Founders and Initial Equity Distribution for Startups

Moderator;

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Speakers;

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Today's Panel Focus

- Providing founders with a "fair and equitable" equity share often is critical to the success or failure of a startup
- We will discuss equity distribution for the founders of startups based on University IP
- We will highlight issues and make recommendations
- Speakers will present their experience with Startups and what went wrong or right; and how to best proceed.
- Panel follow up
- Q and A

Thoughts and Dilemmas

- If Entrepreneurship is a battle, most wounds are self inflicted (N. Wasserman "Founders Dilemma")
- Founding Team's harmony is critical (est. 65% of new companies fail because of founding team)
- Equity is the reason entrepreneurs start companies (not salaries)
- What should founders share be based on: past or future contributions; magnitude of the contribution?
- Should Founders receive equity on conception or over time?
- Are there specific institutional policies or practices that effect distribution and result in non-uniform?
- What are recommendations for "fair and equitable " equity distribution; can you have "corrective" actions after formation?

University Response to Equity in the License

- University Policies vary greatly
- Conflict of interest rules
- Restriction on clinical research
- Equity Distribution vs royalty sharing policies
- Founders' equity and University Equity
- Equity from direct investments in newco

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Founders and Initial Equity Distribution for Startups

Abi Barrow

University of Massachusetts President's Office,
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Founder Discussions

- "The Very First Mistake Most Founders Make" – Noam Wasserman (Harvard) and Thomas Hellmann (Oxford)
- Temptation to split equally and not really discuss contributions
- Founders need a substantial discussion on contributions
- The outcome needs to be formalized

- The 60/40 spilt in one student start-up

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What is Vesting? Why do we need it?

- Vesting – founders and employees don't acquire shares until a specific date or milestone has been met
- Understand who vests and who doesn't vest – and why they are different
- Vesting schedules

Owns Shares Outright (past contributions)	Needs to Vest (future contributions)
Academic co-founders	Business co-founders
University	New employees

When one founder has too much?

- Academic co-founders often believe that their contribution is the major asset of the start-up company so they should get the majority of the equity
- Case Study 1
  - The academic founder took majority ownership
  - This reduced shares that could be given to other co-founders and early employees and gave him too much control of the board
  - Unbalanced ownership and incentives for other founders and investors
  - Company raised a small amount of angel funding but was not able to raise sufficient funding to be successful and failed after 2 years

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When the split is worked out fairly

- Case Study 2
  - Founding scientists believe they should have over 50% of founding stock
  - Founding entrepreneur (CEO) – decides that this deal may not work for her
  - Education of founding scientists
  - New negotiation
    - CEO receives same %'age of ownership as the combined founding scientists
    - Small pool of available shares for new employees, board members, SAB etc.
  - Company has raised two rounds of investment and is still a going concern

When students are involved

- Case Study 3
  - Start-up company licenses technology and several grad students have intimate knowledge of the technology
  - Students become co-founders and are given equity
  - However, students haven't yet graduated so now we not only have a conflict of interest issue with the faculty founders but also the students
  - Several of the students left fairly soon after company founding as neither revenues nor investment was flowing in and they needed to be paid
  - Their stock was crammed down in a subsequent funding round
  - Need to help students understand equity and the risks
  - Need to try to ensure that students don't get equity until they leave the university

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Distribution of Founders Equity

Robert Creeden

Managing Director – UVA LVG Seed Fund

Issues in Founder Equity Distribution

- Never divide equity by head count: a recipe for corporate divorce among founders
- Studies and my experience demonstrate that one or more founders will move on, be terminated or voluntary depart inside of 24 months
- No understanding of fundamental roles and responsibilities of each of the founder team members: what will leach founder contribute directly to the enterprise over the next three years?
- Reduction in Founder's equity for failure to perform assigned roles and responsibilities, semi-annual assessment
- Know the rules of your institution - COI

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What to do?

- Issuance of Restricted Stock, subject to a four-year vesting schedule, with a one-year or even eighteen-month cliff vesting period
- Company can repurchase a portion of the restricted stock if the disinterested Board determines that any particular Founder has not contributed to his or her assigned roles and responsibilities (Stockholders Agreement)
- Learn from the market of similar companies: ask around, seek advice from other founders (who are not academics), advisers
- Make sure you also set aside a reserve of equity for additional hires, full or part time
- Make disciplined assessments of annual performance of the founder team, and be ready to make the tough decision
- Biggest Disappointment: the founder who does not contribute and who is riding everyone's coattails

Other thoughts

- Consider redistribution and reclassification of Founder Equity (but early enough) when the company has no earnings or profits, avoids a tax problem
  - Nonparticipating Founders agree to return some of their shares
  - Additional issuance of stock or stock options to fully participating founders
- Talk to angel and venture capital investors before you plan the equity distribution: they will inform you whether the equity is properly allocated
- Unfair Equity Distribution portends financing difficulties later: investors will want the company to “fix the problem” before investment, and the longer you wait, the harder the solution and the bigger the tax problem
- One takeaway: Academic Entrepreneurs invariably overestimate their initial and continuing worth to the enterprise.
- The Warning Sign: Is the Academic leaving to join full time, or prefers to remain on the Faculty