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Starting Up the Start-Up: Setting Up the Founders' Round

By Riaz Karamali

The first two installments of this blog series examined when to incorporate the start-up and how to run a start-up venture prior to incorporation. Once the founders decide to pull the trigger on incorporation (and most often startups that expect to be looking for venture capital funding will incorporate in Delaware), their next significant set of decisions will usually be with respect to the founders' round of financing.

Common Stock for Uncommon Folks. Traditionally, founders of a startup receive Common Stock while equity investors get Preferred Stock that carries a liquidation preference, special voting rights and often other provisions such as a board seat, dividend rights and redemption rights. In recent years, alternate models have arisen with respect to a third type of founders' only stock (with names such as Class F Common and Series FF Stock among others). These models are different from each other in important respects, but one thing they have in common is that they seek to grant to founders rights that are traditionally reserved for holders of Preferred Stock. For our purposes, the important thing to note is that insistence on these terms may send the wrong message to potential investors and could cause significant friction in discussions with potential investors and adds expense to the startup process. These "hybrid" varieties of founders' stock should only be considered by founders who are confident that they will be in a situation in which venture capitalists will be competing to invest in the company so they will have the leverage to insist on such founder-friendly terms. Suffice it to say that the founders of the vast majority of startups that are getting funded today have received Common Stock and not a hybrid security with some Preferred Stock elements.

What – Me Vest? We typically recommend that founders' restricted stock purchase agreements contain vesting provisions that vest a founder's shares over a period of time – usually three or four years. The vesting is effected by granting the company a repurchase right at cost (usually fractions of a cent) on all of a founder's unvested shares at the time a founder leaves the service of the company. Vesting is particularly valuable if there is more than one founder -- it is not fair to the remaining team members if early on in the life of the company somebody with a large wad of shares is no longer contributing and that person's replacement needs to be issued equity by diluting everyone else involved. Even if you are the only founder (usually not recommended in any event), it is wise to consider putting vesting on yourself in anticipation of a venture capital financing because the investors will surely impose it on you, and on terms less friendly than what you would impose on yourself. There is a good possibility that if your vesting terms are reasonable, the investors will agree to leave them untouched. One example of founder-friendly vesting terms is for the founders to get vesting credit for the time they worked on the venture prior to formal incorporation. Another example is an acceleration provision that provides for 100% acceleration of the founder's vesting upon a sale of the company.

Whose Crown Jewels Are Those? In return for paying a very low price for their shares, founders typically sign over to the company all rights to any intellectual property related to the company's business plan. Some founders would like to retain ownership to key patents or know-how and only license them to the company for a particular field of use, perhaps in the hope that they will be able to license separately rights to other fields of use or as a safety net in case the company fails. Such tactics understandably unsettle sophisticated investors. Companies whose founders hold back core intellectual property rights rarely get funded.

What Does a Founder's Money Buy? Founders often fund a company's earliest operations at a point that even angels fear to tread. In fact, one test many angels and potential partners will apply is that of whether the founders have made an investment in the company of an amount that is significant for them. Note that these investments should generally not go towards purchasing founders stock but rather should be recorded on the books of the company as loans and ultimately rolled into the company's initial angel or seed financing. In this manner, founders will end up getting a liquidation preference and for at least a portion of their equity will receive the same securities as those purchased by outside investors.

This is the third installment of a series of blog posts addressing start-up matters specifically. The fourth installment will take a look at "Trends in Angel Financing".

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