

UNIVERSITY OF ILLINOIS
AT URBANA-CHAMPAIGN

Startups: Incorporation, Funding, Contracts, and Intellectual Property

Professor Barich
Class 3



illinois.edu



Today

- Review Quiz #1
 - Check grades on compass
 - Some questions will reappear on Exam #1
- Incorporation and Funding Project
 - Team Project Presentations – Thursday, Sept 20th, 7pm, Room TBA
 - Construct Teams later in the class
 - Example presentation template available online



Initial Ownership Agreements -1

- Often very informal
 - “Why complicate things? Everything is going to go great!”
 - Greed, fear, and immaturity
- Lack of clarity of ownership and control
 - Actual/Attempted “re-negotiation” or retroactive “misunderstanding”
 - Failing to be clear may be expensive
 - The better the company does, the more it will need to rely on its clarity of ownership and control
 - Difficult issues of O and C only become more so when



more money is added

Initial Ownership Agreements -2

- Founder's Agreements
 - Many startups initially operate informally and may use a document called a Founder's Agreement
 - “Founder's Shares”?
 - Agreements are not standard and may vary significantly
 - Not all founders may have the same agreement
 - Isn't this really just a partnership?
 - See SeedHack Example



Vesting

- Grants of stock or other ownership may “vest”
 - Ownership of the stock is transferred from the company to the employee when a vesting event takes place, such as passage of time
 - Examples: Employee entitled to 100 shares if she stays with the company full time for three years – but what timeframe?
 - Vest 25% immediately, 25% at end of 1st, 2nd, and 3rd years
 - Nothing immediately, 1/36th each month
- Stock that fails to vest remains owned by the company
 - Useful to keep employees around
 - Almost always used in practice



Stock Dilution -1

- Stock dilution takes place when the company issues new shares, thus making your current shares represent a lesser interest in the company
 - Can be issues of control due to changes in percentage ownership
 - Often a “necessary evil” in order to gain capital, for example for corporate growth or to cash out
 - “Pie may have gotten bigger”
 - Your shares may not have decreased in financial value after dilution



Stock Dilution -2

- Dilution Example
 - You own a company with a value of \$1M and 100 shares (100% ownership – each share is 10K)
 - Accept \$500K in investment (**50 new shares**)
 - You now own 100/150 shares of \$1.5 company
 - 66.6% ownership still worth \$1M
 - Company value gradually increases to \$15M
 - Your 100 shares now worth \$10 M = \$100K each
 - “Go public” - \$5M stock offering (**50 new shares**)
 - You own 100/200 shares of company worth \$20M
 - Company value gradually increases to \$200M
 - Your shares worth \$100M
 - Easy to cash out by selling to the public
 - Note: Can have a stock split at any time
 - “Each share is now 10 shares” – no change in total value



Restrictions on Transfer of Stock

- Want to maintain control of company by “locking in” ownership of shares
- Example: A, B, and C form GoodGuys, LLC. (GG) C gets tired of working for the LLC and sells his interest to Evil Corp, the main competitor of GG
 - Evil Corp only has 33.3% interest, but that may be enough to significantly adversely impact the operation of GG
 - Evil Corp as a member of the LLC may be entitled to the internal information of GG
- Common Examples
 - Requirement to sell only to company or other shareholders
 - Right of first refusal
 - Automatic repurchase by company for certain events
 -  Bankruptcy, divorce, death

Incorporation and Funding Project -1

- A, B, and C are forming Ultra Corp to develop and sell a telephony application for use in voice-driven menus for call centers (a \$10B+ industry). The app can determine the emotional state of a caller based on an analysis of their voice signal and the system adapts the voice-driven menu based on the caller's emotional state. For example, really irate people may be advanced in the queue or routed to specially trained operators
- A is a professor that has done preliminary research on determining emotional states based on components of a voice waveform
- B owns a small telephony app programming company for the call center industry
- C is a believer in the technology and is willing to put up the \$
- The company will require at least \$1MM to develop a viable product
 - Form Teams – Grad Student Team Leaders, responsible for coordinating presentation



Incorporation and Funding Project -2

- Evening presentations–Thurs 9/20 (Next Week!) –
 - 7 pm, Room TBA
 - Powerpoint presentation – e-mail to me by 5pm on 9/20
- What value are you assigning to Ultra at this time? How do you value your respective contributions?
- Who gets what percentage of ownership of Ultra? Any ownership arrangements like vesting or voting modifications?
- How do you structure the company? Partnership? LLC? C or S-Corp?
- How does control work? Will there be a CEO – if so, who? Also, if there is a central leader like a CEO, what actions can the CEO perform without a vote of the equity owners and what actions must the equity owners decide? Will acts be decided by a majority of the share owners? A majority of the people owning shares? Unanimous consent?
- What other negotiated features will your business entity contain?
- Focus on negotiation process at least as much as eventual result



Next Week

- Funding arrangements/How startups get money
 - Equity
 - Loans
 - Grants
 - Stock Options
- Lots of complex material next week – I urge you to review the Coursepack beforehand!



Questions?

See you next week!

