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Happy Entrepreneurs' Day – Commonly Asked Questions by Founders of Startups

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I volunteer some of my time to providing legal office hours to MIT's Venture Mentoring Service (https://vms.mit.edu/), a service that MIT offers to its staff, students and graduates who are looking to start a business. In the spirit of National Entrepreneurs' Day, here are answers to some commonly asked questions during my office hours.

What is a Founders' Agreement and why should we have one?

A Founders' Agreement is a pre-incorporation contract between co-venturers that governs their pre-incorporation business relationship (their respective rights, responsibilities, obligations and liabilities) and provides the road map for the ultimate business structure, division of equity and rights and responsibilities post-incorporation. Things that would typically be covered in a Founders' Agreement are the co-venturers' respective obligations of confidentiality, ownership of intellectual property, anticipated equity split and roles, decision making pre-incorporation, resolution of disputes, how the co-venturers will progress the business, and what happens if one of the co-venturers determines to disassociate from the startup. Having all of the Founders enter into an agreement of this nature will decrease the likelihood of later litigation regarding ownership of the business and any intellectual property as well as other matters.

When should I form an entity?

You should form an entity when your activities have progressed beyond the planning stage and you are taking actions which may expose you to liability to third parties, such as hiring an employee, engaging an independent contractor or entering into customer agreements or other contracts. Another inflection point might be at the point when you and your co-venturers have created significant intellectual property and you wish to vest ownership in a jointly owned entity.

Corporation versus Limited Liability Company?

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Depends. While both entity forms enjoy limited liability protection, I typically recommend a corporation for persons who anticipate needing significant outside funding from investors to grow the business as those investors generally do not want to have pass through tax treatment and are most comfortable with the corporation structure. A limited liability company is often more appropriate for persons who don't anticipate needing significant outside funding and want to use a pass through tax structure to avoid double taxation.

With multiple founders, how do we divide up the equity?

This may be the hardest question to answer and one that doesn't have a legal answer. It calls for some hard discussions among co-venturers about the value of what they are contributing to the enterprise, their respective roles and commitments. Perhaps the most difficult situation is where one co-venturer is contributing the most sweat equity while another is largely responsible for the intellectual property that will form the basis for the business. The division of equity is an important factor in a startup's early success, and perceived unfairness in the split can lead to dissention, division and departures. Generally, however, unless there is a compelling reason for deciding otherwise, if you want everyone to be equally invested in the company's success, there is only one real answer – equal equity splits. As there are no easy answers to this question, this is one reason to enter into a Founders' Agreement early so that the parties' expectations are set early on before everyone has expended significant energy toward developing the business.

Should I raise operating capital through debt or equity?

Raising operating capital by borrowing money from conventional lending sources like banks allows you to retain control and ownership over your business. That said, conventional debt funding may be hard to obtain unless your startup already has an income stream from which a lender might reasonably expect repayment. Alternatively, you may be able to obtain a loan if you are able and willing to give a personal guaranty or offer other collateral to the lender to secure repayment of the loan, thereby increasing your exposure. For similar reasons, conventional sources of debt may be limited in amount and not be sufficient to fund your operating capital needs. That is why many entrepreneurs sell equity, or instruments like convertible notes or SAFEs that will convert to equity upon the occurrence of specified events. The downside to selling equity is that your investors are looking to make a certain return on their investments and often seek rights that impact your ability to control your company.

Disclaimer: This summary is provided for educational and informational purposes only and is not legal advice. Any specific questions about these topics should be directed to attorney Theodore A. Lund.