



Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

Incorporation and Compensation

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Choosing the Form of Business Entity

- Three common organizations
 - Limited liability company
 - Subchapter S corporation
 - Subchapter C corporation

Limited Liability Company

- Limited liability corporation (LLC)
 - Combines features of both corporations and limited partnerships
 - Corporate features: LLC members can operate as managers; all owners have limited liability (i.e., only the amount of their investment)
 - Limited partnership tax features: no entity-level tax—taxes pass through to LLC members
 - Ownership interests of the “members” are defined and established in the LLC operating agreement

Subchapter S Corporation

- **A Sub S corporation has board members/shareholders, etc.; but—**
 - Tax benefits and losses passed through to the individual shareholders (i.e., a single level of taxation)
 - Early stage start-ups will sometimes take advantage of “S Corporation” status: losses get passed through to the owners
- **Requirements for S Corporation status:**
 - no more than 100 shareholders
 - all individuals (family trusts are OK in general)
 - only one class of stock (i.e., no preferred stock)
- **Simple conversion to Subchapter C corporation**

Subchapter C Corporation

- **Attributes of a Subchapter C Corporation**
 - **Corporate governance**
 - Stockholders elect board of directors
 - Board appoints officers, oversees strategic direction
 - Officers manage day to day affairs of the company
 - **No pass through of tax benefits**
 - Subchapter C corporation is taxed as a separate legal entity (unlike the LLC and the Sub S Corp).
 - **VCs can invest in it; employees can understand stock incentives**

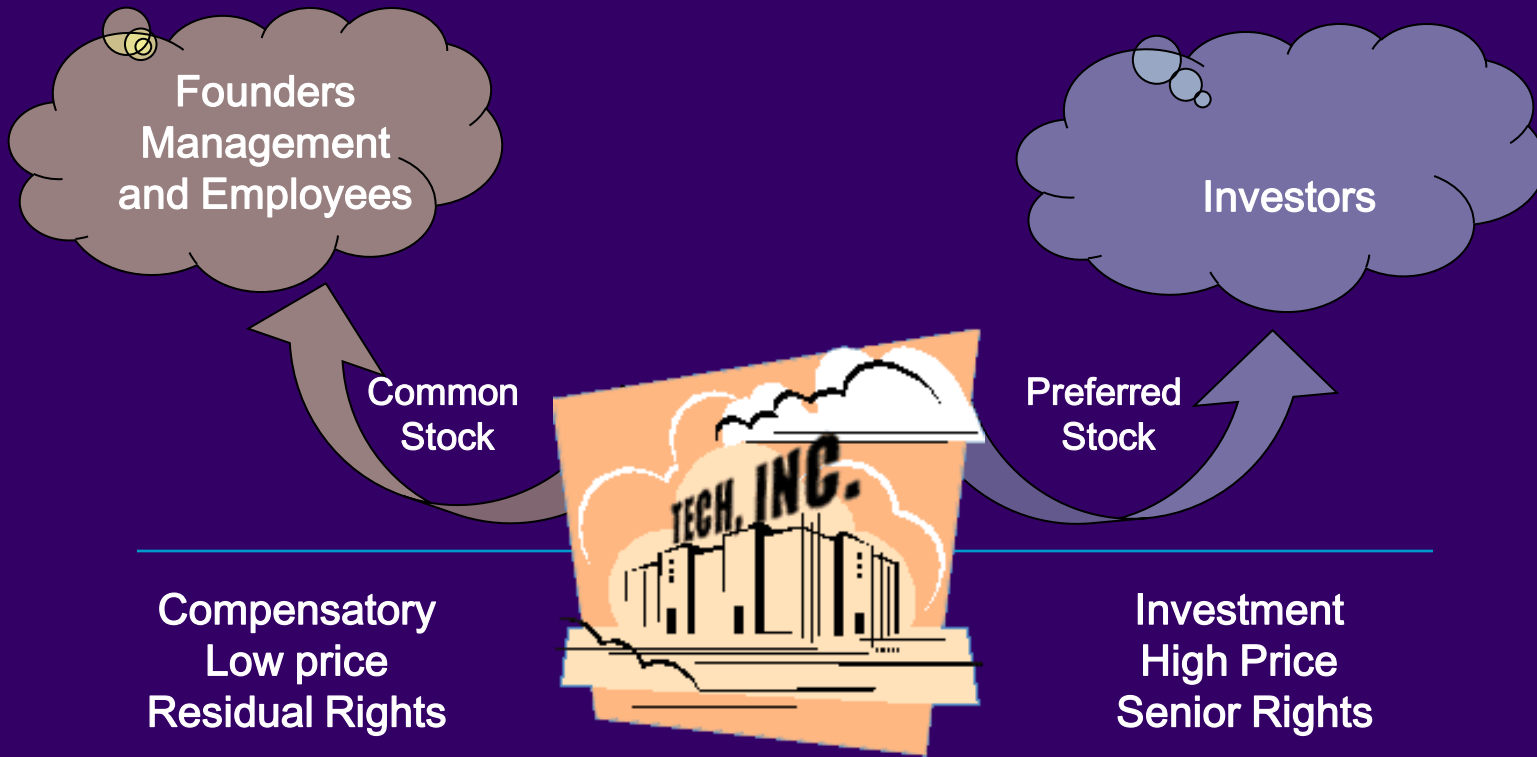
Where to Incorporate

- California or Delaware?
 - Cost
 - Filing services
 - Beneficial corporate law
 - IPO objectives and reincorporation

Stock

- Stock represents the equity ownership of the company
- Stock is a big part of what fuels Silicon Valley and the rest of the technology sector
- Stock--and the philosophies over how it should be used--are what separate technology start-ups from other companies in the general business community

Two-Class Stock Structure



Stock

- The two-class capital structure: preferred and common stock
 - common stock is typically used for compensatory purposes (i.e., employees, consultants, board members, etc.)
 - preferred stock is set aside for investment
 - Liquidation preference
 - Anti-dilution protection
 - Protective voting covenants

Stock

- **Founders' stock: the first step in capitalizing the start-up**
 - Always common stock
 - Typically issued in exchange for technology, hard assets, past services or nominal cash.
 - Objective is to issue founders' stock for lowest possible value

Stock

- A word about intellectual property
 - Is it core to the business?
 - Who has “fingerprints” on it?
 - Is it clear that the new company owns all of it?
 - Assignment of inventions agreement

Types of Equity Compensation

- Restricted Stock (Including Founders' Stock)
- Incentive Stock Options (ISOs)
- Non-qualified Stock Options (NSOs)

Restricted Stock

- Restricted Stock
 - Adequacy of consideration
 - Transfer of IP, past services
 - Company repurchase right
 - Tax occurs as shares vest
 - Exception – 83(b) Election
 - Choose to Tax at Grant
 - File 83(b) election form (within 30 days)
 - No Second Chance!

Process for Granting Options

- Certificate of Incorporation and Bylaws
- Restrictions in other constituent documents (e.g. pre-emptive rights)
- Stock Plan
 - Typically requires *current* service provider status (not future or past)
 - ISO's must be granted pursuant to a written plan
- Securities Laws/International considerations
- Corporate process
 - Actions by written consent vs. meeting
 - No “as of” dating
- Issuing the agreement and maintaining good records
- **Clean-up is costly so better to get it right the first time!**

Incentive Stock Options (ISO's)

- An ISO is eligible for favorable tax treatment
- Key Concepts:
 - No tax at grant
 - No tax at exercise (purchase)
 - Unless alternative minimum tax (AMT) applies
 - Sale or other disposition triggers income
 - Tax consequences differ depending on whether disposition is “qualifying” or “disqualifying”

ISOs

- Applicable Holding Periods
 - 2 years from ISO grant AND
 - 1 year from ISO exercise (purchase)
- Meeting BOTH of these holding periods results in a QUALIFYING disposition
- Failure to meet EITHER of these holding periods results in a DISQUALIFYING disposition

ISOs — Alternative Minimum Tax

- Exercise of ISO's may trigger AMT
 - General Rule - “spread” at exercise is included in the calculation of AMT
 - Paying AMT may generate tax credit against future years' income tax (as long as not subject to AMT)
 - Goal to accelerate tax, not double tax

Characteristics of ISO's

- ISO's must be granted pursuant to a written plan that:
 - sets forth number of shares,
 - states class of employees, and
 - is approved by majority of S/Hs w/in 12 months of Board Adoption.

Characteristics of ISO's (cont.)

- Can only be granted to EMPLOYEES of company (or parent or subsidiary)
- Exercise price must be 100% of FMV on date of grant (110% FMV for 10% S/Hs)
- Maximum term of 10 years (5 yrs for 10% S/Hs)
- Must be exercised within 3 months of termination (12 months if disability)

Nonstatutory Stock Options (NSOs)

- An NSO is any option that does not qualify as an ISO
- No tax at grant (if not subject to Section 409A)
- At exercise, ordinary income = “spread”
- Subject to tax withholding (regardless of liquidity of underlying shares); form W-2
- Sale - capital gain/loss
 - basis = purchase price + ordinary income recognized on exercise
 - long-term capital gain/loss if held for > 1 year

Section 409A

- Discount stock options are treated as a deferral of compensation under Section 409A
- Stock options covering other than “service recipient stock” provide for a deferral of compensation
 - Only includes common stock (i.e., does not include preferred stock)
 - Options in subsidiary stock potentially problematic

Section 409A (cont.)

- Tax at time of vesting, not date of exercise
 - Could result in continued taxation after vesting
 - 20% tax in addition to regular income taxes (plus another 20% in California)
- Potential interest penalty
- Employers have reporting and withholding requirements

Section 409A (cont.)

- Regulations provide for presumptions of reasonableness for determination of value of common stock
 - IRS has burden of proving valuation method is “grossly unreasonable” if satisfy presumption
 - Company (and optionee) have burden of proving reasonableness if no presumption

Section 409A (cont.)

- 3 presumptions:
 - Independent appraisal
 - Good faith written report
 - Binding Formula (generally won't be used)
- Independent appraisal and good-faith written report cannot be relied upon for more than 12 months, or earlier if there's a material event
- A “good faith” written report can not be relied upon if reasonably expect to undergo a change of control within 90 days or conduct an IPO within 180 days from date upon which the report is to be relied

Early Exercising Stock Options

- What does it mean to “early exercise” an option?
 - Exercise prior to vesting
 - Unvested shares subject to a right of repurchase (usually at cost)
- Advantages of early exercising
 - Minimize tax
 - Start holding periods
- What is an 83(b) election?
 - Instructs IRS to treat shares as if they were vested for tax purposes
 - Must be filed within 30 days of exercise
 - Failure to file will result in taxation upon vesting

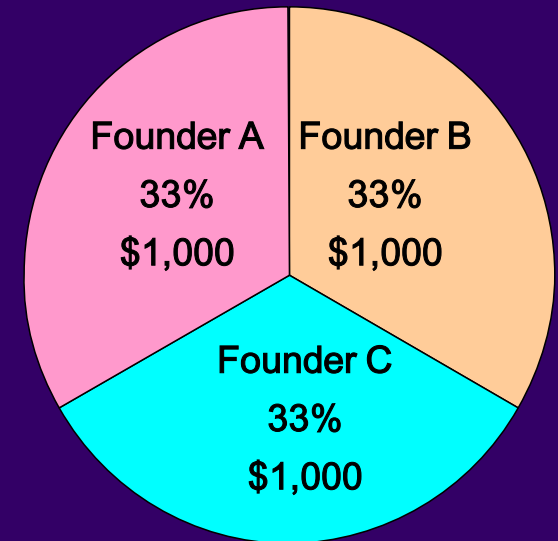
Startup Company Capital Structure

The Expanding Pie

I. Formation of Company

Founders A, B and C each purchase 1,000,000 shares of Common Stock at a purchase price of \$.001 per share.

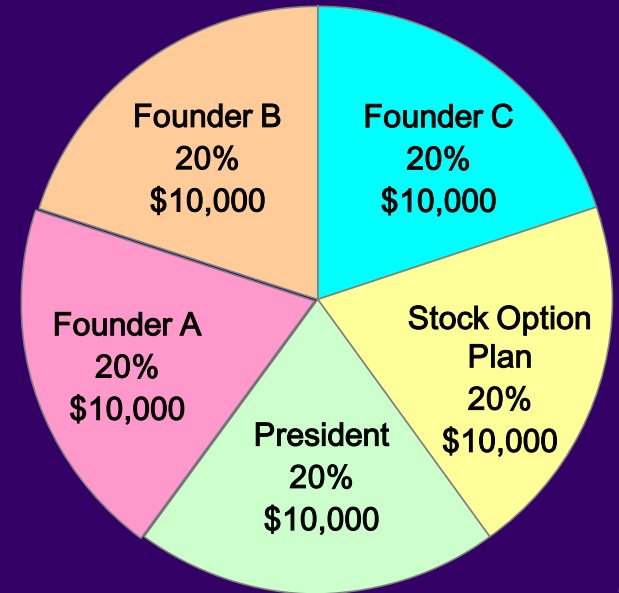
<i>Person</i>	<i>No. of Shares</i>	<i>% of Shares</i>	<i>Value</i>
Founder A	1,000,000	33.33%	\$1,000
Founder B	1,000,000	33.33%	\$1,000
Founder C	1,000,000	33.33%	\$1,000
Total Post-Financing Valuation	3,000,000	100.0%	\$3,000



II. Hiring of Chief Executive Officer & Establishment of Option Plan

The Company hires a chief executive officer who purchases 1,000,000 shares of Common Stock at a purchase price of \$.01 per share. Additionally, in order to attract additional key employees, the Company establishes an employee stock option plan and reserves 1,000,000 shares of Common Stock for issuance under this plan. The pre-financing valuation is \$30,000 and the post-financing ownership structure and valuation are depicted in the following table and pie chart.

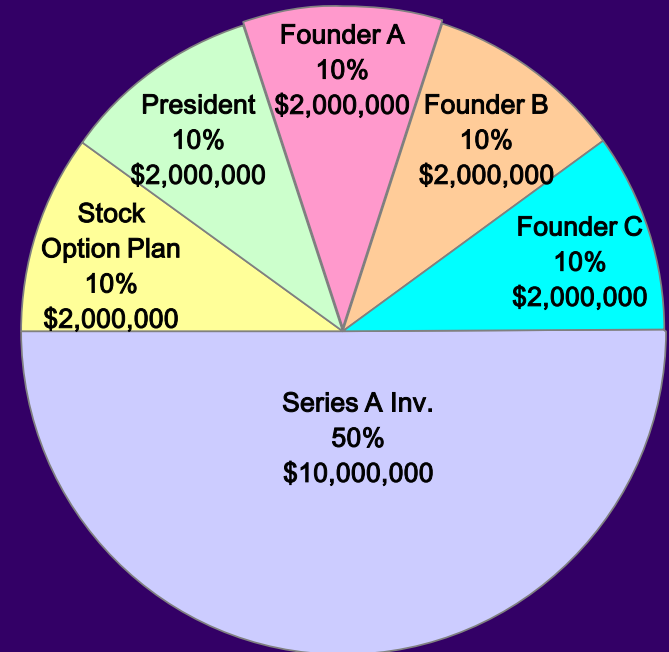
<i>Person</i>	<i>No. of Shares</i>	<i>Percent of Shares</i>	<i>Value</i>
Founder A	1,000,000	20.0%	\$10,000
Founder B	1,000,000	20.0%	\$10,000
Founder C	1,000,000	20.0%	\$10,000
President	1,000,000	20.0%	\$10,000
Stock Opt. Plan	1,000,000	20.0%	\$10,000
Total Post-Financing Valuation	5,000,000	100.0%	\$50,000



III. Initial Venture Financing Round

The Company needs capital to complete product development. Accordingly, the Company completes a \$10,000,000 venture capital financing at a purchase price of \$2.00 per share, representing a pre-financing valuation of \$10,000,000 (5,000,000 shares with a value of \$2.00 per share). The shares sold in the financing are typical, venture capital Series A Preferred Stock with each share of Series A Preferred Stock being convertible into one share of Common Stock. This financing results in the following ownership structure and post-financing valuation:

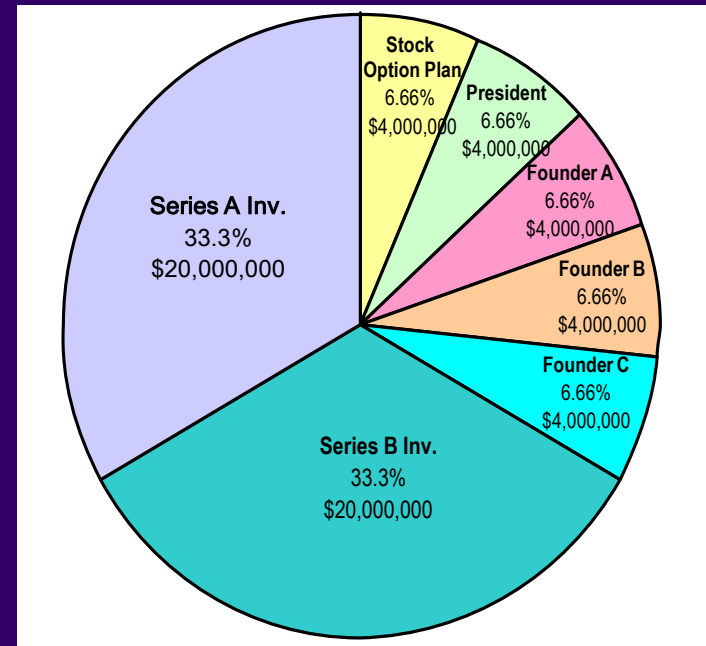
<i>Person</i>	<i>No. of Shares</i>	<i>Percent of Shares</i>	<i>Value</i>
Founder A	1,000,000	10.0%	\$2,000,000
Founder B	1,000,000	10.0%	\$2,000,000
Founder C	1,000,000	10.0%	\$2,000,000
President	1,000,000	10.0%	\$2,000,000
Stock Opt. Plan	1,000,000	10.0%	\$2,000,000
Series A Inv.	5,000,000	50.0%	\$10,000,000
Total Post-Financing Valuation	10,000,000	100.0%	\$20,000,000



IV. Series B Preferred Stock Financing

The Company’s product development is progressing favorably, but an additional \$20,000,000 will be required to complete development. Accordingly, the Company undertakes a \$ 20,000,000 Series B Preferred Stock financing at a purchase price of \$4.00 per share, representing a pre-financing valuation of \$40,000,000 (10,000,000 shares with a value of \$4.00 per share). Like the Series A preferred Stock, each share of Series B Preferred Stock is convertible into one share of Common Stock. This financing results in the following ownership structure and post-financing valuation:

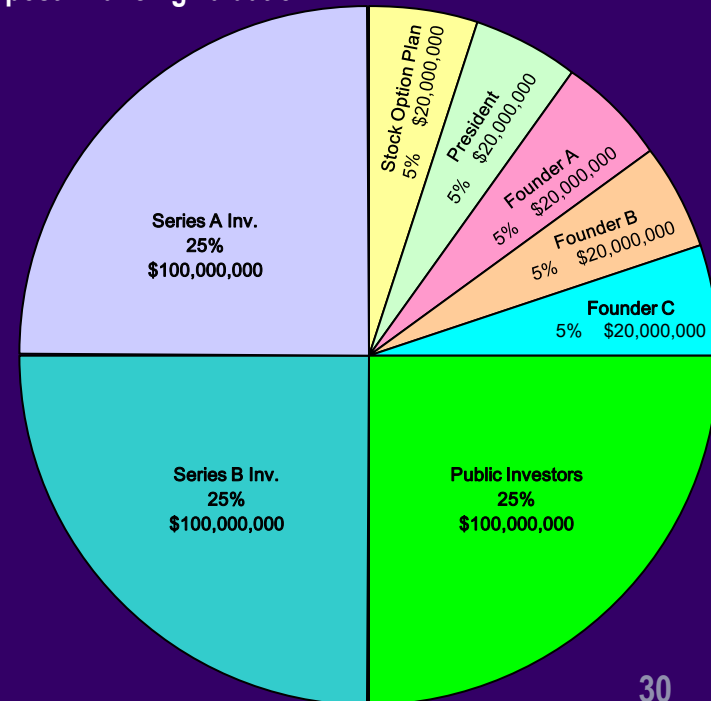
<i>Person</i>	<i>No. of Shares</i>	<i>Percent of Shares</i>	<i>Value</i>
Founder A	1,000,000	6.66%	\$4,000,000
Founder B	1,000,000	6.66%	\$4,000,000
Founder C	1,000,000	6.66%	\$4,000,000
President	1,000,000	6.66%	\$4,000,000
Stock Opt. Plan	1,000,000	6.66%	\$4,000,000
Series A Inv.	5,000,000	33.33%	\$20,000,000
Series B Inv.	5,000,000	33.33%	\$20,000,000
Total Post-Financing Valuation	15,000,000	100.0%	\$60,000,000



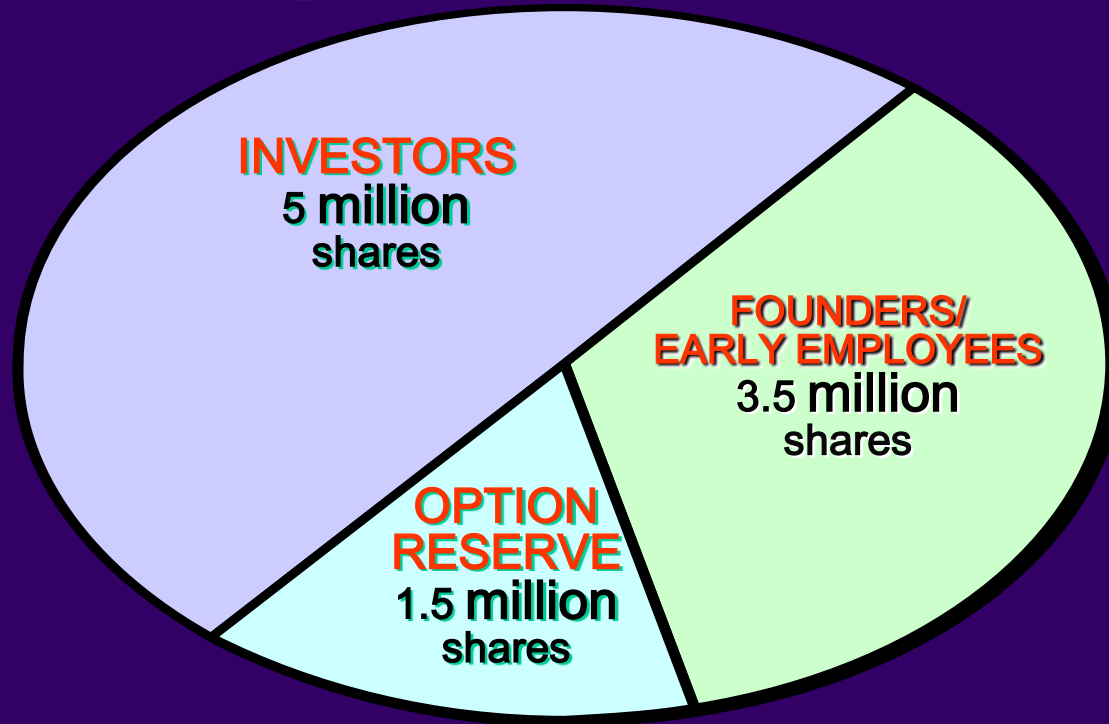
V. Initial Public Offering

The Company needs substantial additional capital to expand the scope of its manufacturing and sales and marketing operations. Accordingly, the Company decides to undertake an initial public offering. As a result of the offering, the shares of Series A and Series B Preferred Stock held by the venture capital investors will be automatically converted into Common Stock at the conversion rate of 1 share of Common Stock for each share of Preferred Stock, and all shares sold in the offering will be Common Stock. A total of 5,000,000 are to be sold by the Company. The shares will be sold at a price of \$20.00 per share, representing a pre-financing valuation of \$300,000,000 (15,000,000 shares with a value of \$20.00 per share). This public offering will result in the following ownership structure and post-financing valuation.

<i>Person</i>	<i>No. of Shares</i>	<i>Percent of Shares</i>	<i>Value</i>
Founder A	1,000,000	5%	\$20,000,000
Founder B	1,000,000	5%	\$20,000,000
Founder C	1,000,000	5%	\$20,000,000
President	1,000,000	5%	\$20,000,000
Stock Opt. Plan	1,000,000	5%	\$20,000,000
Series A Inv.	5,000,000	25%	\$100,000,000
Series B Inv.	5,000,000	25%	\$100,000,000
Public Investors	5,000,000	25%	\$100,000,000
Total Post-Financing Valuation	20,000,000	100.0%	\$400,000,000



Stock Capital Structure



(10 million share model: 5 million for founders/employees + 5 million shares for investors)

Capitalization: Practical Tips

#1 Get the founders' stock arrangements right!

- Make sure the founders are ok with their allocation
- Vest now—and let the VCs reverse it later
- “Buy/sell” arrangements are generally not necessary

#2: Anticipate up to 50% dilution for first/second rounds

- Set aside 20-30% for future employees in the early stage

Capitalization: Practical Tips

#3: Establish an overall game plan for equity incentives

- Create an incentive matrix for all positions in the organization; the board will insist on one (see samples in the materials)
- Be disciplined in implementation
 - Stay within the ranges
- Establish a stock option plan with an established reserve
 - Plan should be geared for anticipated headcount growth over a 12-18 month period

(Stock Plans)

- Equity incentive structures for directors, employees and consultants are usually implemented through the adoption and administration of a “stock plan” or “stock option plan” (these are synonymous)
 - **A stock plan is a formal written document approved by the board of directors and the shareholders. (See sample plan in materials)**
 - The stock plan establishes a “**reserve**” of stock (i.e., **authorized but unissued shares** that are set aside, or earmarked, specifically for issuance under the stock plan).
 - **VC investors include the reserve in negotiating valuation.** They want to ensure that the reserve is established at an adequate level to avoid post-financing dilution to their negotiated equity stake in the company.

(Stock Ownership By Employees)

- A very general rule of thumb for a “mid-stage” technology start-up (i.e., post-Series A) (Note: it does not account for founders’ stock.)

<u>Position</u>	<u>No. of Ees</u>	<u>% of Capital</u>	<u>Aggregate Equity</u>
CEO	(1):	5 - 10%	7%
CFO	(1):	1 - 2%	1%
VPs	(2):	1 - 3%	8%
Dir-level	(6):	< 1/2%	3%
Others	(?):	< 1/4%	<u>6%</u>
		Total	25%

(Stock Ownership by Employees)

	<u>Pre-Series A Preferred</u>	<u>Post-Series A Preferred</u>	<u>Post-IPO</u>
CEO	15-25%	5-10%	3-5%
Vice Presidents	6-8%	2-3%	1-1.5%
CFO	5-7%	1-2%	1%
Director-level	2-3%	<1/2%	<1/4%
Other	n/a	<1/4%	n/a

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