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The Most Common Mistakes Entrepreneurs Make from a Legal Perspective

("Pay a Little Now or a Lot Later")

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Categories of Common Mistakes

I. Organizational

II. Stock Issuances

III. Intellectual Property

IV. Employment

V. Fundraising

Most Common Mistakes

- Selecting an inappropriate form of legal entity
- Failing to properly maintain corporate records
- Failing to adopt an appropriate stock incentive plan
- Missing an 83(b) election
- Creating stock valuation problems
- Selling securities to unaccredited investors
- Failing to obtain good title to intellectual property
- Failing to properly license technology protected by others
- Failing to protect trade secrets
- Incautiously hiring former employees of a competitor
- Misclassifying employees as independent contractors
- Following an undisciplined fundraising approach

Common Mistakes – Organizational

- **Selecting an inappropriate form of legal entity**
  - limited liability company
    - members protected from personal liability for business obligations
    - no separate taxation on business earnings
    - but, very unattractive vehicle for:
      - rapidly growing ownership (each equity owner must become party to operating agreement; K-1s)
      - recruitment of talent (no ability to grant widely understood stock options)
      - venture capital investment (investor limitations on ability to invest in “flow through” entities)
      - acquisition (may require unanimous action by members to sell their membership interests)
      - initial public offering (equity markets will demand conversion to a corporation)
  - corporation (Delaware is most common, California second most common)
    - shareholders protected from personal liability for business obligations
    - separate taxation on business earnings (unless Subchapter S treatment is elected)[1]
    - attractive vehicle for:
      - rapidly growing ownership base (all shareholders are bound by non-contractual charter documents)
      - recruitment of talent (stock options)
      - venture capital investment (preferred stock)
      - acquisition (statutory merger)
      - initial public offering (common stock)

[1]Note that for most startups, expenses (including salaries) will exceed revenues resulting in no taxable income.

Common Mistakes – Organizational

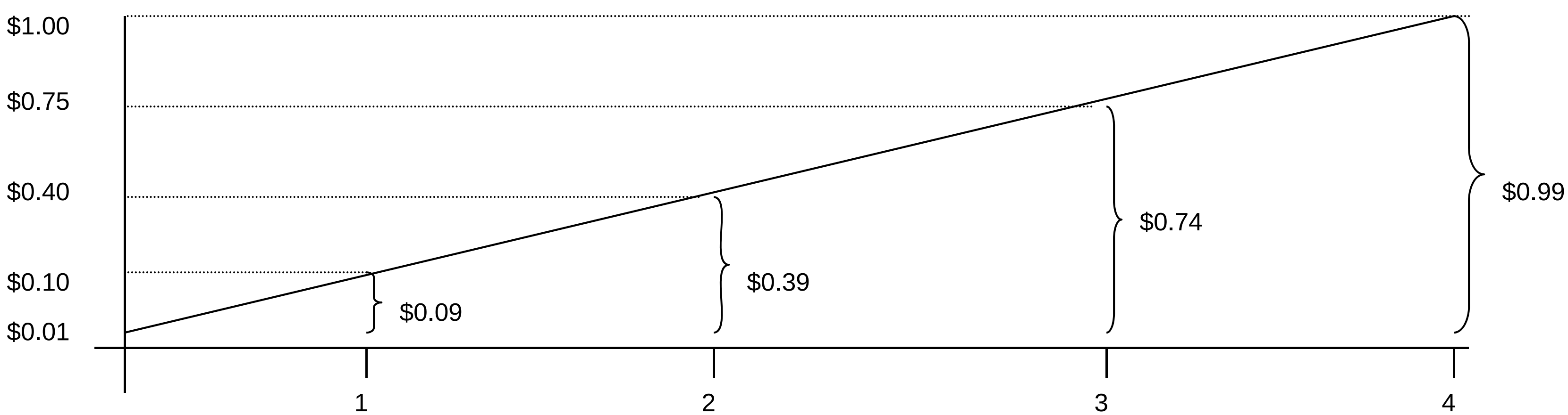
- **Failing to properly maintain corporate records**
  - jeopardizes limited liability of corporate form (i.e. exposes shareholders to personal liability for corporate obligations)
    - creditors can "pierce the corporate veil" and assert claims against shareholders if corporation lacks substance and acts as mere alter ego of shareholders
    - observe corporate formalities (organizational resolutions, adopt bylaws, hold annual meetings, elect directors and officers, observe titles, segregate persona and corporate assets)
  - uncertainty of equity ownership
    - disputes arising from oral agreements and offers of stock and options (most acute in the case of a fractured founder group)
    - compliance with corporate and securities statutes (type of consideration, authorized capital, investor representations)
    - rights among shareholders (voting agreements, buy-sell agreements, pre-emptive rights, drag-along rights)

Common Mistakes – Stock Issuances

- Failing to adopt an appropriate stock incentive plan
  - stock options, restricted stock purchases and restricted stock bonuses
  - time-based vesting (e.g. 25% at first anniversary, monthly thereafter) or performance-based vesting
  - tax benefits of incentive stock options (ISOs)
    - defers recognition of gain upon exercise until time of sale
    - AMT treats spread upon exercise as an item of preference
  - ISOs must be granted pursuant to qualifying plans:
    - in writing
    - approved by shareholders within 12 months of adoption
    - options must expire within 10 years of date of grant (5 years for 10% shareholders)
    - ISOs granted to employees only
    - ISOs priced at FMV (110% of FMV for 10% shareholders)
    - ISOs vest no more than $100,000 worth of stock per year

Common Mistakes – Stock Issuances

- Missing an 83(b) election (within 30 days of issuance)
  - restricted stock awards (i.e. stock subject to risk of forfeiture that lapses)
  - tax imposed on spread between FMV and purchase price at time of lapse



  - 83(b) election to be taxed on spread (i.e. zero) at time of grant

Common Mistakes – Stock Issuances

- **Creating stock valuation problem**
  - delaying incorporation until day before seed financing
    - difficult to argue that the founder stock was only worth $0.001 per share one day before investors pay higher price for their stock)
    - convertible note seed financing avoids valuation issue
  - discounted stock issuances
    - options or restricted stock granted at below-market prices are taxable (409A excise tax)
    - avoid backdating option grants (see backdating scandal circa 2006)
    - charge against earnings and restatement of financials prior to IPO
      - SEC typically reviews grants within 12 – 18 months prior to IPO and looks for ramp up to IPO price
        - 0.5x 12 months prior to IPO
        - 0.75x 6 months prior to IPO
        - 0.9x one month prior to IPO
    - carefully assess value of stock at time of issuance
      - business developments (e.g. achievement of milestones)
      - consider contemporaneous sales to third parties and secondary transfers among shareholders
      - don't overestimate discount of common stock from preferred stock (it is <u>NOT</u> 10:1)
      - third party valuations at time of grant (e.g. independent appraisals under 409A)

Common Mistakes – Stock Issuances

- Selling securities to unaccredited investors
  - take advantage of “safe harbor” of exemption from registration (Regulation D)
  - stringent conditions and disclosure requirements for sales to unaccredited investors in offerings over $1 million
  - “accredited investor” = director, executive officer, $1 million net worth, or $200K/$300K income alone/with spouse in each of two most recent years with reasonable expectation of same in current year
    - use investor questionnaires
  - blown issuance may result in rescission rights for ALL investors in the transaction (i.e. a “money back” guarantee) or enforcement proceeding
  - venture capital investors wont want to invest in a startup with rescission liability
  - more difficult and to acquire startup with unaccredited investors if acquisition proceeds include acquiror stock

Common Mistakes – Intellectual Property

- Failing to obtain good title to intellectual property
  - the company (not the people) must own its intellectual property assets
    - avoids having the company's value walk out the door each night
    - eliminates opportunistic behavior by inventors
  - founders assignment of pre-inception inventions to company
  - employee assignment of inventions conceived on-the-job
    - inducement for employment as consideration
    - limitations of California Labor Code 2870
      - developed entirely on employees own time
      - without using employer's equipment, supplies, facilities, or trade secret information
      - do not relate to employer's business or R&D
      - do not result from any work performed by the employee for the employer

Common Mistakes – Intellectual Property

- Failing to properly license technology protected by others
  - must obtain rights to use patented or copyrighted material of others
    - rights must cover your intended use of the technology
    - beware of contractual restrictions on use of APIs and website terms of use
    - beware of need for license to create derivative works
    - beware of need to sublicense to your end users
    - beware of exclusive vs. nonexclusive rights
    - beware of royalty obligations and termination provisions
  - beware of use of open source components that expose your inventions to public disclosure or public license obligations
  - beware of employees using materials of former employers
  - “freedom to operate” analysis determines under patent law whether a particular action can be undertaken without infringing the rights of others

Common Mistakes – Intellectual Property

- Failing to protect trade secrets
  - trade secret = confidential business information + limited availability + economic value derived from limited availability + reasonable precautions to maintain secrecy
    - employee proprietary information confidentiality agreements
    - third party NDAs (but not sophisticated venture capital investors)
    - limit access to need-to-know basis
    - beware of leakage from departing employees
  - if patentable, trade secret law may protect invention up until publication of patent application
  - must balance desire to maintain secrecy and need to exploit perishable market opportunities (e.g. first to market faces risk of copycats)

Common Mistakes – Employment

- Incautiously hiring former employees of a competitor
  - inevitable in Silicon Valley's environment of workforce mobility
  - claim is usually misappropriation of trade secrets via doctrine of inevitable disclosure; relief is injunction against hiring
  - beware of restrictive covenants on new hires
    - noncompete agreements generally unenforceable in California (but enforceable if in connection with acquisition of former employer)
    - nondisclosure agreements generally enforceable
  - institute employment policies that require written acknowledgment at time of hire

Common Mistakes – Employment

- Misclassifying employees as independent contractors
  - employers must withhold income taxes and pay Social Security, Medicare and unemployment tax on wages paid to employees (reported on Form W-2)
  - payments to independent contractors (reported on Form 1099-MISC) are generally not subject to withholding
  - complicated, 20-factor test applied to determine true characterization of a service provider
    - the stronger the evidence of the degree of the employer's control over the service provider and the weaker the evidence of the service provider's independence from the employer the more likely the classification as an employee
  - improper classification may expose corporation to back taxes, penalties and interest
  - only employees can receive incentive stock options (ISOs)

Common Mistakes – Fundraising

- Following an undisciplined fundraising approach
  - poorly articulated or no business plan
    - absent mitigating circumstances (a serial entrepreneur with a golden track record, a cure for cancer, etc.) ideas alone rarely get funded
    - full-blown formally-documented business plans rarely get read
    - executive summary or 3 – 5 slides must convey subject matter of opportunity or else nothing else gets read
    - sophisticated investors will <u>help</u> develop the plan as the business evolves
    - all investors are different, but most consider (1) size of addressable market, (2) proprietary or competitive advantage, and (3) team as fundamental
  - finding an investor is like finding a date
    - perform research, identify potential investors, find a mutual contact
    - scattershot approach reflects no preparation, no attractiveness and no respect
    - investment terms must be analyzed as a package; valuation is not necessarily outcome determinative