

Tech Start-Ups: Getting the Legal Part Right

Larry Fox and David Peteler

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Twin Cities Startup Week



Choose the Right Entity

- Entity Type (C-Corp, S-Corp, LLC) and Location (e.g. DE or MN) are Tax Driven and Investor Driven
- Use a Good Lawyer and Accountant to Choose the Right Entity
- DE C-Corp is “Standard” for VC and institutional financing
 - Generally assumes acquisition or public offering as exit strategy



Chose the Right Entity cont...

- Sometimes LLC or S Corp (Pass Through Entity) is A Better Choice
 - S Corporation (save FICA and Self Employment Tax)
 - No Corporate Investors. No Foreign Investors, Less Than 100 Shareholders
 - Single Class of Stock – Trap for the Unwary: Preferred Distributions
 - LLC
 - ✓ Good for Waterfall Distributions
 - ✓ Good if Liquidity Achieved Mainly Through Distributions
 - ✓ Ability to Deduct Losses On Personal Taxes (subject to limits)



Set It Up Right

- Consider Overruling Default Rules In some States (like MN)
 - Corporation – Preemptive Rights and Cumulative Voting
 - LLC – Members have Equal Voting and Distributions Even if Capital Contributions Are Different
- Multiple Founders Require Thoughtful Consideration
 - Vesting of Shares
 - Buy Sell; Restriction on Transfer, ROFR; Drag Along, Tag Along
 - Equity Split Among Owners (Part/Full Time; Ideas vs. Implementation; Capital vs. Sweat Equity)
 - Do Not Avoid Difficult Conversations about Potential Disagreements, Break Up or Firing Co-founders



Set It Up Right cont...

- Issuing Equity to Founders
 - Fair market Value –Typically nominal amount at Founding
 - Consider Timely Filing 83(b) Election for Shares Subject to Vesting
 - Board Approval Required
 - Do It Early - Well Before a Priced Round
- Keep All Your Documents Organized and in One Place – DropBox
- Separate Entity Bank Account and EIN
 - Don't Use Entity Accounts for Personal Expenses
 - Keep Your Receipts



Get Employee Hiring Right

- Offer Letter
 - Sets out Compensation (Cash, Equity)
 - Includes Non-Compete, Non-Solicitation and Assignment of Inventions Agreements
 - Specifies Termination (At Will or for Cause)
- Employees (W-2) v. Consultants (1099)
 - Having Non-Exempt Employees Work Without Pay for Potential Equity Creates Tax and Wage and Hour Issues
 - Treating Full Time Employees as Consultants Creates Tax Issues
- Equity Grants Must Be Properly Documented
 - Restricted Stock with 83(b) Election
 - Grant Options Pursuant to Stock Option Plan
 - Board Approval of Equity Issuance or Stock Grant Required



What Is “IP”?

- Intellectual Property, includes:
 - Patents (e.g. Keurig K-Cup)
 - Right to Prevent Others From Practicing Your Invention
 - Does Not Give You Right to Make and Sell Your Product – Third Party Patents May Block You
 - Granted by Government Entity Based on Statutory Factors
 - Patentable Subject Matter, Novel, Non-Obvious, Useful
 - Publicly Disclosed After Filing



What is “IP”? cont...

- Trade Secrets (e.g. Recipe for Coke)
 - Information That Gives Competitive Advantage That You Use Reasonable Efforts to Keep Secret
 - Source Code, Formulas, Methods of Manufacturing, etc.
- Copyrights (Song, Book, Source Code)
 - Original Works of Authorship, Including Source Code
- Trademark – Indicates Source of Goods/Services

Have an IP Strategy

- Decide What to Patent and What to Keep as a Trade Secret
- Understand the Patent Landscape
 - You May Need to License Third Party Patents to Make or Sell Your Product
- Trade Secret is Strategy: Use Reasonable Efforts to Keep Secret and Don't Disclose Without NDA
- Patenting Is Strategy: File Patents Before Sale or Public Disclosure



Have an IP Strategy cont...

- Trademarks
 - Pick a Strong Mark – Fanciful or Suggestive
 - Adequately Clear Mark
 - Unless Trademarks Are Key to Business Strategy (consumer brand) don't spend too much money/time up front



Secure the Company's IP Position

- Get Pre-Existing IP Into the Company
 - Founders Must Contribute Pre-Existing IP to Company at Formation, in exchange for Equity
- Do Not Permit Founder, Employee or Third Party Create New IP Without Assigning it to the Company
 - Assignment of Inventions or Consulting Agreement
 - Third Parties Must Assign New IP or Provide a Sufficient License



Secure the Company's IP Position cont...

- Do NOT Disclose Company Technology/IP/Trade Secrets to Third Party without a Confidentiality Agreement/NDA in Place
 - Public Disclosure can Limit Patentability
 - Public Disclosure can Limit Trade Secret Protection
 - NDA (typically) do NOT assign IP right to the Company. Do NOT rely on NDA for IP assignment.
- Get Non-Compete and Non Solicitation Agreements in Place with Employees, and if possible, with Consultants and Vendors
 - Non-Competes with Employees Must Be Presented with Offer Letter BEFORE Employee Starts



Outside Financing

- Securities Laws Always Apply
- You Always Need an Exemption From Registration or to Register Your Securities
 - Depending on the Exemption, it could:
 - Limit Amounts You Can Accept as Investments Depending On Whether Your Investors are Accredited (\$1m in assets or \$300,000 annual income for married couple) or Non-Accredited
 - Limit on Your Ability to Advertise or Publicly Solicit Investors
 - Create certain Mandatory Disclosures
- Don't pay a "finder" percentage of money raised unless they are a registered broker dealer
- Don't LIE or STRETCH THE TRUTH
- Don't Fail to Comply With Securities Laws
 - You Can Go to Jail or Pay Fines
 - Investors Can Sue You and Get Their Money Back (Even If You've Spent It)



Outside Financing cont...

- Don't Accept investments Without proper documentation
 - Don't Make Oral or "Handshake deals"
 - Use Note, SAFE, Subscription Agreement
 - Honestly Disclose Business Plan, Risks
- Sophisticated Investors will perform legal due diligence
 - You get one chance to show them:
 - You are prepared
 - Where they fit in the capital structure
 - What they will get for their investment



Thank You!

Larry Fox

lfox@avisenlegal.com

612-723-1366

David Peteler

dpeteler@avisenlegal.com

952-237-8700

