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Morgan Legal Services
From an Entrepreneur. For Entrepreneurs

BUSINESS LAW 101 – PART 2

STARTUP EQUITY BASICS

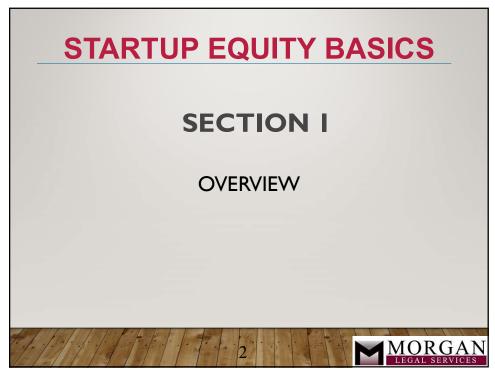


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ABOUT THE INSTRUCTOR

- 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





2

OVERVIEW

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

12

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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



4

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



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

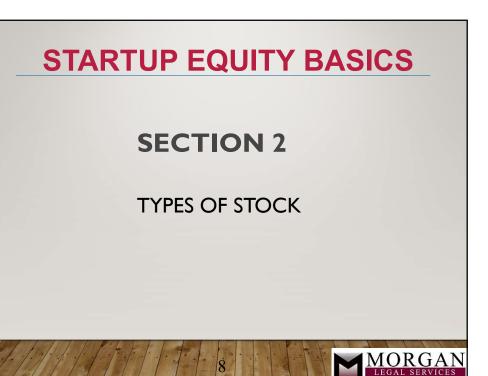


6

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)





8

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 "lowerpriced" financings
- Future Participation keep pro-rata share
- Information financials
- ROFR over Founder sales



10

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



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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12

STARTUP EQUITY BASICS

SECTION 3

RIGHTS TO ACQUIRE EQUITY



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



14

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



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



16

CONVERTIBLE DEBT

- Hybrid Debt and Equity
- Convertible Note issued ("debt")
 - BUT <u>may</u> 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



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

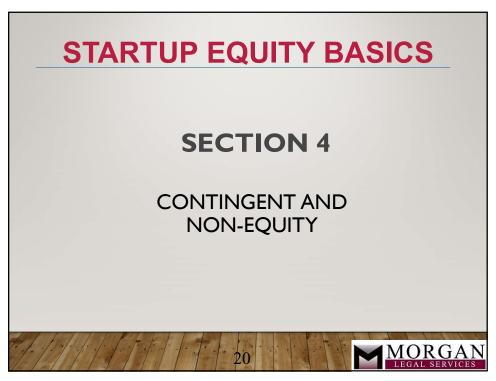


18

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
 - \bullet $\underline{\text{may}}$ convert on a future financing (or $\underline{\text{may}}$ remain debt)
 - NOT equity until converted





20

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")

21



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



22

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



23

NON-EQUITY

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



24

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

05



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 %



26

SECTION 4 – TAKE-AWAYS

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



27

STARTUP EQUITY BASICS

SECTION 5

COUNTING EQUITY –
AUTHORIZED STOCK



28

AUTHORIZED STOCK

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

20



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 <u>up to</u> that number of shares of Common Stock



30

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".



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?



32

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

33

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

34



34

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SECTION 6

COUNTING EQUITY –
OUTSTANDING STOCK



OUTSTANDING STOCK

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



• "Good" Consideration

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



37

37

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



38

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?



40

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



42

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SECTION 7

CAPITALIZATION COMPLICATIONS



CAPITALIZATION COMPLICATIONS

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



44

CAPTABLE: 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?



CAPTABLE: 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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46

CAPTABLE: 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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CAPTABLE: 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 \rightarrow 4 million available for Board to issue



48

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%		

CAPTABLE: 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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50

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%

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 %fullydiluted
- Investor will always look at fully-diluted %



52

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