

Starting a Company, (Co-)Founders and Equity Splits + The NanoGene Case



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Overview

Two sessions on practical **economic** and **human resource** issues that arise early in a startup's life.

First Session

- How/When does an idea become a company (startup)?
- What is a founder?
- What do founders decide?
- Should one have co-founders? Why?
- What conversations should cofounders have?

Second Session

- How many founders should there be at Nanogene?
- How should they divide the equity? (How long will/should the discussion take?)
- Does pay figure into this discussion?
- Should they hire Paige Miller? Why or why not?

**What Does Being a (Startup)
Company Mean ?**

Company Meaning

A company is a **legal entity** formed to conduct for-profit or not-for-profit business activities.

As a separate legal entity, it has its own legal **rights** and **obligations**.

This separation is useful for a variety of reasons (next two slides).

There are many different types of companies in the US and abroad. These types differ in the **rules**, **practices**, and **processes** used to direct and manage the company.

These rules, practices, and processes are typically spelled out in a **Corporate Charter** (“Articles of Incorporation”) and **By-Laws** (“internal governance”).

**What Triggers When an Idea Should
Become a Company?**

Company Triggers

Typically triggered by economic/legal concerns. (Otherwise, you are de facto a sole proprietorship.)

Example Triggers:

- You want to limit (personal) **liability**
- People are **paid** or **money spent** (\$ or equity allocated)
- You are **launching a paid product/service** to the market
- You are **seeking or receiving funds** (even crowd funding)
- **IP** issues need to be sorted out
- **Tax** complications
 - E.g., You expect to be **acquired** in about a year or so.
- You want to establish **business credit**

**What are Good Reasons to not Form a
a Company (or Delay Formation) ?**

Major Impediments

Does the idea (formally) belong to someone else?

- Invention assignment agreement
- Patent, copyright, trademark infringement
- Ethics?

Am I restricted from working in the space?

- Non-compete agreements
- Non-disclosure agreements (NDAs)
- Current employer prevents

Are co-founders/employees similarly restricted?

- See the above for co-founders
- “Antipiracy” agreements (cannot hire other employees)

Value to being in “stealth” mode.

State	Non-compete Clauses	Description of state policy
North Dakota	Prohibited.	This state became the first to prohibit any forms of NCC, as per North Dakota Century Code, § 9-08-06.
Hawaii	Prohibited for high-tech	This peculiar exception to NCCs as per the state's Act 158, effective July 1 2015.
California	Generally not allowed.	Courts are notoriously anti-NCC; 3 strictly limited exceptions not related to normal tech functions.
Colorado	Generally not allowed.	4 strictly limited exceptions not related to normal tech functions.
Oregon	Severely restricted	"The employee must be: an executive, administrative or professional employee exempt from the overtime requirements AND have access to trade secrets or competitively sensitive information."
New York	Restricted (prohibited in the broadcast industry)	Generally anti-NCC, with 4 criteria sometimes considered: legitimate business interest / ability of employee to earn a living / geographic and/or time constraints / not against public interest/free trade.
Virginia	Somewhat restricted	NCC only strictly allowed if prevents employee being a direct competitor. Legitimate business interest only in context of time, duration and geographic area or reach.
Washington	Somewhat restricted	NCC only enforceable if: employee earns \$100,000+ per year / disclosed before or during contract negotiations or consideration given / employee compensated during period and not longer than 18 months.
Massachusetts	Somewhat allowed.	3 criteria must be met: 10 days before start of employment / extra consideration provided / 12-month maximum.
Maryland	Allowed	4 criteria are considered: legitimate business interest / not undue hardship on employee / reasonable geographic/time limits / not against public interest.
Illinois	Allowed.	3 criteria considered: not too injurious to employee / legitimate business interest / not against public interest.
New Jersey	Allowed.	3 criteria considered: not too injurious to employee / legitimate business interest / not against public interest.
Ohio	Allowed.	3 criteria considered: no undue hardship to employee / legitimate business interest / not injurious to the public.
Arizona	Allowed.	3 criteria considered: more consideration offered / legitimate business interest / not too broad
Michigan	Allowed.	3 criteria are considered: duration of the NCC / geographic extent or reach / type of employment or line of business
Pennsylvania	Allowed.	2 criteria are considered: legitimate business interest / geographic extent or reach.
Texas	Allowed.	2 criteria are considered: not a greater restraint than needed / limitations on geographic extent/time
Florida	Often allowed.	Considered quite 'pro-NCC': (vague) condition that the NCC should not be 'too broad' / not normally for more than 2 yrs
Georgia	Easily allowed	'Backdoor' enhancement of NCCs due to much stricter NDA rules and no time limits on non-trade secret confidential information.
Source: https://nanoglobals.com/starting-business-while-employed-legality-ethics/		

Apple Sues Former Executive for Starting Competitor During Work Hours

Employers should draft strong agreements to protect their resources



By Lisa Nagele-Piazza, J.D., SHRM-SCP

January 27, 2020

Business Conduct

The way we do business

August 2022

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How (Practically) Do You Start (I.e. become a company)?

Describe a Process and your key considerations...

Lawyers

Get one early. Needed for incorporation, contracts, IP, advice (esp. equity and tax), investor connections, ...

Who?

- You hire a person, not a firm.
- Difference between startup lawyer, IP lawyer, corporate lawyer, tax...
- Do due diligence on the person and interview several. (E.g., Ask other founders in your space.)
- Experience key. (Also, expertise e.g., startup vs. corporate attys.)
- Understand their fees.
- Make sure they are connected.
- Make sure they are interested in you. (But remember with a team they are not your individual advocate!)

Fees:

Delaware C-Corp in Silicon Valley ~ \$5-10,000.

What's Decided There?

Corporate governance issues:

- Company legal form

- State of incorporation

- Corporate governance (sometimes bylaws + charter)

- Equity and its structure (if relevant)

 - Stock types (founders, common, preferred)

 - Vesting

 - Acceleration clauses

- IP Issues and Ownership

- Employee agreements for non-founders

Corporate Forms (Overview)

- Sole Proprietorship/(Some) Partnerships
- LLC
- S-Corp
- C-Corp
- B-Corp Examples. Kickstarter, Patagonia, Ben & Jerrys (Unilever) (<https://benefitcorp.net/faq>)
- Foreign Corporation

There are important distinctions among them.

Advice: consult a lawyer after doing your own research.

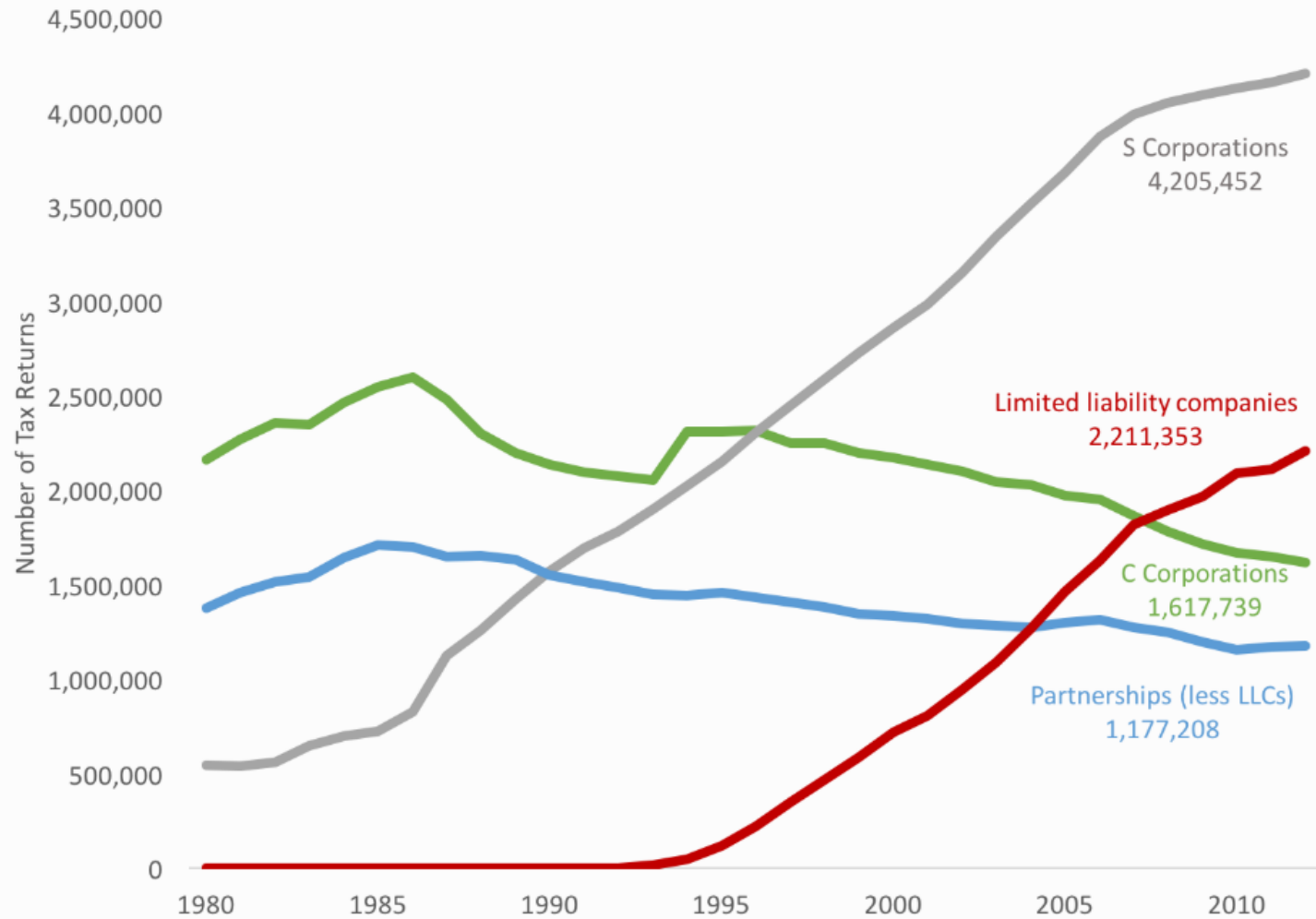
Quick Comparison

Firm Form	Limited Liability	General Tax	Paperwork /Complexity	Sell Shares
Sole Prop.	N	Personal	Little	NA
LLC	Y	Personal	Some	Interest only; no stock.
S-Corp	Y	Personal	Lots(Bylaws,...	Yes w/Limits (Citizens)
C-Corp	Y	Corporate	Even more	Least Restrictive

Note. VC route – Do Delaware C-Corp. No VC will consider LLC.

The IRS says an LLC is **not** an option if you **do more than two of**: Limited liability to the extent of assets, continuity of life, centralization of management, and free transferability of ownership interests.

Legal Entities - Total Number of Tax Filings 1980 - 2012



Source: Berkman Solutions

LLC

- Flexible business form; low start-up costs; and low business franchise taxes.
- Offers “members” asset liability and creditor protection. (Members are at most responsible for their initial investment.)
- Not suitable if you want to issue investors shares or go public. Members own “units”.
- Formed by filing a (state-specific) **Certificate of Formation** and an **Operating Agreement**.

LLC Operating Agreement

- Main governing document. Sets structure.
- Structure broadly depends on members: Single-Party, Multi-party, Multi-party multi-class, and Series (Multi-party, multi-business unit).
- Other structure:
 - Members': identities, capital contributions, ownership interests, rights
 - Who can become a new member (and how)
 - Who manages
 - How profits allocated and distributions made

Sound complex. See endnotes for more subtleties ...

Tax Considerations ...

- LLC owners pay individual federal income taxes (like sole proprietor), but may have to pay additional state taxes (e.g. CA Franchise Tax).
 - Tax Note: Most venture funds are prohibited from investing in LLC's because these entities can create UBTI (unrelated business taxable income) for the venture fund, and therefore for the funds limited partners. (Who risk a change in tax status with UBTI's.)
- S Corp also is a "pass-through tax entity." Like LLC's, income is reported on the owners' personal tax returns, but it is considered to be dividends (subject to less SS tax). There may be some self-employment tax savings compared to LLC (but generally small).
- C Corporation income is taxed at the corporate level, and, if dividends are distributed, at the individual level as well.

Somewhat Longer Comparison of Corporate Forms

Dimension	Sole Proprietorship	LLC	S Corp	C Corp
Management	Sole Owner	Members (or apt managers)	Board and Officers	Board and Officers
Owner Limited Liability	No	Yes	Yes	Yes
Entity Taxed Separately from Shareholders?	No	No/Sometimes can elect corp tax	No	Yes (Entity and Shareholders Taxed)
Capital Source	Owner	May sell shares in some cases.	Can sell shares but not to entities.	Can sell shares.
Multiple Classes of Stock	NA	Yes*	No	Yes
Can Other Entities be Owners?	No	Yes/Subject to operating agreement	No	Yes
Non-US Owners Allowed?	Yes	Yes	No	Yes
Limits on # of Owners	Yes (1)	No	Yes (100)	No
Administrative Requirements	Personal Tax Filings	Relatively few. Annual reports and taxes.	Elect Officers/Directors. Annual meetings. Taxes. State filings/fees.	Elect Officers/Directors. Annual meetings. Taxes. State filings/fees.

What's Decided There?

Corporate governance issues:

- Company legal form

- State of incorporation**

- Corporate governance (bylaws, charter)

- Equity and its structure (if relevant)

 - Stock types (founders, common, preferred)

 - Vesting

 - Acceleration clauses

- IP Issues and Ownership

- Employee agreements for non-founders

Why Delaware?

Legal:

- Has a special court that is dedicated to hearing corporate disputes.
- The Court does not allow juries.
- Judges are appointed on merit, not elected.
- Clearest body of decisions clarifying how business law applies to startups (and large companies).
- Law is pro-management. (Read this as shareholder suits are hard to file.)
- At a funding round, the Secretary of State automatically reviews and approves filings. (In CA this can take time!)

Why Delaware?

- Organizational:
 - Delaware permits a single-member board of directors, whereas some other states (e.g., California) require more directors.
- Economic:
 - Lawyers have set filings, which keeps costs down. **Startup Documents** offers an automated Delaware filing option at a very competitive rate for founders.
 - Delaware annual filing fees (\$50 US; \$125 Foreign)
 - Franchise Tax for no-value startup ~ \$350.
 - Initial Incorporation - \$90

Important: If interested, more in endnotes section.

Stock (Equity)

What is it?

Why have it?

What is vesting?

Why have vesting?

Acceleration Clauses (In Theory)

Single Trigger

“Notwithstanding the foregoing, in either (i) the Change of Control (as defined in the Plan) or (ii) early termination without cause (defined above), then ____% of the then unvested shares subject to the Option will immediately vest and become exercisable upon the date of ...”

Double Trigger

Notwithstanding the foregoing, in the event that your employment is terminated and such termination is both (A) upon the consummation of, or within 12 months following, a Change of Control (as defined in the Plan) and (B) by the Company without Cause (as defined in the Plan) [or by you as a result of your resignation for Good Reason (as defined in the Plan)], then ____% of the then unvested shares subject to the Option will immediately vest and become exercisable upon the date of such termination.

Note: Exceptions may occur in “all cash” acquisitions. In this case, unvested stock technically no longer exists. This means that an acquirer can choose to undo double trigger by paying cash and then terminating. (Though some contracts now anticipate this possibility...)

**Okay, Who Shows Up at the Lawyer's
Office?**

Or, Who Are “Founders”?

Tesla “Founders”



Elon Musk



Martin
Eberhard



JB Straubel



Marc
Tarpenning



Ian Wright

Tesla Motors founded in July 2003 by engineers Martin Eberhard and Mark Tarpenning. Musk joined at the Series A.

Retrospectively, Elon Musk, J. B. Straubel and Ian Wright were “acknowledged” to be co-founders of the company.

Who is a (Co-)Founder?

- No “Legal” definition
- Sometimes: “Those party to a founders’ agreement or incorporation where equity decided or issued”
- Initial founders (those party to incorporation) get to
 - Choose form of incorporation/titles/salary
 - Decide equity splits
 - Decide on up-front/accelerated vesting
 - Issue founder’s stock
 - Buy initial stock at a discount
 - Have more stock/Gain treated as capital gain (83(b))*.
- There also is a “Symbolic” definition of a founder

* Under new tax law there is an 83(i) election.



Tim Kilroy Analytics - LTV - Boosting Profits - Digital Marketing

January 15th, 2015

There is a weird fetish these days with anything to do with "founder" in the title. I, personally, never refer to myself as a "founder" of my company, and the folks on the team are on the team...just like I am. While we all have varying degrees of equity and variable option prices, we are all on the team. There is zero functional difference between a founder and an employee. Being a "founder" is a necessary step in creating a company. That work is DONE. Incorporation papers are signed - that is no more special than choosing which payroll service to use. Stop the founder fetish - all of those folks on the "founding team" should focus on what happens next rather than the act of "founding". Being a founder is easy - being sustainable and successful is hard. Skip the concept of "founder" altogether.

Who is a (Co-)Founder?

Deciding on initial founders can often be reduced to thinking about who should decide the initial economic/organizational structure of the new venture, and...

- Who is committed

- Who is critical to initial success

- Who has a Fit/Skill/Asset not easily duplicated

Also talked about some elements of a conversation about co-founding and whether these can/should be made formal...

What Should Co-Founders Discuss?

Conversation Points

- (1) What are our personal goals?
- (2) What business goals do we have? (e.g., size, culture)
- (3) What are our commitments (job descriptions, time commitments, how do we resolve differences, ...)?
- (4) What behavior won't we tolerate?
- (5) What will we spend (not spend) money on?
- (6) Who gets paid first and how much? (Assumes equity already divided.)
- (7) What happens if a co-founder wants to leave? Sell the company?
- (8) What happens if things involuntarily don't work out (personally, professionally)?
- (9) Who will sit on the board?
- (10) What would be signs we need to pull the plug?

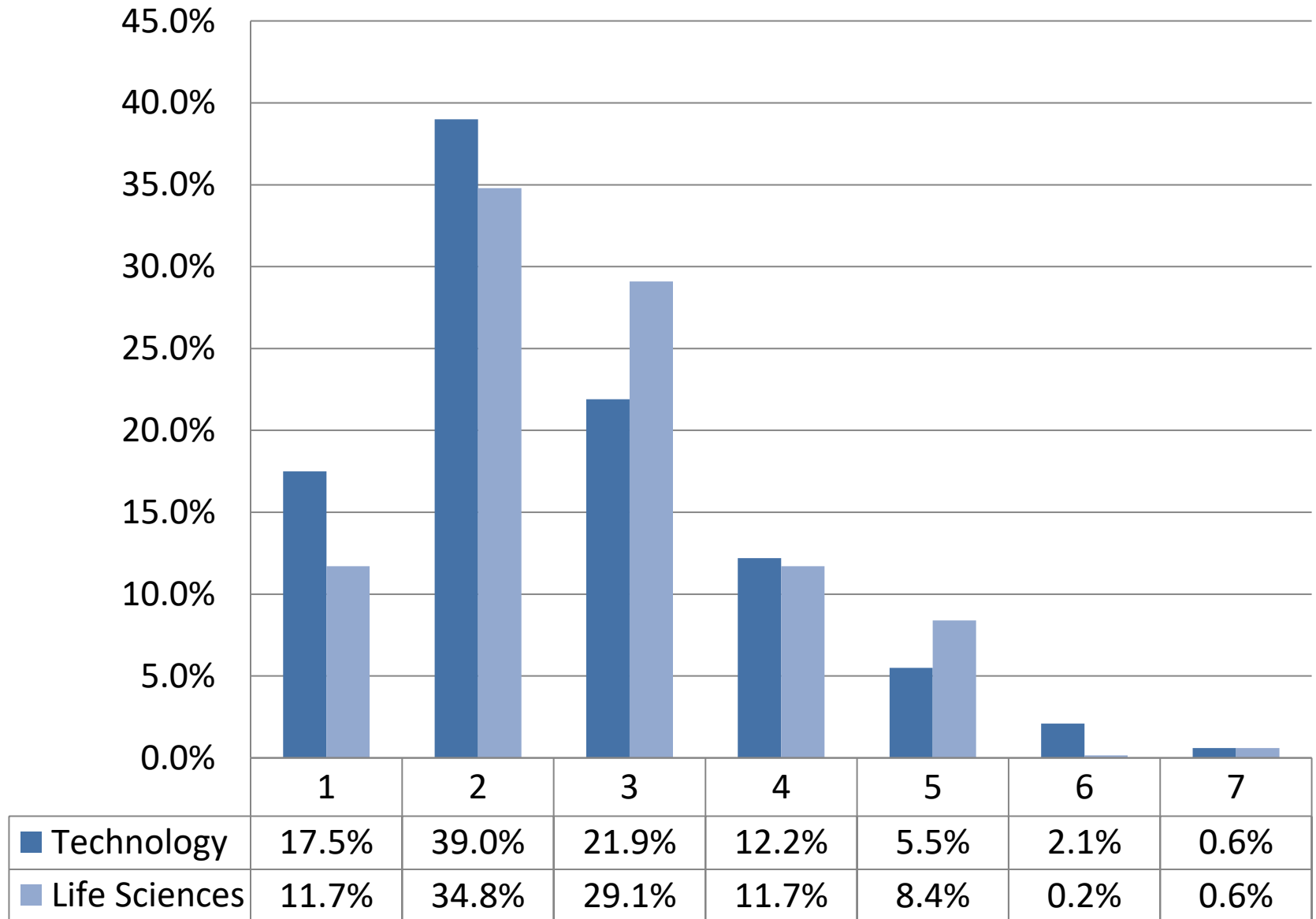
Let's Talk About How These Issues Play
Out in Practice ...

**Who Should be a Nanogene
Founder ?**

**What Criteria Would You Use to
Divide Equity?**

	Salary	Role	Commitment	Contribution
Will Thompkins	\$80K	Scientist	Resigned May	Found angel
		New CEO		Has VC contacts
Mark Masterson	\$90K	Sr. Scientist	Resigned June	Four patents at EIT
Ravi Rhoota	\$65K	Scientist	Resigned October	One patent at EIT
Gary Garfield	\$55K	Post-doc	Will join post Series A	
Don Rupert	?	Lab Head	Not leaving job	Credibility
		Serving as advisor	One day/week	Helped get first funding

Number of Founders



Equity Splits

Multiple methods and considerations

- Equal suggests equal value (reasonable vs practical)
- Role-based or market-based (from comp surveys)
- Expected future contributions (use pay for current contributions)
- Reward commitment and value brought to company

Remember: Be explicit about the rationale and discuss with all founders – it can be difficult (and sometimes impossible) to rework equity split later...

Remember Facebook?

Facebook, Inc. / Founders



Andrew
McCollum



Mark
Zuckerberg



Dustin
Moskovitz



Eduardo
Saverin



Chris Hughes



Recap

Zuckerberg reduced Saverin's stake in the company by creating a new company to acquire the old company.

He then issued new shares and distributed the new shares in the new company to everybody but Saverin.

Mark's Lawyer in an email:

“As Eduardo is the only shareholder being diluted by the grants issuances there is substantial risk that he may claim the issuances, especially the ones to Dustin and Mark, but also to Sean, are a breach of fiduciary duty ... I believe that you previously disclosed these future dilutive issuances to Eduardo before the LLC merger... Nevertheless, it would be great if there is some way you could obtain a shareholder consent from Eduardo approving these new issuances. It isn't *required* but ...

Some Advice on Equity Splits

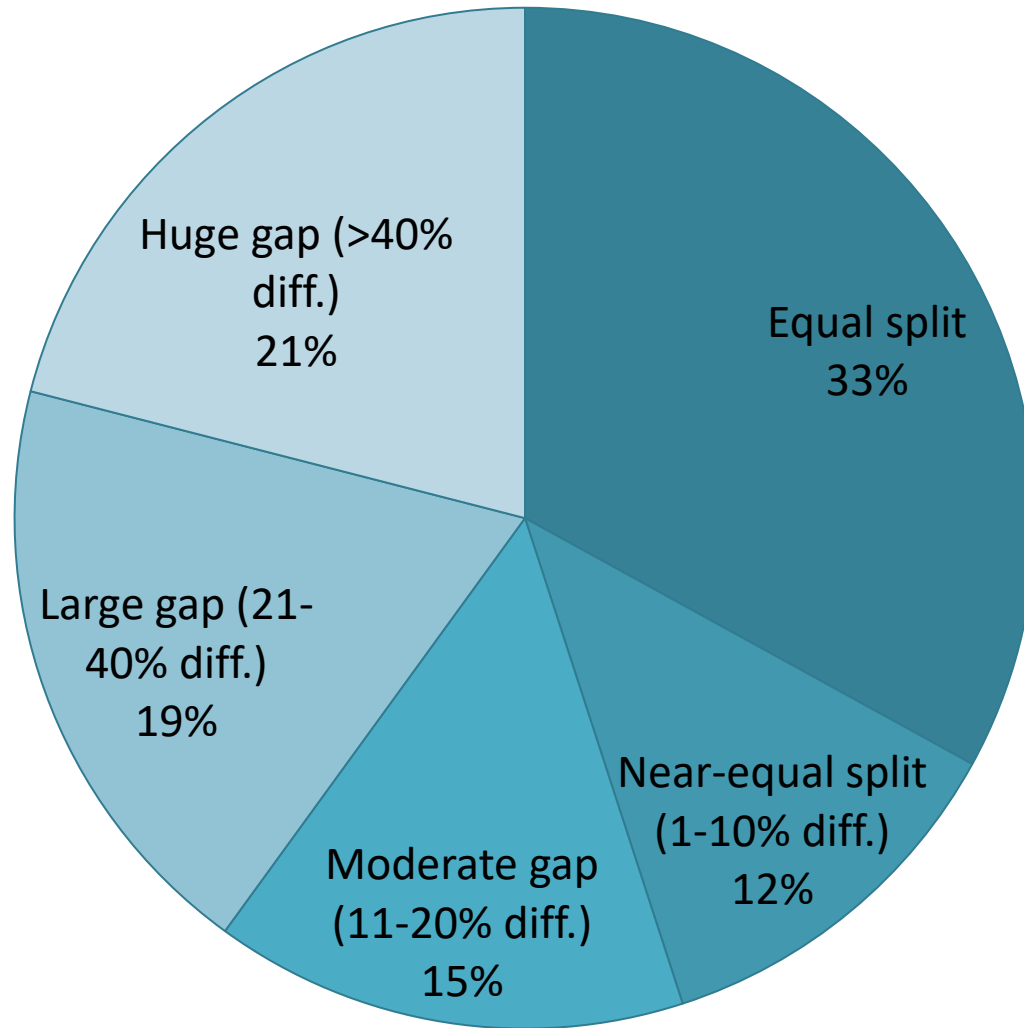
A useful way of proceeding is to think about the following division of tasks for which equity compensates:

Done

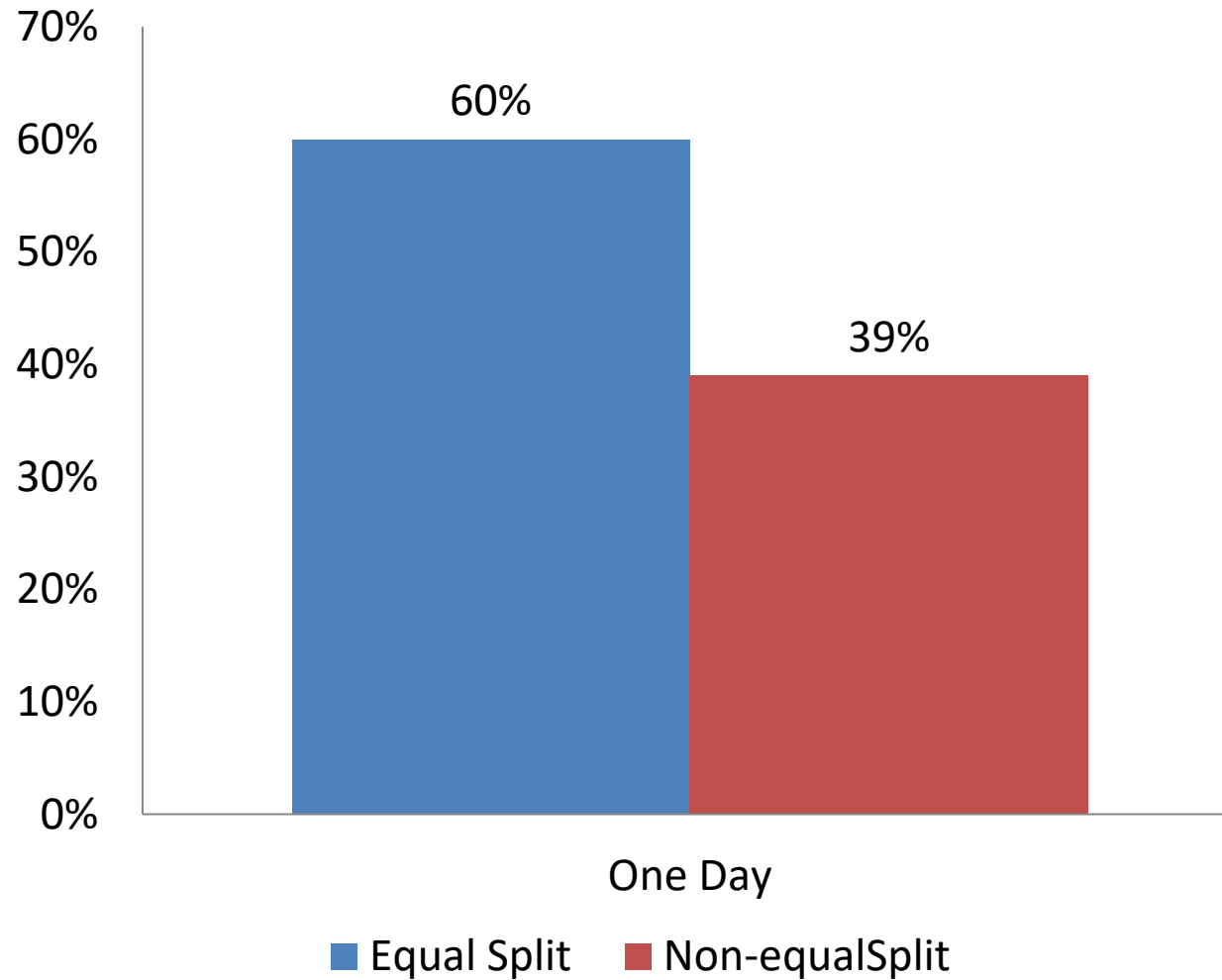
To Be Done

Almost always there is way more to be done. Equity should be reserved for those who are to do things later. This down-weights the importance of “the idea” and focuses on “Where and when will the value be created?”

Equity Split



Time to Agree On Equity Split



Results reflecting a regression of founder equity stake on:

Number of founders;

Years of prior work experience;

Experience in the same industry ;

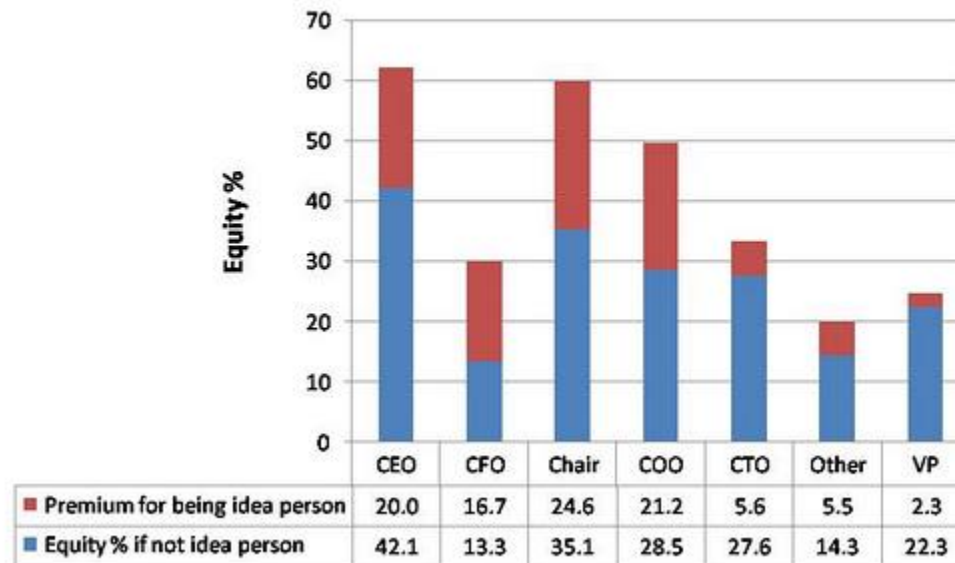
Position;

Capital Contributed;

Serial Entrepreneur;

Idea Person (Dummy Variable)

Equity Stakes, Idea vs. Non-Idea



Dilution !

	Upon Formation		After Angel Round		After EIT negotiation		After Venture Round	
	<u># shares</u>	<u>%</u>	<u># shares</u>	<u>%</u>	<u># shares</u>	<u>%</u>	<u># shares</u>	<u>%</u>
Tomkins	333,000	20.00%	333,000	14.70%	333,000	12.50%	333,000	3.15%
Masterson	333,000	20.00%	333,000	14.70%	333,000	12.50%	333,000	3.15%
Rhoota	333,000	20.00%	333,000	14.70%	333,000	12.50%	333,000	3.15%
Garfield	333,000	20.00%	333,000	14.70%	333,000	12.50%	333,000	3.15%
Rupert	<u>333,000</u>	<u>20.00%</u>	<u>333,000</u>	<u>14.70%</u>	<u>333,000</u>	<u>12.50%</u>	<u>333,000</u>	<u>3.15%</u>
Total	1,665,000	100.00%	1,665,000	73.51%	1,665,000	62.48%	1,665,000	15.76%
Angel investors			<u>600,000</u>	<u>26.49%</u>	<u>600,000</u>	<u>22.51%</u>	<u>600,000</u>	<u>5.68%</u>
Total			2,265,000	100.00%	2,265,000	84.99%	2,265,000	21.44%
EIT					<u>400,000</u>	<u>15.01%</u>	<u>400,000</u>	<u>3.79%</u>
Total					2,665,000	100.00%	2,665,000	25.22%
Option Pool							1,400,000	13.25%
Total VC Investors							<u>6,500,000</u>	<u>61.52%</u>
Total							10,565,000	100.00%

Criteria for Pay and Equity

Cash Compensation

Founders pay

- Surveys suggest that it is common for founders to make less than market early on.
- Differentiation between founders on pay is common even if equity split is even
 - provides a mechanism to compensate for current differences in roles and responsibilities

Founder Compensation

Initial compensation decisions can have broad implications

- Cultural signal for rest of organization
 - Frugal vs free spending
 - Equality vs hierarchical
 - What is valued
 - Implications for roles of individuals
- Signal to investors on long-term vs. short-term perspective

Should They Hire Paige?

Hiring a Senior Generalist Early On

Having someone with start-up experience who can set-up the company and establish key processes can be extremely valuable

- Allows others to focus on the key value-added tasks
- Can prevent mistakes and improve execution
- Gives comfort to investors that the company is being well-managed

You don't always know what you need early-on. Generalists can fill unforeseen gaps.

Selecting the Founding Team

Having a “large team” has advantages and disadvantages

- Can hit the ground running

- May turn off some VCs

- Harder to kick out founders than non-founders if issues arise later

Being a founder has economic advantages

- No need to purchase options to gain capital gains treatment

- Often founders receive some up-front vesting for prior efforts

Establishing Hiring and Compensation Guidelines

Hiring decisions are critical to company success, especially in the start-up phase.

If there is a great opportunistic hire, find a way to bring that person on. But beware the ill effects of special deals. (Remember – we pay market.)

Broad input can reduce (but not eliminate) mistakes.

Interviewing multiple people for roles helps define needs.

Consistently and fairly applied compensation guidelines reduce resentment over pay and equity.

Option Grant Chart – Series A

Level	Titles	Options %
1	Admin, Research Asst, Clerk	0.03%
2	Research or Engineering Associate, Analyst, Sr Admin	0.06%
3	Scientist, Engineer, Specialist	0.12%
4	Manager, Group Ldr, Sr Scientist, Assoc Dir	0.50%
5	Director, Scientific Fellow	1.00%
6	VP, Senior Fellow	2.00%
7	CEO	

Sun Microsystems

Activity	Unix workstations		Company	Sun Microsystems	Incorporation	
Town, St	Mountain View, CA		IPO date	4-mars-86	State	
f= founder	Price per share	\$16.0	Market cap.	\$473'018'288	Date	févr-82
D= director	Symbol	SUNW	URL	www.sun.com	years to IPO	4.0

	Title	Name	Founder's Ownership	Employee Ownership	PreIPO Ownership	Post IPO Ownership	Founder's Shares	Employee Shares	PreIPO Shares
f	CEO		24.1%	9.2%	4.4%	3.9%	1'147'263	1'147'263	1'147'263
f	VP Tech		33.1%	12.6%	6.1%	5.3%	1'571'093	1'571'093	1'571'093
f	Board director		24.2%	9.2%	4.4%	3.9%	1'149'011	1'149'011	1'149'011
f	VP R&D		18.6%	7.1%	3.4%	3.0%	884'077	884'077	884'077
	EVP			2.7%	1.3%	1.1%		336'875	336'875
	VP-SLS							-	-
	VP-FIN							-	-
	VP-EUR							-	-
	Other			9.4%	4.5%	4.0%		1'170'248	1'170'248

Source: http://wiki.epfl.ch/a3-angels/documents/reunions/a3angels07-herve_lebret-equity_split_study.pdf

LLC Operating Agreement

- Other structure (continuation):
 - What matters require majority, super-majority or unanimous member consent
 - What outside activities are permitted
 - How members can be terminated (and terms)
 - Can members sell interests
 - When can the LLC be terminated

LLC Miscellaneous

- Members can be domestic or foreign individuals or entities.
- LLC's can be run by members, member managers, or non-member managers.
- Corporations have articles of incorporation; LLCs have articles of organization. Corporations have bylaws; LLCs have operating agreements.
- An LLC is taxed by the IRS as a pass-through entity since no stock is being issued to its members.
- LLC's can issue new interests without being subject to security laws, but unanimous approval is required.

Endnotes

- Any person, regardless of residence, may form a C corporation in Delaware. Any founder in any country can own stock.
- Visa status has no bearing on ownership or interest in a C corporation. A startup founder in Israel, Chile, Brazil, or California can be a stockholder in a Delaware C corporation.
- BUT... If you plan to work for a US C Corp, and are not a US citizen or green card holder, proper work authorization / visa is required.

Endnotes

- Many VCs will insist Delaware C before they invest. If you have done something else (e.g., California C corporation) or need to re-incorporate you face additional legal costs. You may also trigger tax consequences.

-> Determine the proper state of incorporation early by thinking through your long-term fundraising goals.

Endnotes

- California businesses can incorporate in Delaware, but ...
 - Must qualify to do business in California (and any other state they do business).
 - Must follow laws in every state they do business.
 - Can be sued under California law.
 - Must pay California income, franchise or business tax.