FOLEY HOAG LLP

Driving Business Advantage

Incorporating your Startup

Presentation to MassChallenge Global Startup Competition

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Incorporation

- What is it?
- Reasons for incorporating
- Choosing a form of legal entity
- Deciding when to incorporate

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What does it mean to incorporate?

- From a legal perspective:
  - Creates a legal entity, separate and distinct from its owners
    - Can own assets (including other corporations) and incur liabilities
    - Can enter into contracts (with rights and obligations)
    - Can sue and be sued
    - Can be convicted of criminal offenses (e.g. fraud, manslaughter)
  - Existence based on corporate law on the state level
    - Created by filing Certificate of Incorporation with the Secretary of State
  - In most cases, duration of the entity is perpetual
- From a practical perspective:
  - State laws require fees and formalities.
  - Capital is provided to the corporation in return for equity (stock, membership interests, etc.) or debt.

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Why incorporate?

- Protect yourself and your assets from personal liability
  - Liability limited to invested capital
- Establish ownership rights in assets of business (e.g. IP)
- Issuing equity ("Founder Stock") to founders
- Equity incentives for employees
- Required in order to raise capital
- Easier to sell / liquidate
- Helps to avoid unintended problems:
  - Discussing who does what and who gets what might inadvertently form a "general partnership"
  - Ownership rights that are unclear (the "Forgotten Founder" problem)

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Which form of entity?

- Majority of startups are formed as:

  C corporations, S corporations or LLCs
- Key Considerations:
  - Liability protection
  - Tax treatment (pass-through or double taxation)
  - Ownership issues (stockholders)
  - Raising capital
  - Employee equity incentives
  - Appetite for complexity / legal expenses

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Which state to incorporate in?

- The majority of startups aspiring to be venture funded are set up as Delaware corporations (whether C or S)
- Why Delaware?
  - Investors often insist on it
  - Well developed case law
  - Strong board / officer protections
  - Ease of corporate filings
- Don’t over think it, but get it right the first time

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When to incorporate?

- If more than one founder
- Creation of IP or other material assets
- Signing agreements (e.g. office lease)
- Hiring employees or contractors
- Issuing stock or options
- Conducting business / launching product
- Starting the clock – capital gains holding period
- Raising capital

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What is involved?

- Reserve the name early in DE and MA (or other resident state)
- Certificate of Incorporation (DE)
- By-laws
- Initial consent of sole incorporator
- Initial consent of director(s)
- Stock certificates, receipt and ledger
- Qualification to do business in MA (or other resident state)
- S corporation election, if applicable
- Founder agreements, including restricted stock agreements

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What is involved?

- Certificate of incorporation
  - Very simple at incorporation
  - Gets complicated when you get VC funding (preferred stock)
- Key questions:
  - What is the name of the company?
  - How many shares to authorize?
  - What is par value?
- Bylaws - Generally track the corporate statute

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Dividing the Pie

- Define group of “founders” to receive stock – keep it small and exclusive
- Consider past and future relative contributions of co-founders, and what feels “fair”
- “Sweat Equity” – incentivize founders by allocating enough equity for their sweat
- “Vesting” – incentivize founders by subjecting their equity to reverse vesting
- Cannot divide more or less than 100%

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Reverse Vesting

- 100% of the founders shares are issued day one, but the company has the right to repurchase at the price paid by the founder (usually nominal) if the founder leaves the company for any reason
- Restricted Stock Agreements
  - Typically, the repurchase right is with the company
  - In addition to vesting, restrictions on transfer
- Shares vest over time (usually over 4 years)
- Full or partial acceleration upon sale of the company and termination without cause
- Keep vesting schedule simple and linear
- Consider vesting for past activities
- Impose restrictions from day one
- Venture investors will require it anyway
- Critical tax consideration – 83(b) election!

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83(b) Election

- 83(b) election
  - Tax benefits
  - Consult your tax advisor
  - Strict deadline for filing: Within 30 days after the date of grant of the unvested equity interest; no procedure to extend
  - Proof of timely filing is important
  - All required information must be included on the election
  - Must be filed with correct IRS Service Center and included with personal tax return
  - Use professional help to prepare the form

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Founder "NDA"s

- What's Covered
  - Confidentiality
  - Non-Competition and Non-Solicitation
  - Invention Assignment

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Confidentiality

- Scope
  - Intellectual property and other technical information
  - Business and financial information
  - Marketing information
  - Third-party confidential information
- Duration
  - During employment
  - Post-employment: how long?

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Non-Competition

- Subject matter scope
  - Defined in relation to company's business
- Duration
  - During employment
  - Post-employment: how long?
- Geographical scope
- Enforceability Limitations
  - Reasonableness of restrictions
  - Variation among different jurisdictions
  - California employees
  - Judicial discretion

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Non-Solicitation

- Scope
  - Customers
  - Employees
- Duration
  - During employment
  - Post-employment: how long?

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Invention Assignment

- Scope
  - Intellectual property developed by founder during employment that relates to company's business or products or to tasks assigned to founder
  - Carve-out for specifically identified previous inventions

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