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Business Development

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Getting it right the first time

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The first few decisions bioentrepreneurs make when forming a company can come back to bite them later, but some careful planning can smooth the way for later success.

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Company founders need one eye firmly on the future when they decide what type of business entity to form and how to allocate equity in that entity.

You have developed groundbreaking technology after years in the laboratory. You have validated the technology and decided to commercialize it. Now you need to determine when and how to start a company to make your dreams a reality. When to form a corporate entity, what form the entity should take, how to allocate the initial equity and the form of that equity are all major decisions bioentrepreneurs need to make at the very beginning of their ventures. These decisions can either lay a solid foundation for your business or set up a house of cards. For many scientists who have spent much of their lives doing research in laboratories, forming a business can be a daunting challenge—but it doesn't have to be. If you follow some fairly simple guidelines, the formation of your company can be the start of a very successful and rewarding journey (see Box 1).

Choice no. 1: timing is everything

Your first decision will be when to form an entity to start doing business. This decision is driven largely by two factors: the need to avoid personal liability and to issue founders' equity before the venture has significant value. You want to ensure that your personal assets are not subject to seizure by creditors of your business; forming an entity that provides limited liability to its equity holders will in most cases prevent this from happening. If you sign a contract for the business in your personal capacity, your personal assets can be taken to satisfy your company's liabilities. However, if a limited liability entity signs the same contract, only the assets of the entity can be used to satisfy liabilities, and therefore only what you have contributed to the entity is at risk. Before your business is at the point where you are being asked to sign a contract or agreement containing significant liabilities (that is, a lease, bank loan or joint venture), it is time to form a limited liability entity.

Another consideration that often drives the timing of the business entity formation is the issuance of the equity in the company to the founders. Founders typically receive equity in the entity at its formation for a nominal purchase price that is deemed to be the fair market value of the equity at that time. At the formation of a business, there is often relatively little value in the entity. If you wait to form your entity until there is significant value in the business—for instance owing to receipt of a financing term sheet or completion of a significant strategic agreement—tax issues may make it difficult to issue founders' equity at a nominal price. If a founder pays a nominal price for equity in a company having significant value, the founder may be liable for taxes on the difference between what she paid and the actual fair market value of the equity at that time. The issue is often most acute for founders who are not contributing significant property to the entity. To avoid a potentially large tax obligation at a time when you are not receiving any cash from the business and may not have the cash to pay any taxes, be sure to form your entity and issue your founders' equity before there is significant value in your business.

Choice no. 2: type of entity

Once you have made the decision that the timing is right to form an entity, what type of entity is right for your business? As a startup, your decision should be driven by the need to achieve the following: limited liability, limited complexity, limited expense and limited taxation. Although many types of entities are available, most emerging technology businesses form a 'C' corporation, an 'S' corporation or a limited liability company (LLC) in large part because all three provide limited liability.

Both 'C' and 'S' corporations (the names indicate the subchapter of the Internal Revenue Code the corporation is formed under) have the advantages of limited complexity and expense—the documents required to form them are relatively straightforward and each share of initial equity has the exact same rights. The corporate formation documents for a 'C' and an 'S' corporation are identical, except that the 'S' corporation must file an election with the IRS to get certain tax advantages. Unlike a 'C' corporation, which has a double layer of tax (at both the corporate and shareholder levels), an 'S' corporation has limited taxation because it is treated at the federal level as a flow-through entity. In a flow-through entity, the income of the business or, as is more likely in the case of a startup, its losses, are not taxed at the corporate level but flow through to the entity's shareholders. Each shareholder is taxed on a percentage of the income or loss of the business equal to the shareholder's percentage ownership interest in the entity.

Does this sound too good to be true? In some ways it is—there are both limitations on shareholders' ability to use these passive losses from the business to offset income earned in other ways and a number of requirements that must be met to be eligible as an 'S' corporation. To be eligible as an 'S' corporation, a startup can have no more than 100 shareholders who generally must be US resident individuals or certain types of trusts, and there can only be a single class of stock. For many technology startups, these restrictions are not a problem, so an 'S' corporation is often the entity of choice for technology entrepreneurs starting a business. When the business is ready for an angel or venture capitalist investment, the issuance of preferred stock (which is generally required in connection with such investment) will cause the entity to no longer be eligible as an 'S' corporation, so it will flip into a 'C' corporation at that time. The flip from an 'S' to a 'C' corporation can occur at any time with virtually no cost, no tax and no modification of corporate documents. Thus forming an 'S' corporation for your startup does not hinder, make more difficult or prevent a financing needed by your business to grow.

What happens if you aren't eligible to be an 'S' corporation? You can still form a 'C' corporation, which has all the same benefits as an 'S' corporation except for the limited taxation. This is often the right choice, especially if you either won't be able to use the passive losses from your business or you expect an outside financing of the business to happen soon—many venture capitalists won't invest in an LLC because of disadvantageous tax consequences to certain of their limited partners, and therefore require the conversion of an LLC to a 'C' corporation before any investment. However, if a financing is not expected soon and you believe you will be able to use flow-through losses from the startup business, you may choose to form an LLC. Although an LLC has the advantage of one level of tax similar to an 'S' corporation, the LLC structure is typically more complex and expensive to set up.

An LLC allows the founders to allocate profits and losses and make distributions to its members in any way they wish—unlike either a 'C' or an 'S' corporation, each equity interest in an LLC is not required to have identical rights. With this flexibility, however, comes added complexity and expense—both in setting up the entity and in issuing incentive equity compensation to employees. It is also more complex and expensive to convert an LLC to a 'C' corporation upon an outside financing because the corporate formation documents for each entity are completely different. Although the flexibility that an LLC offers may be attractive for some types of businesses (financial or professional service firms in particular), many entrepreneurs starting an operating biotech or technology company will choose the simplicity and low cost of either an 'S' or a 'C' corporation as the initial entity.

Choice no. 3: allocating equity

Next, you need to determine how the ownership interests in your entity should be allocated. Think about the allocation of founders' equity in two different ways—compensation for past contributions and incentive for future contributions. Consider what each founder has contributed to the development of the business up to the point of entity formation and recognize that these contributions can take many forms (concept development, technology development, development of the business plan and monetary contributions are all forms of contributions). Not all pre-organizational contributions need be given the same weight—the scientist who spends years in the lab developing the technology will have a larger allocation of equity than the business school student who helps write a business plan.

When allocating founders' equity, you also should consider whose contribution is needed going forward to make your business successful. Make sure you allocate enough of the equity to give the people who will be driving the business proper incentives—even if you have dynamite technology, you may end up owning a big percentage of nothing if you don't have someone to build the business. A researcher who developed the technology but isn't going to play an active role in running the business will often give up some equity to increase the incentives for the business people to build a large and successful business. What is important in allocating founders' equity is who owns what percentage of the entity, not the actual number of shares each founder owns. Whether a founder owns 100 shares in a company that has issued 1,000 shares, or 100,000 shares out of an issued 1,000,000 shares, is irrelevant—the founder still owns 10% of the outstanding equity of the entity. You can always do a stock split at the time of a financing to get the numbers to work.

Regardless of how you intend to allocate the founders' equity, make sure that all founders agree on the allocation. Take the time to discuss the allocation among the founders before you form your entity to ensure there are no misunderstandings, unfulfilled promises or unmet expectations. If there are disagreements among the founders or claims by other people to equity in the company, now is the time to resolve them. Disagreements over equity only get worse as the value of the company increases. Building a business is difficult enough when all the founders' interests are aligned, but it is almost impossible if you start out with disagreements over equity allocations.

Choice no. 4: type of equity

Once you know how much equity each founder is going to receive, you have to determine its form. Founders who form a 'C' or an 'S' corporation generally receive either restricted common stock or options to purchase common stock. What is the difference between the two and why would you issue one rather than the other?

Founders often acquire restricted common stock of a company at a nominal purchase price in return for contributed services or assets such as intellectual property (IP). Especially when the technology is developed at an academic institution or hospital, or with government funding, it is imperative to have the founder assign his IP rights to the company in return for the restricted stock and to make sure the company secures all other IP rights from third parties needed to run the business. Upon the purchase of the common stock in return for the founder's contributions, the founder receives all ownership rights in the stock—the founder can vote the stock and the founder's capital gains tax holding period on the stock starts (if a founder holds shares of capital stock for longer than one year, upon a sale of the stock he would be taxed at the long-term federal capital gains tax rate of 15%, compared to a tax rate of 35% if he holds the stock for less than one year). Common stock purchased by founders is typically subject to various restrictions to protect the company and the other founders. Typical restrictions include those on the transfer of the stock, the company's right of first refusal to repurchase the stock if the founder wants to sell it, and reverse vesting, which gives the company the right to repurchase the stock if the founder leaves the company. You don't want founders on whom the company depends transferring their shares to people you don't know.

Alternatively, a founder can be granted options to purchase shares of common stock of the company. An option is the right to purchase shares of a company's stock in the future at a price typically fixed on the date of grant. Unlike restricted stock, the option holder has no ownership rights in the stock, and the capital gains tax holding period does not start until the option is exercised. With an option, the founder would have to hold his stock for at least one year following the exercise of the option to take advantage of the lower capital gains tax rate upon a sale of the stock, and unfortunately this often does not happen—many options are exercised only in connection with a liquidity event like the sale of the company when the holder is able to convert the underlying shares of stock into cash.

An option is also typically subject to forward vesting, meaning the holder is required to maintain her business relationship (whether employment, consultancy or directorship) with the company for set periods of time before she is allowed to exercise her right to purchase the underlying shares of stock. If the option holder leaves the company before any of the option vests, the option terminates, the option holder has no right to purchase the underlying shares and the company has no need to repurchase any shares. The option exercise price generally equals at least the fair market value of the stock on the option grant date, but the option holder doesn't pay the exercise price until the option holder exercises the option. This avoids the tax issue described above when stock is issued to founders at below fair market values and is why options are typically granted once there is value in the business.

Although options may be appropriate for a founder who joins the company at the time of formation and thus hasn't contributed to the business before formation, founders of biotech and technology companies will generally receive restricted stock at the formation of the entity because of the advantages discussed above. Thereafter, as the business progresses and increases in value and restricted stock is increasingly difficult to issue for a nominal price without disadvantageous tax consequences, you will generally grant options with forward vesting to employees, consultants and others helping to build the business.

Choice no. 5: vesting

Reverse vesting on restricted stock issued to founders at the formation of your entity plays a significant role in protecting the collective interests of the founders and your company. Vesting protects the company and the other founders from a founder leaving the company and taking his stock without performing the services he was expected to perform and in anticipation of which he received his equity position. If a founder terminates his business relationship with the company for any reason before the vesting time periods have occurred, the company will have the right to repurchase some or all of the founder's shares of stock. The amount that may be repurchased depends on the particular vesting schedule, which in technology companies typically ranges from three to five years. Vesting can be annual, monthly or quarterly and often companies will require at least a one-year period before any shares of stock become vested (known as 'cliff vesting'). For example, if a founder has a four-year vesting schedule with quarterly vesting and leaves after 13 months, he will have earned 25% of his shares of common stock and the company is able to repurchase 75% of the common stock at the purchase price originally paid by the founder. Occasionally, founders will decide that it is appropriate for some or all of them to get vesting credit for their pre-organizational contributions, and therefore some portion of their common stock will be fully vested on issuance. If you do this, make sure that the portion of fully vested shares is small enough so you don't defeat the entire purpose of vesting.

A final consideration when dealing with vesting of restricted common stock for founders is what happens to the founders' equity on a change of control. Does it then make a difference if the founder remains with, or is terminated by, the acquired company following the change of control? Founders often want 100% of their restricted stock to vest automatically on a change of control (known as a 'single trigger') based on their having earned their equity by building the company to the point when it is ready to be sold and therefore having created value for all investors. This full acceleration of vesting on a change of control increases the costs to a potential acquirer because the acquirer must issue additional equity incentives to those founders it wants to keep after the acquisition. Investors often will not agree to full acceleration on a change of control for founders as it may make it more difficult to complete a likely liquidity event. A frequent compromise position is to have a portion (usually 25–50%) of a founder's unvested shares accelerate on the change of control with the remainder vesting in accordance with the continued vesting schedule. One proviso is that 100% of the remaining shares of common stock should accelerate and be fully exercisable by the founder if a founder's business relationship with the company or the acquirer is terminated without cause or after the change of control (known as a 'double trigger'). The double trigger is often more acceptable to acquirers and thus investors, because the founder only gets 100% of her shares vested if her employment is terminated by the acquirer in connection with or after the change of control —if the services of the founder are not wanted following the change of control, the acquirer doesn't need to grant additional incentives to retain the services.

If founders receive restricted common stock subject to vesting, they will often file a Section 83(b) election. This is an election to be taxed at the time of the stock issuance on the difference between what the founder paid for the stock and the stock's fair market value on the date of issuance. Because founders generally pay fair market value for the restricted common stock, the 83(b) election often results in no tax obligation. If an 83(b) election is not filed within 30 days of the stock issuance, the founder will be subject to tax each time a portion of the stock vests equal to the difference between what the founder paid for the stock and the then-fair-market value. If the stock appreciates in value as you build your business, this can create a significant tax issue for founders.

Things to remember

The time has come to translate the breakthrough technology you have developed into a business that will create products and bring them to market. You don't want to do anything that prevents you from accomplishing the steps necessary to build a vibrant business, such as raising money, attracting strategic partners and hiring the right executives. Creating a successful business is a difficult challenge—give yourself the chance to succeed by doing it right from the very beginning. Remember three things: keep your corporate structure simple and clean; make sure all your founders agree on the equity allocations and the direction of your business; and have fun, work hard and hang on for the ride.

Box 1: Dos and Don'ts

Do

1. Establish the right form of entity for your business at the right time so you don't incur personal liability or create disadvantageous tax issues.
2. Allocate the equity in your entity based on both past and expected future contributions to your business in a manner that gives the right people incentives to build a successful venture.
3. Protect the interest of your company and all of the founders by having reverse vesting on the restricted stock granted to founders. This ensures that your entity will continue to benefit from the services of those people you need to grow the business.

Don't

1. Personally sign a contract for the business that has significant liabilities.
2. Wait to issue your founders' equity until you have a financing term sheet or significant agreement.
3. Promise equity in your business to people before the founders have agreed on the equity allocation.
4. Allocate too much equity to past contributors and not enough to those individuals needed to build the business.
5. Make your entity and equity structure too complicated.
6. Fail to file an 83(b) election within the 30-day period.