WEBINAR:
“Using Stock Options to Build Your Startup Team Before Venture Funding”

NATIONAL COUNCIL OF ENTREPRENEURIAL TECH TRANSFER (NCET2)
NOVEMBER 14, 2019
NCET2's Startup Development Program

NCET2's mission is to discover, develop, and fund corporate-aligned startups from universities, angel groups, federal labs, and state funding agencies specifically aligning startups to corporate business units.

- Startups do R&D, research commercialization, product testing and market testing
- Corporates do scale-up, marketing, manufacturing, distribution and sales around the world
NCET2 Startup Services

- NCET2 will incorporate startups and set up Stock Option Plans for small amount of equity compensation
- Provide Startup Development Officers (SDOs) to find team members and develop business
- Put startup through our Corporate-Startup Finders Program for sponsored research, licensing, joint venturing and other strategic alliances
- Investor funding from our National Angel group
This webinar covers why stock options are so important for venture-backable startups and how to use them to build your team so you can receive funding.
Funding Dilemma

- **Illusion:** When many entrepreneurs start a company they mistakenly believe that investors will fund them on a business plan or because of a patent.

- **Reality:** Investors invest in teams who they strongly believe can execute on business plans to deliver the promises in the plans, not the plans themselves.

- So entrepreneurs rebut by saying: “Give us the money and we’ll hire the team” thus completely missing the point.
The team starts with the founder-entrepreneur, who has a vision (Employee 1).

The first and most important job of the founder-entrepreneur is to find and convince team members (Employees 2-10) who want to see that vision become a reality.

- IMPORTANT: These are not 9-to-5 employees or consultants looking to exchange hours for a pay check (since the startup lacks cash to pay them).

Startup team members are people who believe enough in what the founder is doing to take below market rates in pay now in order to help build the company.

To be fair to startup team members, morally and financially, they would need to be over-compensated later for helping to increase value of the company now.... And that's what stock options do.
Stock options are cash equivalents to compensate early employees who believe in the vision and want to help the founder-entrepreneur see the vision become a reality.

They are paid below market rates now to show their commitment and because the company lacks the cash.

They get over-compensated later by the increased value of the stock options in the successful company that they help build.
A typical setup:

- Founder(s) get(s) 70-80% of stock
- Team members share 20-30% of the stock option pool
- Stock options are used to compensate early employees in lieu of cash until investors fund the company
Say you have carefully selected 5 key early employees:
- Who have the skill sets needed to perform specific functions in the business plan, and
- Who believe in the vision enough to take below market rates until funding

Founder executes employee agreements stipulating:
- Work that the employees will do
- Hours per week that they will provide (usually part-time, 5-20 hrs)
- Amount of stock options that they will receive per month
- A condition that they convert to full-time employees at a set pre-determined salary + stock options when investor funding is received
Importance of Executed Employee Agreements

Benefits:
- Employee agreements are executed with full terms
  - Team can start working together part-time producing some early milestones
  - Seamless conversion to full-time when funding is received
- Investors can assess how well team works together
  - Investment takes an established team from part-time to full-time

Caution: Without executed employee agreements:
- Risk of employees not joining the startup when the funds arrive. They have to seriously think about what it really means to leave their current jobs
- Killing funding deal that promised the existing team would go full-time
- Working together and executing employee agreements concentrates the mind to take the planning seriously by all members of the team
Need a C-Corp, not an S-Corp or Limited Liability Company (LLC)

- Usually incorporated in Delaware, because investors are most comfortable with that
- Has the appropriate governance structure for investors and employee stock option plans
Setting Up a Stock Option Plan

- Stock option plans can be set up anytime
- But easiest and cheapest to set up when incorporating
Setting Up a Stock Option Plan

- Need to legally authorize sufficient amount of stock in C-Corp for allocations to:
  - Founders
  - Employees, advisers, consultants
  - Investors
- If insufficient stock initially authorized, need to go back to state and duly execute Certificate of Amendment for additional stock
- If sufficient authorized stock, stock plan only needs a Board resolution and stockholder approval, which can be done solely by the founder when incorporating in Delaware
- Easiest and cheapest to do correctly at initial incorporation
  - Possible later, but added complications and costs
EXAMPLE: If incorporated with 20 million shares

- 7 million can be allocated to founder(s)
- 3 million can be duly allocated to a stock option plan for employees, advisers, and consultants
- 10 million reserved for later investors

The 3 million shares pool can the be used to compensate early employees before funding and to sweeten cash salaries after funding

- Specific allocations of stock options are part of the compensation terms in employee and consulting agreements
Setting Up a Stock Option Plan

- To be properly issued:
  - Stock plans need to be legally documented
  - Adopted by the Board of Directors
  - Approved by all stockholders

- If appropriately structured:
  - There are tax benefits for the startup and the employees
  - Otherwise, taxes may be payable when employee doesn’t receive cash to pay the taxes
    - Very stressful situation
To ensure that team members are adding value to the company (which added value is being shared through the stock options), stock options have a “vesting schedule”

- Most common is a 4-year vesting with a 1-year cliff
- The “4-year vesting” period means that the team member needs to stay with the company for 4 years to earn all the shares allocated to them
- The “cliff” means that the team member needs to not be terminated (voluntary or involuntary) for 1 year before any shares are legally assignable

In other words, there’s a probation period to make sure that the team works well together without complicating the capitalization table with stockholders that don’t work out

- For team members who are working without a cash salary in very early days, a 3-month cliff is fairer and more common
Stock options can be used as a cash substitute for unfunded startups without the cash to pay for early team members.

They allow founders to start building their teams before funding.

They provide for and compensate early milestones by using “sweat equity” by the team members.

Importantly, they provide a team for investors to assess and fund.
NCET2 Startup Services

- NCET2 will incorporate startups and set up Stock Option Plans for small amount of equity compensation
- Provide Startup Development Officers (SDOs) to find team members and develop business
- Put startup through our Corporate-Startup Finders Program for sponsored research, licensing, joint venturing and other strategic alliances
- Investor funding from our National Angel group
NCET2 Services

- If you would like to set up a call to discuss how we can help you, please email us at startupdevelopment@ncet2.org
- Or directly schedule a call at https://calendly.com/ncet2calls
Tony Stanco, JD, LLM
Executive Director
National Council of Entrepreneurial Tech Transfer (NCET2)
tonystanco@ncet2.org
http://ncet2.org
Q&A

USING STOCK OPTIONS TO BUILD YOUR STARTUP TEAM BEFORE VENTURE FUNDING