital by the founders, investors, employees, and others. Those constituencies benefit from the increasing value of the hub, which is dependent on it's ownership of all relevant assets.

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Notwithstanding the hub-and-spoke concept, all of the IP need not necessarily be transferred irrevocably to the business at the outset. The scientific genius among the founders may want to defer transferring ownership of the brilliant idea until the company becomes real (i.e., gets funded) or some other milestone is achieved. In that case, it is always advisable to avoid a future change of heart to put an IP license and transfer agreement in place at the outset where the transfer irrevocably becomes effective on the occurrence of one or more specified events.

What is the role of the company's lawyer? Once the entity is formed, all parties should understand that their lawyer's real role and duty at that stage is to the entity, not to the individuals. The lawyer customarily counsels the founders as to the business and legal decisions they must make and what is typical in the situation, but he or she should not decide these issues for the client. To a certain extent, the goals of each founder are adverse to those of the other founders and to those of the business. If, however, every founder of every business hired his or her own lawyer at the outset of the business, the start-up industry would be in serious trouble.

It is ultimately in each founder's interest to make decisions that are the best for the enterprise as a whole. The money to be made by each founder is as much dependent on the ultimate success of the enterprise as it is on the individual founder's deal. For example, one or more of the founders may well be fired from the business or quit before an initial public offering (IPO) or other liquidity event. A mechanism must be put in place, if possible, to permit termination of a founder by the other founders. This mechanism is a voting agreement that specifies a board of directors composition consisting of multiple founders. Under this mechanism, a majority of the board can terminate one founder. The ability to terminate a non-performing founder is crucial to the success of the enterprise. Conversely, not permitting an unproductive founder to be fired is not in the interest of the business. Each founder should be willing to put this voting mechanism in place not knowing which end of the stick he or she is ultimately going to get: He or she may be among the board members firing another founder or may be the founder who is being fired by the board. Without an effective power structure, the business may fail simply because the founders' time and energies are focused on dispute resolution and not on the business.

In an initial meeting between the prospective founders and their lawyer, what are the most important issues? There are several fundamental questions to be answered:

- Who gets what percentage of the equity (founders' stock) of the business?
- What are the vesting terms of the stock—what do you need to do going forward to earn the right to keep all of your stock? Surely, it is not fair if one founder quits the business the day after it is founded and keeps all of his or her stock, and the other founders have to sweat it out for years with long hours and low pay in order to **earn** their equity (hence the term "sweat equity").
- When are the business idea and the related IP to be transferred to the enterprise: at the outset, upon funding, or upon funding from outsiders? In other words, the business has to own its IP in order to get funded and in order for the founders or others to risk working for the company. However, if the business fails before it gets funded, it is not inappropriate for a mechanism to be set up for the IP to be transferred to the founder who created it. This arrangement can be accomplished by an irrevocable license for the start-up exclusively to use the IP for some period of time and that provides for automatic transfer of the IP to the start-up on the occurrence of specified favorable events.
- Who is to hold what office; who is to perform what function; and when should some or all of the founders be required to quit their jobs and join the new business full time? What happens if the business gets funded and a founder decides not to join the new company: Does that founder lose a portion of his or her founders' stock?
- How do the founders legally extract themselves from their current employment without being sued by their current employers? What are the danger areas? How do you minimize the risk of a suit by current employers for theft of trade secrets or a breach of a noncompetition covenant? What is an employee of one business permitted to do to get a new business going while he or she is employed by another company? Does a founder's business idea really belong to his or her (former) employer?

- What is the budget for the initial phase of the business, and where is the money to come from?

These issues are discussed in more detail later in this chapter.

INTRODUCTION. This section provides an overview of the main corporate and business considerations in organizing an emerging business entity. The discussion begins chronologically by addressing the question of when to incorporate. Following this is an overview of the basics regarding initial capitalization and equity allocation among founders. Next is a focused discussion of the most prevalent form of legal entity, the corporation, beginning with a discussion of choice of state and then moving on to cover the mechanics of the organization process, the corporation's key governing documents (charter and bylaws), and other typical agreements. This section then explores the basics of corporate stock splits, dividends, and redemptions and finishes with an overview of fundamental fiduciary duty laws as they apply to officers and directors. This section assumes that the corporation has been formed under Delaware law.

WHEN TO ORGANIZE THE BUSINESS. Entrepreneurs often ask their lawyers for guidance on the timing of corporate formation and may be hesitant to form a company for any number of reasons, including the costs associated with formation, uncertainties regarding the identity of the founders, the equity split among the founders, or conflicts of interest with existing employment obligations. Although these are all legitimate concerns, there are several good reasons to form the company as early as possible. These reasons are discussed next.

Holding Periods. The earlier the company is formed, the sooner the founders' stock can be issued and the sooner the capital gains holding period (for income tax purposes) begins to run. Upon a liquidity event in which the stock is sold, stock that has been held for one year or more will be taxed at the long-term capital gains rate, which is significantly lower than the tax rate for ordinary income. Conversely, gains on stock sold that has been held for less than one year at the time of sale are taxable at an individual's ordinary income tax rate, which is significantly higher than the capital gains tax rate. This is not a critical factor, however, because a sale within one year of start-up is extremely rare (other than during the Internet bubble).

Cheap Stock Issues. Founders of companies often make the mistake of waiting until they have received a strong indication of interest from an investor before they decide that it is time to incorporate. Forming a company on the eve of raising capital may create a tax liability for the founders. The difference between what the founders pay for their stock and the fair market value of the stock at the time of purchase (as determined by reference to what outside investors are willing to pay) may be characterized as income, possibly resulting in significant tax liability to the founders. For example, if stock is issued to the founders at the time of formation for $.01 per share and, within a short period of time thereafter, outside investors pay $1 or more per share, the Internal Revenue Service (IRS) may take the position in connection with an audit of a founder that the founders issued themselves stock at significantly below the fair market value per share.

This risk is significantly mitigated by the issuance of preferred stock to the investors in the company. This capital structure is discussed in detail in Chapter 2, but in sum, investors will invest in a start-up only if their investment receives the protection of a preferred stock/common stock structure. To take an extreme example, imagine that the company sells 50 percent of the outstanding common stock to investors for $1 million and then liquidates the next day; in that case, the founders and the investors will split the investors' $1 million equally. If, instead of common stock, the investors received preferred stock with a liquidation preference, upon dissolution and liquidation in that situation, the investors would get all of their money back, with nothing left for the founders. That is as it should be. Given that the founders would not realize any increase in value of their common stock in that situation, in a very early stage company, common stock typically is viewed as being worth in the range of 10 to 25 percent of the price of preferred stock. The price differential should narrow as the company matures, so that the common stock and preferred stock are priced the same at the point at which the liquidation preference of the preferred stock ceases to be of any real value.

Ability to Contract. The founders may want to establish relationships with third parties that require entering into contracts. For example, an independent contractor may be developing software code. For the company to own this code, it needs to enter into a work-for-hire agreement with the contractor. This cannot be done until the company is formed.

Nondisclosure agreements (NDAs) raise a similar issue. Founders are often in contact with potential strategic partners, advisors, employees, and others at the very earliest stages of a company's formation. Although the individual founders may, and often do, enter into these types of agreements with third parties before the formation of the company, this arrangement is not ideal; in some instances, it may raise issues regarding enforceability of the contracts by the company once it has been formed and may create potential personal liability under such contracts for the founders.

At minimum, contracts entered into by founders in their role as promoters prior to incorporation should be transferable to the corporation once formed and should then result in protection by the company of the founder from any related personal liability.

Limited Liability. The most fundamental benefit of incorporating is the protection of the corporate shield. Individual stockholders generally are not liable for the liabilities of a corporation (or limited liability company) in which they hold an equity interest. Until a corporate entity is formed, the individuals are acting in their personal capacity, and thus they may be held personally liable for their actions or omissions in conducting their business. Once a corporate entity has been formed, to enjoy the benefit of the corporate shield, certain corporate formalities must be adhered to, including the maintenance of separate corporate records and accounts, the holding of annual meetings of the stockholders and directors, and the execution of contracts and other documents in the name of the company.

CHOICE OF JURISDICTION. Once it has been decided that a corporation is the preferred form of organization for a new entity, the question of the state of incorporation remains to be answered. As a practical matter, lawyers have two choices: incorporation in the state in which they practice, or incorporation in Delaware.

Sophisticated practitioners usually incorporate in Delaware. First, Delaware corporation law is generally considered to be the most sophisticated, comprehensive, and well defined. It is extremely flexible and is updated frequently to adapt to emerging practices. It is also the most familiar to the widest range of people, including lawyers, investors, and executives. For this reason, venture capital investors, investment bankers, and others tend to be more comfortable with Delaware corporations.

Second, an emerging business often must move quickly to obtain stockholder approval. An example of this is stockholder approval of a charter amendment that may be necessary in order to close a round of financing. All major corporation statutes permit stockholder votes to be taken at a meeting or by written consent in lieu of a meeting. In contrast to many state corporation law statutes that require unanimous stockholder written consents or impose other limits, Delaware law permits such consents to be effective if signed by holders of the number of shares that would be sufficient to approve the matters at a stockholders' meeting. Although the requirement of a unanimous written stockholder consent may be valuable protection for minority stockholders in the context of a closely held corporation (and may otherwise be seen as valuable protection for founders or other groups who are or may become minority stockholders), most companies that plan to grow quickly and obtain venture financing find this requirement of unanimity in connection with any written stockholder consent to be more of a burden than a benefit.

INITIAL CAPITALIZATION AND ALLOCATION OF EQUITY OWNERSHIP AMONG FOUNDERS. Determining how to divide the founders' equity is one of the earliest and most difficult decisions that founders confront. Unfortunately, the discussions among founders regarding how the founders' stock is to be divided may sometimes expose divisions among the founding team due to different motivations, concerns, risk profiles, and the like. Although such divisions present challenges to the business lawyer who is, after all, engaged to represent the corporation and not the founders, it is often in the best interests of the founders and the company to have such divisions play themselves out at the start and not remain dormant until a later date. This section offers some guidance on how to think about this sensitive and often pivotal decision in a company's formative days.

BASIC DEFINITIONS. To better understand the discussion that follows, the meaning of certain terms that are often used in the context of equity capitalization are set forth here

- **Authorized stock.** The total number of shares of capital stock, whether common or preferred, that a company may issue at any given time pursuant to its charter. This number can be easily changed later and is not that important.

- **Issued and outstanding stock.** The total number of shares of capital stock that is actually issued, whether founders' stock, stock issued pursuant to financings, the exercise of stock options or otherwise.
- **Issued and outstanding common stock on an "as-converted" basis.** The total number of shares of common stock that are issued and outstanding at any time, plus the total number of shares of common stock that the issued and outstanding convertible preferred stock (and other outstanding convertible securities) would convert into at such point in time.
- **Issued and outstanding common stock on an as-converted, fully diluted basis.** The total number of shares of issued and outstanding common stock on an as-converted basis, plus the total additional number of shares of common stock that would be issued and outstanding if all holders of outstanding options, warrants, and other similar rights to purchase stock were to exercise such rights in full.

Selecting the Number of Authorized Shares and the Number of Shares to Be Issued to Founders. In forming a company, decisions must be made as to the total number of authorized shares of capital stock the company will have, what classes of stock will be authorized, and how many shares will be issued to the founders. The total number of authorized shares, and the total number of issued and outstanding shares at the time of formation of the company, is largely arbitrary, and in the end may be modified based on external circumstances, such as the preferences of a venture capital investor. What really matters initially is the relative percentage allocation of the outstanding equity among the founders. It does not matter if you own 1 out of 10 shares issued and outstanding, or if you own 1 million out of 10 million shares issued and outstanding. In either case, it is completely irrelevant how many shares are authorized and unissued. More shares always can be authorized down the road when needed. Issued and outstanding shares can be, and often are, adjusted upward through stock splits, where each share outstanding is converted into a higher number of shares. Issued and outstanding shares can also be reduced by a reverse stock split, where a specified number of outstanding shares are converted into a specified number of fewer shares. For example, there could be a 10-for-1 stock split, where each outstanding share is converted into 10 shares, or a 1-for-10 reverse split, where

each 10 shares outstanding are converted into 1 share. Nevertheless, a couple of guiding considerations exist.

The number of shares issued to the founders should be large enough so that an option pool can be created that allows the company to grant restricted stock or stock options for a large number of shares. Fair or not, prospective hires often focus more on the total number of shares awarded to them (either outright in the form of a restricted stock grant or by the granting of options to purchase the shares) than the percentage of the company's outstanding shares that such shares represent. As a result, the company should consider putting in place an equity incentive plan that has a significant number of shares, often between 1 million and 2 million shares. This will allow the company to make awards in the range expected by prospective hires. For a company that has just been formed, an equity incentive pool might have a number of shares equal to 15 to 25 percent of the number of committed shares (i.e., the total number of founders shares plus the number of shares in the incentive pool). For example, to establish an equity incentive pool that has 1 million shares in it and that represents 20 percent of the committed shares, the founders would need to own 4 million shares in the aggregate.

Who Are the Founders; What Does the Title Mean? Differences of opinion exist regarding the significance, if any, the title "founder" carries, and no one "correct" answer exists. The word "founder" is really nothing more than a designation that the original promoters of an idea to start a company bestow on one another to identify to the outside world the people credited with getting the company off the ground. The founders usually are the people who are present at the time the company is formed and participate in the original allocation of equity. However, it is not unusual for a key hire who joins the company well after its formation to be described as a founder.

Although the founder title is primarily honorary and has no legal significance per se, situations exist in which being a founder can make a difference. Sometimes this difference is beneficial to the founder; sometimes it is burdensome. For example, venture capital firms often distinguish founders from other employees for certain reasons. In the first round of financing, venture capitalists often require founders to make certain representations and warranties about the company and their ability to work for it individually. Making such representations

and warranties subjects the founders to potential personal liability if any such representation or warranty were later determined to be false. Founders are also often asked to subject their stock to first refusal rights of the company or the investors and to co-sale rights of the investors. (These concepts are explained in Chapter 2.) Being a founder may have its advantages in the context of a financing transaction, however. For example, founders may be able to negotiate for certain rights to have their shares registered with the Securities and Exchange Commission (SEC) for sale in an IPO (these are called registration rights). They may also get the benefit of a more favorable stock vesting schedule than later employees, including, for example, a portion of their stock considered to be vested on issuence and acceleration of vesting upon a change of control.

Considerations in Dividing Up Equity. The issuance of stock among the founding group is a determination to be made among the founders and typically is based on relative contributions to the formation of the company, including the conception of the idea, leadership in promoting the idea, assumption of risk to launch the company, expenses incurred preorganization, role in writing the business plan, assembling the team, approaching prospective investors and customers, and the development of any underlying technology. In addition to preformation contributions, the potential for future impact on the growth and development of the company may also be a factor, including the background, experience, and reputation that each person brings with him or her, and the relative value of each to the company, and differing levels of commitment to working for the company following formation.

If three people jointly conceive of an idea that is based on a business model rather than a technology, they may split the founders' equity evenly at formation. However, if one person conceived of the idea, wrote the business plan, and assembled the team, a 50, 25, and 25 percent split might be more appropriate. In addition, when the business plan is based on a proprietary technology, the developer of the technology usually receives a significantly higher percentage of the company. However, if the technologist is fortunate enough to attract as a cofounder a chief executive officer (CEO) with established industry credentials and connections, the business experience of this other person might level the playing field and argue in favor of a more equal split of the founders' equity.

Often, if one person is primarily responsible for pulling the founding team together, he or she may initiate the discussion by making offers of equity to the other prospective founders. These offers typically result in discussions and negotiations before the final equity split is determined. Anyone in the position of being the lead promoter of an idea and faced with making the initial proposal regarding the division of equity should keep in mind that nibbling around the edges of a prospective cofounder's equity position may be penny wise and pound foolish. Such an approach will not engender the level of trust and cohesiveness that is essential among the members of a founding team. The objective is to reach an allocation that is perceived to be fair and that provides all of the founders with the incentive to do what is necessary to make the business a success.

Intellectual Property Ownership Issues. Before a corporation is formed, the founders often have developed intellectual property that will be a central asset of the corporation once it is formed. At the time of incorporation, it is important to make sure that all of this IP is properly contributed to the corporation. Failure to properly make and document these transfers can have serious later consequences to the corporation, especially if one of the founders leaves the corporation. For example, investors will be interested in evaluating the ownership of any IP of the company in connection with their due diligence and will likely find any defects in this initial transfer process to be an impediment to the deal. This transfer generally is accomplished by means of a transfer and assumption agreement pursuant to which the contribution is made, often as consideration for the equity issued to the founders. Often this IP is transferred to the company in exchange for all or part of the founder's initial stock allocation. As mentioned, where the funding of the company is uncertain, a founder may irrevocably license the technology to the company, with the license to terminate if specified milestones are not achieved in specified time frames; in addition, an irrevocable transfer of the IP to the company can be built in if the milestones are achieved on the specified timetable.

If a founder has any IP that might be construed as related to the business of the company but that is not intended to be transferred to the company, this fact should be made explicitly clear in the instrument of transfer, usually by specifically listing the IP of the founder that is not being transferred. Finally, to properly transfer certain types of IP

to the corporation, filings may be necessary with the U.S. Patent and Trademark Office (and, if Internet domain names are being transferred, compliance with any filing or other process requirements of a domain name registration authority). To minimize the risk that the contribution of appreciated property will result in taxable gain, a tax attorney should be consulted to ensure that the contribution is tax-free under Internal Revenue Code (IRC) Section 351.

Stock Restriction (or Vesting) Agreements. If a company has more than one founder, it is a good idea to have the founders enter into stock restriction agreements pursuant to which each founder is required to "earn" his or her shares by continued service to the company. Such a stock restriction agreement is important not only to the company, but to any founders who may find themselves in the position of continuing with the company after one or more of the founders has left. Because such a situation would result in a significant portion of the outstanding stock of the company being held by a then "nonproductive" person, the ability of the company to retrieve the unearned portion of a prematurely departing founder's stock is important. Even if the founders decide not to enter into stock restriction agreements at the time of formation, they should be advised of the high degree of likelihood that sophisticated investors will require such agreements from them at the time of financing. For this reason alone, it may be preferable to enter into such agreements at formation. If the terms of such agreements are reasonable, investors may be willing to allow such agreements to remain in place instead of requiring new agreements on less favorable terms. Any stock restriction agreement entered into at founding that deviates too significantly from what sophisticated investors will require likely will not survive the investment process without significant changes.

Other types of agreements typically entered into between the company and its founders, or among the founders, at the time of formation frequently are incorporated into a single agreement called a stockholders' agreement. For example, one agreement might govern a right of first refusal to either the company or the other founders (or both) to purchase the shares of a founder who may wish to sell the shares before they can be transferred to a third party. Founders frequently ask if they should enter into buy/sell agreements whereby the parties agree that upon the death of one of the founders, the other founder(s) or the company (or both) will have the right to purchase

the stock of the deceased, often with the proceeds of a life insurance policy that was purchased for that specific purpose. For technology companies, these agreements are completely inappropriate because it is essentially impossible to arrive at a fair valuation of the company or even a fair process for determining such a valuation, particularly in the early stages.

Because this book focuses on technology and other emerging businesses, this discussion concentrates on the types of agreements most common among founders of companies that expect to grow quickly by raising capital through the private sale of equity.

The way stock restriction agreements work is to give the company the right to buy at original cost a declining percentage of the shares held by a founder in the event that the founder leaves the company prematurely for any reason. This purchase option applies only to shares that are unvested (i.e., subject to such forfeiture) at the time of the founder's departure from the company, with shares becoming vested over a predetermined, usually time-based, schedule. Sometimes a stock restriction agreement allows the remaining founders to purchase the stock of the departing founder instead of, or along with, the company. Although this move can be advantageous for the remaining founders, it will be resisted by investors, who want all shareholders, including themselves, to benefit from the forfeiture by having all shareholders' percentage interest in the company increase proportionately.

Founders who enter into stock restriction agreements should be aware that the lapse of the repurchase restrictions can have significant tax consequences unless the founder makes an election under IRC Section 83(b) within 30 days after the purchase of shares subject to such restrictions, and possibly the later imposition of such restrictions if part of a plan when issuing the shares. Without the election, as the shares vest, the founder is subject to income tax on the amount by which the value of the vested shares at the time they vest exceeds the amount he or she paid for such vested shares. If the founder makes a Section 83(b) election upon the imposition of such restrictions, he or she is taxed only on the amount by which the value of the shares at the time of receipt exceeds the amount paid for the shares, which usually is considered to be zero. Therefore, if the founder's shares are likely to appreciate significantly in value, a Section 83(b) election

is essential. In preparing a stock restriction agreement, these issues should be addressed:

- The amount of stock that will be considered vested at the time the agreement is entered into, if any. (If some of the stock is to be fully vested on day 1, this is referred to as up-front vesting.)
- The time period over which the unvested shares will vest and the increments in which the shares will vest (monthly, quarterly, yearly, etc.).
- Whether a certain minimum period of time must elapse before any unvested stock vests, for example, a year. (If this is the case, the stock is subject to cliff vesting.)
- Whether any acceleration of vesting will occur upon termination of employment by the company without cause.
- Whether any acceleration of vesting will occur upon a sale of the company.

Some general guidelines with respect to these questions follow. These guidelines are subject to change from time to time because of the venture investment climate and other external factors, and can vary by industry and by region of the country.

Founders' stock generally vests over a period of three or four years. Usually founders have some percentage of their stock vested up front as an acknowledgment of the efforts, assumption of risks, and the like already taken with forming the company. The range of up-front vesting typically falls between 10 and 25 percent. Six- and 12-month cliff vesting is also fairly common, with 12 months being the most common. The rate of vesting (subject to the use of a front-end cliff vest) is usually in equal monthly or quarterly installments. Equal annual installments are seen occasionally. In determining the installments to be used, careful consideration should be given to the consequences of the installment periods, including the impact on possible later termination of the founder's relationship. The less frequent the vesting installments, the more likely the timing of the vesting installments will have an impact on such things as the timing of a termination of an employment relationship. A strong argument can be made not to encourage keep an unproductive employee to stay for a long period until the next vesting date. Also termination by the company at the end of a long vesting period exposes the company to a claim that the employee was fired in bad faith.

Some arrangements provide that a portion of the founder's shares vest on termination ("accelerate") depending on the circumstances surrounding the termination. The termination of a founder's employment with the company may occur for four basic reasons:

1. Resignation (for no reason or for good reason)
2. Termination (for cause or without cause)
3. Death
4. Disability

If the founder resigns voluntarily or is terminated for cause, typically no additional stock vests on the theory that he or she has forfeited the right to vest further by either quitting or engaging in conduct that is sufficiently egregious and detrimental to the company that a "for cause" termination is justified. If the founder resigns for good reason (in other words, is forced out) or is terminated without cause, the vesting schedule may provide for partial acceleration so the founder gets to keep more stock than he or she otherwise would have been entitled to keep based on the duration of employment. Although such acceleration is not universal, when it is in effect, the vesting will accelerate for anywhere from an additional six months up to full vesting. This type of provision (especially if the accelerated vesting is in the range of six additional months) seems to strike a reasonable balance between the underlying premise that stockholders need to earn their stock and the fairness principle, which suggests that a company should not be able to unreasonably deprive a stockholder of the ability to earn the stock subject to vesting. Harsh as it may seem, in the event of a founder's death or disability, acceleration of vesting is not common; death and disability benefits are more properly provided by insurance. Many sophisticated investors do not like to see a distinction drawn between the treatment of different types of termination of the employment relationship because of the potential for litigation over whether there is cause for termination or whether the individual's employment has been terminated for good reason. In this view, the effect of an early departure by a founder is the same whatever the reason for departure. This effect is that a significant stockholder, if allowed to continue to hold his or her entire stock position after such an early departure, will continue to benefit from the efforts of others (whether those efforts are actual day-to-day work at the company or investment of money

in the company) without any further effort on the stockholder's part. In the process, this will likely create difficulties for the company in its efforts to strike a proper balancing of the stock positions of the remaining founders/management/employees with those of the outside investors. Investors also want to mitigate the dilutive effect of hiring a replacement and issuing new stock to him or her.

Definitions of "cause" and "good reason" vary considerably. They are discussed in the last section of this chapter.

Founders often are entitled to some acceleration of vesting upon a sale of the company. There is a discussion of this issue in the section "Stock Option Plans and Other Equity Compensation Arrangements."

CONTROL AND DECISION-MAKING ISSUES: OFFICERS, DIRECTORS, AND STOCKHOLDERS. A company is managed on a daily basis by its officers, who in turn are overseen by the board of directors, who owe duties of loyalty and care to the stockholders.

Election of Board of Directors; Role of Directors in Corporate Governance. The business and affairs of every corporation are managed by or under the direction of the board of directors. Certain major decisions, such as a merger of the company, require stockholder approval by law, under the company's charter (certificate of incorporation), or under agreements with investors. The business and affairs of a company may encompass a wide range of activities, including the election of officers, the development of the business plan and strategy for the company, the issuance of equity and grant of stock options, and the payment of bonuses and dividends. The board of directors meets periodically at meetings called in accordance with the company's bylaws to review the state of the company's affairs and to take certain actions reserved for the board of directors.

A company's board of directors is elected by the stockholders of the company. Directors hold office until their successors are elected and qualified, or until their earlier resignation, removal, or death.

Election of directors is generally done by plurality vote of the stockholders at the stockholders' annual meeting or at a special meeting in lieu of an annual meeting. Plurality voting provides for election to the board of directors of the top vote receivers until the number of seats established for the board is filled (thus, if the board is to have four

members, the top four candidates based on votes received are elected), irrespective of whether any particular candidate receives a majority of the votes cast. Delaware law provides, with certain exceptions, that any director, or the entire board of directors, may be removed, with or without cause, by the holders of a majority of the outstanding stock then entitled to vote at an election of directors. These provisions are largely academic in a technology company because the shareholders' agreement or other similar agreement among the founders or among the founders and the investors will require the signatories to vote in a specified way for the election of directors.

A majority of the total number of directors constitutes a quorum for the transaction of business at a board meeting, unless the certificate of incorporation or the bylaws provide otherwise. The board of directors may designate one or more committees to exercise the powers and authority of the board of directors in the management of the business and affairs of the corporation (subject to a few statutory exceptions and to such exceptions as may be set forth in a company's charter or bylaws).

Issuance of Stock; Role of Stockholders in Corporate Governance. In Delaware, the authority to issue stock resides in the board of directors of a corporation. Stock issued to the founders usually is authorized by the board of directors in its initial meeting. Generally speaking, stock may be issued in exchange for cash, services rendered or to be rendered, tangible or intangible property, debt or promissory notes, or a combination thereof. In Delaware, a subscriber of stock paying for such stock in the form of a promissory note (or for services to be rendered in the future) must pay at least the aggregate par value of the stock being issued in cash. The typical par value for a start-up company is either $.01 or $.001 per share.

Unless the charter provides otherwise, each stockholder is entitled to one vote for each share of stock owned. Although the charter may provide for different voting rights between classes or series of stock, in the absence of any such distinction in the charter, all shares of stock are, subject to certain exceptions, such as the right of a class to vote as a separate class if the class is adversely affected by the action that is the subject of the stockholder vote, treated the same for voting purposes.

The composition of the board of directors is largely a function of the company's stage of development. For a newly formed company in which the only stock outstanding is held by the founders and the founders therefore control the composition of the board of directors, the board typically would be comprised of some or all of the founders. A majority vote would allow the company to take adverse action against a founder. The board's composition will likely change as the company grows. Outside investors and, in particular, venture capitalists usually require one or more seats on the board of directors. The balance of power in these situations is extremely important and closely negotiated. This balance of power is discussed in Chapter 2.

With respect to size, emerging companies tend to work better with smaller boards. A board comprised of five members seems to work well for many emerging companies; seven may be seen as an outside limit before the size of the board begins to get unwieldy. The board of an emerging company often may be called on to act quickly and with little notice. Coordination among a smaller group is easier than with a larger one. Boards of emerging companies tend to meet frequently as well—as often as once a month for a company with venture capital or other sophisticated investor backing. Again, attempting to coordinate the schedules of five members on a monthly basis is often substantially easier than coordinating the schedules of a larger group. When possible, choose an odd number of directors to avoid the problems associated with deadlocks.

As mentioned, a number of actions cannot be taken without the consent of the stockholders. These actions include amendments to the charter; approval of a plan of merger or consolidation (subject to certain limited exceptions); reorganizations and recapitalizations; the sale, lease, or exchange of all or substantially all of its property or assets; and the liquidation or dissolution of the corporation.

Election of Officers; Role of Officers in Corporate Governance. The officers of a corporation are responsible for managing the daily operations and affairs of the corporation and for taking actions within their authority to allow the corporation to pursue its business objectives, in each case under the direction and supervision of the board of directors. Officers typically include a president, treasurer, secretary, and such vice presidents and other positions as the board of directors deems appropriate.

Under Delaware law, every corporation must have such officers as are stated in the bylaws of the corporation or in a resolution of the board of directors. Assuming the company wants to issue shares of stock, these officers must include such officers as are necessary to sign the corporation's stock certificates: the chairperson or vice chairperson of the board of directors, or the president or vice president and the treasurer or assistant treasurer, or the secretary or an assistant secretary. Officers are elected in such a manner and hold office for the terms that are prescribed in the bylaws or that have been established by the board of directors, and each officer holds such position until such officer's successor is elected or until such officer's resignation or removal. The bylaws of a Delaware corporation typically provide for the board of directors to elect and remove officers with or without cause. One of the officers should be responsible for keeping records of the meetings of the stockholders and directors; this is usually the secretary or assistant secretary.

MECHANICS OF ORGANIZING THE CORPORATION (FOR LAWYERS ONLY)

Certificate of Incorporation. The first action to be taken is for a person called the incorporator to file the certificate of incorporation with the Delaware secretary of state. The incorporator is typically the lawyer who represents the company or one of the founders. Companies called service companies handle the actual filing. These companies also act as statutory agents in Delaware to accept service or process and the like. It is a statutory requirement to have such an agent. One initial mistake that is often made is to have an individual employee of the service company act as the incorporator. This may cause problems later if the incorporator does not take certain essential actions (to be discussed). It may be impossible to fix the mistake later since the individual at the service company may be long gone.

For Delaware corporations, the charter is known as the certificate of incorporation. Later amendments are referred to as certificates of amendment. The charter is, in effect, a contract between the corporation and its stockholders as well as a contract among the stockholders.

The charter includes certain items that are required by statute and other items that may be added at the incorporator's discretion so long as such terms do not violate law. The name of the corporation is required to be set forth, and the name must include either "corporation"

or "incorporated" (or Corp. or Inc.) or some other indication of the limited liability nature of the entity, as allowed by statute for purposes of putting the public on notice of such limited liability. Also, the name chosen may not be confusingly similar to the name of a then existing corporation either incorporated in the state or registered to do business as a foreign corporation in the state. The determination of whether a name is confusingly similar is made by state authorities. It is prudent to check in advance of incorporation to make sure the preferred name is available and, if it is, to reserve it. Names of Delaware corporations are published on the Delaware secretary of state's Web site. Such an advance reservation is allowable but may be maintained for only a limited period of time (with limited rights to renew the reservation). Keep in mind, however, that simply because a name is available for use as a corporation's name in a particular state does not mean that the use of the name does not violate the trademark or trade name rights of others. Another corporation may have incorporated in another state (or may be doing business under a name other than its corporate name) and may have developed trademark or trade name rights in such name. Therefore, an appropriate search, and possible registration, of trademarks and trade names should also be undertaken.

Also required is a statement regarding the purpose or purposes of the corporation. Delaware law requires only a simple statement that the corporation is being formed for the purpose of "engaging in any lawful act or activity for which corporations may be organized under Delaware law." Limiting the statement of purpose to this simple statement is all that is normally done in order to avoid any issues later as to the proper authority of the corporation to take a particular action.

The authorized capital stock of the corporation is required to be set forth in the charter. In deciding on the authorized capital structure, it will be necessary at the least to include common stock. It is not, however, immediately necessary to include preferred stock. Even in the case of corporations that intend to raise venture capital or other sources of sophisticated investor financing and therefore will need to authorize and sell preferred stock, because the actual terms of the preferred stock are determined by negotiation with investors, such preferred stock cannot be set up in detail ahead of time. However, it is possible to establish "blank check" preferred stock. Blank check preferred stock allows the

board of directors of a corporation to establish one or more series of preferred stock from shares of undesignated but authorized blank check preferred stock without the consent of the stockholders that is normally required for a charter amendment. In effect, the stockholders have authorized the board of directors to designate and issue these shares in advance.

Although blank check preferred stock can be very useful, for example, to quickly and easily establish a series of preferred stock for sale to venture capital investors following a simple initial round of financing without going back to any of the corporation's stockholders for approval, its convenience has become diluted by the increasing prevalence of veto and other approval rights that prevent later rounds of financing without the approval of existing investors, irrespective of the existence of blank check preferred stock. Although these veto and other rights have long been standard in institutional venture capital deals, they have increasingly worked their way into seed and first-round angel deals as angel investors become more sophisticated in structuring their deals. Nonetheless, blank check preferred stock may be useful in allowing a company to have to go only to its preferred stock investor group, and not back to its common stockholders as well, to approve subsequent rounds of financing. Clearly, however, the value of blank check preferred stock is at its lowest in a true start-up situation, in which the only stockholders are the founders of the company.

Because the number of shares of stock that is authorized always may be changed by a charter amendment, the number of shares to authorize initially is largely a matter of personal style. Differences in filing fees must be considered.

The par value of the authorized stock is required to be stated. It is advantageous to set the par value at a low number (e.g., $.001 per share) so founders may purchase their shares for the minimum amount of consideration they wish to put into the company without creating problems with respect to the fully paid nature of their stock.

Delaware law requires that there be a registered office in Delaware and that the name and address of the corporation's registered office in Delaware be listed in the charter. As discussed, the registered office will be the office of a service company located in Delaware that provides the registered office for an annual fee, as well as other

useful services, such as the filing of charter amendments, obtaining good standing certificates, and answering inquiries regarding Delaware procedure.

The name and address of the incorporator of the corporation are required to be listed in the charter. The incorporator will be required to sign the initial charter too. Later charter amendments, as well as restatements, will be signed by an authorized officer. Often the attorney for the company acts as the incorporator. This can simplify the mechanics of the process.

Although often useful in public companies, staggered board provisions, supermajority voting provisions, poison pills, and other anti-takeover provisions are not used in the charters of emerging companies because such companies are not susceptible to hostile takeovers. Hostile takeovers effectively require that there be a public market for the stock. Also, first refusal and other restrictions set up at the outset effectively preclude a private tender offer for the outstanding stock of a private company.

Initial Consent of the Incorporator. Under Delaware law, the incorporator is required to hold an organizational meeting after the filing of the certificate of incorporation at which the incorporator adopts the initial bylaws of the corporation, elects the initial board of directors, and accomplishes other organizational actions. Since there is usually only one incorporator, this is done by written consent. It is also possible under Delaware law to substitute an initial directors' meeting for such organizational meeting (or a unanimous written consent) if the certificate of incorporation lists the initial directors. Such initial directors' action would involve the same tasks as the incorporators' organizational meeting except that instead of electing the initial directors, the officers of the corporation would be appointed. As a general rule, the incorporator will merely perform the ministerial tasks relating to incorporation and will thereafter hand over the running of the corporation to its initial board of directors. This said, it is possible in Delaware for the incorporator to continue to run the corporation following incorporation by putting off the date of election of the initial directors. Better practice is to immediately elect a board of directors to take over the business of running the corporation from the incorporator.

Minutes of Board of Directors' First Meeting. The initial meeting of the board of directors, as appointed by the incorporator(s), or written consent should occur as soon as reasonably practicable after the directors are elected (which will occur when elected by the incorporator(s) in Delaware). The purpose of this initial meeting or action is for the board of directors to, among other things:

- Elect officers
- Adopt the seal of the corporation
- Specify the fiscal year of the corporation
- Adopt banking resolutions
- Accept the subscriptions for and approve the initial issuance of stock to the founders and approve any related stock restriction agreements
- Adopt a form of stock certificate for use with the company's common stock
- Make, subject to appropriate stockholder approval, a Subchapter S election (if applicable)
- Authorize employment agreements (as applicable)
- Authorize the company to qualify to do business in other jurisdictions
- Authorize the lease of business premises
- Approve other material transactions, agreements, and documents as may then be necessary (such as any agreements or documents relating to the transfer of the intellectual property being transferred to the company by the founders)

Specimen Stock Certificate. The form of stock certificate for the company's common stock is generally adopted at the initial meeting of the board of directors. Forms of stock certificates for various series of preferred stock are adopted at the time such series of preferred stock is established.

Subscription Agreement. In conjunction with the issuance of capital stock of the corporation to the initial stockholders of the corporation, the corporation should use an appropriate subscription agreement or incorporate those provisions in the shareholders' agreement.

In its most basic form, the subscription agreement addresses, among other things, these issues:

- Identity of the purchaser
- Amount and class of the capital stock being purchased
- Consideration paid or to be paid for the stock purchased
- Appropriate representations of the purchaser for securities law compliance by the company (purchase for investment only, knowledge or sophistication of the purchaser, acknowledgment of the risks associated with an early-stage company, and the like)
- Issues relating to the possible later registration under applicable securities laws of the capital stock being acquired
- Restrictions on transfer of the capital stock, if any

Bylaws. Bylaws set forth certain rules and procedures regarding the governance of a corporation's internal affairs. The bylaws supplement the applicable corporate law and the corporation's charter. When a conflict or inconsistency exists among these three sources, the applicable corporate law controls first, followed in most cases by the charter and then the bylaws. To the extent a corporation enters into any agreement that is contradictory to any of these three, it is likely to be unenforceable.

HOUSEKEEPING

Periodic Filings. Once a corporation has been formed, it has an obligation to maintain current information with the state in which the entity is incorporated. The primary periodic filing for a Delaware corporation is the annual franchise tax report. The State of Delaware sends a standard form and franchise tax invoice directly to each Delaware company at the beginning of each year. Companies are required to file franchise tax reports "annually on or before the first day in March."

In practice, while the failure to make either of these filings when due usually can be corrected quickly and easily, until it has done so, the company will be out of good standing with the state. This may make it difficult for the company to close a round of financing or effect any other significant transaction.

In addition to filings required by the state of organization, practitioners should be aware that similar filing requirements may exist in any state in which the company is qualified to do business.

Stock Issuance, Legends, and Transfer. Maintaining complete and clear stock records is an absolute necessity for any corporation. The company's lawyer typically maintains a stock record book containing copies of issued stock certificates. Good practice is for the lawyer to keep the signed stock certificates in the stock record book and furnish a copy of each issued stock certificate to its owner. This practice rarely is objected to and saves time and effort later if the stock certificates must be produced in connection with stock transfers and various corporate purposes, such as mergers. In addition, the lawyer's firm or the company should keep an Excel spreadsheet that shows outstanding stock options and warrants as well as outstanding stock. This spreadsheet always must be produced in connection with later financings. Copies of all stock option agreements and warrants should also be kept on file.

Securities law compliance should be addressed from the outset. Because emerging companies are private companies, compliance with securities laws will hinge on qualifying for an exemption from registration under federal and state securities laws. Certain federal regulations and many state laws address not only the issuance of stock but also the offer of stock. Accordingly, the practitioner should review the anticipated securities law exemptions before any offering of stock occurs. During an offering, corporations should keep complete records of the offering process, including a list of all recipients of any offering memoranda or disclosure materials and addresses and residencies of offerers and purchasers, because this information may be necessary to complete federal and state securities law exemption filings. Additionally, prior to the issuance of any stock, the corporation must have authorized the securities to be issued in the company's charter.

Evidence of payment for shares (either a copy of a check or wire receipts) and executed subscription agreements should also be kept on record.

Legends must be placed on the back of the certificates stating the existence of any restrictions. For private companies, the most basic restriction comes in the form of a '33 Act Legend, which is a statement that the shares have not been registered under the Securities Act of 1933 and, as such, any transfer of such shares must fall within an exemption from registration. Other common legends disclose the existence of more than one class of stock (a statutory requirement) and the existence of certain contractual agreements pertaining to the

shares, such as agreements that impose restrictions on transfer or that impose voting obligations on the holder of the shares (also a statutory requirement).

Once stock is issued and outstanding, the stockholder may wish to transfer the shares to a third party. Documenting a stock transfer requires, at the very least, a stock power from the current holder that authorizes the transfer of the certificate to a new buyer. Transfers of stock in an emerging company also typically require navigating the restrictions that apply to a stockholder's securities. These include any contractual restrictions, such as the company's right of first refusal on the purchase of any shares transferred, the right of first refusal of other stockholders to purchase any shares in the event the company turns down its opportunity, and broad restrictions on transfers to outside third parties. In addition, any resale of securities needs to be done in compliance with the securities laws. Investors who sell immediately after receiving shares in an exempted transaction may be deemed to be involved in the unlawful resale or distribution of securities. Under certain circumstances, such an immediate subsequent transfer may destroy the exemption that the issuer was relying on in the initial offering.

Stockholders' Actions. Stockholders own companies, but they do not run companies in their capacity as such. Stockholders elect a board of directors and charge the board with managing the company. Directors, in turn, elect officers and charge the officers with the day-to-day operations of a company. The officers report to the board of directors, and the board answers to the stockholders. Stockholders have the power to elect, remove, and replace the board of directors. This broad and general power is very typical of stockholder activity in an ongoing company. Stockholders have the final word on election of the board and authorization or approval of any event that significantly changes a company's legal structure, such as a charter amendment, the authorization of a new class of stock (other than blank check preferred stock), the sale of all or substantially all of the company's assets, or the merger of a company with another entity.

Directors' Actions. Directors, being charged with managing a company, tend to meet much more often than stockholders, and must

authorize and approve significant transactions and often other routine matters.

Electronic Communication. Delaware law permits the conduct of certain corporate affairs, including certain matters pertaining to the taking of stockholder and board action, through electronic communications.

Foreign Corporations. Once a company is incorporated, the company still may have filing obligations in states in which it does business. Most states require the registration of companies doing business in their state, even if those companies are incorporated elsewhere. The analysis of what level of activities rise to the level of doing business is different for each state. Most states have codified certain activities that they deem to be doing business, and such activities usually involve some sort of presence in the state, such as leasing a local office. Case law regarding "doing business" fills out the discussion for areas in which the statutes are vague or unclear. Failure to register as a foreign corporation where required in a state usually can be fixed easily later as a mechanical matter, but may also involve the payment of troublesome back sales and other taxes.

In significant transactions, parties generally will request good standing certificates not only from a company's state of incorporation, but also from each state in which the company is registered to do business.

STOCK SPLITS, DIVIDENDS, REPURCHASES, AND REDEMPTIONS

Stock Splits. A corporation may subdivide each share of its outstanding capital stock into a greater number of shares (a stock split) or combine any number of its outstanding shares into a smaller number of shares (a reverse stock split). The primary reason for effecting such a transaction in a private company context is to adjust the company's capital structure so as to fall within certain established norms.

Stock splits and reverse splits will require an amendment to the corporation's charter and, thus, will require shareholder approval.

Stock Dividends. A corporation can achieve the same result as a stock split via a stock dividend declared by the board of directors. Unless otherwise provided in the charter or bylaws, or by contract, a stock

dividend does not, unlike a stock split, require shareholder approval. In Delaware, no dividends may be distributed other than out of capital surplus or profits in the year of distribution. These terms are described in the statute. In the case of a stock dividend, the corporation must transfer from its surplus to its capital account an amount necessary to cover the post dividend aggregate par value of its outstanding stock.

Stock Redemptions and Repurchases. Redemptions and repurchases both involve the repurchase by the corporation of outstanding stock from one or more of its shareholders. A corporation may be required by its charter, bylaws, or other contract to redeem stock (usually preferred stock) under certain circumstances. Alternatively, a corporation may voluntarily elect to repurchase outstanding stock. If a corporation voluntarily elects to repurchase stock from one or more shareholders, careful consideration should be given to the rights of minority stockholders to participate in the transaction. It may be appropriate, depending on the particular situation, to obtain waivers from nonparticipating stockholders. Under Delaware law, stock may not be repurchased if the corporation's capital is impaired or would be impaired as a result of the redemption.

Before effecting a stock split, stock dividend, repurchase or redemption, a corporation should evaluate what, if any, approvals are required beyond the statutory approvals just described. A corporate charter or bylaws or a material contract may require the prior approval of a particular class or series of stock or the prior consent of a third party. Moreover, as with all material corporate transactions, consideration should be given to the accounting and tax implications of the transaction.

FIDUCIARY DUTIES OF DIRECTORS AND OFFICERS. Directors and officers of corporations owe a fiduciary duty of care and loyalty to the corporation and its stockholders. The duty of care applies to all actions a director or officer takes on behalf of the corporation. The duty of loyalty arises primarily in situations in which directors or officers act on a matter in which they have a personal interest. The duty of care requires that directors and officers perform their duties in the best interest of the corporation, and with reasonable care under the circumstances. Under Delaware common law, the business judgment rule essentially establishes a presumption that in making a business decision, the directors

of a corporation are disinterested and informed, and are acting in good faith for the best interests of the corporation. Generally speaking, provided that the directors have acted in the honest belief that their actions are in the best interest of the corporation and have exercised due care in making the decision, the decisions the board makes will not be subject to reexamination by the courts, and the directors will benefit from a presumption that they discharged their fiduciary duties to the corporation and its stockholders. If it can be demonstrated that the directors either failed to act based solely on what was in the best interest of the corporation and its stockholders (by, e.g., putting their own interests or that of an affiliate ahead of the corporation), or failed to exercise reasonable care under the circumstances (by, e.g., not taking adequate steps to make an informed decision under the circumstances), then the presumption of the business judgment rule will not be available. The deference accorded directors through the business judgment rule is intended to recognize that directors need to be given the benefit of the doubt in discharging the mandate that they safeguard the interests of the stockholders, without which directors might be discouraged from making difficult and potentially controversial decisions or even serving as directors in the first instance.

The duty of loyalty is related to the duty of care. Generally speaking, the duty of loyalty requires that a director not engage in self-dealing. The Delaware General Corporation Law directly addresses the issue of transactions that involve interested directors. It defines what types of transactions raise interested party issues and establishes a safe harbor of sorts by providing that no transaction involving an interested director or officer shall be void solely for this reason, provided that the nature of the interested party’s interest is fully disclosed and a majority of the disinterested directors or stockholders approve the transaction. The Delaware code prohibits any limitation of the liability of a director for a breach of the duty of loyalty.

Notwithstanding this statutory provision, there is Delaware case law that insider transactions are subject to a higher standard, called the entire fairness standard, to the effect that both the substance and the procedure involving an insider transaction must be fair to the corporation and its noninterested stockholders. This standard is usually applied in the mergers and acquisitions context, but the principles of the cases establishing this standard apply in other contexts as well,

such as down-round venture capital financings. Many Delaware cases deal in detail with a board's fiduciary duties in connection with a sale of the corporation or a change of control. A discussion of the landmark cases in this area, such as *Revlon* and the like, are beyond our scope.

MECHANICS OF ORGANIZATION: OTHER ENTITIES

Subchapter S Corporations. A Subchapter S corporation is established the same way a C corporation is established except, unlike a C corporation, an S corporation and its stockholders make an election with the IRS to be taxed as an S corporation.

To elect S status, a corporation and its stockholders must timely file a properly completed S election form with the IRS within a prescribed time period. Once effective, an S election remains in effect until it is revoked by the corporation or terminated by the corporation's failure to satisfy the Subchapter S corporation eligibility requirements. An S election must include the consents of all of the persons who are shareholders on the date the election is made. In addition, if the election is to apply retroactively back to the first day of a taxable year, all persons who held stock at any time during the year but before the election is made must consent to the election. The S election must be signed by an officer with authority to sign the corporation's tax returns. Special consent requirements apply to spouses who hold shares jointly and to trusts.

Delaware Limited Liability Companies. A Delaware limited liability company (LLC) is formed by filing a certificate of formation with the Delaware secretary of state.

The Delaware LLC statute permits a Delaware LLC to have only a single member. A single-member LLC is disregarded as an entity separate from its owner for tax purposes unless it elects to be classified as a corporation. A single-member LLC, therefore, has the unique advantage of not existing for tax purposes but existing for purposes of serving as a liability shield.

Next we discuss the factors relevant to deciding whether an S corporation or an LLC is a better vehicle to conduct the business of the new entity.

CHOICE OF ENTITY

One issue that needs to be addressed in the organization of a business is the legal form that the entity will take. There are several choices: C corporation, S corporation, general or limited partnership, and LLC. The parameters for the choice include tax efficiency, impact on future financing sources, simplicity and cost, and familiarity for the various stakeholders, including employees, financial backers, lenders, strategic partners, and others. The choice in the vast majority of cases is a C corporation, but it is always advisable to consider the feasibility and desirability of another form when organizing a start-up entity.

The three most common entity types for a new company are the C corporation, the S corporation, and the LLC. While all three entity types insulate the founders from personal liability, the differences among the three types for tax purposes are substantial. A C corporation reports and pays tax on its income separately from its owners. The income or loss of an S corporation or LLC generally is reported by the owners on their personal returns. The choice, therefore, is often tax-driven and requires an analysis of how the founders expect to profit from the business.

C CORPORATION. A C corporation reports and pays taxes on its income. Because any income (including gain from an asset sale) that a C corporation distributes to its shareholders is taxable again in the hands of the shareholders (double-taxed), distributed income of a C corporation can be subject to tax at higher effective rates than those applicable to the distributed income of an S corporation or LLC. The losses of a C corporation are also reported by the corporation rather than by its shareholders. With limited exceptions, owners report any losses of their investments as capital losses only when they dispose of their shares. Individuals may use capital losses to offset only capital gains and small amounts of ordinary income (and may carry unused capital losses forward but not back).

Factors Favoring the C Corporation. While the potential for double taxation is a serious concern, a number of factors may favor the C corporation. Those factors include:

- Venture capital funds prefer to invest in C corporations. The funds may not make equity investments in S corporations

because the funds are partnerships and partnerships are not S corporation eligible shareholders. Equity investments in LLCs can cause tax problems for the funds' tax-exempt and foreign partners. In addition, the funds usually want to purchase preferred stock, which is not permissible in an S corporation.

- Equity-based compensation arrangements are simplest with C corporations. C corporations (and S corporations, but not LLCs) may grant tax-favored incentive stock options (ISOs). In practice, it can be difficult to provide corporate equity incentives that permit the participants to avoid tax (or an obligation to pay the then fair market value) upon receiving their stock and report the benefits of their arrangements at long-term capital gain rates. Through the use of profits interests, LLCs are able to structure arrangements with service providers in ways that achieve the service providers' tax objectives without requiring that the service providers pay a purchase price or tax upon receiving their interests. But these arrangements are somewhat complicated, and many are not willing to use this approach.
- Only shares of stock in C corporations may be qualified small business stock. The disposition of such stock at a loss can be treated as an ordinary loss within certain limits.
- If certain requirements are satisfied, the shareholders of a C corporation (or an S corporation, but not an LLC) may exchange their stock for stock of a corporate acquiror without tax in a tax-free reorganization (other than on any cash or other non-stock property they receive). Instead, the shareholders defer the reporting of their gains until they dispose of their stock in the acquiror.
- Depending on the amount and nature of a C corporation's income and the tax brackets of its shareholders, reinvested income of a C corporation can under certain circumstances be taxed at a lower effective rate than reinvested income of an S corporation or LLC.
- The use of a C corporation prevents the owners from having to file personal tax returns in all the states and other jurisdictions in which the business has a tax presence.

When a C Corporation Makes Sense. Founders should consider the C corporation if they intend to grow their business for a public offering

or sale by obtaining venture capital financing and motivating employees and consultants with equity. The primary risk to forming the business as a C corporation is the potential for double taxation if the business becomes a cash cow or if an acquiror wants to buy the assets of the business in a taxable transaction. Sometimes founders of a business with this type of plan want to take a wait-and-see approach to preserve their ability to sell assets without double tax and at individual capital gain rates and to report early-stage losses (subject to applicable passive activity loss, at risk, and other limitations) on their personal returns. The wait-and-see approach is generally better served by using an LLC as the interim entity. Conversion from an LLC to a C corporation usually can be accomplished without triggering tax. Converting from an S corporation somewhat is more complicated.

S CORPORATION. The income and, subject to certain limitations, losses of an S corporation are reported by the corporation's shareholders in proportion to their shareholdings. Thus, the use of an S corporation usually avoids the double taxation of distributed earnings characteristic of the C corporation. Special rules apply to an S corporation that has assets acquired, or earnings and profits accumulated, while it or any corporation it acquired in a tax-free exchange was a C corporation. Since the focus of this book is on structuring a new business venture, those special rules are not discussed. Distributions of "tax-paid" S corporation income are not subject to further taxation in the hands of the shareholders. Unfortunately, due to qualification requirements, the S corporation is not always available as an option. Among the more onerous qualification requirements are that the corporation have only a single class of stock (differences solely in voting rights are permissible) and have 100 or fewer shareholders (all of whom must be U.S. citizens or resident individuals, estates or certain types of trusts, qualified retirement plan trusts or charitable organizations); certain family members count as a single shareholder.

It should also be noted that S corporations may have different state tax consequences.

Factors Favoring the S Corporation. Often founders must first decide between a C corporation and an S corporation or an LLC (i.e., between a taxable entity and a nontaxable, or pass-through, entity). Once the founders have ruled out the C corporation (usually because

they suspect that their returns may take the form of periodic distributions of operating income or a distribution of the proceeds of a sale of the assets of the business), they must decide between the S corporation and the LLC. Among the factors that may favor the S corporation over the LLC are:

- S corporations may be more versatile than LLCs in terms of exit strategy. Like shareholders of a C corporation (but not the owners of an LLC), shareholders of an S corporation may exchange their stock for stock of a corporate acquiror without tax (other than on any cash or other nonstock property they receive) if the exchange is part of a transaction that qualifies as a reorganization for tax purposes. In addition, it may be easier for the owners of an S corporation than for the owners of an LLC to report their exit gains as capital gains rather than ordinary income by structuring their exit as a stock (as opposed to asset) sale.
- Although equity incentive arrangements are more complicated with S corporations than with C corporations, they are simpler with S corporations than with LLCs. Like C corporations, S corporations may grant incentive stock options (ISOs).
- If a participating owner of an S corporation receives reasonable wage payments from the S corporation as well as S corporation distributions, only the wage payments are subject to employment tax. A participating owner of an LLC, however, may be subject to self-employment tax on his or her entire share of the LLC's business income. While the amount of income subject to the social security component of the employment or self-employment tax is subject to a cap, the cap does not apply to a Medicare component.
- S corporations may be eligible for local property tax exemptions that are not available to LLCs. These exemptions can be particularly important if the business will have significant amounts of inventory, machinery, or other personal property.

When an S Corporation Makes Sense. Founders should consider the S corporation if they want a simple arrangement that will avoid double taxation while preserving their ability to sell the business for stock of an acquiror on a nontaxable basis, maintaining their ability to

motivate employees and consultants by granting ISOs, and minimizing employment tax issues.

LIMITED LIABILITY COMPANY. Unless an LLC elects to be treated as a C corporation, it is treated as a partnership (or, if it has only a single owner, as a sole proprietorship) for federal tax purposes. Because the income and, subject to certain limitations, losses of an LLC are reported by the LLC's owners (referred to as members) in accordance with their agreement, the LLC also avoids the double-taxation issues presented by a C corporation. While an LLC is far more flexible than an S corporation in many respects, the added flexibility often comes at the price of added complexity. There may, though, be situations where the LLC is simpler than the S corporation. For example, an LLC with a single owner generally need not even file separate tax returns.

Factors Favoring the LLC. Among the factors that may favor the LLC over the S corporation are:

- An LLC is not subject to the S corporation qualification requirements. In particular, an LLC may have multiple classes of owners (with different economic rights and preferences), and may include entities and foreigners among its owners. (Note that foreigners may be reluctant to invest in an LLC because of other tax complications.)
- With certain exceptions, an LLC may distribute appreciated assets without triggering gain. Assets may therefore pass in and out of an LLC more freely than with an S corporation. For this reason, the LLC is the type of entity that is most easily converted to another type if circumstances change. (Note that conversion as part of a transaction intended to qualify as a tax-free reorganization may cause the transaction to be taxable.) The conversion of a C corporation or S corporation to an LLC generally triggers tax on any appreciation in the value of the corporation's assets.
- To avoid tax on a contribution of appreciated property to an S corporation (or C corporation) for stock, the person making the contribution must, among other things, own (either individually or together with other persons making contemporaneous contributions of cash or property) at least 80 percent of the outstanding stock of the corporation as of the time immediately

after the contribution is made. No such control requirement applies to contributions of appreciated property to LLCs. As a result, adding new owners for property contributions can be simpler for LLCs than for S corporations.

- If the owners of an LLC exchange their LLC interests for shares of stock in a conversion of the LLC to a C corporation, the shares of stock issued to the owners are not precluded from being qualified small business stock by reason of the prior existence of the LLC. If all the other requirements for qualified small business stock treatment are satisfied, the owners have merely postponed the beginning of their holding periods until they receive their shares of stock.
- Unlike an S corporation, the owners of an LLC may include their shares of the LLC's borrowings in their tax bases in their interests in the LLC, even if they are not personally liable for the borrowings. The inclusion of borrowings in basis enables the owners to withdraw borrowing proceeds from the LLC on a tax-free basis and (subject to applicable passive activity loss, at risk, and other limitations) report greater amounts of loss.
- If an LLC makes a special tax election, people who acquire an interest in the LLC by purchase or inheritance may write up their share of the LLC's basis in its assets to their initial basis in their interest in the LLC (thereby enabling them to report less income or greater deductions with respect to the assets). The same election permits the LLC to write up its tax basis in its assets when an owner's interest is redeemed by the LLC at a gain. Once made, the election applies to all transactions and could result in a write-down if values fall.

When an LLC Makes Sense. Founders should consider the LLC if they want to avoid the double taxation of distributed corporate earnings (or any taxation on in-kind distributions) while preserving their ability to issue interests of multiple classes (providing holders with different economic rights and preferences) or to owners who could not qualify as S corporation shareholders. The LLC is also the best choice when the founders want to use a pass-through entity on an interim basis. The LLC may also be better suited than the C corporation or the S corporation to activities involving investments in assets such as real estate or securities.

CONCLUSION. In conclusion, a C corporation may be the best choice if the founders intend to reap their profits by selling their shares after growing the business using venture capital financing with the expectation that the equity will be broadly distributed. If the founders anticipate reaping their profits in the form of distributions of income from the business (including gain from an exit structured as an asset sale), however, they should consider using an S corporation or an LLC.

STOCK OPTION PLANS AND OTHER EQUITY COMPENSATION ARRANGEMENTS

Equity compensation (restricted stock and stock options) is one of the principal factors that has driven the technology revolution in the United States. Technology entrepreneurs are willing to work for substantially less cash income at a start-up in exchange for equity compensation. Enormous fortunes have been made by thousands of technology entrepreneurs over the last two decades; the mechanism was equity compensation. Most already-public companies have stock option programs as well, but the potential appreciation is much greater at the start-up stage.

The equity compensation game is to get restricted stock in a start-up at a low purchase price per share or a stock option with a low exercise price. The hope is that the company will appreciate in value substantially over a relatively short period of time and then go public or be sold. The normal time period for such a liquidity event is 4 to 10 years. During the Internet bubble, frequently this time period was compressed to less than a year. Entrepreneurs with a hot new Internet or telecom technology would start a company and then sell it within a year, sometimes for many hundreds of millions of dollars. These get-rich-quick stories are mostly gone, but the prospect of accumulating great wealth in a relatively short time persists.

One important point to understand about equity compensation is that the percentage of a company's equity that the person owns is what counts, not the absolute number of shares. In order to understand why, it is important to understand some basics about the IPO process. When a company goes public, the price at which the stock is sold to the public is first approximated by the underwriters' so-called pre-money valuation of the company. A range of per share values is set forth in the preliminary prospectus for the offering that reflects the pre-money

valuation per share. Underwriters arrive at pre-money valuations using a number of valuation methodologies, but the object is to set a price or range of prices at which they think they can sell the shares, given the current stock market environment and the reception that other similar companies have recently received. So, let us say the underwriters value the company at $100 million before the offering. The offering price to the public per share is simply that number divided by the number of shares outstanding and share equivalents (options, etc.) at the pre-IPO company. But, because the price per share for IPOs is customarily set at around $10 or $15 per share, the underwriters require the company to do a stock split or reverse stock split to arrive at the correct price per share. A forward split increases the number of outstanding shares, and a reverse stock split lowers the number of outstanding shares—with the objective being to arrive at a number of shares that, when divided into the pre-money valuation, results in a price per share of $10 to $15.

This process is often poorly understood by the engineers and others who work at technology start-ups. It is not uncommon for highly intelligent and well-educated employees to go through a mental exercise that says "If I get options on 10,000 shares and the typical price per share in the IPO is around $10, then I'll make around $100,000 less the small amount I have to pay to exercise the stock option." Big mistake. This analysis has no validity whatsoever because of the almost universal requirement to split or reverse split the stock. That is why private companies typically like to give out loads of options—to create an unjustifiable expectation of value. Again, the number of shares under an option is meaningless without knowing how many shares are outstanding. It is the *percentage* of outstanding stock that counts. That information is rarely given out as a matter of routine.

FORMS OF EQUITY COMPENSATION. Several forms of equity compensation are common in private companies. The most common are restricted stock purchases and stock options—with the options being both in the form of ISOs and nonqualified stock options (NQSOs). A restricted stock purchase is simply the purchase of a company's stock in a private transaction, with the stock typically being subject to declining vesting (forfeiture) provisions and to sale restrictions. Upon termination

of employment, the company can buy back the unvested stock at its original, and presumably low, purchase price. The other form of equity compensation is the stock option, where the employee is given the right to buy the stock at a fixed price for a specified period of time. The optionee is given the opportunity to exercise only a portion (or none) of the option at the outset, with that portion increasing (or vesting) over the period of employment. When employment ceases, vesting ceases. In effect, companies granting equity to employees or others rendering services to the company provide that the equity holder must earn this equity over time by continuing to remain in the employment/service relationship. This is what is known as sweat equity.

One disadvantage of options, other than tax disadvantages, is that employers frequently provide that the employee must exercise the vested portion of his or her option within a certain number of days after termination of employment. Doing this requires the employee to make a difficult investment decision and to pay the cash exercise price, which can be significant, particularly where the company is past the start-up stage. In the case of a NQSO, because the difference between the fair market value of the stock received on exercise over the exercise price is compensation income, the employee also incurs a tax liability on exercise that cannot be funded by a sale of the stock because of the legal and practical restrictions on selling stock in a private company.

Vesting schedules vary. Sometimes a portion of the equity is vested up front; this is usually the case for founders and often for senior executives; the rest vests over a period of three or four years. Sometimes the first vesting installment is after a year of service, with monthly or quarterly vesting thereafter. Another provision that is negotiated by senior management, but rarely by others, is to provide more favorable vesting if the employee is terminated without cause or if the employee terminates the employment relationship for good reason, meaning that he or she has been effectively forced out by a pay cut or otherwise.

Vesting tied solely to tenure with the company is by far the most common form. The reason for this is that historically, time vesting was the only form of vesting that was eligible for favorable accounting treatment. Under the old accounting rules, options granted at fair market value with the vesting tied to tenure resulted in no accounting

charge (expense). Under new rules, options are valued based on certain standard mathematical formulas (such as Black-Scholes) and that value is charged to (deducted from) earnings over the vesting period of the option, whether time-based or based on some performance measure. Because all options now result in an earnings charge, companies are more frequently structuring vesting to tie more closely to individual and company-wide performance goals. Achievement of performance goals is what the company really wants to incentivize, not just hanging around.

Other than stock issued upon incorporation, restricted stock and options typically are issued to employees pursuant to what is known as an omnibus stock plan—a plan that permits the issuance of restricted stock, stock options, and other forms of equity compensation. An example of such a plan can be found in the appendices to this chapter.

In order to avoid adverse tax consequences, restricted stock must be sold to the employee at its fair market value, and stock options must be granted with an exercise price equal to fair market value. In a private company, fair market value is largely in the eye of the beholder. In venture-backed start-ups, venture capitalists always buy convertible preferred stock that has a liquidation preference over the common stock. That means that upon a liquidation (defined to include a sale) of the company, the preferred stockholders get their money back (or more) before the common stockholders get anything. In a big success story, where the stock is sold for multiples of the liquidation preference of the preferred stock, the value of the common stock equals or approaches the value of the preferred stock.

Because of the inherently greater value of preferred stock, the common stock is usually sold, or the option exercise price is set, at a price that is a discount to the price per share of the preferred stock. In the early stages of the company, this is usually 10 to 25 percent of the preferred stock price. This practice became so frequent that many directors came to believe that the formula automatically was a fair reflection of the value of the common stock. Occasionally the company's accountants would challenge the price because the pricing of options has accounting consequences. In an IPO, the SEC often challenged the price of the common stock if it was set at a significant discount to the IPO price, particularly if the price was set within a year or maybe two before the IPO.

New tax and accounting rules, including IRC Section 409A, have resulted in more attention being paid to the price of restricted stock and the exercise price of employee stock options. These developments have effectively forced boards of directors to make a much more professional analysis of fair market value. In many cases, boards are involving outside valuation experts to support the company's equity pricing. In the very earliest stages of a start-up, however, the old rules of thumb continue to be used since valuing the company at that stage is as much guesswork as anything else.

There are also more exotic forms of equity compensation, including stock appreciation rights (SARs), phantom stock, and other forms of compensation tied to equity value. SARs are issued by some public companies and represent the right to have the company cash out the difference between the original value of the stock and the current fair market value (in other words, the stock appreciation). The employee never owns the stock itself. Phantom stock is sometimes issued by private companies. It is a contractual right to be treated *as if* the employee were the holder of a specified number of shares, so that the employee would be entitled to dividends and the proceeds of sale if the company were sold. Phantom stock is issued by private companies where the existing owners of the business do not want to have any new owners with the technical rights of stockholders: voting and so on. All of these alternative forms of equity compensation do not entitle the holder to capital gains treatment; the income from gains is treated as compensation income taxed at ordinary rates.

Companies sometimes provide, particularly for senior executives, that all or a portion of the options or restricted stock will vest on an acquisition of the company. Rarely, a portion may vest on an IPO. This provision has important employee morale implications and is a potential impediment to an acquisition.

Equity rarely accelerates in connection with an IPO. The reason is the perception that acceleration would impair the marketing of the stock in the IPO. The buyers of the stock in the public offering want the founders to continue to "sweat."

With respect to accelerated vesting on an acquisition, there are competing considerations.

- From the company's and a potential acquiror's point of view, no acceleration is best because what the acquiror is paying

for in a technology acquisition is, in part, the expected continuing contribution of the company's employees, particularly the technologists. The acquiror wants them to have an incentive to continue working and do not want them to get so rich via accelerated vesting as to lose the incentive to continue to work.

- The competing viewpoint is that the employee has earned something from the venture capitalists (VCs) and other stockholders by delivering an acquisition and allowing the VCs to realize value. Why should the VCs cash out with the employee being required to continue to earn his or her equity through continued vesting?

The normal solution, at least for senior management, is a compromise between no vesting and complete accelerated vesting (i.e., partial acceleration on an acquisition). A portion of the options are accelerated on an acquisition, with the balance continuing to vest, perhaps at an accelerated rate or with a shortened full vesting date, provided the employee remains employed by the acquiror. A fixed number of options can vest; a percentage of the unvested options can vest; or a specified additional vesting period can be deemed to have elapsed; there are subtle differences among these alternatives. In addition, full vesting can be provided for after a transition period—say six months or one year. Frequently in that case, the employee is also relieved from the threat of loss of unvested equity if he or she is terminated without cause; in that event, there is full vesting. Some might argue that if the employee is never offered a job with the survivor/acquiror then there should be full accelerated vesting, either on general fairness principles or because the acquiror should not care; if the employee is not wanted, then incentives are not needed to keep the person on board. The problem with this approach is that employees who are not hired are treated better than those that are hired.

TAX ASPECTS OF STOCK OPTIONS AND RESTRICTED STOCK. Historically there has been a significant disparity under the federal income tax laws between the maximum ordinary income rate and the maximum long-term capital gains rate. This disparity results in the employer and the employee attempting to structure equity-based compensation arrangements in a manner that will produce capital gains.

A stock option generally allows for the taxation of pre-exercise appreciation in the value of the underlying stock at long-term capital gain rates only if the option is an ISO and the grantee satisfies a holding period requirement with respect to the option itself and with respect to the stock after exercising the option. Not all options, however, qualify for treatment as ISOs. In addition, while the exercise of an ISO is not a taxable event for the optionee under the regular tax regime, the exercise may subject the grantee to federal alternative minimum tax (AMT) liability. In practice, the ISO qualification rules, the holding period requirement, and the potential AMT liability often serve to render the capital gains advantages of ISOs unavailable or undesirable.

Nonqualified Stock Options. The grantee of an option that is not an ISO (a NQSO) generally recognizes ordinary compensation income upon exercising the NQSO in an amount equal to the excess of the fair market value of the stock received upon exercising the NQSO (measured as of the time of exercise) over the exercise price of the NQSO (the excess is sometimes referred to as the spread). (Where the exercise price is so low as to be a sham, this treatment does not apply.) The grantee then receives the underlying stock with a fair market value basis and a capital gains holding period beginning on the date of exercise. If the stock received upon exercising the NQSO is restricted (i.e., nontransferable and subject to a substantial risk of forfeiture; see discussion under "Restricted Stock"), however, the grantee is deemed to exercise the NQSO when or as the restriction lapses unless he or she makes a Section 83(b) election with respect to the stock (in which case the restriction is disregarded and the exercise of the NQSO is the relevant tax event). Subject to any applicable deducibility limitations, the corporation granting the NQSO has a compensation deduction that mirrors the compensation income of the grantee in both amount and timing if it properly reports the grantee's compensation income on a Form W-2 or 1099, as the case may be. The corporation must also withhold and pay employment tax with respect to the grantee's compensation income if the grantee is an employee.

NQSOs may be attractive because they are not subject to the various requirements and limitations applicable to ISOs, they may be granted to nonemployees and they entitle the granting corporation to compensation deductions. In the absence of special circumstances that would preclude ISO treatment, however, an employee generally will

prefer to receive an ISO so as to avoid taxation of pre-exercise appreciation in the value of the underlying stock at ordinary income rates at the time the option is exercised. If a NQSO is required to be exercised by the terms of the option agreement within a specified period after the employee's employment terminates (usually 90 days by analogy to ISO requirements), the grantee is put in an extremely difficult position—not only does the grantee have to come up with the cash to pay the exercise price, but he or she also is taxed on the appreciation in the stock at the time of exercise.

Many people are under the misimpression that an option agreement relating to an ISO must provide that the option must be exercised within 90 days after termination of employment. This is not the case. The ISO rules require that *in order to receive ISO treatment*, an option must in fact be exercised in the 90-day period. An option agreement for an ISO can provide, without violation of the ISO rules, that the option will not expire for a specified period of time whether employment has been terminated or not. In that case, the ISO is effectively converted into a NQSO if it is not exercised within 90 days of termination of employment.

Incentive Stock Options. An option may qualify as an ISO only if:

- It is granted pursuant to a plan that specifies the aggregate number of shares that may be issued and the employees or class of employees eligible to receive grants and is approved by the stockholders of the granting corporation within 12 months before or after the date on which the plan is adopted.
- It is granted within 10 years after the earlier of the date of the adoption of the plan or the date of the approval of the plan by the granting corporation's stockholders.
- It is not exercisable more than 10 (or, if the grantee is a 10 percent stockholder, 5) years from its grant date.
- The exercise price of the option is not less than the fair market value (or, if the grantee is a 10 percent stockholder, 110 percent of the fair market value) of the underlying stock as of the grant date.
- The option is not transferable by the grantee other than by will or the laws of descent and distribution and is exercisable during the grantee's lifetime only by the grantee.

- The grantee is an employee of the granting corporation (or of a parent or subsidiary corporation) from the date of the grant of the option until the date three months (or one year in the case of the grantee's death or disability) before the exercise of the option.

In addition, an option will not qualify as an ISO to the extent that the underlying stock with respect to which the option is exercisable for the first time during any calendar year has a value exceeding $100,000 as of the grant date. For example, if an employee is granted an option to acquire stock worth $500,000 on the grant date and the option is immediately exercisable, only 20 percent of the option ($100,000/$500,000) may qualify as an ISO. If the option vests 20 percent per year over five years, the option may qualify as an ISO in its entirety.

The exercisability of an ISO may be made subject to conditions that are "not inconsistent" with the rules just described. Accordingly, ISOs (like NQSOs) may be granted subject to vesting provisions.

With two caveats, the grantee of an ISO is not taxed upon exercising the ISO, and the grantee reports long-term capital gain upon selling the underlying stock equal to the excess of their amount realized in the sale over the exercise price of the ISO. The corporation granting the ISO reports no compensation deduction with respect to the ISO.

The first caveat is that the grantee must hold the underlying stock until at least two years after the grant of the ISO and at least one year after the exercise of the ISO. A disposition of the underlying stock before the holding period has run (referred to as a disqualifying disposition) requires the grantee to recognize ordinary compensation income for the year of the disposition equal to the lesser of the spread on the option at the time of exercise or the gain realized by the grantee on the disposition. If the grantee fails to satisfy the holding period requirement, the corporation can deduct the compensation reported by the grantee subject to any applicable deductibility limitations and the compliance by the corporation with applicable reporting rules.

The second caveat is that the AMT rules accord no special treatment to ISOs. Thus, the grantee must include the spread on the ISO at the time of exercise in computing the alternative minimum taxable income for the year of exercise. Depending on the size of the spread and the grantee's other adjustments and preferences, the AMT rules can subject the grantee to tax for the year of exercise on some portion of the spread at the time of exercise.

RESTRICTED STOCK. As an alternative to options, corporations sometimes offer restricted stock to employees, consultants, and other service providers. The term "restricted stock" means stock that the corporation issues to a service provider subject to a right of the corporation to repurchase the stock at the service provider's cost (or some other amount that is less than fair market value at the time of repurchase) if specified service-related vesting conditions are not met. Technically, the applicable tax regulations refer to stock that is both "nontransferable" and "subject to a substantial risk of forfeiture," as defined therein, upon its issuance to the recipient as "substantially nonvested" stock. The restricted stock we have been discussing is stock that is "substantially nonvested" within the meaning of those regulations. Restricted stock can be made subject to the same time- or performance-based vesting conditions as might apply to options. In the case of an option, vesting permits the grantee to exercise the option and thereby purchase the underlying stock at a price fixed on the grant date. If the corporation retains any right to repurchase stock purchased by the grantee by exercising a vested option, the repurchase price is typically the fair market value of the stock at the time of the repurchase (or some formula price intended to approximate fair market value). In the case of restricted stock, vesting generally terminates the obligation of the recipient to sell the stock back to the corporation upon termination of the employment or consulting relationship at a price that is less than fair market value. Thus, vesting in each case establishes the right of the service provider to receive any value of the stock in excess of the price established at the outset. The difference between restricted stock and stock options approaches is that, under a restricted stock arrangement, the stock is actually issued to the service provider up front subject to a right of the corporation to repurchase unvested stock at the service provider's cost if he or she fails to vest. Because of the additional complexity, corporations often hesitate to make restricted stock available to a broad pool of employees and other service providers. Also, the corporation wants to avoid the bookkeeping and procedural complexities of keeping track of a large number of shareholders, each of whom is entitled to participate in corporate governance.

Occasionally, a company will want to maximise the tax planning opportunities for the grantee of an option. The company allows the optionee to exercise the unvested portion of the option, with the stock

received upon the exercise of that portion being unvested restricted stock.

A recipient of restricted stock generally has two choices for tax purposes. He or she may, within 30 days, make a Section 83(b) election with respect to the stock. In that case, the receipt of the stock is the relevant tax event, and the grantee is taxed at ordinary income rates on any excess of the value of the stock at the time it is received (without regard to the service-related restrictions) over the amount paid for the stock. The grantee takes a fair market value basis in the stock, and the capital gain holding period begins. The grantee then suffers no tax consequences upon vesting. Instead, the grantee reports capital gain upon the later sale of the stock equal to the amount received in the sale over the basis in the stock. If the stock is forfeited by failing to vest, however, the ability to take any loss is limited; the grantee is not entitled to recoup any income reported upon receiving the stock by taking a corresponding deduction upon forfeiture. The forfeiture rule may be even more harsh if the corporation is an S corporation and the recipient has had to report a share of the corporation's income without receiving a corresponding tax distribution. Subject to any applicable limitations and the compliance with applicable reporting rules, the corporation's compensation deductions mirror the recipient's compensation income in both amount and timing.

However, the recipient may forgo making a Section 83(b) election. In that case, the grantee is taxed at ordinary income rates when (or as) the stock vests (i.e., ceases to be "nontransferable" and "subject to a substantial risk of forfeiture") on the excess of the value of the stock at the time of vesting over the amount he or she paid for the stock. The postreceipt appreciation in the value of the stock is taxed at ordinary income rates (and at the time of vesting). The basis in the stock becomes the fair market value of the stock, and the capital gains holding period begins at the time of vesting. Again, subject to any applicable limitations and compliance with the applicable reporting rules, the corporation's compensation deductions mirror the recipient's compensation income in both amount and timing.

In practice, Section 83(b) elections are *always* made with respect to stock received in a technology or other emerging growth company. In practice, the board of directors purports to grant the restricted stock at fair market value, and the grantee purports to buy it at fair market

value. The grantee fills out the Section 83(b) election form to show that the purchase price and the fair market value are the same. Voilá—no tax. Because the actual fair market value of a start-up technology company is almost impossible to determine fairly, it is extremely unlikely that price set by the board and used by the grantee will be challenged as not being fair market value. The recipient must file the Section 83(b) election with the IRS within 30 days after receipt of the stock. The grantee must also provide the corporation (and others in certain instances) with a copy of the election and attach another copy to the grantee's tax return for the year of receipt of the stock.

If the Section 83(b) election is not made, the grantee must pay tax equal to the fair market value spread of the stock on each vesting date over the purchase price. This creates an impossible situation for the grantee; the spread may be significant, and the grantee is unable to sell the stock to pay for the tax because of legal and practical restrictions on transfer of the stock of a private company.

The use of restricted stock raises a number of practical issues, including:

- Typically, the recipient must pay for the stock upon receiving it. If the recipient borrows the purchase price from the corporation, the IRS may attempt to treat the recipient as having only a NQSO if the recipient is not personally liable for a substantial portion of the debt. Arrangements that obligate the corporation to repurchase the stock can undermine the tax objectives sought in using restricted stock. In addition, under SEC rules under the Sarbanes-Oxley Act, loans from the corporation to officers must be repaid before the *filing* of the IPO registration statement, even though the IPO may never get to a closing.
- Often restricted stock is issued to a service provider solely to accommodate the service provider's tax objectives. If not for the tax laws, the corporation would have granted options to the service provider to condition his or her right to hold shares on the satisfaction of vesting requirements. For state law purposes, however, the recipient is a shareholder despite the fact that he or she might not yet have fully earned the shares. Issues may arise as to the extent to which the recipient is to be accorded rights of a shareholder under a shareholders' agreement.

- If the recipient does not make a Section 83(b) election, the recipient is not deemed to own the stock for tax purposes until vesting. Any distributions made to the recipient with respect to the stock before vesting are treated as compensation payments and not a dividend. If the corporation is an S corporation, the recipient does not report any of the corporation's undistributed income, even though he or she might be entitled to receive a share of the income if later distributed. It is not unusual, therefore, for S corporations to require recipients of restricted stock to make Section 83(b) elections.

EMPLOYMENT AGREEMENTS

Employment agreements, at least long, fancy, real ones, are relatively rare in start-up technology companies. Almost all employees, other than senior employees, are usually given a simple offer letter that describes their compensation and other employment basics. These offer letters always provide (or should provide) that the prospective employee will be an employee "at-will" (i.e., that the employee may be fired at any time with or without cause). In addition, all employees and consultants (and anyone who may come into contact with any of the company's trade secrets) also must be required to sign a confidentiality/invention assignment/noncompetition agreement. A sample "real" employment agreement and an employee confidentiality/inventions/noncompetition agreement are included in the appendices to this chapter.

Most provisions of employment agreements are relatively noncontroversial. The agreement specifies a salary and benefits, and may specify a formula for a bonus. If not already the subject of a separate agreement, the agreement will also contain relatively customary confidentiality, assignment of inventions, and noncompetition agreements.

There are, however, several critical areas of negotiation. The most important point to remember with respect to employment agreements is that they should never guarantee the employee the right to remain as an employee or in a specified position for a fixed or minimum period of time. Guaranteeing employment or a specified position is highly imprudent from the company's point of view. If the board decides that the employee must be fired, then the company must be able to do so for the well-being of the company. The company always

needs to be protected from incompetent or nonperforming employees. There really is not (or should not be) such a thing as a "two-year employment contract."

What is properly understood by a two-year employment contract is that if an employee is fired, then he or she has to leave immediately, but the employee is entitled to some amount of severance. When and under what circumstances severance is paid is a critical element of negotiation. What many people mean by a "two-year employment contract," for example, is that if the employee is fired within the first two years of employment, he or she continues to receive a salary for the remainder of the term, in a lump sum or paid in the usual increments, even though no longer employed by the company—or he or she is entitled to receive the greater of a specified lump sum (or a specified number of months' installments). The employee's viewpoint is that he or she is entitled to the greater of the lump sum or specified installments, or the balance of the two years' salary. This is the key negotiating point.

The other key negotiating points are whether there is a difference in the employee's treatment if the employee is fired with cause, fired without cause, quits for good reason, or quits without good reason. Generally speaking, the employee is entitled to nothing other than accrued salary if fired with cause or if he or she quits without good reason. The employee typically gets severance only if fired without cause or if he or she quits for good reason. Thus the definitions of "cause" and "good reason" become critical in the employment agreement.

Astute lawyers for employees will ensure that the definition of "cause" does not include failure to perform according to expectations as long as the employee is making a reasonable effort. Such lawyers take care to limit the definition of "cause" to egregious acts where the malfeasance is clear and is not the subject of reasonable differing interpretations. Here are six increasingly onerous (to the employee) definitions of "cause." The real dividing line is between 5 and 6; the ones before the dividing line are within the reasonable control of the employee, but the one after the line may well not be. This is a huge distinction.

Examples of Cause Definitions

1. The employee's indictment for or the pleading of the employee of nolo contendere to a felony.

2. The commission by the employee of an act of fraud, embezzlement, or any other illegal conduct in connection with the employee's performance of his or her duties.
3. Disregard of the material rules or material policies of the company that has not been cured within 15 days after notice thereof from the company.
4. Gross negligence in the performance of the employee's duties, willful misfeasance in connection with the employee's work, or a breach of fiduciary duty by the employee.
5. Willful failure to perform the employee's employment duties, or willful failure to follow instructions of the board of directors, if such failure is in any way significant, but only if such failure does not result from an ambiguity in such duties or instructions; provided, however, that such duties or instructions are specific in nature and not in the nature of performance goals or objectives.
6. Unsatisfactory performance by the employee as determined in the sole discretion of the company's board of directors [or failure to meet performance goals and the like].

Another issue is whether the employment agreement will contain provisions dealing with the situation where the employee quits for good reason. The argument for the employee is that, to take an extreme example, if the employee's salary is reduced to minimum wage, then the employee is forced to quit, which is not substantively different from being fired without cause. This is tough to argue against. The only issue is how broadly "good reason" is defined. Here is a sample of a definition of "good reason":

> "Good Reason" shall mean any of the following: (i) a material diminution in the Employee's responsibilities, duties or authority to which the Employee has not consented and which remains unremedied for thirty (30) days after written notice from the Employee [*Question:* What does this phrase mean if the company is acquired by a substantially larger company—does the employee have the right to be an executive officer of the acquiror?]; (ii) the relocation of the Employee by the Company outside the Company's main office without the Employee's written consent [or a change in the location of the Employee's office by more than a specified number of miles]; or (iii) a material decrease in the Employee's compensation or aggregate benefits without

the Employee's written consent (sometimes with an exception for across-the-board reductions among all senior executives).

It is generally accepted that, from the viewpoint of the employer, generally the shorter and simpler the agreement, the better. Generally, other than confidentiality, invention assignment, and noncompetition provisions, what is in an employment agreement is viewed as being for the employee's benefit.

From the viewpoint of the employee, in addition to the critical issues just discussed, there are a myriad of negotiating points for the employee and his or her lawyer to consider. A list of issues for prospective employees to consider in negotiating an employment arrangement with a new employer follows.

Term

- A stated term is not necessary. The key issue to consider is the amount of severance, when it is paid (up front or periodically), and how the circumstances of termination affect or do not affect the severance provisions.

Compensation

- Bonus opportunity—clear definitions of metrics and ability to earn pro rata assuming no for cause termination.
- Benefit arrangements.
- Vacation, expenses, and so on—state initial agreement relating to these items.
- State that the executive is entitled to participate in all benefit programs for which other executives of the same level are eligible.

Position/Responsibilities

- Scope.
- Clear definition of duty of loyalty (i.e., devote full time/best efforts/noncompetition, etc.), which defines what activities can be pursued without violating the duty (e.g., service on other boards, nonprofits, private investing, etc.).
- Location of office or duties that tie in to executive's voluntary termination for "good reason" if the location of office or duties is materially changed.
- Board seat or not.

- Reporting structure (i.e., to whom will executive report)/tie into a voluntary termination for "good reason" (which may include demotion).

Termination

- For cause definition:
  - Narrow and clearly defined.
  - Eliminate any provisions that are performance standards or disguised performance standards.
  - Notice and opportunity to cure as to the others.
  - Materiality qualifications.
  - Willfulness/knowing qualifications as to misconduct provisions.
  - Opportunity to be heard for any termination decision.
- Death/disability.
- Voluntary termination by executive for "good reason."
  - If the contract makes any distinction as to consequences of a cause/no-cause termination, then a good reason provision is usually regarded as a corollary.
  - *Components of good reason*. Diminution of title or duties; diminution of salary or benefits; relocation, change of control or sale of the company.

Severance Arrangements

- Triggers/entitlement/amounts:
  - Payable if voluntary termination for good reason. What if the employee quits without good reason?
  - Is severance payable for balance of a stated term or x months, if greater?
  - Is the severance payable up front as lump sum?
  - Does periodic severance cease or become reduced if other employment is obtained during the severance period?
  - Upon death or disability?
  - Does severance include provision of health benefits during severance period or payment of COBRA (Consolidated Omnibus Budget Reconciliation Act) premiums?
  - Will employer include payment for outplacement services of employee's choice?

  - Will arrangements be made for use of offices/technology voicemail upon termination?
  - Will employer agree to reasonable reference arrangements?

Equity Compensation

- Stock/restricted stock. Restricted stock is much better for the employee as a tax matter but does involve economic risk. If restricted stock is purchased and requires a substantial outlay of cash, consider using a note for all or part of the purchase price, and also maximize the nonrecourse portion of note. Is buyout at termination automatic or at option of the company? (Should be automatic if a real-money purchase price.)
- Options (ISO/NQSO)—both ISOs and NQSOs should provide for a fixed term to exercise and not terminate within a specific period after termination. As discussed, this is not an ISO requirement. This provision is particularly important for NQSOs because exercise is a taxable event.
- Vesting schedule—how much up front; vesting period and timing of balance; is there accelerated vesting if termination without cause?
- Acceleration upon change of control—if not full acceleration, try to obtain a specified amount of vesting on a change in control and a so-called double trigger clause which means that if executive is not offered employment, or if executive remains for a transition period, or if executive terminated without cause during the transition period, then full acceleration.
- Antidilution—examine (good luck) possibility of protection against dilution from extraordinary preferred stock terms and/or down round financings—so-called make-whole provisions. For example, the executive is entitled to a bonus equal to a fixed percentage share of the proceeds from the sale of the company, or a share calculated without regard to the liquidation preference of the preferred stock on an as-converted basis. Good luck with that one.

Restrictive Covenants

- Noncompete/nonsolicit/antipiracy:
  - Preferable to define precisely a competing business rather than just say that the employee will not compete with the business of the employer.

  - Does covenant terminate on substantial cessation of business?
  - Is period shorter (or nonexistent) if terminated without cause?
  - Make sure the definition of competing business does not generically include the business of a successor.
  - Can the employee go to work for a large company that competes but may not work in the competitive division?
- Invention assignments
  - Avoid invention assignments that cover posttermination inventions.

280G

- Does the employee get protection from IRC Section 280G taxes? (This section is a tax code provision that imposes severe penalties for exces parachute payments.) Consider up-front shareholder approval of parachute provisions if a private company, or a tax "gross up" for parachute taxes.

Attorneys' Fees

- Reimbursed by employer?

Merger Clauses

- Ensure that employer is obligated to require assumption, in writing, of employment agreement in the event of a sale of the company.

Indemnification

- Consider obtaining provisions requiring employer to indemnify the executive under the company's existing bylaws and provide that the executive is entitled to the fullest indemnification permitted by law if the bylaws are inadequate or are amended. Consider a requirement for insurance coverage under Directors and Officers (D&O) or other insurance policies.

APPENDICES

These appendices are located on the Web site that accompanies this book. For information on the Web site, see the "About the Web Site" section.

Appendix 1A: Start-Up Suite of Incorporation Documents:

- Certificate of Incorporation (Delaware)
- Bylaws (Delaware) corporation
- Action of Sole Incorporator (Delaware)
- Initial Written Consent of the Board of Directors (Delaware)
- Shareholders' Agreement
- Employee Confidentiality, Inventions, and Noncompetition Agreement
- IRS Section 83(b) Election

Appendix 1B: Stock Option and Incentive Plan
Appendix 1C: Stock Option Agreement (Companion to Stock Option and Incentive Plan)
Appendix 1D: Employment Agreement