The Entrepreneur's Guide to Early Stage Financing
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Introduction

The transformation of an idea into a business is an exciting process. Entrepreneurs face many challenges as they charge ahead into the great unknown. At several points along their journey, they will be faced with legal questions. What entity should I choose? In what jurisdiction should I form my entity? I need capital—how do I go about finding it? What does that financing transaction look like? This guide will briefly touch on these subjects and several other questions emerging companies face in their quest to grow.

The Lawyer’s Role

Lawyers play many roles in the growth of a young company. First and foremost, the lawyer’s role is to be an advisor to his or her client to help them avoid common missteps. The first such opportunity typically presents itself in assisting with the choice of entity. Thereafter, the lawyer can help his/her client position itself for investment by making sure that intellectual property is protected, proper procedures and regulations are followed, the contracts the company enters into are commercially reasonable and that all necessary records are kept. Involving your lawyer throughout in the early stages of development can result in large savings down the road.

When the time comes, lawyers are often in a position to assist the client with finding venture and angel funding through an extensive network of strategic alliances and contacts. While an introduction to a financing source does not necessarily guarantee financing, a recommendation and call from a lawyer at an experienced law firm can increase the likelihood of a meeting between the potential investors and the early stage company. Furthermore, lawyers who regularly work with venture capitalists can help assist the client in understanding the types of projects that are receiving financing, by whom and on what terms.

Once the time for a financing transaction has arrived, lawyers play many roles in a typical venture capital investment transaction. These roles include:

1) providing market perspective and insight on the key terms of the investment, typically through the negotiation of the term sheet;
2) drafting or reviewing and commenting on the investment agreements containing the agreed upon terms;
3) conducting legal due diligence on matters such as the company’s capitalization, governance documents, and material contracts,
4) preparing board and shareholder communications describing the transaction and soliciting the necessary consent and
5) steering the transaction to a closing as timely and efficiently as possible. The basic agreements in a typical venture capital transaction are:
   a. the stock purchase agreement, which sets forth the terms of the purchase of shares and contains representations, warranties, and covenants of the company and the investors;
   b. shareholders agreements, which contain provisions relating to board of directors representation, share transfer restrictions and purchase rights;
   c. an amendment to the company’s organizational document, typically articles or certificate of incorporation, which contains the terms of the shares being purchased; and
d. a registration rights agreement, which contains provisions with respect to the future public offering and sale of the shares purchased by the investor.

After all agreements, have been negotiated and the requisite consents obtained, the lawyers will assist with the closing of the transaction, issuance of shares and the transition of the company into the next phase of its life cycle.
Forming the Company

There are several good reasons to form a company early. First and foremost, the founders should have the protection of limited liability. Until the company is formed, the founders are acting in their personal capacity, and may be personally liable for contract and tort claims.

Second, the earlier the company is formed, the sooner the stock (or in the case of a limited liability company, units of membership interest) can be issued and the capital gains period begins to run. Stock that has been held for at least one year will be taxed at the long-term capital gains rate, which is likely to be lower than the individual’s ordinary income tax rate.

Third, if the company is formed close in time to an equity financing transaction, the difference between what the founders paid for their stock and the fair market value of that stock (based on the sale to outside investors) may be characterized as compensation income resulting in what could be a significant tax liability to the founders.

Choice of Entity

There are generally three types of entities to consider when forming a company: an S corporation, a C corporation, or a limited liability entity such as a limited liability company, limited liability partnership or limited partnership (collectively referred to herein as "LLC"). Although each type of entity generally provides limited liability to its owners, the tax treatment of each entity varies significantly.

An S corporation is taxed as a pass-through entity in a manner similar to that of a partnership. The principal advantage to an S corporation is that losses will pass through to the corporation's shareholders allowing them to offset other income (subject to certain limitations) and income will pass through and be subject to only one level of tax. The principal disadvantage to an S corporation is that only individuals are generally permitted as stockholders. Thus, a venture capital entity cannot invest in an S corporation without terminating the S status and converting the entity into a C corporation.

A C corporation is taxed as a separate entity. The principal advantage to a C corporation is that anyone may be a shareholder and, as discussed below, it avoids some of the issues that may arise when using a pass-through entity. The principal disadvantages are that the shareholders may not utilize losses incurred by the C corporation and any income will be subjected to two levels of tax (once at the corporate level and once when dividends are distributed or upon liquidation).

An LLC has the option of being treated as a corporation or a partnership for tax purposes, but members generally elect to be taxed as a partnership. The principal advantages of an LLC are that there are no restrictions as to who qualifies as a member and LLCs typically offer significantly greater tax flexibility. Further, if an LLC elects to be taxed as a partnership its members may utilize losses incurred by the LLC against other income (subject to certain limitations) and income is subjected to only one level of tax. The principal disadvantage of being taxed as a partnership, as discussed below, is that the pass-through nature of the income may cause problems for certain types of investors, such as venture capital funds, that have pension funds as limited partners.

Despite the tax disadvantages to using a C corporation, venture capitalists have traditionally preferred to invest in C corporations for several reasons. First, as noted above many venture funds receive substantial funding of their own from pension funds. These pension funds are not permitted to incur unrelated business taxable income ("UBTI"), which may occur if the venture fund invests in an entity that has pass-through tax treatment, such as an
LLC. As a result, many venture funds are obligated not to invest in pass-through entities. Second, venture fund principals are comfortable with the corporate governance of corporations and resist investing in LLCs because fiduciary issues are not as legally refined as they are in the corporate law. Third, if the early-stage company is highly successful, the C corporation will be the forum required by the public markets in an IPO. Finally, non-corporate investors may take advantage of Internal Revenue Code ("IRC") Section 1202, which permits the exclusion of up to 50 percent of the gain on sales of stock in certain types of C corporations held for more than five years.

More recently, however, there is a trend emerging for founders to form as LLCs. That way, the founders and other early investors can take advantage of the losses generated in the early stages of an emerging business and may be able to significantly reduce their tax liability by potentially avoiding a double tax upon exit. Venture firms are also increasingly willing to consider investing in LLCs, either if they have no UBTI sensitive investors or if they are willing to utilize a more complicated transaction structure, such as a “blocker” corporation or a hybrid C corporation/LLC structure, to take advantage of the tax benefits. If the capital structure of the LLC is kept relatively simple, it is fairly easy to convert from an LLC to a C corporation in the future (although the opposite is not true). If the ultimate goal of the entity is later to convert to a C corporation from an LLC, the corporate structure of the LLC should mimic the structure of a traditional C corporation, considering factors such as voting power, ownership preferences, and employee options or profit interests. As a result, LLCs are becoming the preferred entity choice among early stage start-up companies. However, because most venture investments remain in the form of C corporations we will focus on those concepts in this article.

State of Organization
In making the decision of where to organize the entity, founders should consider the relative state tax ramifications. In many cases, organizing in the jurisdiction of the principal place of business will make sense. However, it remains the case that most venture capitalists prefer companies to incorporate in Delaware, which is more investor friendly and has a more settled body of corporate law. The decision as to where to incorporate should be given careful thought as it has a major impact on the statutory requirements with which the company must comply and the law that will ultimately be applicable to the governance of the entity.
Equity

Founders should become familiar with the following definitions which will be vital at formation.

**Authorized stock**: the total number of shares of capital stock, whether common or preferred, that the company is authorized to issue at any given time.

**Issued and outstanding stock**: the total number of shares of capital stock that have actually been issued or sold pursuant to financing, stock options or otherwise, and that are still owned based on the corporate records of the company at any time.

**Issued and outstanding common stock on an as-converted basis**: the total number of shares of common stock that are issued and outstanding at any time, plus the total number of shares of common stock that the issued and outstanding preferred stock would convert into at that point in time were it to convert.

**Issued and outstanding common stock on an as-converted, fully diluted, basis**: the total number of shares of issued and outstanding common stock on an as-converted basis at any given time, plus the total additional number of shares that would be issued and outstanding if all holders of convertible securities (i.e., options and warrants) converted into common stock or exercised their option to purchase common stock.

**Capitalization at Time of Formation**

The total number of shares authorized and the total number of issued and outstanding shares at the time of formation of the company is largely arbitrary. The main issue for companies to consider is the relative equity among the founders. Prospective hires often focus on the total number of shares awarded to them through restricted stock or by the grant to them of options to purchase the shares rather than the percentage of the company that those shares represent. Therefore, the company should consider putting in place an equity incentive plan that has a significant number of shares. This allows the company to establish a low issuance (in the case of restricted stock) or exercise (in the case of options) price.

**Division of Shares Among Founders**

Founding members often base the issuance of stock on contributions to the formation of the company. Contributions include not only monetary contributions, but also the conception of the idea, leadership in promoting the idea, the assumption of risk to launch the company, the development of the underlying technology and sweat equity. The potential for future impact on commercializing the idea may also be a factor, including the background and experience that each person contributes. It is the founders’ decision to allocate the stock among the relevant parties.

**Stock Purchase Agreements**

The principal purpose of the initial stock purchase agreement or subscription letter is to set forth the terms on which the stockholders will purchase and hold stock in the corporation. Typically, the individuals who participate in this type of stock purchase will be founders or other key employees and thus will not require the protection afforded by the representations and warranties given to outside investors. It is also unusual, although not unheard of, for members of the management team to receive registration rights from the corporation. In contrast to stock purchase agreements used with investors, employee stock purchase agreements will generally provide the corporation with an option to reacquire the employee’s stock if employment with the corporation terminates.
before a specified period of service has elapsed. Because this type of restriction may affect the tax treatment, the recipient should consult with a tax advisor prior to or immediately upon the receipt of the shares. (See discussion below regarding “Restricted Stock.”)

Equity Budgeting
Many companies find it useful to put together a spreadsheet that projects the founder’s stock ownership in the company through several rounds of financing. The budget can be a useful tool for thinking about the dilutive impact that financing will have on the founders’ equity stake. Historically, statistics have shown that founders as a group may retain only 15 to 20 percent of the company by the time of the initial public offering. This suggests that founders may experience 80 percent dilution at a minimum prior to going public.

Dilutive Impact of Employee Pool Required by Venture Capitalists
Venture capital term sheets typically include a requirement that the company put in place an equity incentive plan equal to between 10 and 20 percent (sometimes higher) of the common stock of the company on an as-converted, fully-diluted basis, including for this purpose the entire employee pool even though no awards may have been made at the time of the closing of the venture investment. The more key hires the venture capitalist perceives will be necessary to fill out the executive management team, the higher will be the percentage of the proposed employee pool. Very few first time entrepreneurs understand the important dilutive implication that this percentage has for their equity stake in the company.

Valuations
Various formulae and concepts have been used to value the stock of closely held companies. Valuation becomes a frequent issue when options to acquire stock are given to employees. If the company has been in business long enough to achieve revenues and earnings, it may be possible to develop a formula which capitalizes earnings or other operating results in some reasonable manner. However, in the initial start-up stages of operations, there have been no operating results and prospective earning power may be too speculative. Consequently, the valuation may have to be based on some concept relating to net worth or capital invested. At this stage of an enterprise's history, the most reliable indication of its value may be the amount that outside investors, on an arm's length basis, have paid or are paying for stock of the class being sold or for which options are being granted to employees. Thus, if the equity financing of the enterprise included the purchase of one class of common stock by outside investors for $20 per share, employee stock options for shares of such common stock that are substantially contemporaneous with that investment might safely be valued at $20 per share. Of course, the task will be complicated to the extent that the company's financing deviates from this simple model by utilizing different classes of stock, convertible securities or other securities with specially designed features, and by timing differences and other factors that make it difficult to equate the securities which are sold to investors on an arm's length basis with the stock for which options are granted.

Conversely, it is essential to recognize that if employee stock options are granted at a time near an arm's length investment by outside investors or a negotiated financing, including a public offering, it may be very difficult to sustain the burden of demonstrating that the option exercise price was set at a fair market value if that price was substantially less than the price used in the investment or financing. To sustain that burden, it may be necessary to show that events occurring between the time of the investment or financing and the time the options are granted warranted the difference in valuation. Such intervening events might include the achievement of specific milestones in the company's business history, such as obtaining a key patent or entering into a key customer contract or the commencement of successful revenue-producing activity. The importance of a significant time lag
must be emphasized. A $5 per share exercise price for employee options granted two or three months before an underwritten public offering of equivalent shares for $20 per share may be difficult to explain, even if the company achieved significant successes in its business development during those months.

Equity Incentive Plans
Companies often offer stock options to management and employees. Stock options come in two forms, incentive stock options (“ISOs”) and non-qualified stock options. These forms differ primarily in tax consequences to the recipient and the company. Stock options are a contract between the company and the recipient that gives the recipient the right to pay a certain exercise price per share specified in the option grant agreement, and in exchange, receive a certain number of shares of stock. This right to “exercise” the option typically vests over a period of time—three or four years, usually in equal monthly or quarterly installments.

There are substantial differences between ISOs and non-qualified options. ISOs may only be issued to employees. They must meet the requirements of Section 422 of the Internal Revenue Code (“IRC”) which requires that the exercise price be the fair market value of the stock on the date granted and requires the recipient to meet certain holding periods, and must be approved by the shareholders. Holders of ISOs are not taxed (other than for AMT and certain withholding purposes) until the stock is actually sold. The gain is treated as capital gain and is based on the difference between the exercise price of the option and the sale price of the stock. The company gets no tax deductions on ISO exercise if all conditions are met.

Non-qualified options may be issued to anyone and do not have to meet any particular IRC requirements. Holders of non-qualified options are generally taxed when the option is exercised. The gain is treated as ordinary income and is based on the difference between the exercise price of the option and the FMV of the stock on the date of exercise (the “spread”). The company generally may take a tax deduction on the spread.

If the company is a limited liability company (LLC), options are not typically useful. Profits interests are typically used instead. Profits interests in an LLC are analogous to stock options in a corporation (but in some ways are better than stock options). Profits interests can allow funds and portfolio companies to provide significant equity incentives to management and employees. By allowing capital gains upside without up-front cost, they combine some of the best features of options and equity grants. However, they do create issues. For instance, the holder of a profits interest is treated as a partner in a partnership for tax purposes, so that person can no longer be treated as a W-2 employee but instead would receive a K-1 — including for any salary received — and would be responsible for paying quarterly self-employment taxes. This also means that the holder may not be eligible to participate in benefits plans on the same terms as regular W-2 employees. There are some structures (such as separate management companies) that allow holders of profits interests to remain W-2 employees, but they create other tax and governance challenges.

Restricted Stock
Restricted stock, also given to employees, is stock that is held outright but is subject to certain restrictions imposed by the company. The restrictions usually give the company the right to repurchase the stock upon termination of employment and are usually in the form of a restrictive stock agreement (sometimes called a buy-sell agreement or stockholders’ agreement).

Restricted stock may be desirable to the recipient because certain tax issues generally associated with options are avoided and the holder is entitled to voting rights, a benefit that may make a key employee feel more involved in the ownership of the company. If stock is issued to an employee as compensation, the value of such stock will be immediately taxable to the employee unless the stock is subject to a substantial risk of forfeiture. The terms of
A stock restriction agreement may constitute a substantial risk of forfeiture if the company has the right to buy back the stock at less than its FMV at the time of repurchase. In most cases, the restriction will disappear over time as the stock vests. The Restrictive Stock Agreement should specify the nature of the vesting schedule (whether yearly, monthly or by some other period of measurement). Further, provisions should clarify the precise nature of those events which will trigger the issuer's right or obligation to repurchase nonvested stock held by the employee and those conditions, if any, which will accelerate vesting in favor of the employee. For example, a provision may be included in the agreements which provides for an acceleration in vesting upon the death of the employee or upon the event of a merger in which the issuing company does not survive.

Upon receipt of shares of restricted stock, the employee has two choices: (i) not pay any tax upon receipt, but pay tax at ordinary income rates on the difference between the purchase price of the stock and the FMV of the stock when the stock vests and the risk of forfeiture disappears, or (ii) make an election under IRC Section 83(b) within 30 days after receiving such shares agreeing to pay tax immediately on the FMV of the shares when they are received. Since it is expected that the shares will appreciate significantly in value, it may be a good idea to make a Section 83(b) election and pay tax at the lower value when the shares are issued rather than at a much higher value later after the company grows. Any subsequent sales of the stock after the Section 83(b) election will be only taxed at capital gains rates.
Financing Transactions

Emerging companies will typically enter into several types of financing transactions throughout their lifecycle. Initially, start-ups may receive seed funding from a government or non-profit incubator. Alternatively or in addition to this seed financing, companies often engage in a friends and family round of financing, seeking investment from those who are most familiar with the founders and their capabilities. Thereafter, young companies will most often seek additional financing from angels or venture capital firms. Angel investors tend to invest at earlier stages than many venture capital funds, although there are several venture capital funds that will invest in pre-revenue companies.

Angel Financing

An angel is generally a wealthy individual who invests in his/her individual capacity. Recently, groups of angels have formed alliances. One potentially significant downside of negotiating with a group of angels is that because they pool their collective knowledge base, they tend to be more sophisticated than individual angels. This can result in terms that are more demanding on the company than would otherwise result. Once an investment is made, however, the company may benefit from the collective knowledge base and their collective contacts.

Angels will typically invest in preferred stock or debt convertible into preferred stock. Preferred stock is a security that entitles its holders to certain rights, preferences or privileges that are not generally afforded to the holders of common stock. A corporation may issue preferred stock in one or more classes or series. The various rights, preferences, privileges and restrictions of each class or series may be set forth in the organizational documents. Most angel investments precede venture capital financings; therefore, it is important to manage expectations of angels and ensure that the angel investors are willing to make the concessions required by venture capital firms when the right financing transaction comes along.

The following rights and preferences associated with the preferred stock are usually requested by Angels:

(a) **Liquidation Preference:** A liquidation preference gives the holder the right to receive its original investment back upon liquidation, dissolution or a sale of the company prior to distributions being made to holders of common stock. The liquidation preference typically includes declared or accrued, but unpaid, dividends. It is also typical for venture capital firms to require that even after receiving their initial investment back, their preferred shares be entitled to share with common in any additional liquidation distributions (so called "participating preferred" or a "double dip"). Occasionally, venture capital firms have even insisted that the liquidation preference give the holder the right to receive double, or even triple, the holder's original investment back upon liquidation or dissolution, so called two times or three times liquidation preferences (which may also be participating).

(b) **Dividend:** A dividend is usually a fixed percentage return on the original purchase price for the stock every year, much the way interest is paid on a loan. The dividend may be (i) cumulative, which means that if it is not paid in one year, it will carry over and continue to build until it is eventually paid; (ii) non-cumulative, which means that the dividend does not carry over from one year to the next if not declared by the company; (iii) automatic, which means that the company must declare it every year or at some other pre-determined time.
such as on or prior to a sale of the company; or (iv) discretionary, meaning that the dividend is payable only if and when declared by the company’s board of directors.

(c) **Conversion and Anti-Dilution Protection:** Preferred stock is typically convertible into common stock. Usually the conversion ratio when issued is one-to-one, which means that the preferred stockholder may convert each share of preferred stock into one share of common stock at any time. The preferred stockholder typically has anti-dilution protection that results in an increase in the conversion ratio in the event that the company were subsequently to undergo structural changes or to sell any of the stock below the price paid for it by the preferred stockholder.

Typical anti-dilution provisions call for adjustments in the conversion price (and thus the number of shares of common stock issuable upon conversion) in a number of circumstances:

i. **Structural:** An anti-dilution clause which provides for an adjustment in the conversion price in the event of certain "structural" changes in the underlying common stock, such as stock splits, dividends or combinations of the outstanding shares, is virtually always included. However, the inclusion of certain additional anti-dilution provisions will depend upon the nature of the transaction and the relative bargaining power of the parties.

ii. **Weighted Average:** A "price protection" clause provides for an adjustment in the conversion price upon the issuance or sale of additional shares of common stock at a per-share price which is less than the price of the common stock at the date of issue or sale.

Under the "weighted average" approach, the conversion price in effect prior to such issuance or sale is generally reduced to a price determined by dividing (A) an amount equal to the sum of (i) the number of shares of common stock outstanding immediately prior to such issuance or sale multiplied by the then applicable conversion price and (ii) the consideration, if any, received by the corporation upon such issuance or sale, by (B) the total number of shares of common stock outstanding immediately after such issuance or sale.

iii. **Full Ratchet:** Under the "full ratchet" approach to price protection, the conversion price is adjusted down to the exact price of the subsequently issued common stock. Although issuers may view full ratchet anti-dilution provisions as onerous, capital sources occasionally required these provisions more often at times when the possibility of subsequent so-called "down round" financings was greater.

(d) **Conversion vs. Liquidation Preference:** Preferred stockholders often have choices upon the sale of the company in the form of an asset sale or stock merger. The preferred shareholder may either treat such sale or merger as a liquidation and get the liquidation preference back before the distribution of the proceeds to any of the common stockholders, or convert to common stock prior to the sale and be entitled to receive what the other stockholders are getting. A preferred stockholder has to decide which of these two options makes the most economic sense.

(e) **Convertible Debt:** Instead of issuing preferred stock to angels, early stage companies may issue debt that converts into whatever the company issues in the future. The security sold in a convertible debt offering is typically a promissory note that automatically converts into preferred stock at some future time. The intent of the company and investors is that the preferred stock into which the note will convert will be whatever is negotiated between the company and the venture firms in the first venture financing--typically Series A Preferred Stock. The debt typically converts at some discount--usually in the 15 to 30 percent range.
Companies occasionally try to come up with complicated discount matrixes where the discount may vary as a function of the venture firm valuation (i.e., the higher the valuation, the steeper the discount in order to align the interests of the note holder and the company) and the duration that elapses between the time of the sale of the convertible note and the closing of the venture round (i.e., the longer the duration, the steeper the discount on the theory that the venture must have been riskier at such an early point in time).

**Venture Financing**

Companies may seek venture financing in lieu of or following angel financing. In addition to the terms used in angel financing, certain additional terms are likely to be included in a typical venture term sheet that may not be included in an angel financing. Further, as a general rule, venture capital firms will require the rights afforded to previous angel investors be subordinated to the rights of the venture capital firm and will often seek to exclude angel from further participation in the financing of the company and undo many of the blocking rights and protections that angels have required in connection with their investment. As such, it is important to set the stage with angel investors regarding their relative position vis a vis a venture capital firm if additional funding is required.

An example of a typical venture term sheet is attached as Exhibit A. Additional terms used in venture deals include:

(a) **Blocking Rights:** Venture firms will uniformly require the right to approve certain corporate transactions. These typically include the sale of all or substantially all of the assets, a merger, liquidation or dissolution, changes to the charter and by-laws, and certain other fundamental actions.

(b) **Board Representation:** Venture firms will often seek to place one or more persons on the Board of Directors of the company.

(c) **Right of Redemption:** Venture firms will often seek to have a right to sell the Series A Preferred Stock back to the company at an agreed upon price. This gives them the opportunity to get their money out, plus some nominal return, after a certain period of time if the company does not appear to be headed toward a significant liquidity event.

(d) **Registration Rights:** While the right to include securities in a registration statement filed by the company in connection with a public offering is typical (often called "Piggy-Back Rights"), demand registration rights are also used in angel preferred stock financing. Venture firms are likely to require a more comprehensive set of rights, including the right to initiate what is called a demand registration after a certain period of time has elapsed, usually three years after the Series A closing or six months post IPO.

(e) **Rights of First Refusal:** Venture firms will negotiate for the right to purchase shares that are issued in the future by the company. These rights will at a minimum give the venture firms the ability to preserve their pro rata share of the common stock of the company on an as-converted, fully-diluted basis, and may allow them to purchase all of the stock issued in a future financing.
Conclusion

There are a number of factors that need to be considered when starting a company and seeking investment capital. As the past decade has shown, the markets for public and private equity can change dramatically in a very short time. Founders need to ensure that they understand the current market and weigh all of the consequences of their decisions in forming an entity and seeking an equity partner.

This information is intended to provide you with an introduction and items that should be considered when forming a company. Before forming a company or in a company’s early stages, it is highly recommended that the advice of counsel be sought.
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