About the Founders Agreement Guidebook:

This guidebook was compiled by the New York State Science & Technology Law Center to provide information to individuals evaluating the feasibility of a new, technology based business. The founders can be so focused on the research and development of the technology that they fail to anticipate issues critical to the success of a venture that must be decided on at an early stage to prevent problems in the future.

About the NYS STLC:

The New York State Science & Technology Law Center (NYS STLC) is located at the Syracuse University College of Law's Innovation Law Center. It has been a leading resource in technology commercialization since 2005. Since its inception, the NYS STLC has assisted with hundreds of commercialization projects across New York State. It is funded by NYS Empire State Development's Division of Science, Technology and Innovation (NYSTAR) to facilitate New York State's economic development by leveraging the experience and expertise of law faculty and SU College of Law students to assist New York businesses and institutions in delivering new and emerging technologies to the marketplace.

Advisement:

The information contained in this pamphlet is intended to be a general guide for founders evaluating the prospects for a company to commercialize a new technology. The guide was written by Chris Horcek, Esq. a retired medical device company general counsel and retired professor in the Innovation Law Center at the Syracuse University College of Law. No part of this booklet, attachments, or related discussions constitutes legal advice or written opinion of counsel. For legal advice, please consult with an attorney. Any opinions, findings, conclusions or recommendations expressed are those of the Innovation Law Center and do not necessarily reflect the views of the New York State Department of Economic Development.

Table of Contents

1 Overview

Before a business begins, its feasibility is explored. The initial evaluation process typically involves a first set of activities that are performed for the purpose of determining the feasibility of the business. If the business is thought to be feasible, a further set of activities to form a company to conduct the business is undertaken. Each set of activities will generate business and legal issues that should be addressed by the people who are actively involved in evaluating the feasibility of the business. These people are the Founders, and this guidebook is written for them.

The guidebook identifies key issues likely to arise during the period of time in which the Founders are determining the feasibility of their contemplated business, before the decision on whether to form a company is made. These issues should be addressed in a written agreement that is made between the Founders, in their capacities as individuals, which will be referred to as a Founder's Agreement.

If the business is determined to be feasible, the key issues that will need to be addressed by the Founders in connection with forming a company are also discussed in the guidebook. The issues that arise in connection with the formation of a company are addressed by the written organizational and operating agreements for the legal entity that the Founders ultimately choose for the company (Company Agreements). The Founders enter into the Company Agreements in their capacity as members or shareholders in the Company.

The boundary between Founder's Agreements and Company Agreements is flexible and will depend on the circumstances of each startup company. Some of the provisions of a Founder's Agreement will be incorporated into the Company Agreements (directly or by reference), and the extent of overlap depends on the timing of the decision on whether to form a company. Founder's Agreements typically cover periods in which there are no sales revenue, no significant operating expenses (e.g. production and marketing) paid to third party suppliers or contractors, and no equity investors other than the Founders. To the extent that some factor, such as the need for outside equity investors to fund product development, accelerates the decision to form a company to a point in time before the feasibility of the business is known, the necessary provisions of the Founder's Agreement can be incorporated into the Company Agreements. The Founder's Agreements and Company Agreements are presented separately in this guidebook, because there are frequently-occurring startup scenarios in which only the Founder's Agreement will be necessary.

2 Issues to be Addressed in a Founder's Agreement

There are three key issues that should be addressed in a Founder's Agreement:

1) Pre-company Activities Issues relating to performing the work necessary to evaluate the feasibility of the business, (section 2.1),

2) Ownership Rights Issues relating to ownership rights in the business assets that are likely to be created by the Pre-company Activities, (section 2.2) and

3) Issues relating to the decision on whether to form a company.

2.1 Pre-company Activities

Pre-company activities typically include but are not limited to:

2.1.1

Characterizing the product or service concept for the business,

2.1.2

Preliminary market research - Identification and review of published material to characterize the market(s) that are relevant to the product / service concept,

2.1.3

Primary market research -- Primary market research consists of communicating with potential customers about the requirements for the product or service. In some instances surveys are conducted to assess aspects of the contemplated model,

2.1.4

Research and development - Research and development can take a number of forms. The design and specifications necessary to transform the product concept into a functional product or service offering must be created, independent verification can be very important , and

2.1.5

Creation of a business plan for commercialization of the product

2.1.6

Agreement on Founders Roles and Responsibilities - The Founders should agree on their respective roles and responsibilities in performing the Pre-company Activities. Each Founder's role and responsibilities should be described in terms of:

1) Identification of the specific Pre-company Activities to be performed and the amount of time to be committed (e.g. per week or per month) to each activity,

2) A description of work product deliverables to be provided to the other Founders, and

3) The contribution of money or other assets to be used in performing the Pre-company activities. The means to be used to track and account for the Founder's contributions of money and other assets

should be agreed upon, including how the value of assets other than money will be determined.

2.1.7

Confidentiality - The Founder's Agreement should include a provision that covers confidentiality. The confidentiality provision describes how the Founder's will identify information about the Pre-company Activities that is deemed confidential, and it establishes an obligation of all Founders not to disclose the confidential information to third parties. The Founders should also agree on the security measures to be used to prevent the confidential information from being inadvertently discovered or misappropriated by third parties.

2.2 Ownership of Business Assets

Pre-company Activities often create proprietary information, technology, product designs and specifications, and other intangible or tangible assets that have some potential value (Business Assets). The Founders' co-ownership rights in the Business Assets must be addressed, regardless of whether the Founders ultimately determine that the business contemplated is feasible and a company is formed to operate the business. The Founder's Agreement should define the Founder's respective co-ownership rights in the Business Assets.

The agreement on co-ownership rights should be informed by a basic understanding of how the relevant law (statutory law or common law based on court decisions) deals with co-ownership interests in the absence of any agreement. A summary of the legal rules regarding co-ownership rights in property is provided in the following paragraphs.

2.2.1 Co-Ownership Rights in Business Assets in General in the Absence of a Founders Agreement

In general, an asset that is created by the combined efforts of a

group of people is co-owned by the people whose work contributed to the creation of the asset. In legal terms, the asset is owned by the creators as tenants in common. Depending on the jurisdiction, the percentage of ownership allocated to each owner may be equal, or it may depend on the relative contributions of the work that was preformed to create the asset. It is important to recognize that this rule allocates a co ownership interest only to persons actually involved in the creation of the specific Business Asset.
The Founder's Agreement should explicitly define the Founders respective co-ownership interests the Business Assets with respect to the following considerations:

- Will each Founder be a co-owner in all Business Assets created by the Pre-company Activities of all Founders, or will each Founder be a co-owner only of the Business Assets that he or she helped to create. The former is preferred, because it promotes the joint effort of the Founders in the common enterprise of starting a business.

- Will each Founder's co-ownership interest in the Business Assets be equal, or will they be based on the relative co tributions of time, money, and property. The latter is preferred, but it requires that the Founders agree on th method by which their relative contributions of time and property other than money will be valued and whether the valuations will be updated periodically.

    - o Alternative methods of determining the value of each Founder's contribution to the development of the Business Assets relative to the contributions of all Founders include methods that put explicit dollar values on contributions of time and property at periodic intervals, such as annually, and methods that simply determine relative values for periodic intervals, without putting explicit dollar values on the contributions. The latter may be simpler to implement. There are many ways to implement either type of method. An example of the relative value method is provided in the next paragraph.

o Relative values for each Founder's contribution for an agreed upon time period can be expressed as percentages, with the largest contribution assigned a value of 100% (or 1) and lesser contributions assigned a value between 0 and 100%. For example, assume three Founders work for two years developing Business Assets. At the end of the first year, the Founders agree that they all made equal contributions, and at the end of the second year, the Founders agree that Founder 1 made the largest contribution, Founder 2's contribution was 75% of Founder 1's contribution, and Founder 3's contribution was 50% of Founder 1's contribution. There would therefore be 5.25 total "relative annual contributions", 3 in year 1 (1 for each Founder) and 2.25 in year 2 (1 for Founder 1+.75 for Founder 2+.5 for Founder 3). The Founder's relative contributions, and therefore co-ownership rights in the Business Assets, would be Founder 1 - 38% (2/5.25), Founder 2 - 33% (1.75/5.25), and Founder 3 - 29% (1.5/5.25).

2.2.2 Co-Ownership Rights in Business Assets that Include Intellectual Property Rights in the Absence of a Founders Agreement

Business Assets may include intellectual property rights that are potentially available to protect the values of the Business Assets. There are three types of intellectual property rights that can be used to protect Business Assets: 1) patents, 2) copyrights, and 3) trade secrets. The fourth type of intellectual rights, trademarks, applies to logos and brand names that come into existence only when the logo or brand is used in connection with the marketing and sales of products or services, and therefore they are unlikely to be relevant to Business Assets created before any sales of products or services have been made.

There are legal rules that define the rights of co-owners in the intellectual property rights that are inherent in the Business Assets, which supplement the above-described rules that govern ownership of the Business Assets in general. The rules on the rights of co-owners are different for patents, copyrights, and trade secrets. There are legal rules that define the rights of co-owners in the intellectual property rights that are inherent in the Business Assets, which supplement the above-described rules that govern ownership of the Business Assets themselves. The rules on the rights of co-owners are different for patents, copyrights, and trade secrets.

Patents
Each co-owner of an issued patent has: 1) the right to make, use, and sell products or services that embody the patent claims without payment of any royalties to the other co-owners, and 2) the right to non-exclusively license the patent to third parties without sharing the royalties with the other co-owners. No co-owner can exclusively license the patent to third parties or enforce the patent against infringement by a third party, unless all the co-owners agree to the license or agree to, and participate in, the legal action to enforce the patent.

Copyright
Each co-owner of a copyright has: 1) the right to make, use, and sell products or services that are covered by the copyright, subject to payment of a reasonable royalty to the other co-owners, 2) the right to non-exclusively license the copyright to third parties, subject to sharing the royalties with the other co-owners, and 3) the right to enforce the copyright against infringement by third parties without the participation of the other co-owners. No co-owner can exclusively license the copyright to a third party unless all the other co-owners agree to the license.

Trade Secret
Each co-owner of a trade secret has: 1) the right to make, use, and sell products or services that are based on the trade secret and 2) the right to non-exclusively license the trade secret to third parties. In both the foregoing situations, state law will determine whether royalties must be paid to, or shared with, the co-owners. State law will also determine whether each co-owner can independently enforce the trade secret against misappropriation, or whether an enforcement action must be joined by all co-owners. No co-owner can exclusively license a trade secret to a third party unless all the other co-owners agree to the license.

With the foregoing legal rules on co-ownership of intellectual property rights in mind, the Founder's Agreement should define the co-ownership rights that the Founders desire for their collective intellectual property rights in the Business Assets. The Founder's Agreement should provide that until the decision on whether to form a company is made, all co-owners must agree to any business use, licensing, or enforcement of the intellectual property rights in the Business Assets. This provision will ensure that if the decision is made to form a company, full ownership rights in the Business Assets and the associated intellectual property rights will be assigned to the company to enable commercialization.

2.2.3 Ownership Rights if a Company is Not Formed

The Founder's Agreement should also define the co-ownership rights that each Founder will have in the Business Assets, and their associated intellectual property rights (Business Assets-IP), in the event the decision is made not to form a company to conduct the contemplated business. It is desirable to provide for the same co-ownership rights for all three types of intellectual property that apply to the Business Assets, even though the legal rules are different for patents, copyrights, and trade secrets. The co-ownership rights in the Business Assets- IP should address the following:

- Whether each co-owner will have the right to independently make, use and sell products or services that embody the Business Asset IP (as a sole proprietor) and non-exclusively license the Business Asset IP; and whether each co-owner would be required to pay royalties to the other co-owners on such sales of products or services or to share royalties received from non-exclusive licensing to a third party.

- The Founder's Agreement cannot change the rule that all co-owners must agree to, and therefore sign as a licensor, an exclusive license, because the definition of exclusivity typically means that the licensee alone can commercialize the licensed intellectual property, to the exclusion of all owners.

- The Founder's Agreement also cannot effectively change the legal rules on enforcement of intellectual property rights through legal proceedings, because the governing federal or state laws are in the form of procedural rules for bringing legal actions in the relevant federal or state courts, and those rules for the administration of court cases cannot be changed by a contractual agreement between the parties to a lawsuit.

2.2.3 Decisions about Whether to Pursue Intellectual Property Rights to Preserve the Value of the Business Assets

The last key issue that is related to the ownership of Business Assets which should be addressed by the Founder's Agreement is the manner in which the Founders will decide what types of intellectual property rights will be pursued to preserve the value of the Business Assets and how the costs of pursuing the agreed upon intellectual property protection will be funded.

- All forms of intellectual property protection start with obtaining contracts that include assignments of intellectual property rights (to the Founders or their company) from persons other than the Founders who create the intellectual property. The cost of obtaining appropriate forms of agreement with assignments can usually be limited to less than a thousand dollars.

- The cost of applying for and prosecuting an application for a US patent can range between $5000 and $15,000, and there is no guarantee that an application will result in the grant of a patent. The costs are similar for each international jurisdiction in which a patent is pursued.

- Copyrights automatically come into existence when a copyrightable work is created, but there are costs if a copyright is registered. The costs of applying for and obtaining a registration of copyright are much less than patent costs, ranging between several hundred and a couple thousand dollars, depending on the complexity of the application.

- The costs of protecting a trade secret (in addition to the cost of contracts for assignments and confidentiality) consist of the cost of implementing the security measures necessary to maintain the secrecy of the trade secret.

2.3 Decision about Whether a Company should be Created

There are many issues that should be thoroughly considered by the Founders before making the decision whether to form a Company. This section summarizes a few of the key issues. Founders should consult with a qualified attorney and accountant to the extent necessary to fully understand these issues.

2.3.1 Business Plan with Revenue Forecasts

The feasibility of the business to be conducted by the Company should be demonstrated by a detailed business plan, which incorporates revenue forecasts that are based on adequate primary market research (ie direct feedback from potential customers) and costs that address all of the operational and regulatory requirements that the Company must meet. It is especially important for the business plan to address the means of funding costs that will be incurred before the Company earns enough revenue to pay the costs, the so-called pre-revenue period. To the extent that the business will require investors in addition to the Founders to fund costs incurred in the pre-revenue period, the business plan should include estimated cash flows of the business for a five-year period. The cash flow will be negative in the pre-revenue period and the initial post revenue period, until the revenue received is enough to pay all operating costs. The estimated cash flows will be the basis for estimating the potential market value of the Company, which will be used to determine the amount to be paid by investors for their ownership interests in the Company.

2.3.2 Ability to Create and Maintain Necessary Company Records

If a Company is formed, it will require creation and maintenance of a dedicated set of records that document the Company's financial transactions, compliance with any applicable regulatory requirements, and the legal organizational formalities required for a legal entity, such as holding meetings and creating minutes that document actions taken by the Company through its representatives. These records are essential to maintain the status of the Company as a legal entity that is separate from the Founders. Failure to create and maintain Company records can result in a judicial disregarding of the legal entity status of the Company, which will in turn impose on owners of the Company personal liability for its debts.

2.3.3 Understanding Company Ownership

The Founder's must understand the basics of Company ownership before deciding whether to form a Company. The ownership of any Company, typically a Corporation or a Limited Liability Company (LLC), is comprised of some number of ownership units, which are called Shares in Corporations and Units (or Member Interests) in LLCs. Shares and LLC Units are referred to collectively as Ownership Units or Units in this discussion.

Ownership Units

Rights to the Company's assets and profits are determined by the percentage of Ownership Units that a person owns; if a Company has issued 1000 Ownership Units and a person owns 500 of the issued Units, the person has rights to 50% of the Company's accumulated assets and 50% of the Company's profits and losses. The power to make decisions that guide the business operations of a Company is based on the voting rights that are inherent in Ownership Units. Ownership Units will have one vote per Unit, unless the organizational documents of the Company provide for different classes of Ownership Units which have different voting rights, eg a class of Ownership Units without any voting rights, or a class with multiple votes per Unit. Company business decisions are typically made by a majority of votes cast, unless the Company defines certain types of business decisions that require a larger percentage of votes.

Price v. Value of Ownership Units

There are two financial aspects of Ownership Units, which will be referred to respectively as their price and their value. The price of an Ownership Unit is the amount of money or the value of property or services that are contributed to the Company in return for issuing the Unit. The value of an Ownership Unit is the fair market value of the Company as an operating enterprise divided by the number of issued Units. The market value of a Company that is publicly traded can be determined by multiplying the current price per Share in the securities market by the number of issued Shares. The price and value of publicly traded Shares are roughly equivalent.

On the other hand, the market value of a privately-owned Company is commonly estimated by using a financial model that is based on forecasting the total cash flow that the company will generate during its expected lifetime and discounting that total cash flow to its present value. (There are alternative methods of estimating the market value of a Company, but discounted cash flow models are the most common.) The price and value of an Ownership Unit in a startup Company are typically very different because of the difficulty of accurately forecasting future cash flows due to various risks. However, the estimated market value of a startup Company will be used by early-stage investors to determine the price that they are willing to pay for the Ownership Units that are issued to them. Early-stage investors will employ their own financial models to value the Company and negotiate the price of their Units, but most of these financial models will require the estimated cash flows for the Company for a three to five-year period. The estimated cash flows are in turn calculated from the revenue and operating expenses forecasted through the business plan.

Dilution

Founders should understand the concept of dilution, which is a term commonly used in discussions about startup Companies. As a Company issues new Ownership Units to obtain capital, the relative percentage of the Company represented by each Ownership Unit is reduced. The relative percentage of the Company owned by each shareholder or LLC member is also reduced, unless the shareholder or LLC member purchases a percentage of the new issuance of Ownership Units that is equal to the shareholder's or LLC member's percentage of Units owned before the new issuance. For example, assume a Company with 1500 Ownership Units, owned equally by 3 Founders, that issues 1000 new Ownership Units to an investor in return for some amount of money. Before the new issuance of Ownership Units, each Founder owns 1/3rd of the Company (500/1500), while after the new issuance of Ownership Units, each Founder owns 1/5th of the Company (500/2500) and the new investor owns 2/5ths of the Company (1000/2500). Dilution of the Founder's interests in a startup Company is necessary to the extent that capital from outside investors is required. Of course, the goal is that each Founder obtains a financial benefit despite dilution, because a diluted percentage ownership interest in a potentially very valuable Company translates into a large amount of money.

2.3.4 Means to Decide about Whether to Form a Company

The Founder's Agreement should provide for the means by which the decision to form a Company will be made. Alternative means of deciding include: 1) a majority vote, with each Founder having one vote, 2) some degree of a supermajority vote, with each Founder having one vote, and 3) a majority or supermajority vote, with each Founder having an amount of voting power that is weighted by the Founder's co-ownership interest in the Business Assets. A Founder's percentage co-ownership interest in the Business Assets would be determined by the Founder's contributions of money, time, and property that were consumed in creation and development of the Business Assets as compared to the contributions of all Founders.

2.3.5 Method to Determine the Founders percentage Ownership Units

Finally, the Founder's Agreement should provide for the method to be used to determine each Founder's percentage of the Company's initial issuance of Ownership Units. Typically, each Founder's percentage of the Company's initial issuance of Ownership Units will be equal to the Founder's percentage co-ownership interest in the Business Assets. The latter would be determined by the Founder's contributions of money, time, and property that were consumed in creation and development of the Business Assets as compared to the contributions of money, time, and property of all Founders (as described above in the section on Founder's relative Ownership Interests in the Business Assets).

3 Issues to Be Addressed In a Company Agreement

3.1 Choice of Legal Entity

If the decision to form a Company is made, the next decision will be what form of legal entity to choose for the Company. The common alternatives are a Corporation or a Limited Liability Company (LLC). The laws governing both Corporations and LLCs provide that owners (Shareholders of the Corporation or Members of the LLC) are not liable for debts or expenses incurred by the entity, unless the Shareholder or Member agrees to guaranty a debt or expense (or unless the Company's legal entity status is lost because of failure to follow organizational formalities and maintain organizational records).

Both Corporations and LLCs permit the Company to be either a tax paying entity or a "pass-through entity" for income tax purposes. A pass-through entity files a separate income tax return but does not pay income tax on the taxable income of the entity. The taxable income of the entity is allocated among the owners of the entity in proportion to their ownership percentages, and each owner reports his / her share of taxable income on his / her personal tax return and pays income tax as calculated on the personal return. The same form of LLC can be either a tax paying or a pass-through entity, and the choice is made by simply checking a box on the LLC's first income tax return. There are two separate statutory tax regimes for Corporations, the S Corporation regime provides for a pass-through entity, while the C Corporation regime provides for the Corporation as a separately taxable entity. The choice of income tax status for the Company legal entity involves many considerations that should be discussed with an accountant or tax attorney before deciding on the tax status.

In general, the LLC is a more flexible and informal structure for a business which works very well for a relatively small group of owner members, who are either active in or closely associated with, the business. For example, the LLC does not require a formal board of directors and permits owner members to either manage the LLC business directly or to delegate management to a manager. The members can also create committees to either manage specific parts of the LLC's business or oversee the manager in running parts of the business.

On the other hand, if the business plan for the Company indicates that large amounts of capital will need to be raised from outside investors who will not be actively involved in the normal course of business operations, then a C Corporation will probably be the preferred form of entity. While there are many reasons for the C Corporation preference in situations where there will be significant passive investors in the Company, a couple of key reasons are worth mentioning. First, passive investors will desire to have input into management of the Company via a formal board of directors, which will include some number of the significant passive investors as directors. Second, passive investors will prefer to hold Shares, which have more standardized types of voting rights and financial characteristics. Such financial characteristics include preferences that can be granted to classes of preferred stock, such as mandatory accruals of dividends and priority to receive liquidating distributions in circumstances when the Company has lost money and cannot return the capital contributions that it received from all its investors.

The Company Agreement for an LLC is commonly called an Operating Agreement, and it will contain all of the provisions that are relevant to the management of the LLC as well as the terms and conditions that apply to the owners' rights to transfer their LLC Units. There are three main types of Company Agreements for a Corporation, which consist of: the Articles of Incorporation, the Bylaws, and in a privately owned Corporation, a Shareholder's Agreement. The Articles of Incorporation mainly cover the scope of the Company's business and the characteristics of all classes of Shares that the Company can issue to Shareholders. The Bylaws cover mainly the management of the company via the board of directors and management (Corporate Officers). The Shareholder's Agreement covers mainly the restrictions on transfer of Shares by the Shareholder owners. The overview of a few key provisions that should be considered for Company Agreements which follows will apply to both the Operating Agreement for an LLC and to the relevant agreement for a Corporation, either the Articles of Incorporation, the Bylaws, or the Shareholder's Agreement.

3.2 Authorization and Issuance of Ownership Units

The Company Agreement must specify the number of Ownership Units that the Company is authorized to issue. The number of Units authorized should be large enough to satisfy the Company's anticipated capital requirements for the foreseeable future. The Company will issue the authorized Units incrementally in blocks of Units as it needs capital or other contributions of resources. Ownership Units are issued via action of the Directors or Shareholders of a Corporation or via action of the Members of an LLC. If the Company will have more than one class of Ownership Units, the Company Agreement must clearly define the rights that are inherent in each class of Units, such as preferential rights to dividends, guaranteed distributions of money (similar to dividends), or preferential voting rights, in addition to the number of Units in each class that are authorized for future issuance.

The Company action to issue each block of Ownership Units will establish the price to be paid for the Units issued, or alternatively identify the services to be provided to the Company or the property to be transferred to the Company in return for the Units. As explained above, the Founder's Agreement should provide for the method to be used to determine the percentage of the initial issuance of Ownership Units by the Company that will be granted to each Founder in return for the transfer of the Business Assets to the Company. That agreed upon method will then be used to determine the number of Units issued to each Founder in the Company action to issue the first block of Units.

The Company Agreement also should provide for the method to be used to determine the price of Ownership Units to be issued to the Founders (and investors who are closely associated with the Founders) after the initial issuance of Units and before outside investors are solicited for capital investments. The solicitation of outside investors will require a version of the Company's discounted cash flow model in which there is a degree of confidence that is acceptable to the outside investors. Before outside investors are solicited, a startup Company may not have a cash flow model that is accurate enough to set the price of Units issued to Founders after the initial issuance of Units for the Business Assets.

- As discussed above, when the first outside investors purchase Ownership Units and contribute money capital to the Company, the price of Units will be based on an estimate of the fair market value of the Company (determined with a discounted cash flow model) that is reasonable in the judgment of the outside investors. The initial price of Ownership Units sold to the first outside investors will establish a baseline reference for the pricing of subsequent issuances of Units, because it will be the first estimate of the Company's market value that is established in an "arms-length" negotiation with an independent third-party investor. In general, it is expected that the price of Ownership Units will increase on each successive round of issuing Units, because there is less risk in predicting the Company's success. In other words, the assumptions used as inputs to the valuation model have been partially validated by the Company's progress under its business plan.

- However, before outside investors purchase Ownership Units (ie the Company is owned by the Founders and insiders who are closely associated with the Founders) Units may be issued at prices that are determined without using a discounted cash flow model to estimate the value of the Company, or by using a preliminary cash flow model that is very speculative.   In these circumstances, Units may be issued based on much more qualitative estimates of the relative values of contributions to the Company of money, property, and services. It can be useful if the Founders discuss and agree on the methods to be used to set: 1) the price of Ownership Units which will be issued before the first issuance of Units that is successfully placed with outside investors, and 2) the value of contributions of services and property that are provided to the Company in return for the issuance of Units.

- o The numeric values of the price of a Unit and the value of services and property contributed in return for issuance of the Unit should in theory be roughly the same, but the methods of determining them are different. Pricing of Units is based on the estimated value of the Company, while the value of services and property is based on the market cost of equivalent services and property.

The following example illustrates the foregoing explanation of the authorization, issuance, and pricing of Units. The example is over-simplified to show only the most important features.

- Two Founders decide to form a Company, and the Company authorizes 250,000 Ownership Units of a single class. The Founders transfer to the Company the Business Assets that they developed through their pre-formation business activities in return for issuance of 25,000 Units, 12,500 Units to each Founder. At this point, each Founder owns 50% of the Company.

- The two Founders each continue to work roughly equal percentages of their time for the Company for about a year, and a family member of one of the Founders is interested in investing $200,000 in the Company. Without doing an explicit discounted cash flow valuation of the Company, the Founders and family investor agree that: 1) each of the Founder's services for a year are worth roughly $200,000, and 2) the total value of the Founder's services and the $200,000 investment are worth roughly twice the value of the Business Assets that were originally transferred to the Company. The Company will issue 51,000 Units (about double the initial issuance of 25,000 Units, 17,000 to each Founder and the family investor in return for these contributions. At this point each Founder owns roughly 39% of the Company (29,500 Units / 76,000 issued Units) and the family investor owns roughly 22% of the Company (17,000 Units / 76,000 issued Units).

- After some period of operation, the Company develops a business plan and an associated discounted cash flow valuation that shows that the Company would have a discounted present value of $5,000,000, if it could obtain an investment of $1,000,000 to fund expenses during the period before its revenues will cover expenses. The Company solicits investors to invest $1,000,000 in return for a 20% interest in the Company based on the discounted cash flow valuation (20% = $1 million / $5 million) and is successful in obtaining one investor who agrees to pay $1,000,000 for a 20% interest in the Company. The Company issues 19,000 Units to the investor, which increases the total number of Units issued to 95,000. At this point, each Founder owns roughly 31% of the Company (29,500 Units / 95,000 issued Units), the outside investor owns 20% of the Company (19,000 Units / 95,000 Units), and the family investor owns 18% of the Company.

- The issuance of Units to the outside investor sets a "reference" price of about $53 per Unit, and if the Company's actual performance as compared to its business plan is favorable, the price of Units that are issued in subsequent rounds of raising capital should be greater than $53 per Unit.

3.3 Restrictions on Transfer of Units

Units of privately-owned companies are nearly always subject to restrictions on transfer, because the owners want to retain control over who is permitted to participate with them in management of the Company. The restrictions would typically be set out in the LLC Operating Agreement or in the Corporate Shareholders Agreement. This section summarizes a common framework that is used to restrict transfers of Units, but there are many variations on the framework.

The restrictions on transfer framework consists of two parts: 1) identification of a group of transfers that are permitted by owners of Units without triggering option rights of other owners (Preauthorized Transfers), and 2) for all other proposed transfers, setting out a pre-sale process that must be followed by the owner who wants to sell his/her Units (the Transferor). The pre-sale process provides the other owners of the Company with an option to purchase the Transferor's Units, before the proposed transfer to a third party is pursued. This option right for the benefit of the other owners of the Company is called a right of refusal. The right of refusal option process applies to situations in which the Transferor has identified a potential buyer for the Transferor's Units, and it gives the other owners of Company Units the right to pre-empt the Transferor's proposed transfer of Units to a third party by purchasing the Transferor's Units. The right of refusal does not enable the Transferor to require the other owners of the Company or the Company itself to purchase the Transferor's Units. The right of refusal option is therefore a restriction on transfers of Units and not a put option, which would enable an owner of Units who wanted to sell (Seller) to require the Company or other owners of Units to purchase the Seller's Units.

The relevant Company Agreement should define the Preauthorized Transfers that can be consummated by an owner of Units (as the Transferor) without going through the right of refusal process. Preauthorized Transfers may include the following types of transfers: 1) transfers of Ownership Units by the Transferor to other existing owners of Units, 2) transfers of Ownership Units by the Transferor to members of the Transferor's family (the scope of family must be defined as part of this Preauthorized Transfer), 3) transfers of Ownership Units by the Transferor to a company that is controlled by the Transferor, and 4) transfers of Ownership Units to a person or company that is approved by the Company (either Board of Directors or LLC Management Committee).

The right of refusal process that must be followed by the Transferor for all proposed transfers of Ownership Units, other than Preauthorized Transfers, provides the other owners of Units issued by the Company with an option to purchase the Transferor's Units. The right of refusal process includes the following steps:

- The Transferor first identifies a buyer for the Transferor's Units, negotiates the sales price of the Units, and obtains a written offer to purchase the Units from the buyer, which is conditioned on the right of refusal option not being exercised (Firm Offer). The Transferor then notifies the other owners of Units issued by the Company (Option Holders) of the Firm Offer and the sales price of the Units under the Firm Offer. Each of the Option Holders has the right to purchase a percentage of the Transferor's Units at the per Unit price set in the Firm Offer. The percentage of the Transferor's Units which can be purchased by each Option Holder is equal to the Option Holder's percentage ownership of Units issued by the Company. The right to purchase must be exercised by the Option Holders within some specified time.

- If some, but not all, Option Holders exercise their rights to purchase, some of the Transferor's Units will not be covered by exercised options to purchase (Unsold Units). In this case, the Option Holders who did exercise their options can elect to purchase the Unsold Units, usually in any agreed upon percentage, or the Company can elect to redeem the Unsold Units (at the price per Unit set in the Firm Offer). The right of refusal is effectively exercised only if all the Transferor's Units are purchased by the Option Holders or redeemed by the Company. In in this case, the purchase / redemption of the Transferor's

Units must be closed within a time specified in the right of refusal process. If the right of refusal is not effectively exercised, the Transferor is permitted to sell the Transferor's Units to the proposed third party on the terms of the Firm Offer.

In addition to the substantive restrictions on transfer of Units that comprise the framework described above, any transfer of Ownership Units that is permitted by the restrictive framework must also satisfy any legal conditions that may be specified in the Company Agreements. There are two common legal conditions which permitted transfers of Units must satisfy. First, the transferee who buys the Units must agree to sign and be bound by the terms of the LLC Operating agreement or the Corporate Shareholders Agreement, so that the transferee is bound to all the terms and conditions that bind the other owners of Units. Second, the Transferor of the Units will be required to show that the proposed permitted transfer of Units is exempt from all applicable securities laws, typically via a written opinion from the Transferor's attorney.

Ownership Units issued by Companies are securities, which are subject to regulation by both federal and state securities laws. Securities must be registered with federal and the relevant state securities regulatory agencies before they are sold, unless either: 1) the security is of a type that is exempt from regulation, or 2) the type of sales transaction proposed for a regulated security is exempt. In practice, Company Ownership Units will not be a type of exempt security, and so the exemption from securities regulations will depend on whether the proposed sales transaction qualifies for an exemption. The attorney for the Transferor of Units should therefore be involved in planning the sales transaction, as well as the manner in which potential buyers are identified and solicited to purchase the Units, to ensure that the sales transaction will qualify for an exemption from securities laws.

A discussion of the types of sales of securities that are exempt from securities laws is beyond the scope of this guidebook. However, qualifying for most exemptions will include complying with requirements regarding: 1) the total market value of securities offered for sale in a group of related sales transactions, 2) the number of investors who are solicited to become purchasers, 3) the qualifications of solicited investors in terms of their experience in business and investing in Companies, as well as their minimum net worth (i.e. their ability to withstand a loss of their investment), 4) the means of conducting the solicitation of investors (e.g. no general advertising to the public), and 5) the amount of information about the Company, its operations, and its business plan that must be provided to prospective investors.

3.4 Company Operations Decisions

Decisions regarding operation of the Company are ultimately made by the owners of Units via voting of their Units. Each owner can cast a number of votes which is determined by the number of Units owned. If there are classes of Units with different voting rights, the number of votes each owner can cast is determined by the total number of votes that are inherent in all of the Units (of all classes) owned by that owner. There are several categories of business decisions made for a legal entity, which differ based on the level of authorization that is required for the decision. Categories of decisions consist of: 1) decisions that require a supermajority vote of the owners of Units (based on voting rights inherent in Units), 2) decisions that require a simple majority vote of the owners of Units (based on voting rights inherent in Units), 3) decisions that will be made by a Corporate board of directors or LLC management committee, based on one vote per person voting rights, and 4) decisions that are delegated to management.

Company Agreements typically address the level of authorization required for business decisions by providing that Company business decisions will be made by the Corporate board of directors or LLC management committee unless: 1) the decision-making authority is delegated to management, or 2) the decision-making authority is reserved to voting by the owners of Units. Delegations of decision-making authority to management are commonly done via resolutions and documentation in the minutes of meetings of the board or management committee. However, business decisions that are reserved for voting by the owners of Units are specified in the Company Agreements, and these decisions are often further grouped into those decisions that can be made by a simple majority of votes cast and those decisions that must be made by a specified supermajority vote (eg 75%).

Election of the corporate board of directors or the LLC management committee and modifications of the Company Agreements are decisions that are always accomplished by a vote of the owners of Units issued by the Company. Other decisions that are commonly reserved for voting by the owners of Units, either via a simple majority vote or a supermajority vote, include the following:

- Issuing additional ownership Units

- Sale or merger of the Company, or a sale of substantially all the Company's business assets

- Dissolution and liquidation of the Company

- Changing the primary business in which the Company is engaged

- Incurring more than a specified threshold amount of debt or borrowing more than a specified threshold amount of money

- Entering into transactions with owners of Units or members of management (which represent potential conflicts of interest that should be vetted and approved by owners of the Company)

- Entering into guarantees of the debts of a third party

  The Company Agreements also will specify the rules for conducting the meetings at which voting of ownership

Units is conducted. These rules include such things as: 1) when regular meetings will occur, 2) who can call special meetings, 3) what type of advance notice of meetings must be sent to Unit owners, 4) what level of detail must be included in the agenda for each meeting, 5) who runs the meeting and how minutes of the meeting are taken, 6) what constitutes a quorum for conducting business at a meeting, 7) whether an owner can use a proxy to delegate to a representative the power to vote the owners Units at a meeting, and 8) whether Company decisions can be made via consent of the owners without holding a meeting.

3.5 Competitive Activities

The Company Agreements also should provide whether owners of Ownership Units are subject to any restrictions on engaging in activities that may compete with the Company's business. While it is common to limit the competitive activities of employees of a Company and Founders who are actively engaged in the regular operation of the Company's business, it is uncommon to limit the competitive activities of Company owners who are not actively engaged in management and operation of the Company's business. Most outside investors will not agree to be bound by non-competition restrictions on their activities, since they may invest in several companies, at least some of which may be in the same market segment.

Any non-competition provisions that are put in place between a Company and its employees or Founders will be enforceable only to the extent that they are deemed to be reasonable under the law of the state(s) in which the Company operates. The reasonableness of a non-competition provision will depend on: 1) its duration, 2) its scope in terms of the geographic area in which competition is prohibited, 3) its scope in terms of the competition that is prohibited, for example all competitors in an industry, all competitors in a market segment within an industry, or only specifically named competitors, and 4) the consideration that is provided in return for the agreement not to compete. In order to maximize the reasonableness of the non-competition provision for an employee or Founder, it should be as narrow / limited as possible in scope and duration, while still preventing the employee or Founder from taking a new job or position in which his / her knowledge of the Company would inevitably be used as an unfair advantage against the Company.

3.6 Dissolution of the Company

The Company Agreements will contain a clause that provides for the termination of the Company if it goes out of business or sells substantially all the assets that are used in operating its business. The process of terminating the Company's legal existence is called dissolution, and it typically involves liquidating the assets of the Company through one or more sales transactions and then using the proceeds of the sale(s) to pay the Company's debts and liabilities. Any balance of the proceeds of liquidation of the Company assets that remains after payment of Company liabilities are distributed to the Owners of Units in proportion to their ownership interests.