Questions or Comments?

Type them into the questions box!

"Why am I muted?"

Don’t worry. Everyone is muted except the Presenter and the Host. Thank you and enjoy the show.

Chat

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**How to Approach Gender, Language, and Intersectionality**

Wed., June 23, 2022 | 2:00pm-3:15pm ET

Co-produced with ACS Office of Diversity, Equity, Inclusion & Respect

**Chemistry and the Economy: 2022 Mid-Year Review**

Wed., June 29, 2022 | 2:00pm-3:00pm ET

Co-produced with ACS Industry Member Programs

**Starting a Company: How to Set Up Essential Business Contracts**

Thurs., July 28, 2022 | 2:00pm-3:15pm ET

Co-produced with ACS Division of Small Chemical Businesses and ACS Division of Business Development & Management

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THIS ACS WEBINAR® WILL BEGIN SHORTLY...

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Starting a Company: How to Set Up Equity and Securities Structures

BENJI JONES, JD, MA
Co-Founder, Innovate Capital Law and Adjunct Professor, Campbell University School of Law

H.N. CHENG, PhD
ACS Immediate Past President

JIM SKINNER, MBA
ACS SCHB Chair and CEO, Terregena, Inc.

DIANE GROB SCHMIDT, PhD
2015 ACS President and Adjunct Professor of Chemistry, University of Cincinnati

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Download the Presentation Slides Under GTW Handouts Section
FUNDAMENTALS OF CORPORATE STRUCTURE

Ownership Tied to “Stock” Issued to Persons/Entities

Control Tied to Whether “Stock” has Voting Rights and Whether Rights are Limited By Contract

Fundamental Rights attached to “Stock” (voting power, liquidation, dividends) are defined in Certificate of Incorporation

“Capital Structure” (i.e. max number and type of shares) defined in Certificate of Incorporation. Usually is more than stock issued.

VOCABULARY LESSON #1

- “Charter” (Certificate of Incorporation or Articles of Incorporation)
- Bylaws
- Board of Directors
- Officers
- Equity
- Capital stock
- Common stock
- Preferred stock
- “Authorized but unissued” shares
- “Issued and Outstanding” shares
- Shares "reserved" for future issuance
- "Cushion" or "Dry Powder" in the context of shares
- "Founders" Stock
- “Super Shares”
- "Restricted " Stock
- Vesting
- Forfeiture
- Equity Compensation/Sweat Equity
- Deadlock

ARTICLE VII
AUTHORIZED SHARES

The number of shares the Corporation is authorized to issue is [number of all shares (_______)]; of which [number of all common shares (_______)] shares shall be Common Stock, par value [par-value common shares] per share (the "Common Stock") and [number of all preferred shares (_______)] shares shall be Preferred Stock, par value [par-value preferred shares] per share (the "Preferred Stock").
**BASIC SCENARIO**

Three-person Founder Team

- Two will work "full time" on company (CEO (100%) and CTO (50%))
- One is a university professor – inventor of IP to be used by Company. He will not leave his university position and will act more as an advisor
- University will expect to have some form of ownership of Company through tech transfer office.

Founders have been "working" on IP and business concept for over 3 years. Want to apply for grant funding

Need to form a Company: Delaware C-Corp

Currently no employees, but anticipate need to use “sweat equity" to top 5-10 employees in future

Will need to raise outside capital but founders are not clear how to structure and what form it should take

---

- Is there one key person “in charge”, if so, who?
- Who is on Board?
- How is ownership divided?
- Will everyone have same voting power?
- Will ownership be subject to vesting/repurchase or other forfeiture?
- If vesting, will “credit” be given for prior "work"?
- Can university own voting shares?
- Does university have a cap on ownership % and will it have antidilution protection to maintain ownership?
- How much of the Company do you want to put aside for employees?
- Should employees get voting shares?
- How much capital ($) do you need to launch the company?
BASIC SCENARIO

Is there one key person “in charge”, if so, who? Prefer this to be “yes” – deadlocks can be challenging. Assume CEO is “main” founder.

Who is on Board? Recommend ODD number of persons on board to avoid deadlock. Could be all three founders or could just be CEO to start. Th is more challenging if you have an even number of founders. University rules may limit Inventor from being on Board. Outside investors may require board position in future. Assume CEO is sole director.

How is ownership divided? Critical question: if equal, what threshold of vote controls (majority? Super majority)? (More challenging if even number of owners). Assume ownership is commiserate with time invested. (See Cap Table)

Will everyone have same voting power? Use “super shares”? Assume no. Not typical outside of Silicone Valley.

Will ownership be subject to vesting/repurchase or other forfeiture? Unless founders are putting a significant amount of $ into the company at formation, this is typical, but not required. Outside investors may expect it later. (4 years, 1 yr. cliff, monthly thereafter). Forfeiture is case by case

If vesting, will “credit” be given for prior “work”? Not unreasonable in this circumstances.

Can university own voting shares? Case by case, assume here no they can.

Does university have a cap on ownership % and will it have antidilution protection to maintain ownership? Case by case, Assume cap at 10% and no antidilution protection.

How much of the Company do you want to put aside for employees? Amount varies. 7-15%. Assume 10%.

Should employees get voting shares? Case by case, assume here yes.

How much capital ($) do you need to launch the company? Minimum amount you can pay for shares is “par value” (which can be very low), but you may need “more cash” to handle initial operating expenses. Assume about $10K. (Alternatively, could do founder loans, but assume not)
BASIC SCENARIO

At Organization

Charter filed with DE. Incorporator appoints board, approves bylaws and charter. Board will undertake initial corporate approvals – issuance of stock to founders and, if complete, University tech transfer documents; may approve Equity Compensation Plan (but could be delayed)

Bylaws include typical rules (majority of Board and SH) plus we recommend:
- Transfer Restrictions
- Right of First Refusal benefiting Company (may be assigned)
- Drag-Along Rights
No Voting Agreement needed at this time because of allocation of shares.

Founders will each sign a "Founder's Restricted Stock Purchase Agreement" which will contain vesting terms and forfeiture provisions. Will also required Founders to assign IP. Additional employment/consulting documents may be needed (Section 83b election).

Board approves tech transfer arrangements with University, including issuance of shares.

We recommend not issuing stock certificates but doing "book entry" uncertificated shares

WHAT'S NEXT? VOCABULARY LESSON #2

1. Transfer Restrictions
2. Lock-up or Market Stand Off
3. Tag-Along/Co-Sale Rights
4. Drag-Along Rights
5. Rights of First Refusal
6. Participation Rights/Preemptive Rights
7. Pre-Money Valuation
8. Post-Money Valuation
9. Dilution
10. Typical Rights of "Preferred Stock"
- Liquidation Preference/"Participating" Preferred
- Dividends (Cumulative/Compounding)
- "Protective Provisions"
- Priced-Based Antidilution Protection
- Conversion Rights/Conversion Ratio
- Underlying Shares
- Redemption Rights
WORKING WITH LEGAL COUNSEL to RAISE CAPITAL

- Make sure you **KNOW** how to navigate Securities Law exemption(s) and how you are communicating with potential investors
- Get help with offering **STRUCTURE** and **STRATEGY**
- Have counsel **REVIEW** your marketing campaign, if used or permitted to be used
- Have counsel **SIGN OFF** on your Disclosure Statements

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Big Bang: Expanding Universe of Types of Securities

<table>
<thead>
<tr>
<th>Common Stock*</th>
<th>SAFEs*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible Preferred Stock*</td>
<td>KISS</td>
</tr>
<tr>
<td>Convertible Notes*</td>
<td>Revenue Share Notes</td>
</tr>
<tr>
<td>Notes with Warrant Kickers</td>
<td>Royalty Sharing</td>
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<tr>
<th>SAFTs</th>
<th>Clawbacks</th>
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<td>Coins</td>
<td>Hybrids</td>
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<td>Tokens</td>
<td>Air Drops</td>
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<tr>
<td>Dual Tokens</td>
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PROMISSORY NOTES


• Most non-bank promissory notes are securities
• Debt that has priority in liquidation over all equity
• Secured or unsecured
• Demand
• Fixed Term
• Installment
• Line of Credit
• Can be combined with equity kickers (like warrants)

BRIDGE CONVERTIBLE NOTE

Conversion Price depends on the price of a future Priced Equity Round
Price Equity Round is usually Preferred Stock
Conversion Price is often the lower of:
- a discount from the price of the priced equity round
- a maximum pre-money valuation
Usually automatically converted when Company raises a stated amount of capital in a Priced Equity Round
May have the option to convert before a Priced Equity Round at a fixed conversion price
Usually earns a small amount of interest, but interest is converted
Originally was used for short term (e.g. 90 days) bridge loans from a VC investor to keep the company alive until close bigger investment
Has evolved into longer term maturity (one to two years)
Most often used in financings of $100,000 to $1 Million
Documentation is less costly than for a VC Convertible Preferred Stock Round
Fewer contract rights and protective provisions than in a Priced Round
Often used as a way to avoid a full valuation of the Company – later investors value the Company and negotiate detailed terms
COMMON STOCK

- All economic and voting rights that are not allocated to any other class of security and are permitted or required by the state statute
- Can be multiple classes
- Sometimes Voting and Non-Voting
- Sometimes one class can be convertible into another class
- Charter, Bylaws or Shareholders Agreement may impose transfer restrictions, pro rata, first refusal co-sale, come along, drag along, buy-out and other rights and obligations

VC CONVERTIBLE PREFERRED STOCK

- Preference in Liquidation over Common Stock usually Purchase price plus any accrued unpaid Dividends
- Toxic Preferred has Multiple of Purchase Price
  - Participating Preferred
  - Non-Participating Preferred
- May have a fixed annual dividend or may have same dividend rights as the Common Stock
- Convertible into Common Stock at fixed Price
- Antidilution Protection
  - Full Ratchet
  - Weighted Average
- Redemption Rights
- May or may not vote as same class with the Common Stock (on as converted basis)
- Often Class Vote for Stated Number of Members of Board of Directors
- Protective Provisions – list of events over which the company cannot do unless a majority or higher percentage) of the class of Preferred Stock votes to approve (Veto Rights)
- Contract or Charter Rights
  - Information
  - Drag Along
  - Pro Rata
  - First Refusal on Founder Re-Sales
  - Come Along
  - Registration
SEED PREFERRED STOCK

Often mimics the VC Convertible Preferred with less onerous rights
- Non-Participating Liquidation Preference
- No Fixed Dividend
- Fewer Protective Provisions
- Fewer or no Board seats
- Weaker anti-dilution protection
- No Redemption Right or longer period
- Fewer contract rights

SHADOW PREFERRED STOCK

A class or series of Preferred Stock that has similar rights as another class or series
Often issuable upon conversion of Notes to reflect a conversion price that is lower than new investors pay for Preferred Stock
Differences most often focus on
- Liquidation preference
- Dividend rights
- Trigger for anti-dilution protection
- Might include Voting or Protective Provisions
SIMPLE AGREEMENT
FOR FUTURE EQUITY
(SAFES)

- A contractual right to receive stock or the economic benefits of stock at some later date
- Keeps the number of actual shareholders low
- Formula for determining the number of shares is often similar to the conversion rights of a convertible note or agree to Most Favored Nation

Primary differences from convertible note are:
- No debt on balance sheet
- Usually, no interest
- May not receive equity until the company is sold or does IPO

TYPES OF SAFES
- Pre-Money SAFEs
- Post Money SAFES (include in the conversion calculation all shares issuable on conversion of all SAFES)
- Crowdfunding SAFES – defer conversion until liquidity event
- Pro Rata Rights Side letter gives SAFE investors right to maintain % ownership

WARRANT KICKERS

Warrant is issued to provide the investor with upside
Right to purchase shares in the future at a fixed price
Right expires if not exercised during a stated period
May have antidilution protection
Often has cashless exercise provision
REVENUE SHARE NOTES

Similar to a Promissory Note
Instead of a stated interest rate, the borrower agrees to repay a fixed multiple of the amount borrowed (e.g. 1.75x or 2x)
Fixed stated maturity date when the unpaid balance of the loan is due (often 5 years)
Monthly or quarterly installment payments
Installment payments fluctuate up and down based on a agreed percentage of the borrower’s revenue each month or quarter
Investor’s ROI increases if the loan is repaid before the final maturity date

LIMITED LIABILITY COMPANY (LLC) SECURITIES

% Interest in P&L
Units mimics a share of stock
Profits Interests – as equity comp
Members Interests vs Units Owner
Flexibility – can duplicate almost any type of rights of a security in a corporation subject to partnership tax rules (beware of capital account partnership tax rules)
Not all LLC interests are Securities, but most manager-managed LLCs are
INVESTMENT CONTRACTS

Howie Test: Catch-all concept the SEC Uses to Have Securities Laws Cover Hybrids and New Types of Securities
- invest money or other value
- in a “common enterprise”
- led to expect profits
- solely or primarily from the efforts of others
Can turn real estate into a security (E.g. Condo Hotel)
Some digital assets (tokens/crypto) are investment contracts

DIGITAL ASSETS (TOKENS)

Security Token
SAFT (Simple Agreement for Future Token)
Simply Digital form of ownership of a Traditional Type of Security
Ownership of a Fractional Part of a Stream of Revenue or Profit from a Defined Product or Service
Stable Coin – backed by an asset and redeemable for the asset
Benji Jones and Jim Verdonik

Crowdfunding & Venture Capital
Public Securities
Corporate Formation
Business Law Clinic
Entrepreneur Education & Economic Development

50 Years Combined Experience

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The Live Q&A is about to begin!
Keep submitting your questions in the questions window!

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