Common Legal Pitfalls Startups Need to Avoid

March 1, 2019

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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

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<tr>
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<th>Limited # of owners</th>
<th>Limited Liability to Owners</th>
<th>Tax efficient Equity Grants</th>
<th>More expensive accounting/legal fees</th>
<th>SE tax savings opportunities</th>
<th>One layer of tax</th>
<th>Passive investors pain for owners</th>
<th>Flexible</th>
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* 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.”
Questions?

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Appendix
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