Considerations for Founders:
Issues in Structuring Relationships Among Members of the Founder Team

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There are so many things which Founders have to worry about and do in launching a new venture- financing, people, customers etc. All of these are important but the reality is that most <u>ventures fail because of people issues and are really a failure of the relationships among the team members</u>. Teams come together around an interesting or exciting idea or opportunity and tend to get swept up in the idea. They often don't talk about their shared aspirations, vision and what they want to get out of the venture. The venture gets launched without these discussions and then problems surface "Big Time" down the road when these undiscussed topics collide.

These problems can be surfaced and dealt with early on if Founders work at it. This can be done by addressing some of the practical issues which should be considered in structuring the relationships among the Founders. This rest of this memorandum outlines some of the legal and business issues which the Founders of a new venture may want to consider in structuring their relationships among one another. It is not intended to cover all of the potential issues; rather it is meant to stimulate thought and discussion. Versions of this memo have been used by the founders of the over 120 startup companies I have had the privilege of being directly involved in over the years. I have incorporated feedback from these entrepreneurs into the current version of this memo. If you find the thoughts here to be helpful or have additional ideas, please email me so we can share this collective knowledge with those entrepreneurs who come after you. On that theme, please remember to contribute to the development of entrepreneurship in some way – please "give back" some of the knowledge and experience you gain from your entrepreneurial ventures with others.

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Of primary concern to members of the founder team is the question of how the equity in the new venture is to be allocated, both initially and over time. Ownership of stock carries with it two attributes: economic participation in the venture and the right to have a say in decision making. These attributes can be structured in a variety of ways, including preferred economic returns and limited or expansive voting rights. To determine how to allocate these attributes the following are among the questions to be considered:

<u>Initial Ownership/Contributions</u>. In the typical situation each member of the founder team is bringing a unique skill or property to the party for which he or she is to receive a portion of the equity of the venture. It is important to understand that unless the participants specifically agree otherwise, once stock is issued to a person it is owned free and clear by that person. For example assume that Bill, Sam and Mary are the founders and their

understanding is that Bill will invest $20,000, Sam will work on marketing and financing and Mary will develop the product. They agree that each will receive 1/3 of the stock. In this situation, Bill has done everything he promised once he pays his $20,000. The founders should consider what happens if Sam or Mary don't do what they promised.

A method of handling this is to "vest" the stock of the founders. Vesting can take many forms. For example, the founders might agree to a calendar vesting schedule (e.g., straight line vesting over 5 years) so that if a founder leaves the company after one year of employment or involvement then he or she would be entitled to keep only 20% of his or her stock. Calendar vesting is usually a surrogate for the tasks each founder is to undertake. For example, it might be assumed that Mary will complete the product within a year or alternatively if she doesn't it may not matter because an opportunity window might have passed. An alternative to calendar vesting is "milestone vesting" which vests stock on the basis of achieving identifiable milestones such as "first beta ship" or "prototype" completion. One obvious problem here is whether the milestones can be identified clearly or even if they can what happens if the business plan changes.

There are several important tax issues which must be considered if vesting is selected. These issues will not be discussed in this memorandum because they are somewhat involved. However, it is *extremely important* to address the equity and tax issues early on because there can be *large personally adverse economic consequences*- seek advice from an experienced startup lawyer.

<u>Scope of Economic Participation</u>. A related question is whether a person whose stock has vested should be entitled to participate in the economic success of the venture after he or she leaves the company. The philosophical issue is whether the person is to be rewarded only for the increase in the value of the venture until the time he leaves. If so then either the company or the other founders or both should have the right to repurchase the departing founder's stock at some price, perhaps the "fair market value" or an agreed value or an appraised value. Another reason for having a repurchase right is to prevent dilution in ownership which would occur if the company has to issue stock to someone new who is taking over the departing founder's tasks. On the other hand if the deal is that once the stock vests a departing founder is entitled to participate in the future increases in the value of the venture then there would not be a need for such a repurchase right.

<u>Transfers of Stock</u>. Except for certain federal and state securities law restrictions, once the stock has been issued it can be transferred by any founder or other stockholder. It may be in the best interest of the company and the stockholders to restrict the ability of a stockholder to transfer stock. For example, without such restrictions a founder could transfer his or her stock to a competitor. Restrictions can take the form of a "right of first refusal" under which the company and/or the other stockholders have a right to match the price which a third party offers. This right could be triggered by a specific third party offer or a general statement by a stockholder that he wants to sell at $x and giving the company and/or the other stockholders the right to purchase at $x. Alternatively the founders could agree on a formula price for repurchases or that on a periodic basis the Board of Directors

would set the price at which all transactions in the company's stock would occur.

Take-along Rights. Although it is more commonly imposed by venture capital investors, founders sometimes agree among themselves that if any one of them finds a purchaser his or her stock then all will be able to participate in the sale by selling off a portion of their stock ownership ("take-along rights"). Sometimes this is combined with a right of first refusal to provide the stockholders with the opportunity to purchase the stock of a stockholder if they think the price he proposes to sell at is favorably low or to sell their shares if they think the third party price is high.

Death/Disability. Founders should consider what happens if one of the founders dies or becomes disabled. In the case of death the stock owned by the deceased stockholder will end up with his or her heirs. Since the other founders may not want the deceased stockholder's spouse, son or daughter on the Board of Directors, the company and/or the other stockholders often are given the right to purchase the stock owned by the deceased stockholder. This repurchase right is often funded by the proceeds of a "key man" life insurance policy.[1]

The founders should also consider whether they want to give the deceased stockholder's executor the right to force the company to buy back the stock. This might be necessary where the estate of the deceased stockholder lacks the liquidity needed to pay estate taxes, etc. This put right could also be funded by insurance. An alternative is to have each stockholder purchase his own insurance to provide estate liquidity. The optimal arrangement depends on a number of factors including tax law considerations, which of course have a tendency to change.

Permitted Transferees. With any stock transfer restriction it is appropriate to ask if all transfers will be subject to the restriction. For example, does a gift of stock to a child trigger the various rights? What about a transfer from one stockholder to an existing stockholder? Even if the founders decide that such transfers do not invoke the restrictions, it is usual practice to have the transferee agree to be bound by the restrictions on subsequent transfers.

Preemptive Rights. Preemptive rights provide that the company cannot issue any additional stock without giving the existing stockholders the right to purchase the stock. In this way the founders can avoid a dilution in the percentage ownership of the company as a result of new stock issuances. Preemptive rights can be a valuable item to offer outside investors because it gives them a chance to increase their investment.

Duration of Restrictions. The duration of restrictions should be considered. Do they apply indefinitely? Until a public offering? For x years? It should be kept in mind

[1] . In addition the company may want to have a life insurance policy which will provide the company with operating funds while a replacement for the deceased stockholder/officer is found.

that if outside financing is anticipated the new investors will have their own ideas about restrictions.

Control. With stock ownership usually comes the right to vote for a Board of Directors. Even with nonvoting stock there are certain fundamental corporate transactions which require approval of a certain percentage of each class of security. Often the founders agree to vote their stock in a manner that each has a seat on the Board of Directors. It is not uncommon for the founders to agree that "Major Events" will not happen unless there is agreement of all or a majority of the founders. In addition to such events as a merger or sale of assets of the venture, Major Events could include such items as incurring more than $x of debt, entering into major license agreements or distribution agreements for the company's products, issuing additional equity or options etc.

Proprietary Information. In most situations the founders will want to provide that any inventions or discoveries made in the course of the venture will belong to the venture. Where a founder is bringing certain technology to the venture he or she may want to have a clear understanding as to what rights the venture has in the technology. For example, who owns what if the venture fails? Can some but not all of the founders start a new venture? Is the venture limited to exploiting a technology in a particular niche? Of course later investors as a condition to their investment may require that all rights to a technology be transferred to the venture.

Employment. Is the continued employment of one or more founders considered important either to the founders being employed or to the other investors? Under what conditions can a founder be terminated and what consequences does this have to his or her stock ownership. What if major differences arise about the direction of the venture such that the services of a founder are no longer needed?