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Common Legal Pitfalls Startups Need to Avoid

UCLA TECHNOLOGY DEVELOPMENT GROUP

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Stradling Yocca Carlson & Rauth

- Stradling is a full service business law firm with one of the largest corporate practices in Southern California for over 40 years
- Stradling represents companies, entrepreneurs, investors that need a sophisticated law firm with experienced advisors to guide critical transactions and provide strategic counsel
- Stradling is at the forefront of Emerging Companies & Venture Capital, earning national recognition and honors for the practice

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Agenda

1. Forming the Proper Entity
2. Protecting & Respecting Intellectual Property
3. Employees and Service Providers
4. Equity Compensation
5. Does it All Really Matter?

Why Worry?

Risks Include:

1. Unexpected Tax Liabilities

2. More Expensive and Time Consuming to Clean-Up

3. Litigation

4. May Create Significant Challenges – Potentially Cratering a Deal (Financing or Acquisition)

5. May Inhibit Ability to Continue Business

Form the Proper Entity

1. Benefits of Formation
   - Limitation of liability
   - Clarify ownership of entity and assets
   - Tax considerations

2. Form of entity
   - Corporation, LLC, etc.
   - Based on future plans for business

3. Jurisdiction of Formation
   - Delaware, California or other?

Form of Entity

	Limited # of owners	Limited Liability to Owners	Tax efficient Equity Grants	More expensive accounting/ legal fees	SE tax savings opportunities	One layer of tax	Passive investors pain for owners	Flexible
C Corporation		X	X		X			
S Corporation	X	X		X	X	X	X	
LLC		X		X		X	X	X
LP		X*		X	X	X	X	X
LLP		X**		X		X	X	X
GP				X		X	X	X
Sole Proprietor	X					X		

* General Partner has unlimited liability

** Unlimited Professional Liability

Form of Entity for Startups

- Really only two types of entities are recommended for emerging growth companies:

C-corporations and LLCs

Protect Intellectual Property

- At outset: Founders to assignment IP
- At growth: Employee and Consulting agreements
  - Confidentiality Obligations
  - "Work for Hire" critical for independent contractors
- Company Name: Domain Name and trademarks
- Company IP: Trade Secrets, Patents, copyrights
  - Non-Disclosure and confidentiality agreements (NDAs)

Respect Intellectual Property

- Intellectual Property is both a Sword and a Shield

- Emerging Growth Companies must worry about taking other parties IP:

  - Trade Secrets - Patented Ideas - Customer Lists

Employees and Service Providers

- **Often biggest source of legal issues for emerging growth companies**
  - Taking teams and IP from other companies
  - Employee/contractor classification issues
  - Equity allocations and departures
  - Employee exits from startups (threats of lawsuits)

Employees and Service Providers

- **Ways to Protect Startups**
  - **Good Counsel**
    - Attorneys, Advisors and Outsourced HR
  - **Good Documentation**
    - Offer letters, handbook and consulting agreements
    - Contractor/work-for-hire agreements
    - Equity grant agreements with vesting
  - **Good Insurance**
  - **Good Practices**
    - Create an environment of compliance and respect

Advisors

- **Establish the right team of advisors, mentors and service providers early on**

- **Advisors and Mentors (Strategic and Business)**
  - Industry or business expertise to fill in weaknesses
  - Can open doors for strategic partnerships and funding
  - Avoid inactive Advisory Boards

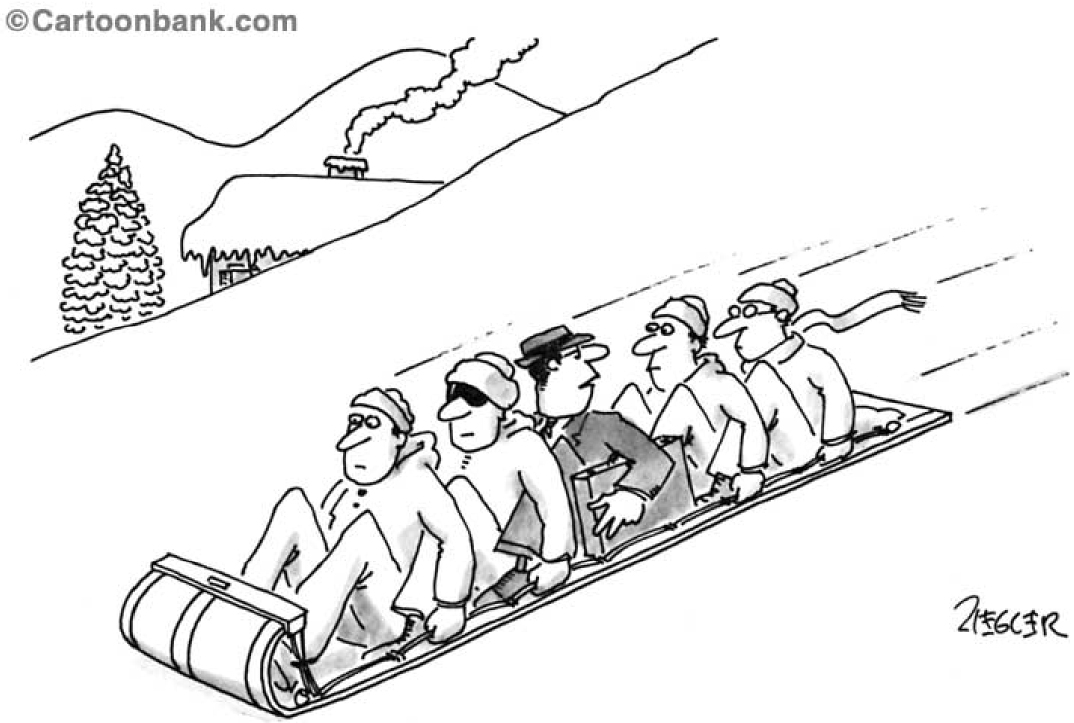
- **Legal, Tax and Accounting**
  - Look for this experienced working with startups
  - Entrepreneur’s perspective is vital

Equity Compensation

- Document everything in writing (including equity promises)
- Options and other equity grants implicate:
  - Tax Laws
  - Securities and Corporate Laws
  - Accounting Rules
- Maintain Proper Practices and Documentation
- Standard Vesting and Award Allocations
- Company Sale - What Happens?
- International Implications for non-U.S. grantees

Parting Thoughts…

- Do it right the first time – this will save time, money and frustration (and possibly a deal)!
- Plan for the future from the start!
- Think big and plan for success!



"Look, I'm not saying it's going to be today. But someday—someday—you guys will be happy that you've taken along a lawyer."

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Questions?

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Appendix

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Fundraising for Early Stage Companies

- **Types of Investors**
  - Friends and family
  - Incubators
  - Angels and Super-angels
  - Venture Capital funds
- **Typical Amounts Raised**

Early Stage Financings: Instruments

- **Equity**
  - – Common Stock
  - – [Series Seed] Convertible Preferred Stock
- **Debt**
  - – Promissory Notes (Bank Loans, A/R Loans)
  - – Convertible Promissory Notes
- **Derivatives**
  - – Simple Agreements for Future Equity (SAFE)

Early Stage Financings: Instruments

- **Equity vs. Non-Equity**
  - When and why should a company issue Preferred Stock?
- **Convertible Notes vs. SAFEs**
  - What is the difference?
  - Are there any drawbacks to using SAFEs?

Convertible Notes (A Closer Look)

- **Convertible Notes are Debt**
  - Term loan (with interest) repaid in cash or equity
  - Intent is to have loan convert into next round of financing, rather than repaying with cash
- **Convertible Notes are "Securities"**
  - Shares issuable upon conversion subject to securities laws.
- **Why issue?**
  - Simpler, cheaper, and faster than an equity investment
  - No formal valuation given : can "bridge" to some event

Initial Fundraising Challenges

- **"Friends & Family" Rounds**
  - – Avoid future issues
  - – Fairness, alignment of issues
- **Plan for future dilution**
- **Securities Law Issues**
  - – Accredited investors
  - – Regulatory filings