TALIGO LLC

Equity Planning

A White Paper For Those Associated With Restructuring an Early Stage Startup

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Table of Contents

Disclaimer

This white paper provides information that may be useful to some executives and others in preparing questions to ask their legal counsel. However, the facts and circumstances of each situation are different and may be fluid and unpredictable. Thus, advice must be sought on each specific situation from well-informed legal, tax, financial, and management professionals.

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Executive Summary

This white paper is written for those who are trying to prepare questions to ask their legal counsel concerning equity plan issues relating to the restructuring of an early stage startup. This restructuring is probably occurring because the company is progressing more slowly than originally anticipated either due to internal issues or external market conditions.

The process of winning or losing during a restructuring process is to some extent a power game or "free-for-all" that is only partly played out according to the legal rules. The relative "winning" nature of an individual's position is determined by:

- Access to funds
- Financial obligations owed
- Relative knowledge of the process (addressed by this white paper)
- Access to sound advice concerning the applicable facts and laws
- Whether or not someone has created legitimate grounds for a lawsuit
- Key knowledge or key contacts (usually) on the part of technical employee
- Willingness to exert strength of will
- Timing

The authors prepared this white paper with the intent that companies that "fit" the discussion included have not yet completed an "A" round of venture capital investment. However, there is some ambiguity here. Some seed stage investors prefer to invest via convertible notes. However, the use of convertible notes is decreasing. Currently, other investors prefer to force seed stage valuations and receive preferred stock even when a relatively small amount of money is involved. In the current "climate," startup executives should anticipate that all investors will want to protect themselves from a future "cram down."

It would be helpful if all chief executive officers of startups appreciated the need for an equity plan or "budget" before shares are allocated to founders, investors, employees, consultants, or anyone else. Those who do not appreciate this need may learn that "overhang" or too much equity in the hands of employees/founders can be a serious "boat anchor" hanging around the neck of a CEO.

This white paper describes:

- Equity budgets before and after a major restructuring
- The restructuring process and experience
- Stakeholder perspectives and issues

The authors of this white paper encourage good corporate governance and communication with all shareholders. Ongoing communication minimizes surprises and aids in building the consensus needed to complete a restructuring.

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Need for Equity Restructuring

Some companies experience hard times. For whatever reason, the company is progressing more slowly than originally anticipated. The root cause may or might not have been within management's control. For example, market conditions are not within management's control. In some cases, the companies go out of business. In other cases, there is a need to re-capitalize, or, if there is an especially severe problem, to reorganize.

Prior to Restructuring

Prior to restructuring, the authors assume that the startup has the following characteristics:

- Is incorporated in California, Delaware, or (less desirably) Nevada as a "for profit" corporation, preferably a "C" corporation.
- Is a "traditional" startup
- In theory the concepts discussed in this paper are applicable worldwide. For example, many investors would claim to make decisions based on discounted cash flows or internal rates of return criteria. However, the authors have seen restructurings in real life to reflect instincts, egos, whims, personalities, etc. as well as criteria from academia. Implementation and impact seems to vary from country to country. Further, the San Francisco Bay Area has a unique set of subcultures and ways of doing business. So, the authors prefer to think in terms of startups located in the San Francisco Bay Area.
- Completed at least a seed stage round of financing, but, not yet completed an "A" round of venture capital financing
- The company probably needs additional external capital to achieve breakeven or other fundamental milestones that are necessary for it to be perceived as a viable business.
- The company has an equity budget similar to that described in Table I.

The reader should understand that sometimes these restructuring "adventures" occur after the A round, sometimes after a B, C or later round. For example, a number of startups have spent millions more than originally planned in completing operable prototypes or achieving other key milestones. In some cases, the investors changed management and made substantial changes to the capital structure along the way. Management might then seek funding for what they should probably call a B round.

Table I: Equity Budgets for Typical Seed Stage Startups

(Post Seed Stage Round – Before any Restructuring)

Class	Group	% of Total Shares Authorized	
Common[1,2]		Up to 70%	
	Founders		Balance
	Option pool for employees[3,4,5,6,7,8,9]		10-15%
	Option pool for all advisors		10-15%
	Consultants and members of the Board of Advisors		Usually included in total for all advisors at this time
	Board of Directors members		Usually N/A (0%) at this time[10]
	Friends and family investors		Varies up to 20%
	Other holders of equity[11]		Varies
Preferred	Angel and venture capital investors only	No more than 30%[12]	

1 All equity and options for founders and employees vest on a 3-5 year schedule with a one-year “cliff” (6 months in some cases for some founders and officers). Founders will often want vesting “accelerators” such as upon a termination without cause or a change of control followed by termination (double trigger).

2 All equity and options for advisors vest on a schedule, usually monthly with a cliff in some cases.

3 CEO is individually negotiated, but, in the 5-10% range

4 CFO is individually negotiated, but, in the 1-3% range

5 VP Marketing is individually negotiated, but, in the 2-3% range

6 VP Engineering is individually negotiated, but, in the 2% range. For a more technical startup such as a Fab-less chip startup, the senior technical VP may be in the 2-5% range. Some technical experts may want more. But, one must consider the implications of the total “overhang” and the need to compensate all present and future employees.

7 Other vice presidents are individually negotiated, but, in the 1-2% range

8 Directors are individually negotiated, but, in the 0.5 - 1% range

9 These percentages will vary based on 1) tradeoffs of cash vs. equity in the compensation packages, 2) seniority, and 3) capitalization and stage of the company.

10 Frequently, there are no outside directors who are not investors at this time.

11 Convertible debt must be taken into account. Non-convertible debt is unlikely to be paid down during a restructuring unless a negotiation for debt reduction is contingent upon accelerated payment. Such negotiations are often required as part of an equity restructuring agreement.

12 Prior to the A round, some believe it would be unusual to give up more than 30% of the authorized equity to investors (not including Friends and Family). However, depending on the circumstances, **SOME INVESTORS WANT 40-50% OF THE COMPANY EVEN AT THIS STAGE.**

Corporate Equity Restructuring

How it Starts

- The CEO, CFO, an investor, or a Board member perceives a need for a restructuring. The perception may be based on:
    - Financial issues (access to funds and/or burn rate are the typical reasons)
    - The threat of lawsuit
    - An unsustainable business model
    - The CEO, CFO, or Board realizes that too much equity was given out in the past and that the problem needs to be addressed sooner rather than later
    - One of the key players perceives a need to solve a substantive problem that does not seem resolvable by other means
- There is discussion. This may or may not evolve into a verbal "free-for-all."
- At some point conversations evolve either towards a supposedly suitable business solution or degenerate into dissolution or lawsuits. Those interested in creating a suitable business solution may find this white paper to be a useful reference prior to conversing with their legal counsel.
- As participants work to establish agreement concerning a new capital structure and (usually) attract new investors, they each try to understand the impact of what is being proposed.

The Financing Event

In essence, each financing event is a restructuring, and the extent of the restructure depends on the attractiveness of the investment opportunity. The different classes of stock, their rights, and their protective provisions force even the youngest companies to comprehend the interrelation between the classes of stock, the company's time line to profitability, cash burn getting there, and potentially new financing events. In the positive scenario, a new financing will involve an issuance of a new class of stock and all the current protective provisions are honored. It is when investors cannot be found that are willing to pay the previous or higher valuation that the capitalization of the company, and all protective provisions, become negotiable and the dreaded "down round" is born.

What Occurs

A restructuring results in the following potential changes:

- Management (key technical executives are less likely to be replaced)
- Board membership
- The business model, or at least the business plan is usually revised
- Number of employees
- Restructured debt
- Relative and absolute equity positions of all who hold equity. The presumed value or valuation of the equity will be lower than prior to the restructuring. As the level of "trauma" of the re-capitalization increases towards a re-organization, the continuity in the capital structure is substantially diminished. The company simply disappears in the trauma of a sale of assets or Chapter 7 bankruptcy.

Re-capitalization / Reorganization Methods

Possible re-capitalization / reorganization methods include:

- Creation of a new series of preferred stock for the "new" money. This is usually accompanied by diminution of the "power" of existing classes of stock. This action may be done in part because existing stock options for employees are worthless. Or, this action can make the value of existing stock options essentially worthless when the exercise price is higher than the new per share price. Therefore, in this case, the Board of Directors will often establish a new stock option plan and/or new options for existing (ongoing after the re-capitalization or reorganization) employees.
- A sale of assets such as intellectual property in which case the company disappears.
- A sale (merger) of the corporation in which case there is unlikely to be any continuity of capitalization.
- A Chapter 7 or Chapter 11 bankruptcy. In a Chapter 7, the company disappears. In a Chapter 11 bankruptcy there may be some continuity for key employees and some investors.
- Dissolution. One apparently otherwise successful startup was dissolved because the CEO had created the threat of a non-defendable lawsuit and not sought legal advice or told the Board until the Board perceived that it was too late to do anything else. However, dissolution by itself, does not eliminate the risk of a lawsuit.

Re-capitalization At A Lower Valuation With Added Incentives (A Pay to Play Down Round)

Re-capitalization due to new financing at a lower valuation (a down round) does not have to be that negative. Stocks in the public markets go up and down, and the value of private equity will rise and fall with its public brethren. After all, there is an intrinsic relationship between the two since a successful company will likely enter into the public markets through an IPO or be acquired by a public company that will have to justify the valuation placed on the acquisition. The intent of any restructuring due to distressed financing is to offer incentives to everyone associated with supporting the company from the financing event *forward*. This usually includes participating investors, the management team, the Board of Directors, and the employees. Often, previous employees that are no longer with the company or investors that do not participate in a current financing will suffer a greater equity percentage loss than their respective counterparts. In a well conceived restructuring, the ongoing employees and the management team will retain adequate equity incentives through a grant of new stock options. They may also be given other incentives to mitigate the down side risk scenario such as a "fire sale."

What to Expect in a Typical Distressed Equity Financing

The participant should expect the following in a typical distressed equity financing:

- A clearly articulated business plan associated with the financing such as finishing a product or market validation with first customers.
- Sometimes it is necessary to improve the cash position as the company seeks to be acquired and avoid the fire sale scenario. Cash is a necessary but insufficient condition for such avoidance; paying customers and a realistic path to profitability will better position the company for acquisition.

- A plan by which investors are rewarded for their continued risk, and employees and management are rewarded for their continued hard work. In essence, everyone will share in the risk and the reward. Often the current investors are the only ones that are willing to support the company, and often there is a real concern that enough money can be raised to progress the company to a meaningful milestone. Extra incentives may be applied such that previous investors who participate in the current financing get the customary new class of preferred stock but also get additional shares of a new class of preferred stock. The allocation of the new class is granted in such a way that it severely dilutes any non-participating class. The new investors, the ones willing to continue to support the company with additional cash, benefit by maintaining or increasing the percentage ownership for the previous investment in addition to the new percentage ownership obtained by the current investment.

  See Table II below for a summary of a simplified example. Both of the following examples assume the new investment is the same amount as the pre-money valuation.

Table II: Incentive by Dilution of Preferred

Impact on Equity Budget

Incentive Is New Series of Preferred	Before Financing	After Financing
Common	50%	25%
Series A	50%	5%
Series A-1 (A investors who invest in B)	Non-existent	20%
Series B	Non-existent	50%

Another form of restructure that has a similar intent is to force the non-participating investors to convert their preferred shares to common. See Table III below for a simplified example.

In table 3 below, it is assumed that only 50% of the preferred A holders participate in the preferred B offering, and the other 50% are converted to common. Pre-money valuation is the same as the amount to be raised in the series B offering

Table III: Incentive by Preferred That Converts to Common

Impact on Equity Budget

Incentive Is Preferred Converts to Common	Before Financing	After Financing
Common	50%	37.5%
Series A	50%	12.5%
Series B	Non-existent	50%

In some cases, investors who do not invest any new money will have their interest reduced to zero. In all cases, ongoing and new management and employees should be granted new options that provide appropriate incentives for superior performance.

For *interested* directors, there is a loyalty duty and counsel should be sought early in the process so that no undue liabilities are incurred. Often the liability can be mitigated with a rights offering, majority of shareholders consent, and a representation of deliberation that shows no other investors could be found and that the company could not continue without additional financing.

Current investors that cannot or will not continue to invest are never happy about this sort of restructuring. The choice to shut the company down or suffer severe dilution is a difficult one, but *it is often clear that dilution is preferable to a total loss of an investment. With the right structure, it can be the best alternative for the company, the employees, the current investors, and even the non-participating investors.*

Threats to a Successful Recapitalization

There are several threats to a successful restructuring. These include:

- Egos
- Unreasonable expectations (usually caused by a lack of understanding of business realities)
- Lack of willingness to compromise. Some CEOs/CFOs take a "hard" line in negotiations. This is frequently true of negotiations with departing employees. Some investors take a "hard" line with the founders/management. Either of these approaches can create lawsuits or destroy an individual's desire to foster success.
- Mistakes or intentional acts that create reasonable grounds for lawsuits or bad feelings can create disputes (lawsuits or threats of lawsuits). As a matter of course, those who are in control of the restructuring may want all involved to sign some kind of release of claims. The reasonable approach is a mutual release that is confined to relevant matters. In some cases only restructured creditors are asked to sign releases.[13] Some companies may try to force employees to sign releases in exchange for severance pay. If the employee has an employment contract that provides for severance pay, then, under California law, a company cannot require that he or she sign a release in exchange for the severance pay. An exception would be if the employee were naïve enough to have signed an employment agreement that required him/her to sign a Release upon termination (such agreements are usually only proffered to executives).
- Lack of continuity in the capital structure and other equity participation issues are a key cause of potential disputes. These may surface as demands for preferential treatment, refusals to sign

13 The act of requesting a release can sometimes create legal problems.

documents, or lawsuits. In any case, those involved may want to seek advice from legal counsel to reduce the possibility of later lawsuits from creditors, investors, employees, etc. There are rumors that a number of Angel/seed stage investors in the Bay Area were recently "crammed down" in ways that violated corporate Articles of Incorporation or other agreements with the startup. Supposedly, a number of these investors plan to file a lawsuit just prior to a future liquidity event. Your counsel can advise you as to what would pose a legitimate vs. a frivolous or "greenmail" lawsuit.

The Stakeholders

In considering a restructuring process, the participant may want to think through possible attitudes, activities of, and impacts on the other stakeholders. In any event, it is basic to assume that almost everyone wants to feel that they are involved in the process and was consulted in a meaningful way. Attorneys will almost always recommend this.

Experienced attorneys, executives, and investors may have different "post re-capitalization / reorganization" expectations than investors and employees with less relevant business experience. Typical differences of opinion will focus on the relative continuity in the capital structure. Individuals may think of this in terms of the "worth" of equity positions and Board seats, which an investor or founder/employee "deserves" due to his/her present and or "prior" contributions. In fact, *prior contributions by those who are not contributing in an ongoing way are typically "washed out."*

Board of Directors

Members of the Board of Directors do not acquire significant clout in the restructuring process unless they have other strengths (additional investment, key technical officer, or etc.). As with "normal" equity financings, new investors investing substantial amounts will require Board representation.

Employees

Employees with easily salable skills will depart if they sense impending failure or a lack of acceptable (in their eyes) future equity participation with a reasonable probability of substantial reward.

In any case, those who purchase the intellectual property assets, or otherwise are in control, will frequently find that the key employees have expectations that must be addressed if they are to be involved in a productive capacity. Those with key technical knowledge or to a lesser extent, those with key contacts, are most likely to win larger chunks of equity.

CEO

Some employees such as the CEO and CFO may find their time is drawn into meetings with lawyers and accountants with the subsequent need to spend time keeping the Board members informed. As the amount of funds previously invested (or otherwise at risk) increases, or as the risk of lawsuits increases for other reasons, these involvements will increase.

The CEO may well be concerned about personal liability. In any event he/she may be overwhelmed with an avalanche of simultaneous activities.

CFO

The CFO may also be concerned about personal liability. In any event he/she may also be overwhelmed with an avalanche of simultaneous activities. In parallel to all this, the CFO will be reducing burn and preparing budgeting and equity planning models.

Senior Technical Officers

The senior technical officer (and sometimes others) may see him/herself as key to the future of the company. For reasons based in fact, prior performance, ego, or whimsy, others may not agree. Conflicts over this issue may make the re-capitalization non-salable to the key participants.

Other Officers and Non-Officer Employees

All officers should think through why or how they may have liabilities tied to their fiduciary responsibilities and seek advice from counsel. In startups, liabilities are less frequently an issue for non-officers unless there has been substantial malfeasance.

Future Employees

Future employees will want to be able to believe that the restructuring was/is "clean" and "safe."

Investors

Some investors believe a startup that has just experienced a re-capitalization or reorganization carries an implied higher risk for investors. Investors with this mindset will request a higher ownership percentage in a reorganized startup. Other investors have stated that they appreciated that management had experienced difficult times. So, they wanted to increase management's stake in the equity to ensure good feelings and motivation. One sometimes wonders which approach the investors think elicits an adequate level of commitment from management? In any event, investors need to leave enough equity on the table to motivate management and others who must lead and operate the business.

Many investors claim to make decisions based on discounted cash flows or internal rates of return criteria. However, many decisions are not made based on such perceptions. The authors have seen investment decisions in real life reflect instinct, egos, whims, personalities, etc. as well as criteria from academia.

Unfortunately, competing desires for equity on the part of investors vs. others may make this an impossible situation without cramming down founders and/or others who are no longer actively involved in the business or investment group, or who have relatively little voting power or other control.

Investors who are young and inexperienced, or whose prior experience was in large companies sometimes have difficulty understanding how to focus on what is important for a startup. Other investors have an emotional, as opposed to a business-centric decision-making process.

In the end, all new equity investors will invest only at a valuation where they believe that the ultimate return achieved will satisfy both their fiduciary duty to their investors (their limited partners if they represent a fund) and their own compensation requirements.

Venture Capitalists

Venture capital today is becoming institutionalized as an asset class. In the past five years, the number of venture capital professionals has doubled in size. The practice of the professional deal structure has permeated throughout the Bay Area.

Venture capitalists can be grouped into venture capital firms and corporate venture capitalists. Venture capital firms almost always have financial objects when they invest. Corporate venture capitalists are housed within companies. They may have financial or strategic objectives. If their objective is to generate financial returns then they are somewhat similar to traditional venture capital firms. However if their objectives are strategic, then their objective is to support the future product/service offerings of the corporation.[14] Thus, they may also be interested in licensing technology or in some other business relationship with a startup. Their due diligence processes frequently differ from those of financial investors. Similarly, their decision process during a restructuring may hinge on whether the corporations plans for product "X" have changed since their last investment in the startup.

Venture capitalists are particularly keen on the startup achieving positive cash flow or profitability. Profitability mitigates the need for future funding from current investors (more capital at risk) or new investors (dilution, sometimes severe). When a company is unable to reach profitability on the current cash position, many investors these days currently ask for further incentives to continue investing. It is when no new investors can be found that the existing investors sometimes act to protect their previous investment and allow the company to continue with its business plan. To do this they put forth greater incentives for new investors.[15]

In these troubled times, many venture capitalists have portfolios that are "under water." In some cases this seems to hamper their judgment concerning reasonable solutions to re-capitalization/ reorganization of troubled companies in their portfolios. Some become overly aggressive and predatory in the terms they demand for continued support for a company, thereby alienating management and key staff. In other cases, they may be too eager to seek wholesale replacement of prior management and staff as a quick solution to perceived problems.[16] Such a course of action may worsen the situation, particularly when the true causes for the company's problems have not been carefully and frankly analyzed. In either case, too aggressive a stance will tend to cause acrimony within the stakeholder group and aggravate an already delicate situation.

Angel Investors

The sophistication of Angel investors varies widely. They range from busy executives who know little about investing to "retired" venture capitalists and chief financial officers with extensive startup investment related experience.

Overall, Angel investors in the Bay Area are becoming more and more sophisticated. For example, it is becoming more difficult to find sophisticated Angel investor that will accept common stock.

Many sophisticated Angel investors and the more experienced organized Angel groups function like venture capitalists and require preferred stock. It is becoming more the norm for them to ask for the

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14 Some corporate venture capitalists purchase large equity positions in a startup, sometimes more than 50%. The startup then may have difficulty raising further capital because potential investors are concerned that the corporate venture capitalist may "dump" the startup.

15 Please see the section on Re-capitalization at a Lower Valuation

16 Investors replaced the CEO of one startup three times in two years. After the fourth CEO, the company faded into oblivion.

other terms and protective provisions that venture capitalists request. They can be viewed as motivated in the same way as are venture capitalists.

Since most Angels invest very early in a company's history, it is important for Angel investors to keep a portion of their capital free to protect their investment. It may be necessary to make another investment, sometimes years later, to mitigate a severely "dilutive" event.[17]

In these troubled times, some Angels have portfolios that are "under water." For the less sophisticated Angels, this seems to hamper their judgment concerning unrelated matters.

While not necessarily so personally attached to their investments as founders and founder's friends and family, some Angels may feel a similar emotional attachment to their investments that hinders clear decision-making.

Friends and Family

Friends and family investors may be involved in a grieving process that hampers decision-making. These investors, being particularly closely associated with the founders, often have an emotional attachment to their stake in the company that further hinders clear decision-making.[18]

Founders

Founders may be involved in a grieving process and/or ego "trip" that hampers decision-making. Alternatively, they may be concerned about "making a difference" or about the welfare of their employees who are "counting on them."

Others Who Hold Equity Positions

Depending on the record keeping of the CEO, founders, and/or CFO, there may be written documents and verbal commitments that create a host of rights holders that is a genuine mess. For example, one Chairman/CEO wrote a letter purportedly transferring equity to a third party and then did not have it confirmed by the Board or properly recorded. Investors will want to have great certainty about the identity of stockholders and their ownership interests.

Future Investors

Future investors will want to be able to "prove" that the restructuring was/is "clean." In particular, they will want assurance, documented if possible, that potential legal liabilities, as well as any substantial debt, have been fully addressed in the re-capitalization/ reorganization.

Private Bankers and Other Hedging Strategy Advisers

The private banking departments in a number of banks and investment banks offer hedging strategy advice to founders. In essence they advise the founders what Board resolutions need to be passed in order to facilitate the creation of certain types of options. The Founders can then hedge their investments by creating option positions. The private banking officers who assisted the founders in hedging their equity positions will probably suggest that the new capital structure also support such possibilities.

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17 Please see the section on Re-capitalization at a Lower Valuation.

18 Friends and family rounds can be problems if undertaken without experienced legal advice. Some startups formally call their Friends and Family round an A round and sell them preferred stock. This may become a problem in the "real" A round that may force a restructuring in order for the company to be "fundable."

Consultants and Other Service Providers

Consultants and other service providers may be creditors and may have or believe they have the right to chunks of equity.

Board of Advisors

Members of the Board of Advisors may want to just exit quietly with their name removed from web sites and documents as quickly as possible. Alternatively, they may be evangelical about the company's future prospects.

Customers

Some customers may become investors if they sense a corporate financial weakness in a startup vendor. Other customers will distance themselves immediately upon the first sign of trouble. Officers and managers of larger corporations are less likely to stay involved with a startup vendor that is in trouble. Often this decision is based upon the importance of the startup to their business, the available alternatives, and anticipated switching costs.

Attorneys

Access to advice from an experienced attorney with business acumen is a very powerful asset to a participant. Inexperienced attorneys with litigation as a first objective (as opposed to business discussions) are less helpful. In any case the attorney will be attempting to uncover the essential facts so that he/she can further his client's best interests.

After the Restructuring

The Board or other group of key players of a (to be) successful startup plans ahead to foster a success-nurturing environment. In other words, after the restructuring, the business objective is for all players to work together to promote success.

Unfortunately, during a restructuring some Boards gets focused on only obtaining agreement to substantive issues from stockholders representing more than 50% of the equity. As a result, they sometimes drop smaller shareholders from distribution lists. However, under both Delaware and California corporate law there is a duty to notify all shareholders when a corporate action is taken by less than unanimous written consent (i.e., more than 50%). Unfortunately, a number of companies fail to do this. The authors of this white paper encourage good corporate governance and communication with all shareholders. Table IV below may be a useful reference in thinking through equity budgeting questions.

Table IV: Equity Budgets For Seed Stage Startups
Just After a Major Equity Restructuring
(A Seed Stage Round Occurred on Some Prior Date)

Class	Group	% of Total Shares Authorized	
Common[19,20]		20-50%	
	Founders		0-5%[21]
	Option pool for employees[22,23,24,25,26,27,28,29,30]		Balance
	Option pool for all advisors		10-15%
	Consultants and members of the Board of Advisors[31]		Usually included in total for all advisors at this time
	Board of Directors members		Usually N/A (0%)
	Friends and family investors		Varies up to 20%
	Other holders of equity[32]		Varies
Preferred[33]	Angel and venture capital investors	50-80%	May be diminished[34]
	New preferred class (see Tables II and III)		For new investors

19 All equity and options for founders and employees vest on a 3-5 year schedule with a one-year “cliff” (6 months in some cases for some founders and officers). Founders will often want vesting “accelerators” such as upon a termination without cause or a change of control followed by termination (double trigger).

20 All equity and options for advisors vest on a schedule, usually monthly with a cliff in some cases.

21 Founders will likely have their relative portion of the equity reduced, sometimes drastically. Those who are still active in a key role may have that portion “protected" or even increased.

22 There may be some equity held by former employees (prior to the reorganization) who are not still actively involved. But, this is probably diminished in some way.

23 Some investors want to decrease employee participation as their equity budget is increased due to supposed increased risk. Other investors want to increase employee participation to encourage their continued involvement post restructuring.

24 CEO is individually negotiated, but, in the 5-10% range

25 CFO is individually negotiated, but, in the 1-3% range

26 VP Marketing is individually negotiated, but, in the 2-3% range

27 VP Engineering is individually negotiated, but, in the 2% range. For a more technical startup such as a Fab-less chip startup, the senior technical VP may be in the 2-5% range. Some technical experts may want more. But, one must consider the total “overhang” and the need to compensate all present and future employees.

28 Other vice presidents are individually negotiated, but, in the 1-2% range

29 Directors are individually negotiated, but, in the 0.5 - 1% range

30 These percentages will vary based on 1) tradeoffs of cash vs. equity in the compensation packages, 2) seniority, and 3) capitalization and stage of the company.

31 Those who are no longer actively involved will probably be “crammed down” unless there are protective features in their agreements.

32 If these are holdovers from the prior capital structure, they were likely diminished.

33 Prior to the A round, it would normally be unusual to give up more than 30% of the authorized equity to investors (not including Friends and Family). However, after a restructuring, the situation is much less predictable and there are no set parameters either in business law or practice.

34 This class of preferred stock and common stock is subject to “cram down” during a restructuring.

Future Dilution of Equity

All US startup companies that anticipate a major liquidity event (historically this has almost always been an IPO on the Nasdaq) (should) expect that early holders of equity will be diluted as the company progresses towards such an event. Dilution also occurs when acquisition is the likely liquidity event since more financing and employees will likely be needed to create value. Because of currently lower company valuations, there will have to be more discipline in the number of units of shares allocated to all shareholders. In the recent past, at the time of an IPO, a company could have 30-40 million shares outstanding on a fully diluted basis. An initial public offering would probably be at a per share price in the $12-15 range. This means the startup at the time of its IPO would have a pre-money valuation of about $400-500 million. This is a much less common valuation in these times.[35]

Assuming that an IPO is feasible for a particular startup, it may be delayed for a better economic "climate" (read higher valuation) or, if held as of this writing, it will likely have a much lower valuation. Therefore, fewer units of shares should be allocated in the equity plan or "budget" in an effort to avoid the need for a reverse stock split at the time of an IPO.

For medical device and biotech companies, the major liquidity event is frequently an acquisition by a major industry player. An acquisition is currently the most likely liquidity event in other industry sectors as well.

Planning for Potential Future Re-capitalization

An investor or other person/entity who invests in the equity of an early stage startup may want to consult counsel as to the best way, if any, to minimize the risk of being "crammed down" by a future re-capitalization or reorganization. He/she may wish to include anti-dilution or other protective terms in investment agreements. Many sophisticated Angels and seed stage investors are now insisting on receiving preferred stock with "standard" protection provisions as required by venture capitalists in professional financing rounds. In other words, "professional" financing is starting to appear at Angel and other seed stage "rounds."

There are some who believe that thought should be given to using the services of an arbitrator to attempt settlement of disputes in the first instance, although this is more typical of dealings by the company with outside parties rather than for dispute resolution within the company itself. But if re-capitalization or reorganization discussions have not yet reached a stage in which legal battle lines have already been clearly drawn, arbitration may provide a cheaper and less cumbersome method of reaching a settlement before potential problems become acute. However, others feel that a good litigation attorney is constrained by a requirement to "litigate", either offensively or defensively, within the constraints of binding arbitration. Your legal counsel can advise you on which environment you may prefer to establish for your startup.

35 This is one reason why there are currently fewer IPOs.

Glossary

A Round	The A round is the first round of professional capital financing beyond the seed round, and often is provided by business Angels and early stage venture capital firms. It precedes the B round. As indicated, the A round currently may occur earlier because many investors want to value the company for the seed round.
Cliff	Vesting schedules frequently provide for a 6-month or 12 month "Cliff." Prior to the Cliff, the person has not earned any shares/options. At the time of the Cliff, the person receives rights to all of the shares/options earned during the preceding 6 (or 12) months.
Major liquidity event	The financial "exit strategy" of the investors and many founders is a "major liquidity event." This includes IPOs and acquisition. IPO means initial public offering. The major liquidity event is the point at which the investors begin to be paid the (hopefully) large rewards for their time, funds, and risk.
Overhang	Overhang is the amount of equity held by the founders and employees. If this is too high, i.e. more than 20% of what will be the outstanding equity at the IPO, the company becomes non-viable because new employees cannot be "paid" enough equity as a part of their compensation. This percentage limitation at the time of an IPO is usually only with respect to outstanding options and options available in the option plan not the percentage of shares actually owned by founders and employees. The authors wish to presume that the founders did not create (or if so, did not allow to continue) a "percentage of shares" overhang problem. The perception that the overhang is "too high" usually impacts a startup well before an IPO. It may occur when investors are looking at the "Equity Plan" before an A or B (or even a Seed) round; or when potential employees are trying to develop their perception of what percent of the company they will "own" as of a hoped for future "Major Liquidity Event."[36,37] This perception may also occur when management tries to expand the option plan/pool to accommodate future employees and consultants. At that time, some members of the Board of Directors may disagree with management as to how much equity should be reserved for use by the employee and non-employee option plans. This can create problems if the CEO has committed the company in employee contracts or consulting contracts before the option plan expansion is officially authorized.[38] Overhang at the time of an acquisition (or for a startup that plans its "Major Liquidity Event" to be an acquisition) can be more acceptable as those startups may not be complete companies in that some functions such as sales and marketing may never have been established or fully developed. Examples include some medical device startups and some semiconductor chip startups.

36 Executive recruiters are more likely to correctly understand overhang as an issue than the potential employees.

37 If a startup replaces an officer or officers just before an IPO, vesting clauses in employment contracts may prevent overhang from becoming a problem from the company's perspective. However automatic vesting clauses in employment contracts (usually only for CEOs) can complicate this issue.

38 Some employee and non-employee option plans provide for the distribution of stock as well as options.

