Allocating and Granting Equity in Start-Up Companies

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TOPICS TO BE COVERED:

- Overview of key terms and concepts
- How should equity be allocated and/or granted in a start-up?
- Overview of equity agreements
THE BIG PICTURE

**Equity** generally refers to an ownership interest in a business enterprise

- can be thought of as the value remaining after all of the company’s debts and liabilities are paid off (aka *equity value* or *residual value*)
- often used to refer to stock or membership units that represent an ownership interest in a company (i.e., *equity security* or *equity interest*)
- in accounting, *equity* refers to the amount of funds contributed by the owners plus the retained earnings (aka *shareholders’ equity*)
# Balance Sheet of Newco, Inc.
## As of December 31, 2011

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES AND SHAREHOLDERS’ EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>$100,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>500,000</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>$700,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES:</th>
<th>SHAREHOLDERS’ EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$150,000</td>
</tr>
<tr>
<td>Accrued compensation</td>
<td>10,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>340,000</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>500,000</strong></td>
</tr>
<tr>
<td><strong>SHAREHOLDERS’ EQUITY</strong></td>
<td></td>
</tr>
<tr>
<td>Common stock, par value $.01</td>
<td>150,000</td>
</tr>
<tr>
<td>(1,000,000 shares authorized; 50,000 issued and outstanding)</td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total shareholders’ equity</strong></td>
<td><strong>200,000</strong></td>
</tr>
</tbody>
</table>

| **TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY** | **$700,000** |
KEY DISTINCTIONS

- Corporation versus Limited Liability Company
- Stock (shares) versus Membership Interest (units)
- Board of Directors versus Board of Managers
IMPORTANT TERMINOLOGY

- Authorized stock/authorized shares
- Issued and outstanding shares
- Options/warrants
- Fully diluted shares
- Par value
- Capitalization
- Capitalization table (aka equity table)
# Capitalization Table of Newco, Inc.
## As of December 31, 2011

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Issued and Outstanding Shares of Common Stock</th>
<th>Shares Underlying Options/Warrants</th>
<th>Fully Diluted Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder #1</td>
<td>20,000</td>
<td>-</td>
<td>20,000</td>
</tr>
<tr>
<td>Founder #2</td>
<td>20,000</td>
<td>-</td>
<td>20,000</td>
</tr>
<tr>
<td>Seed Investor</td>
<td>10,000</td>
<td>1,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Director #1</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
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<td>-</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>50,000</td>
<td>7,000</td>
<td>57,000</td>
</tr>
</tbody>
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**Authorized Shares:** 1,000,000 shares of common stock, par value $.01 per share

**Issued and Outstanding Shares:** 50,000 shares of common stock

**Fully Diluted Shares:** 57,000 shares of common stock
THINGS TO REMEMBER:

- There is no magic to share numbers; actual share numbers don’t tell you anything by themselves.
- Ownership percentage is more significant than share numbers, but even ownership percentage doesn’t indicate value.
VALUATION IS EVERYTHING!

- Equity is worthless unless there is ultimately an exit event or liquidity event, such as a sale of the company or an IPO (or if the company makes and distributes significant cash flow)
- An exit event or liquidity event will presumably be priced based on valuation principles that investors and investment bankers utilize
- Ergo, it is important to have a general sense of valuation principles and concepts when discussing equity grants and allocations (even if a valuation event is far off)
CRASH COURSE IN VALUATION

“Fair market value” is generally defined as what a willing buyer would pay a willing seller in a voluntary transaction in which neither is under a compulsion or obligation to buy or sell.
CRASH COURSE IN VALUATION (Cont’d)

Several possible ways to value a company:
– Net book value
– Net asset value
– Discounted cash flow (DCF)
– Market comparables
CRASH COURSE IN VALUATION (Cont’d)

Terms that investors use:

- Pre-money valuation
- Post-money valuation
- Value per share
- Value per fully diluted share
- Founder stock
- Incentive equity
- Incentive pool (or option pool)
Question: How much equity would an investor get in Newco if the parties agreed that Newco had a total pre-money valuation of $12.0 million and the amount of the investment is $3.5 million?
## Purchase Price Calculation for Newco, Inc.

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- Pre-Money Valuation: $12,000,000
- Fully Diluted Shares: 57,000
- Value per fully diluted share: $210.53 per share
- Amount of investment: $3,500,000
- Price per share: $210.53
- Total number of shares issued: 16,625 shares
Valuation of Start-Ups:

- Market-comps often aren’t available or helpful
- Projections are often a wild guess (and are often meaningless for life science and high-tech companies)
- Sometimes (maybe most of the time) the purchase price will have no relation to valuation principles
- Parties often back into a valuation based on “gut” feelings regarding desired percentage ownership
- Nevertheless, the resulting valuation potentially becomes a baseline
ALLOCATING AND GRANTING EQUITY IN A START-UP
ALLOCATION OF STOCK AMONG FOUNDERS

- Should generally be allocated based on relative value of contributions
- Should address what happens if a founder doesn’t “stick around” or otherwise contribute what is expected
  - Vesting provisions
  - Buyback provisions
- For tax reasons, need to be careful about distinction between capital contributions and subsequent equity grants
GRANTING EQUITY TO KEY TEAM MEMBERS

- Generally referred to as “incentive equity”
- Often granted to employees, contractors, directors, and sometimes vendors
- Need to clearly define and document what is expected of the grantee
- Don’t forget that equity grants are taxable income in year of grant (or, if later, in year of vesting)
  - Use of options granted at FMV may help
  - In LLC, use of “profits interests” may help
GRANTING EQUITY TO KEY TEAM MEMBERS (cont’d)

How much equity should I give someone such as a CEO, a Director, or a Chief Scientific Officer?
GRANTING EQUITY TO KEY TEAM MEMBERS (cont’d)

- Equity should be “issued” by the company, not “given” by the founders.
- Even though incentive equity grants result in a percentage ownership shift from founders to grantees, these grants should come from company (not from founders).
- Because of tax considerations, equity should generally be granted early but with vesting conditions to prevent the “over-grant” of equity.
ISSUING EQUITY TO INVESTORS

- Investors will often want some sort of preferred security, like convertible preferred stock or convertible debt
- Such securities will usually involve preferred returns/dividends, liquidation preferences and distribution preferences
- Beware of anti-dilution rights
- Many investors will want to limit the ability to grant incentive equity without triggering anti-dilution rights
THE “D” WORD

Dilution is one of the most oft-discussed but least understood topics
Potential different meanings of the word *dilution*:

- Dilution in ownership percentage
- Dilution in net book value per share
- Dilution in net asset value per share
- Dilution in earnings per share
- Dilution in economic value per share (*i.e.*, price dilution)
DILUTION (cont’d)

- “Anti-dilution rights” that investors seek are usually intended to protect against dilution in economic value per share.
- They are really worried about subsequent investors receiving equity at a per-share value less than what they paid, meaning that they overpaid.
- “Price protection” is probably a more accurate term than “anti-dilution rights.”
DILUTION (cont’d)

Two general types of “price protection” anti-dilution rights:

- **“Full-ratchet” Anti-Dilution Rights**: If shares are issued at a price lower than my price, I get the lower price (even if only one share is issued).

- **“Weighted-Average” Anti-Dilution Rights**: If shares are issued at a lower price, I get a reduction in my price based on the relative amounts of equity issued in the two rounds.
DILUTION (cont’d)

- Anti-dilution rights are typically implemented by adjustment to the conversion price of preferred stock or convertible debt, or by issuing new shares of common stock to the right holder.
- These provisions are usually set forth directly in the investment agreements.
- There are typically “exceptions” to the triggering of such rights, such as the issuance of incentive equity grants up to a certain percentage of the company’s fully diluted outstanding shares or shares issued in certain non-financing transactions.
DILUTION (cont’d)

Protection against dilution in percentage ownership generally doesn’t make sense (and is unfair) except in limited circumstances:

- Certain seed-stage money and technology licensors
- Should generally be capped out
EQUITY AGREEMENTS
EQUITY AGREEMENTS

- Often also called by other names, such as “Shareholder Agreements” or “Investor Rights’ Agreements”
- In LLCs, these matters are typically included directly in the Operating Agreement
- While such agreements are often required by investors (including universities), founders may want to have a separate agreement or may want to include provisions that the investors don’t require
Equity Agreements: Provisions relating to stock transfers

- Rights of first refusal
- Other transfer restrictions (i.e., transfers to competitors)
- Buyback rights upon involuntary transfers
- Buyback rights upon other triggering events
EQUITY AGREEMENTS:
PROVISIONS RELATING TO EQUITY ISSUANCES

- Anti-dilution Rights (full-ratchet or weighted-average)
- Preemptive Rights
- Registration Rights
EQUITY AGREEMENTS: VOTING AND GOVERNANCE PROVISIONS

- Provisions that establish board size and composition
- Provisions that require shareholders to vote in favor of certain board members or in favor of other matters
- Provisions requiring a supermajority vote or investor consent for certain major items (often called *protective provisions*)
EQUITY AGREEMENTS:
DRAG-ALONGS AND
TAG-ALONGS

- *Drag-along* provisions generally require shareholders to agree to sell their equity to a third party if certain investors or a majority of the shareholders want to sell the company.
- *Tag-along* provisions generally give minority shareholders a right to sell their equity to a third party if the majority shareholders want to sell out.
Q&A

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