



**KATOVICH**  
L A W G R O U P

**UC BERKELEY**  
**HAAS BUSINESS SCHOOL**  
**ENTREPRENEURSHIP**

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# OVERVIEW

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- ❑ Choice of Entity
  - When and Why
  - What Type: C-Corp, S-Corp, LLC
  - Where: Delaware or California
- ❑ Incorporation of Entity
  - Documents
  - Formalities
- ❑ Founder's Stock Issuance
  - When and Why
  - Technology Assignment
  - Vesting and other Restrictions
- ❑ Capitalization and Dilution
- ❑ IP Protection

# Choice of Entity – Why?

## □ Limit Personal Liability

- Protect Founders – from outside claimants
- Protect Company
  - Ownership of Technology / IP
  - Disenfranchised Founder Leaving

## □ Allocate Economic Interests

- Issue Stock to Founders
- Sell Stock to Investors
- Grant Options to Employees/Consultants

## □ Vehicle for Transactions and Investment

# Choice of Entity – When?

## Earlier is Better

- Get IP into Company early
- Commitment to Enterprise
- Establish Ownership among Founders
- Keep Pricing Low

## When Contracts or other Liabilities

## When Second Equity Participant

# Choice of Entity – What Type?

- Sole Proprietorship
- Partnership
  - General
  - Limited
- Limited Liability Company (LLC)
- Corporation
  - C Corporation
  - S Corporation

# Limited Liability Company (LLC)

## □ Ownership:

- Owned by the members
- Governed by managers:
  - some/all members (elected by membership); or
  - outside managers (chosen by membership)

## □ Liability (similar to corporation):

- Limited liability for members

# LLC (cont'd)

## ☐ Tax (similar to Partnership):

- Flow Through: income taxed directly to members

## ☐ Formation:

- LLC agreement required – filed with State
- Members will typically have an Operating Agreement

# S Corporation

- ❑ Ownership (same as C Corp)
  - Owned by shareholders, governed by Board of Directors
- ❑ Liability (same as C Corp/LLC)
  - Limited to shareholder's investment
- ❑ Tax (Flow Through)
  - No corporate entity tax (similar to LLC)
  - Profits and Losses flow through to shareholders

# S Corporation (cont'd)

## □ Formation:

- Articles/Certificate of Incorporation filed with State
  - IRS Form 2553 Election – within 2.5 months
- Several limitations apply
  - Only one class of stock allowed
    - Watch out for Convertible Promissory Notes
  - Number and type of shareholders
    - 75 shareholders max. (husband & wife = 1)
    - Natural persons only (certain estates, trusts)
    - No non-resident aliens

# C Corporation

## □ Ownership:

- Owned by shareholders
- Governed by Board of Directors  
(elected by shareholders)

## □ Liability:

- Limited liability for shareholders  
(limited to investment)

# C Corporation (cont'd)

## ☐ Tax:

- Corporate earnings taxed at corporate rate
- Dividends to shareholders taxable (double-taxation)

## ☐ Formation:

- Articles/Certificate of Incorporation filed with State
- Other operating documents (bylaws, board resolutions, etc.)

# Where to Incorporate?

## □ California

- Minimum franchise tax
- Filings (Financings, Mergers) much harder
- Reincorporation to Delaware if IPO (some VC's also will require for financing)

# Where to Incorporate?

## □ Delaware

- Very business-friendly (easy filings)
- Higher franchise tax (higher costs)
- Need to qualify as foreign corporation in CA
- Laws more favorable to investors
  - But – CCC §2115 could deem entity a “quasi-CA” corp.

# Incorporation

- ❑ Articles of Incorporation
- ❑ Bylaws – internal governance, size of board
- ❑ Organization Resolutions (first minutes)
  - Appoint Board, Officers, Banking Resolutions
- ❑ Founders' Restricted Stock Purchase Agreements
  - Technology Assignment
  - Securities and Tax Filings
- ❑ Ongoing Maintenance
  - Minute Book, Stock Records
  - Invention Assignments, Confidentiality Agreements
  - Filings (SEC, IRS, FTB, EDD ...)
  - Business Licenses, Qualifications

# Founder's Stock Issuance

## □ When and Why

- Earlier is Better
  - Stock is cheap (valuation still low)
  - Determine allocations – who are the founders and what do they get
- Establish ownership
  - Get technology into company
    - Transfer Technology – in exchange for stock
    - Company MUST own its technology – good title
  - Avoid Free Rider – with vesting schedule

# VESTING

## □ What is stock vesting?

- If Founder leaves the company, Company has right to repurchase “unearned” shares (at original purchase price)
- The longer the founder stays, the more stock earned

## □ Vesting Schedule

- 4 years vesting, 1 year cliff (sometimes no cliff)
- Monthly after the cliff
- “Pre-vest” for past work (keep it defensible)

## □ Why Have vesting?

- Incentive for founder to provide services
- Earn the right to keep the stock
- Avoids “free-rider” problem if a founder leaves
- VC’s will require vesting

# OTHER RESTRICTIONS

- ❑ Right of First Refusal (ROFR)
  - Right to repurchase shares at bona fide offer price
  - Keep control over stock transfers
  - Keep out of unfriendly hands
  - Terminates on IPO
- ❑ Escrow
  - Stock Certificates held in Escrow
  - Stock powers, spousal consents

# ACCELERATION

- Change of Control (merger)
  - Double trigger
    - Company Acquired – Trigger One
    - Founder terminated (e.g., within 12 months) – Trigger Two
  - How much Acceleration?
    - 100% – rare (keep founder motivated)
    - 25% - 50% – more common
- Terminations (without merger)
  - Termination without Cause (1<sup>st</sup> year)
  - Constructive Termination

# PRICING

- ❑ Common stock (Founders)
  - ~\$0.001/share (at incorporation) – CHEAP!
  - Price increases closer to financing
  - Can't use for \$\$ investment – “blow” FMV
- ❑ Options (employees)
  - ISO – must be issued at FMV of common stock
    - Need to keep common stock cheap – for incentive options
  - IRS 409A – severe tax penalty if option < FMV
    - Valuation by independent third party appraiser
    - Valuation by internal “expert” written report
- ❑ Preferred Stock (Investors)
  - Determined by Valuation
  - Affects FMV for Common stock

# CONSIDERATION

## □ Form of Consideration

- Cash – need to capitalize the company
  - 2,000,000 shares at \$0.001 = \$2,000
- Past services – if rendered and unpaid
  - But, will trigger “compensation” tax to founder
- Technology Transfer
  - company must own its technology – good title essential
  - Transfer all at same time (avoid §351 Tax)

## □ Tax – 83(b) election

- **MUST FILE WITHIN 30 DAYS!!**
- Restricted stock – not fully owned

# ALLOCATION

## □ Incorporation – 3 Founders

- Equal split – 2M shares each founder
- Option Pool
  - Should be 15-25% total fully-diluted
  - Assume – 2M shares
  - Each founder = 25% (2M each = 6M total)
  - Option Pool = 25% (2M Pool = 8M fully diluted)

## □ Series A Financing (post-closing)

- Investors = 50%
- Option Pool = 25% (increase counted pre-\$)
- Founders = 25% → each founder = 8.3%

# Allocation and Dilution

## □ Bridge Financing

- Angel or F&F provide \$100K - \$500K
- Convertible Promissory Note
  - Converts to Series A when VC invests
  - Usually converts on same terms as VC
  - May have “equity kicker” – warrants or discount conversion price
- Warrants will be counted as “pre-money” (dilute Founders, NOT VC’s)
- Shares for Angel/F&F Notes will be counted as “pre-money”

# Allocation/Dilution - Example

## □ Pre-Money

- Founders (3) – 2M each (<25% each)
- Pool – 2M (<25% each)
- Angel – \$500K
  - Warrants – 1% (post-money)

## □ Post-Money

- Pre-money Valuation = \$4M
- Total Investment = \$4M (\$3.5M VC, \$0.5M Angel)
- **Price = \$4M / (8M+[\$500K]+[1%]+[Pool Increase]) = \$0.26/share**
- VC = 13.5M (46.4%)
- Angel: Note = 1.9M (6.7%); warrant = .29M (1%)
- Pool = 7.2M (25%)
- Founders = 2M each (6.9% each)
- Total shares = 28.9M

# IP PROTECTION

- ❑ Trade Secret/Know-How
  - Mark “Confidential”, have Policy
  - Non-disclosure Agreements (NDA’s), Invention Assignments
- ❑ Trademark/Trade Name - ™ ®
  - Corporate name used as trade name (branding)
  - Search/file with PTO
- ❑ Domain Names
- ❑ Copyright © 2009, Haas, Inc., all rights reserved
  - Attaches when fixed in tangible medium
- ❑ Patent – provisional, utility
- ❑ Prior Employment – What Constraints?

# Trade Secret

## □ What is Trade Secret?

- Confidential information, Know-How
- Technology – software, processes, materials, compositions, formulas
- Marketing/Business Strategies – customer lists, business plans, marketing strategies

## □ How to preserve

- Mark “Confidential”, have internal Policy
- Non-disclosure Agreements (NDA’s) – 3<sup>rd</sup> parties
- Invention Assignments – employees/consultants

## □ Prior Employment

- Do you own what’s in your head?

# Trademark/Trade Name

## □ Availability

- As Corporate name – search Secretary of State
- As Trademark - search PTO
  - Similar to another name?
  - Confusion with another business/product?
    - Newsletter vs. software (“SoftView”)
    - Hamburger vs. computer (“Mac”)

## □ Rights acquired by Usage

- First come – first served
- Can file intent to use – prior to use in interstate commerce

## □ Domain Names

- Obtain name and all similarities

# Copyright

- ❑ Protects original expression
  - Does NOT protect ideas
  - Attaches when fixed in tangible medium
- ❑ Notice – to preserve rights
  - Copyright © 2009, Haas, Inc., all rights reserved
- ❑ Can file with Copyright office
- ❑ Exceptions to protection
  - Fair use doctrine
  - First sale doctrine

# Patents

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- ❑ Inventions / Business processes
  - Preferred embodiment
  - Specification
  - Claims
- ❑ Should you patent?
  - Defensive
  - Offensive
- ❑ Provisional Patents
  - File specification only
  - “Hold” the date, until full filing can be made
  - Limited time
  - Cannot revise specification



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