

Top 10 Formation and Compensation Dos and Don'ts for Entrepreneurs

Entrepreneurial Best Practices Series

Incorporation & Compensation

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6:30-8:30pm

Wells Fargo Room- Haas School of Business

ReedSmith

The business of relationships.

SPEAKERS

Rob Dellenbach

Partner

415-659-4755

rdellenbach@reedsmith.com

Craig Tanner

Partner

415-659-4734

ctanner@reedsmith.com

Oakland

1999 Harrison Street

Suite 2400

Oakland, CA 94612

San Francisco

Two Embarcadero Center

Suite 2000

San Francisco, CA 94111

Silicon Valley

1510 Page Mill Road

Suite 110

Palo Alto, CA 94304

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Top 10 Formation and Compensation Dos and Don'ts for Entrepreneurs

- **DO create an entity; DON'T assume it must be a C corporation**
- **DON'T sell Common Stock to investors; DO issue Convertible Notes or Preferred Stock**
- **DO vest co-founders stock; DON'T risk co-founder windfall**
- **DON'T forget Section 83(b) Election; DO file WITHIN 30 DAYS**
- **DO get written IP assignments and NDAs; DON'T assume you own IP**
- **DON'T go it alone when hiring employees; DO seek out professional advice**
- **DON'T take stock awards lightly; DO consider alternatives to options**
- **DON'T promise "percentages" of equity ownership; DO offer specific stock numbers**
- **DO professionally value stock option prices; DON'T ignore Section 409A**
- **DON'T ignore non-US and expat employees; DO think globally**



DO form an entity

DON'T assume it must be a C corporation

- Form entity to allocate ownership and financial interests, limit liability, hold rights
- C corporations (Delaware) are the entity of choice for VCs
- S corporations are good for closely held companies
- LLCs are more flexible (separate control and economics) but complicated
- Consider benefits of incorporating offshore



DON'T sell Common Stock to investors DO issue Convertible Notes or Preferred Stock

- Common Stock is simple to issue but difficult to value
- Convertible Notes protect investors on downside and company on upside
- Venture proposition: low priced common stock for sweat equity; higher priced preferred stock for investors



DO vest co-founders stock

DON'T risk co-founder windfall

- Single founder can wait for investors to impose vesting
- Vesting keeps co-founders engaged
- Credit co-founders for time served
- Accelerate vesting on M&A and termination



DON'T forget Section 83(b) Election

DO file WITHIN 30 DAYS

- Restricted stock or reverse vesting: shares subject to repurchase right that lapses over time
- IRC Section 83: lapsing repurchase right is a tax event
- Taxable income: difference between FMV and purchase price – increases with FMV
- Section 83(b) election results in tax on income (\$0) as if fully vested today; no tax on vesting
- Must file WITHIN 30 DAYS following purchase or lose benefit



DO get written IP assignments and NDAs DON'T assume you own IP

- IP created by contractor belongs to contractor unless assigned
- Employee IP assignment not automatic other than copyright
- Trade secrets require reasonable efforts to maintain secrecy; NDA puts teeth in statutory rights



DON'T go it alone when hiring employees DO seek out professional advice

Employee or independent contractor - know the differences

For Employees

- Employment contract or at-will employment
- Invention assignment, non-disclosures, and do not compete agreements
- Set compensation at realistic levels based on the industry
- Provide a realistic benefits package - medical, dental, vision, life insurance, disability
- Proper withholding and reporting



DON'T go it alone when hiring employees DO seek out professional advice (cont'd)

For Independent Contractors

- Independent contractor agreement important
- Invention assignment, non-disclosures, and do not compete agreements
- Set contract pay at realistic levels based on the industry
- Consider whether to grant stock awards



DON'T take stock awards lightly DO consider alternatives to options

- Options v. restricted stock v. RSUs
- Vesting - time based v. performance
- Exercise restrictions
- Forfeiture
- Change in control



DON'T promise "percentages" of equity ownership DO offer specific stock numbers

- Typical grant packages by positions with company (non-founders)
 - CEO - 5.2%
 - President - 2%
 - CTO - .9%
 - CFO - .9%
- Board should consult with compensation experts to determine appropriate equity ownership for the industry
- Address dilution issues in award agreements

DO professionally value stock option prices DON'T ignore Section 409A

- Stock options must be granted at fair market value
- Restricted stock and RSUs not subject to Section 409A unless deferral features
- Valuation must satisfy one of the safe harbor methods
- Failure to comply with 409A will result in significant monetary penalties for the employee
- Consider other equity alternatives if a compliant valuation is not possible



DON'T ignore non-US and expat employees DO think globally

- Standard US practices will not work outside of the US
- Consider country specific agreements based on where the person will work
- Consider permanent establishment issues for your company



THANK YOU AND GOOD LUCK!

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