

BUSINESS LAW 101 – PART 2

STARTUP EQUITY BASICS



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ABOUT THE INSTRUCTOR

- Startup Attorney
 - Silicon Valley Attorney – over 25 years
 - Private Practice – focusing on Startups
- Entrepreneur
 - Startup and ran two companies
- Instructor
 - Golden Gate School of Law – taught “High Tech Startups” class
 - Guest Lectured at UC Berkeley Haas School of Business – on Startups



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STARTUP EQUITY BASICS

SECTION I

OVERVIEW

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OVERVIEW

- What is Equity?
 - Representation of ownership in an entity
 - Units of ownership in an entity
 - Characterized by number (amount) and type (class)

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EQUITY AND ENTITIES

- **Partnerships (General and Limited)**
 - Equity holder – Partner
 - Partnership Interest (%Interest) or Units
- **Limited Liability Company**
 - Equity holder – Member
 - Membership Interest (% Interest) or Units
- **Corporation**
 - Equity holder – Stockholders / Shareholders
 - Stock or Shares

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OWNERSHIP

- **Who are the Owners of the Corporation?**
 - Stockholders (Equity Holders)
- **What does ownership give you?**
 - Rights to receive distribution of corporate assets in a Liquidation
 - After creditors are satisfied
 - Certain limited voting rights

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CONTROL

- Board of Directors – Control corporation
 - Under State Corporation Statutes
- Board appoints Executive Officers
 - CEO, CFO ...
 - Run the daily business of the corporation
- Stockholders ELECT the Board
- Stockholders must approve certain (significant) Board actions

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SECTION I – TAKE-AWAYS

- Stockholders
 - OWN the Company
 - Have only limited CONTROL of the Company
- Board of Directors
 - CONTROL the Company
 - Appoint Executive Officers
- BUT – Stockholders ELECT Board
- AND – Stockholders are required to approve certain major actions (by statute)

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STARTUP EQUITY BASICS

SECTION 2

TYPES OF STOCK

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CLASSES OF STOCK

- **Common Stock**
 - Founders; Employees (Stock Options)
 - Usually Voting (but can be non-voting)
 - Last in Distribution / No special rights
- **Preferred Stock**
 - Investors
 - Superior rights, preferences, privileges
 - Divided into Series (Series A, Series B ...)
 - Convertible into Common (at option of Holder)

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PREFERRED STOCK

- Liquidation Preference – first to receive payments
- Voting – Board seat; veto power
- Anti-Dilution – protection against future “lower-priced” financings
- Future Participation – keep pro-rata share
- Information – financials
- ROFR – over Founder sales

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PREFERRED STOCK - SERIES

- Financing Rounds
 - Each “round” of new financing will be a new Series
 - Series A, Series B, ... (Series Seed)
- Series may have different rights and preferences
- Series will have different prices
 - “Up” rounds and “Down” rounds
- Series may have different priorities
 - Senior, junior, pari passu

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SECTION 2 – TAKE-AWAYS

- Stock can be divided into **CLASSES**
 - Preferred Stock and Common Stock
- Preferred Stock can be divided into **SERIES**
 - Series A, Series B, ...
- Preferred Stock has **PREFERENCE** over Common
 - Liquidation, Voting, Participation ...
- Series can have priorities over each other

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STARTUP EQUITY BASICS

SECTION 3

RIGHTS TO ACQUIRE EQUITY

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RIGHTS TO ACQUIRE EQUITY

- Rights to Acquire Equity – from the Company
 - Stock Options
 - Warrants
 - Convertible Notes
- Rights to Acquire Equity - from other Holders
 - Right of First Refusal (ROFR)
 - Buy-Sell Agreements

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STOCK OPTIONS

- Option Right
 - Right to buy a set number of shares in future
 - At a price set now (exercise or “strike” price)
- Granted under Option PLAN – Common Stock
- ONLY Service Providers
 - Compensatory grant
 - Employees, consultants, advisors
- Vesting schedule – “earn” right to buy
 - Time based
 - Performance / milestone based

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WARRANTS

- Warrant Right
 - Right to buy a set number of shares in future
 - At a price set now (exercise or “strike” price)
- Investors – Preferred Stock
 - Fully-vested / No “PLAN”
 - Equity Sweeteners
 - Lessors; Vendors; Lenders

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CONVERTIBLE DEBT

- Hybrid – Debt and Equity
- Convertible Note issued (“debt”)
 - BUT may become Equity
 - If “Next Financing” – then Note converts
 - Converts to – stock sold in the Next Financing
 - If Next Financing Fails ...
 - May remain debt (and due)
 - Or, could convert to Common
- Convertible (“Bridge”) Financing

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STOCK TRANSFER RIGHTS

- **Right of First Refusal**
 - Right to purchase pro-rata share of Founder's sale
- **Buy-Sell Agreements**
 - "Buy Side" – Right to purchase pro-rata share upon termination of service provider

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SECTION 3 – TAKE-AWAYS

- **Options / Warrants**
 - A right to purchase stock in the future, at a price set now
 - Are NOT equity – until exercised
 - Options – Service Providers (Common Stock)
 - Warrants – Investors (usually Preferred)
- **Convertible Notes**
 - may convert on a future financing (or may remain debt)
 - NOT equity – until converted

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STARTUP EQUITY BASICS

SECTION 4

CONTINGENT AND NON-EQUITY

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CONTINGENT EQUITY

- Equity that is OWNED, but ...
 - Upon certain contingencies (“trigger” events) ...
 - Company may re-acquire equity
- Company Contingent Rights
 - Company Right of Repurchase
 - Company Option to Redeem (“Call”)

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RIGHT OF REPURCHASE

- Service Provider – issued shares
 - OWNS the shares – bought and paid for
 - Can vote the shares
- Vesting Schedule – vest over time
 - Upon a Termination (contingent event – “trigger”)
 - Company can repurchase UNVESTED shares (“claw-back”)
 - At cost (original price paid)
 - “Negative vesting” – earn the right to keep the shares

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COMPANY REDEMPTION RIGHT

- Company (“Call”) Option
 - Company can require investor to sell stock back to Company
 - At fair market value
 - Negotiated or Appraisal
 - Time or event contingency
 - Rare

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NON-EQUITY

- Rights that “track to equity”, but do not (ever) become equity
 - Phantom Units
 - Stock Appreciation Rights (SARS)
 - Royalties / Investment Contracts

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NON-EQUITY

- Phantom Stock (Units)
 - Payout upon a “Liquidation Event”
 - Equal to value of set number of shares
- Stock Appreciation Rights (“SARs”)
 - Payout out upon exercise
 - “Spread” – fair market value minus exercise price
 - Tandem SARS – granted together with stock option

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NON-EQUITY

- **Royalties**
 - Percent of revenues/profits on certain products
 - Usually tied to specific licenses (ongoing)
- **Investment Contracts**
 - Payouts based on Company meeting certain goals
 - Based on investment, fixed increase or %

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SECTION 4 – TAKE-AWAYS

- **Contingent Equity**
 - Equity is ISSUED – but can be TAKEN AWAY
- **Phantom Units, SARS – NOT equity**
 - Payments – usually tracked to equity

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STARTUP EQUITY BASICS

SECTION 5

COUNTING EQUITY – AUTHORIZED STOCK

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AUTHORIZED STOCK

- Authorized in Charter Documents
 - Articles of Incorporation
 - Certificate of Incorporation
- Treasury Shares
 - Authorized, unissued shares – available for Board to issue

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AUTHORIZED COMMON STOCK

- Charter Example:
 - “This corporation is authorized to issue one class of stock, designated “Common Stock.”
 - The total number of shares of Common Stock authorized to be issued is 10,000,000 shares”
- Allows Board the right to issue up to that number of shares of Common Stock

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AUTHORIZED PREFERRED STOCK

- Authorized separately in Charter
 - Example: “This corporation is authorized to issue two classes of shares, designated “Common Stock” and “Preferred Stock” ...”
 - “The total number of shares of Common Stock authorized to be issued is 10,000,000 shares ...”
 - “The total number of shares of Preferred Stock authorized to be issued is 5,000,000 shares, ...”
 - “... 4,000,000 of which are designated as “Series A Preferred Stock” and 1,000,000 of which are designated “Series B Preferred Stock”.

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AUTHORIZED PREFERRED STOCK

- Authorized Stock:
 - 10,000,000 Common
 - 4,000,000 Series A
 - 1,000,000 Series B
- How many shares of Common Stock can the Board Issue?
 - 10 million? WRONG!
 - Why?

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AUTHORIZED PREFERRED STOCK

- Preferred is Convertible to Common
 - Holders of preferred can convert to Common at any time
 - Need to “reserve” 5,000,000 shares of the Common for potential conversion
 - ONLY 5,000,000 of the Common Stock remains available for issuance by the Board

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SECTION 5 – TAKE-AWAYS

- All (classes/series of) stock must be AUTHORIZED in Charter Documents
 - Common Stock
 - Preferred Stock (designated by Series)
- Preferred Stock is CONVERTIBLE into Common Stock
 - Authorized Common must be “reserved” to cover potential preferred conversions
 - Common available for issuance - reduced

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SECTION 6

COUNTING EQUITY –
OUTSTANDING STOCK

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OUTSTANDING STOCK

- How is stock issued?
 - Board Approval required
 - Stock Purchase Agreement
 - Consideration – payment for stock
 - Stock MUST BE PAID FOR – with “GOOD” consideration

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CONSIDERATION

- “Good” Consideration
 - Cash (or equivalent: check, wire transfer ...)
 - Cancellation of Debt
 - Property (tangible, intangible)
 - PAST Services
 - NOT FUTURE Services
- Par Value
 - Somewhat arbitrary “nominal” value for stock
 - Stated in Charter (but can be zero)
 - Par value MUST BE paid – minimum price

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CAPITALIZATION

- Cap Table – who owns what equity
- Example
 - Authorized – 10 million shares (Common)
 - Marta and Britni – issued 2 million shares each
- What is the Outstanding Stock?
 - Total Outstanding – 4 million shares
- Total in Treasury – 6 million shares

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CAPITALIZATION

- What percent of Company do Founders own?
 - 40%? – WRONG
 - 100% - WHY?
- Ownership is NOT based on Authorized Stock
 - Ownership is based on OUTSTANDING Stock

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CAPITALIZATION

- Add Mayra – 1 million shares
 - Authorized – 10 million shares
 - Marta – issued 2 million shares
 - Britni – issued 2 million shares
 - Mayra – 1 million shares
- What is Company Capitalization?
- What is left in the Treasury?

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CAPITALIZATION

- Capitalization Table: *Sideways Winemaker*

SHAREHOLDER	#SHARES	% OWN
Marta	2,000,000	40%
Britni	2,000,000	40%
Mayra	1,000,000	20%
TOTAL	5,000,000	100% (Total Outstanding)

- Treasury Shares
 - 10 million Authorized
 - 5 million Treasury Shares remain available

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SECTION 6 – TAKE-AWAYS

- Stock Issuances – must be:
 - Approved by the Board
 - Paid for – with GOOD consideration
- Ownership is based on Outstanding Stock
 - NOT Authorized Stock

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SECTION 7

CAPITALIZATION COMPLICATIONS

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CAPITALIZATION COMPLICATIONS

- **Add in RIGHTS to acquire stock**
 - Options
 - Warrants
 - Convertible Notes
- **Add in Preferred Stock Issuances**
 - Series A
 - Series B

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CAP TABLE: STOCK OPTIONS

- **Add STOCK OPTIONS**
 - Authorized – 10 million shares
 - Outstanding – 5 million shares total
 - ADD Stock Option Plan – 1 million shares (set-aside)
- **What is Company Capitalization?**
- **What is available for Board to issue?**

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CAP TABLE: STOCK OPTIONS

- Capitalization Table: *Sideways Winemaker*

SHAREHOLDER	#SHARES	% Outstanding	% Fully-diluted
Marta	2,000,000	40%	33.33%
Britni	2,000,000	40%	33.33%
Mayra	1,000,000	20%	16.67%
TOTAL Outstanding	5,000,000	100%	83.33%
Option Plan	1,000,000	----	16.67%
TOTAL with PLAN	6,000,000		100%

- Fully-diluted % - “worst case” scenario
 - Includes all “rights” to acquire stock
- Issuance – of the 5 million, 1 million has been “reserved” for the Plan

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CAP TABLE: SERIES A

- Add Series A
 - Authorized
 - 5 million shares – Preferred / designated Series A
 - Outstanding
 - Series A – 2.5 million shares
 - Common – 5 million shares
 - Stock Option Plan – 1 million shares
- How much Common stock do we need to authorize?
 - 10 million shares? – WRONG!

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CAP TABLE: SERIES A

- Series A can convert to Common
 - Need to “reserve” common shares to cover Series A conversion
 - Cover ALL 5 million shares Series A authorized
- Total Common Coverage Needed
 - 5 million outstanding Common
 - 5 million Series A potential conversion
 - 1 million reserved for Stock Option Plan
- Common “Float” – authorize > 11 million
 - Authorize 15 million Common → 4 million available for Board to issue

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CAP TABLE: SERIES A

- Capitalization Table: *Sideways Winemaker*

HOLDER	#SHARES	%Class	% Outstanding	% Fully-diluted
Marta	2,000,000	40%	26.67%	23.53%
Britni	2,000,000	40%	26.67%	23.53%
Mayra	1,000,000	20%	13.33%	11.76%
TOTAL Common	5,000,000	100%	66.67%	58.82%
Option Plan	1,000,000	----	----	11.76%
TOTAL with Plan	6,000,000	----	----	70.58%
Series A	2,500,000	100%	33.33%	29.41%
TOTAL Outstanding	7,500,000		100%	88.23%
TOTAL ALL	8,500,000			100%

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CAP TABLE: SERIES A WARRANT

- Add Series A Warrant
 - Authorized
 - 15 million shares – Common
 - 5 million shares – Preferred / designated Series A
 - Outstanding
 - Common – 5 million shares
 - Series A – 2.5 million shares
 - Stock Option Plan – 1 million shares
 - Series A Warrant – 500,000
- What is Company Capitalization?

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CAP TABLE: SERIES A WARRANT

HOLDER	#SHARES	%Class	% Outstanding	% Fully-diluted
Marta	2,000,000	40%	26.67%	22.22%
Britni	2,000,000	40%	26.67%	22.22%
Mayra	1,000,000	20%	13.33%	11.11%
TOTAL Common	5,000,000	100%	66.67%	55.55%
Option Plan	1,000,000	----	----	11.11%
TOTAL with Plan	6,000,000	----	----	66.66%
Series A	2,500,000	100%	33.33%	27.78%
Series A Warrant	500,000	----	----	5.56%
TOTAL Outstan	7,500,000		100%	83.33%
TOTAL ALL	9,000,000			100%

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SECTION 7 – TAKE-AWAYS

- Fully-Diluted Percent – “worst case” scenario
 - Treats warrants, options (and convertible notes) as if exercised/converted
- Authorized Preferred affects Authorized Common needed – conversion coverage
- Cap Table includes %class, %outstanding and %fully-diluted
- Investor will always look at fully-diluted %

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From an Entrepreneur. For Entrepreneurs

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QUESTIONS?

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