IGNITE STARTUP WORKSHOP

Top 10 Legal Mistakes of Startup Entrepreneurs

Michael Meskill
April 5, 2017
Typical Corporate Attorney: Wayne Jarvis, Attorney-at-Law
Mistake 1

“Dammit, I should have formed an entity!”
• Sole Proprietorship
  – Unlimited liability

• General Partnership
  – Unlimited liability
  – Joint and several
  – Unclear terms
• Limited Liability Company
  – Limited liability
  – Pass-thru tax treatment
  – Contractual-based
  – Increasing market acceptance

• C Corporation
  – Limited liability
  – Tax blocker
  – Double taxation risk
  – Statutory-based
  – Wide market acceptance

• S Corporation
  – Investment limitations

• Limited Partnership
  – Real estate, oil and gas, and investment funds

Beware double taxation on sale of C Corp assets
Mistake 2

“Nobody understands their equity awards!”
• Corporation
  – Stock options
  – Restricted stock
  – Easy

• Limited Liability Company
  – Profits interests (K-1 Partner)
  – Separate employee LLC
  – Phantom equity plan
Mistake 3

“We trust each other and don’t need a written agreement.”
• Yes, you need a written agreement
• Ownership percentages
• Voting rights
  – Board members
  – General
• Economic-sharing
• Take-out rights
  – Termination
  – Consider vesting over time
  – Buy-sell
  – Drag-along
Mistake 4

“But I thought WE owned the intellectual property!”
• Patents – patentable ideas, inventions, processes
• Copyrights – works of authorship (including code)
• Trademarks – names, logos, brands
• Apply early

Significant impact on company valuation
• IP assignment agreements with founders and employees
  – Founders and employers may have rights in IP (particularly patents)
• IP assignment agreements with independent contractors
  – Default rule – if independent contractor develops IP, they own the developments
• Beware open source software
• Cautious with license agreements and development agreements
• Execute non-disclosure agreements
Mistake 5

“Hey, let’s name our company Facebook.”
• Do not invest in the wrong brand
  – Costly mistake

• Research infringement risks
  – Online searches
  – USPTO search
  – Domain name availability

• Seek trademark intent to use registration
Mistake 6

“Nana’s investment isn’t a REAL investment.”
• You are issuing securities
• Each sale of security:
  – Register with SEC, or
  – Exemption from registration, or
  – Illegal
• Most common exemptions:
  – 4(a)(2) private placement
  – 506(b) – no general solicitation
• Recent developments
  – 506(c) – general solicitation
  – Crowdfunding
• Accredited Investors – Rule 501(a)
  – No nonaccredited investors!
• PPM + Risk Factors
• Shareholder police force
• Rescission offer
• Hinder ability to raise funds in future
• SEC/TSB penalties

Beware unlicensed broker-dealers

• Finder helping you raise funds
• If fees based on size or success of offering, finder must be registered with the SEC as a broker-dealer
Mistake 7

“We just closed our offering. Let’s go celebrate!”
• Dot your “i”s and cross your “t”s

• Offering closes:
  – Ensure Board approval and enough authorized shares
  – Ensure all subscription agreements and accredited investor questionnaires are completed and signed
  – Ensure all investors are accredited!
  – Ensure all definitive agreements are signed and dated
  – Ensure stock certificates are signed and delivered
  – Ensure cap table is accurate
Mistake 8

“"I have a million more important things to do.""
• Maintain corporate formalities
  – Separate books
  – Separate bank accounts (no commingling)
  – Annual Board elections
  – Board approvals of important items
  – Document approvals and meetings
  – Annual shareholders meetings
  – Ensure all contracts are signed in the correct name and dated
• Maintain accurate records
• Maintain accurate financials
Mistake 9

“You promised me equity! See you in court!”
• Oral “promises” of equity
  – For services such as product development, finance/accounting help, etc.
  – Company doesn’t have the cash to pay
• Service provider may or may not perform or may leave under bad circumstances
• Still has claim to equity
• Service provider raises claim at most inopportune time for maximum leverage
  – Company raise
  – Company sale
• All equity issuances should be documented in a writing signed by both parties
  – Always involve securities lawyer before issuing equity
Mistake 10

“We finally got a term sheet! Sign it now!”
• Term Sheets are negotiable
• Type of Security
  – Common
  – Preferred
  – Convertible notes
• Valuation
• Economics
  – Dividend/coupon (cumulative vs. non-cumulative)
  – Liquidation preference
  – Participating vs. non-participating
  – Conversion discount
  – Valuation cap
• Governance
  – Ownership percentages
  – Founders’ level of control
  – Board representation
  – Special voting protective provisions

• Other rights
  – Preemptive rights
  – Registration rights
  – ROFR/Co-Sale rights
  – Information rights