



Capital Formation Planning for Early Stage Companies

by

David Burton

Haynes and Boone, LLP

2505 N. Plano Rd., Suite 4000

Richardson, TX 75082

Ph: 972-680-7554 / Fax: 972-692-9054

david.burton@haynesboone.com

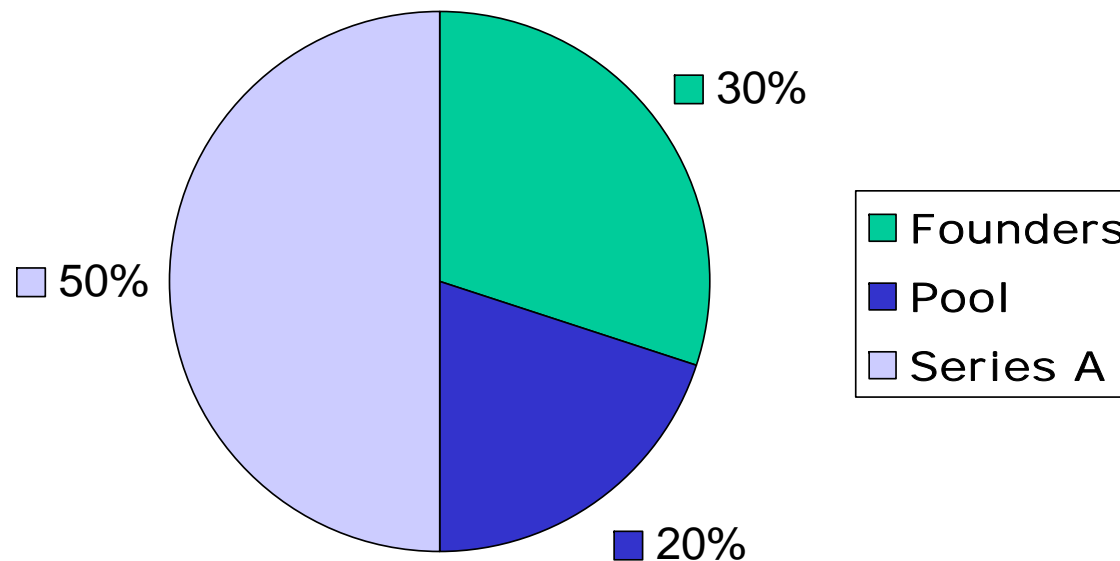
1. Three major categories

- 1. Founders**
- 2. Investors**
- 3. Employees**

2. Who will Own What?

Projected Capitalization for a Startup Company looking for Venture Capital

Series A Institutional Financing



3. Founders

- **Consider granting restricted stock**
- **Make an 83(b) election**
 - ✓ **minimal FMV issues**
 - ✓ **limits taxable income issues**
- **Address transfers, death, disability, divorce and termination of service**

4. Investors

- **Use an “investor class” of stock – i.e., preferred stock**
- **Allows flexibility for valuation differences between investors and employees**
- **Angel investors**
 - ✓ **use convertible notes until sufficient milestones are achieved to raise capital at an attractive valuation**

5. Employees

- **Stock options**
- **Adopt a written plan and standard forms of agreement**
- **Use a vesting schedule to retain talent**

6. Types of Stock Options

- **Non-qualified options**
 - ✓ **employees, directors, consultants**
- **Qualified options (ISO's)**
 - ✓ **employees only**

7. Non-qualified Options

- **Grant of option (assuming exercise price not below FMV on date of grant)**
 - ✓ **generally no tax consequences to the company or the participant**
- **When exercised**
 - ✓ **participant recognizes ordinary income based on the spread between the exercise price and the FMV on the date of exercise**
 - ✓ **company gets a corresponding tax deduction**

8. Tax Treatment of ISOs

- **When granted**
 - ✓ **same as non-qualified options**
 - ✓ **no tax consequences to company or participant**

8. Tax Treatment of ISOs (cont'd)

- **When exercised**
 - ✓ **neither the company nor the participant recognizes any income or receives a deduction**
 - ✓ **But – watch out for AMT**
 - **the spread between the exercise price and the FMV on the date of exercise is an item included in the calculation of a participant's AMT**

9. Incentive Stock Options

- **Rules must be followed to qualify as an ISO**
 - ✓ **must have a written plan approved by stockholders**
 - ✓ **participant may not sell stock following exercise until the later of:**
 - **2 years from date of grant, or**
 - **1 year after exercise**
 - ✓ **exercise price must be at least equal to FMV on date of grant (110% for 10% or greater stockholder)**
 - ✓ **must be exercised within 10 years of date of grant (5 years for 10% or greater stock holder)**

10. Restricted Stock

- **Stock that is acquired but is subject to forfeiture based on future vesting requirements**
- **Works best when FMV is low (*e.g.* – with founders)**
- **Must make an 83(b) election within 30 days of purchase**
 - ✓ **otherwise, will recognize ordinary income as restrictions lapse**

11. Important Do's & Don'ts

- **Keep good and contemporaneous written records**
 - ✓ stock ledgers
 - ✓ option ledgers
- **Document all stock and stock option transactions in writing and get board approval**
- **Avoid oral agreements or promises concerning a specified % of ownership**
 - ✓ stockholders should expect future dilution
- **Make sure you comply with applicable federal and state securities laws**
 - ✓ understand what exemptions you are relying on and what the requirements are to qualify the offering