SCALE FINANCE

5 things that can screw up your exit strategy

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When you are starting up your own company, you're generally not thinking about acquisition. Any stock you give for services (or sweat equity) is likely done out of necessity and expediency.

For the successful and the lucky, those distant dreams of acquisition can become reality. But there are a number of hurdles you can inadvertently set up for yourself in the early days of your company that can make that more difficult. Here are five to beware of:

Not following the formalities of issuing stock - This may seem obvious, but before anyone can own shares, a corporation has to issue the stock. Generally this is a two-step process. The bylaws will say "we, company X, authorize the issuance of Y number of shares." But then you actually have to go through the corporate formality of issuing those shares, which includes issuing the physical share certificate after receipt of consideration. It's just as critical to keep track of the shares.

Too often, I've heard stories of companies in the midst of being purchased, when someone walks in with a bar napkin (and their lawyer in tow) upon which the president granted them a large amount of shares. Suddenly, the stock table looked quite a bit differently.

Deferred compensation - Deferred compensation seems like a great idea. You get a great addition to your team at a fair price. If the company does well, you get to pay them what you agreed on originally and everyone is happy, right?

Not quite. The Internal Revenue Service and potentially your state's labor commission are likely to be quite the opposite, in fact.

When you defer compensation through actual deferred salary or through stock options you will run into the dreaded IRC Section 409A. This covers a multitude of scenarios and is really geared at mandating economic accountability over various forms of compensation to insure that "deferral" is really in place. It's an incredibly complex section of the tax code and you will most definitely need the assistance of a seasoned professional to help you navigate through its intricacies.

In addition to other scenarios, IRC section 409A applies to all nonqualified deferred compensation. This is different from deferred compensation in the form of elective deferrals to qualified plans (such as a 401(k) plan). The penalty for employees violating 409A includes:

- all amounts deferred under the plan for the current year and all previous years become immediately taxable; and
- The employee has to pay an additional 20 percent on the deferred income.

In the labor/ employment scenario, there are additional problems, like employees may claim that although the income was supposed to be deferred, it was not supposed to be deferred indefinitely. This scenario usually arises in a milestone bump up to the deferred amount. After which, the company may have to deal with statutory penalties for not paying the deferred compensation, which will be looked at by the government as ordinary pay. In other words, your company may be liable for penalties to the employee if they never receive the money.

The net result of deferred compensation is that when an acquiring company's attorney is evaluating whether or not to buy your company, they will see a lot of legal work that they have to do to get your company to the point of being acquired.

Promising stock at a below-market rate – It's one thing to promise stock to employees to work for your company. But you should never promise to offer them future shares for a price lower than the market. This may be considered backdating and potential acquirers will certainly not be happy that there are people out there buying stock at such a discount. The IRS will also likely chime in and look at the spread in value as additional income that is subject to income recognition and possible employee withholdings. Essentially, there will be a number of people getting a free ride on the acquirers coattails.

Backdating is generally the practice of issuing options contracts on a later date than which the options have listed. So promising a lower price then the current value could be seen as a type of backdating because you are looking retrospectively at the value of the stock and issuing it prospectively. While not pure backdating, it may not pass the smell test for future acquirers.

Issuing non-board approved options - This goes back to the bar napkin scenario above. Such an issuance of stock may not be valid if the board's approval is necessary for all option grants and can wreak havoc on your capitalization tables regardless. Suddenly there are options that are not on the company's books. When an acquirer comes knocking, they want to know all the outstanding ownership interests in the company to which they are entitled.

Don't promise absolute percentages – When you start a company you may offer percentages in the amount of stock that currently exists, but you do not want to create "non-dilution" guarantees. In other words, if you offer a new CEO 25 percent of your company from the get go, this percentage may change as the company grows and gains more investors.

For example, if you have a new investor that wants to put in money, the company may issue more stock, which may dilute a 25 percent grant to a smaller amount. If you say that the percentage cannot be diluted, you may have a big problem if someone wants to acquire a majority interest in a company and an early member of the company refuses to relinquish his/her large percentage.

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