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The First 30 Days

Legal and Organizational Matters





Getting Out of Your Current Job

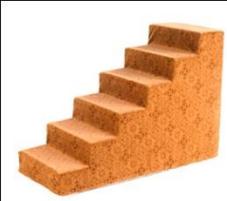
- Dilemma: why leave unless you have something valuable to go to? But if you create something valuable on your former employer's nickel, you could have legal trouble.
- Read your employment agreement carefully (assignment of inventions, be alert for possible hold-over on assignment of inventions).
- Take a 3-6 month break to do consulting
- Invite your employer to participate, go on record as doing so



“if you don’t know where you are going, any road will get you there”

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Get Lawyers

- General Corporate
- Intellectual Property
- Your own individual
- Question: keep it “friendly” or be ready for investors?

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Pick a Law Firm... that knows what the “current terms are”

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Pick a Lawyer that represents Entrepreneurs, not VC' s

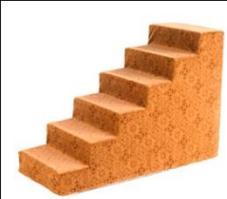
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Lawyers, etc

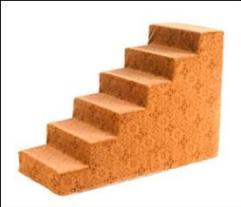
- Write for you and your co-founders:
 - ▶ Offer letters
 - ▶ Employment agreements
 - ▶ Noncompete, Nondisclose, Nonsolicit, Assignment of Inventions, Disclosure of Existing IP
- Consider your exit, acquisition. You will probably be dealing with hostile parties.
- Early stage founders can get heavily diluted if they leave before later rounds, especially down-rounds.



Pick a Law FIRM ...and a Young Partner

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Your Employment Contract

- Termination with or without cause
- “Substantial change” of control or responsibilities; acquisition
- Noncompete, vesting, severance pay, continuation of benefits
- Company’s right to repurchase stock
- Possible advisory capacity upon future shift

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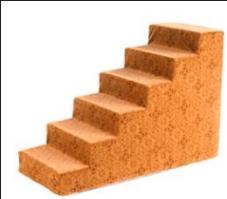


Incorporate

- Delaware & Agency
- Register as a foreign company in Mass
- Federal Tax-ID number

Needed to incorporate:

- Officers
 - ▶ President, Treasurer, Secretary
- Board
- By-laws
- Initial Capitalization



Subchapter S (IRS classification)

- Pre venture-funding
- Must have a small number of employees, all US citizens
- Must have only one class of stock
- Allows stock-holders to pass-through gains(losses) to personal tax returns, pay no corporate taxes
- Ideal for
 - ▶ early venture that's going to lose money in the first year(s)
 - ▶ entity that's going to make money and distribute all of it to the owners
- Alternative is Subchapter-C: will happen when you get big or when VCs come in.



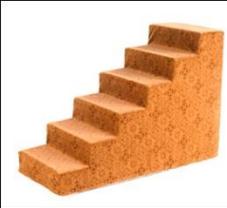
“LLC”

- Pros:
 - ▶ No requirements for formal meetings, minutes, & resolutions
 - ▶ Greatest flexibility
 - Can be treated as sole proprietorship or corporation for tax purposes
 - Can avoid “double taxation”
 - Can be run by a shareholder or elected officers
 - No limit on number of shareholders
 - Corporations can be shareholders
 - Income and loss allocations don’t have to be proportional to investment
- Cons:
 - ▶ May be dissolved if member quits, retires, dies or declares bankruptcy
 - ▶ May be complicated to operate in multiple states
 - ▶ More paperwork than sole proprietorship



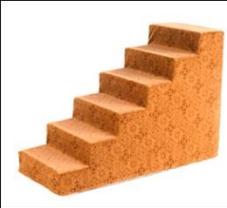
Board of Directors

- Two ways Boards formulate decisions:
 - ▶ Minutes of meetings/resolutions passed
 - ▶ “Consent” forms in lieu of meeting
- Compensation Committee
- Audit Committee



Preparing for Board Meetings

- As you get bigger and have outside Board members:
- t - 3 weeks: ask group heads for status updates, remind them of homework from last meeting.
 - t -2 weeks: review input, prepare powerpoint and other materials, edit, review. Have lawyers review minutes from last meeting.
 - t - 1 week: send to Board members
 - t - 2 days: phone calls to work specific issues



Issuing Stock

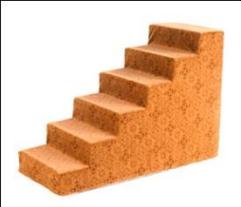
- When you create the company, you issue stock:
 - ▶ maximum number of shares permitted
 - ▶ total number of shares issued
- You pay a fee for having a large number of shares.

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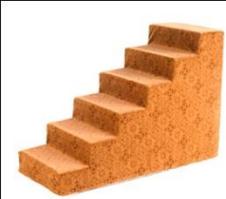
For founding common stock shareholders

- Bill of Sale
- 83(b) election
- Stock Purchase Agreement (with vesting schedule)
- Lock-up
- Company's right to repurchase
- Your right to sell
- Shareholders' agreement



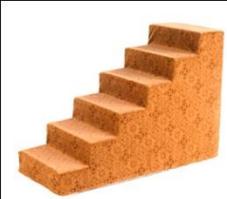
ISO agreements for future employees

- ISO = Incentive Stock Option
- Exercise price
- Vesting
- Buyback on employment termination
- Right of first refusal on any sale
- Very hard to change this stuff later -- get it right!



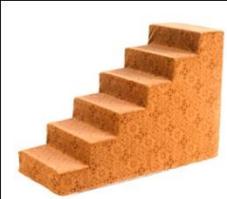
More on Vesting

- 4-year is customary
 - ▶ you get 25% after you stay for one year, nothing if you leave on day 364 (“cliff”)
 - ▶ thereafter, you get an additional 1/36th of the remaining 75% after each of the coming 36 months
- 3-year is possible
- Look-back on previous work
- no guarantee of future employment
- acceleration on termination
- acceleration on company acquisition
- “reverse” vesting...



Reverse Vesting

- Normal vesting example, grant of 100 shares
 - ▶ you own no shares today, after one year you can buy 25 shares, etc
- Reverse vesting example:
 - ▶ you own all 100 shares today, but the company has the right to buy back all 100 of those shares, until one year from now, at which point the company only has the right to buy back 75 of those shares.



Reverse Vesting

- Became popular during bull market, because of “alternative minimum tax” and lock-up provisions, possibly leaving employees in an impossible cash flow situation. Example WITHOUT reverse vesting:
 - ▶ Company has wildly successful IPO and your \$0.25 options are now worth \$250 each
 - ▶ You exercise, and then incur an on-paper capital gain of \$249.75/share (in some cases even a short term gain, which is treated as ordinary income), even though you haven’t cashed out yet, and aren’t allowed to do so for many months



With Reverse Vesting

- You get to buy all the stock today, and the stock grant is taxed today
- Downside: Though you pay taxes on the pennies-a-share price, just the same, you pay the taxes right now, well before the company has any real liquidity
- You have to shell out cash for this tax, which you lose even if you quit and forfeit your vesting
- You still have to pay cap gains tax when you sell



Other stock mechanisms

- NQO - Non Qualified Options for non employees
- Outright stock grants (require a stock restriction agreement), rare because of possible tax issues

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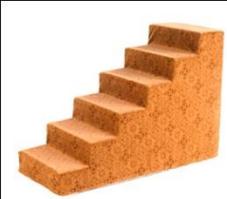


HR

- “PEO” (professional employer organization)
 - ▶ you & your employees actually work for them
 - ▶ pooling of people, larger group buying power
- Payroll services
- Health
- Retirement
- Disability
- Life insurance
- Vacation
- Employee assistance, counseling
- Employee handbook...

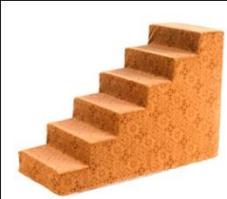
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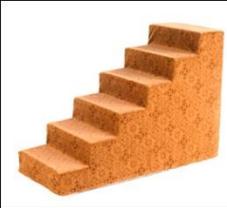
Policies/procedures

- Hiring discrimination based on x, y, and z.
- Sexual harassment
- Attendance
- Reviews (360^o), correction procedures
 - ▶ paper trail in case of termination
 - ▶ rankings in case need to cut
- Travel
- Substance abuse
- Privacy (the employee' s, before and after hiring)
- Confidentiality (the company' s): press, use of name



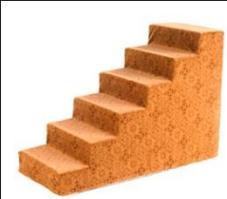
Accounting

- Get an accountant to carefully review Shareholders Agreement, ISO Agreement and strike price, etc.
- Can get by at first with a small accounting firm, or a part-timer



Bank account

- Will need certificate of incorporation and federal tax ID number
- Signers: how many, more for checks over a certain amount
- Simple checking for now, may consider a bank that offers an equipment lease line later
- If raising big VC early, investment banks will want your cash management business



Establishing Credit

- Terms for purchasing from vendors
- Have financial projections ready
- Credit cards
- Some begging with smaller vendors, C.O.D. with larger vendors
- Personal guarantee?
- Give stock?



Insurance

- General Liability (some customers will require this, especially if you're doing any work on their site)
- Property
- Directors and Officers
- Key Person Life

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Offices/Rent

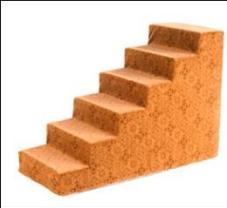
- Your bathtub
- Squatting with a friend/investor
- Your own space
 - ▶ Where to locate: who are you looking to attract?
 - ▶ Term
 - ▶ Sliding rent?
 - ▶ Security deposit

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Outfitting the offices

- Telephone system
- Furniture
- Assorted equipment
 - ▶ computers
 - ▶ fax
 - ▶ projector for PowerPoint
 - ▶ photocopy
 - ▶ kitchen
- snacks!

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