

Noli IP Newsletter

NOLI IP Solutions, PC

7/15/2015

Corporate Edition, Vol. 1

Technology Start-Ups in California: Formation, Corporate & IP Issues

By David Kern Peteler

Entrepreneurs considering a technology start-up are faced with great opportunities, and a wide range of business and legal issues. The technology offering must be innovative; the business case must be compelling; and the legal structure must be robust to protect the technology and accomplish the business goals.

"Entrepreneurs considering a technology start-up are faced with great opportunities, and a wide range of business and legal issues..."

Start-ups involve many complicated and interrelated issues of corporate, securities, tax, employment and IP law. It is in the founders' advantage to address these basic start-up issues carefully with the help of qualified corporate and IP counsel, to get their business started in the right direction.

SOME BASIC ISSUES

A tech start-up needs to address at least certain basic points. All are interrelated,

and must work together for the success of the business.

1. Choose a Name.

The founders will want to choose a name that at least:

- is available from the Secretary of State;
- is adequate for branding and marketing strategies;
- has a URL available that is

not confusingly similar to that of a competitor; and

- can be trademarked.

2. Choose a Type of Entity.

The choice of the entity to use depends on the business plan, the financing strategy, the exit strategy, and legal (corporate, tax, employment and securities law) issues. The entrepreneurial team should meet with corporate counsel to discuss the goals and plans for the business, and select the type of entity

Meet David Kern Peteler



David Kern Peteler, founder and principal of The Peteler Law Office, has over 30 years of experience providing corporate and finance law service to tech companies in the start-up, financing, M&A and operating aspects of their businesses, starting in the Silicon Valley area in the early 1980s.

Ms. Mariana Noli had the opportunity to work with David for the first time over three years ago and it is our pleasure to announce that **The Peteler Law Office** will be strategically aligned with **Noli IP Solutions PC** to provide many of the services mentioned above for our clients.

For more information about The Peteler Law Office, see www.petelerlaw.com.

that will serve their goals best. Good entity choices are:

a. Corporation. The standard corporation (also known as a “C Corporation”) is the classic high-tech startup vehicle. It is preferred by VCs and other investors and financiers. Sometimes East Coast tech investors prefer a Delaware, rather than a California corporation, as they are used to working with Delaware companies.

b. Subchapter S Corporation. The Subchapter S Corporation is a corporation that elects under IRS rules to be treated as a pass-through entity (“pass-through” means the profits and losses of the company are passed through to the equity holders and are taxed to them personally). A Subchapter S corporation has restrictions on shareholders that are not individual US citizens, which must be considered.

c. Limited Liability Company. The limited liability company (LLC) is an attractive vehicle for start-ups, due to its combination of limited liability, pass-through tax treatment, and great flexibility. An LLC is not the classic entity for VC investment, although it is becoming increasingly accepted as investors understand its benefits.

3. Prepare a Business Plan

A good business plan is critical for success. A good business plan will cover at least these topics:

- Company Overview
- Sales Forecast
- Products or Services
- Marketing Plan
- Market
- Management Team
- The Business Case
- Financial Projections
- Financing Plan

4. The Formation Process

a. Filings. A C-Corporation, Subchapter S Corporation, and LLC are all formed by filing the appropriate documents with the Secretary of State. A Subchapter S Corporation requires the additional step of filing an election with the IRS.

b. Other Documents. A corporation will require bylaws, and probably one or more of the Ancillary Agreements discussed below. An LLC, particularly for a tech company seeking outside financing, will require a carefully drafted Operating Agreement, as well as one or more of the Ancillary Agreements below.

c. Transfer of Assets. Often in a tech start-up, intangible assets, such as a patent or patent registration, trademark or trademark registration, business plan, logo or graphics, marketing materials, already exist and are planned

to be used for the business. This may be the property of a founder, who expects equity in the company in exchange for this contribute. A written asset transfer document is required to move these assets into the company.

5. Management

Good management is a key to business success. Management and governance issues should be considered carefully in the start-up process. It is best not to make management entrenched at an early stage, as six to 18 months of operating experience often show that management should be changed; and outside investors will have their own ideas on management.

a. Corporations. A corporation is governed by a Board of Directors. The decisions of the Board are implemented by the officers.

b. Limited Liability Company. An LLC is either “member managed,” in which case it is managed by all the members; or it is “manager managed,” in which case it is managed by one or more designated managers, who function much like directors in a corporation. If outside investment is contemplated, a “manager managed” LLC is the better choice.

c. Management Contracts. Management will want

executive employment contracts and equity compensation. These contracts involve corporate, tax, and securities laws issues. The entrepreneurial team should discuss these with experienced counsel.

6. Personnel

Start-ups frequently have no, or few, employees. Personnel may, at least in the early phase, be either non-employee members of the LLC or S-Corporation, employees, or independent contractors. These three categories of personnel present different issues under corporate, employment and tax law. When you begin paying employees, be sure to comply with federal and state employment and payroll laws. An employee manual or handbook, setting out company policies, is good to have.

All personnel should sign at least the following:

- a. An agreement that clearly sets out their work status, term of engagement, and compensation;
- b. Confidentiality and non-disclosure agreement; and
- c. Intellectual property assignment agreement, so any intellectual property they create within the scope of their engagement is assigned to the company.

7. Intellectual Property Protection

Particularly in a tech start-up, IP considerations are critical. Many start-ups put trademark registration and other IP planning off until a later stage. If the desired mark is not available and protected from the beginning, time and money spent on a branding strategy may be wasted. The founders should meet with IP counsel as soon as possible to discuss at least the following:

- * Initial assessment of IP assets;
- * Identification of IP needs; and
- * Developing a plan of IP protection.

8. Important Ancillary Agreements

For most tech start-ups, one or more of the following agreements are useful at the start-up stage; and important at the financing stage. In an LLC, many of these provisions should be included in the Operating Agreement. References to “shares” and “shareholders” also refer to membership interests of members in an LLC.

a. Rights of First Refusal. No equity holder can sell his or her equity without first offering it to the company and the other equity holders.

b. Tag- Along Rights. If a shareholder finds a buyer for his or her stock, the other shareholders can “tag along”

and sell some of their shares to the buyer.

c. Drag-Along Rights. If the Board of Directors (or managers of a manager-managed LLC) and a majority of the equity holders approve a sale of the company, then all shareholders must agree to that sale.

d. Pre-Emptive Rights. If the company issues new equity, all equity holders may purchase their pro-rata share of the issuance. These are often required by outside investors.

e. Vesting Agreements. “Vesting” means that an equity holder (typically an employee) does not fully own the equity until the vesting requirements have been met.

f. Voting Agreements. Voting agreements provide that all equity holders must vote for one or more particular persons to be directors of the corporation, or managers of a manager-managed LLC.

g. Lock-Up Agreements. This provides that shareholders may not sell their shares in an IPO unless the sale is approved by the underwriters. The underwriters will require Lock-Up Agreements before an IPO.

h. Indemnification Agreements. These provide formal indemnification

obligations of the company as to directors / managers and officers. Outside directors / managers will likely require this agreement.

i. Stock / Equity Purchase

Agreements. A start-up should require all equity holders, whether inside team members or outside investors, to sign written equity purchase agreements.

j. Section 83(b) elections. An 83(b) election is a form filed with the IRS in the event a shareholder acquires shares that are subject to a risk of forfeiture (such as repurchase or failure of vesting).

k. Management Bonus Plans and Stock Option Plans.

Stock option plans are a good management incentive tool. Stock option plans must comply with detailed corporate, tax and securities laws rules. LLCs may also have incentive equity plans, although the corporate and tax rules and benefits are different from those of a corporation.

l. Confidentiality Agreement.

All personnel, including founders, directors, officers, employees, independent contractors, and all investors, should sign an appropriately drafted confidentiality agreement. Potential investors and others should sign an appropriate confidentiality agreement before they are allowed to do

obtain any significant company information.

9. FINANCING

Financing is where the business case, the management team, the corporate structure, and proper corporate documents come together to present a favorable investment opportunity. All these elements must pass the scrutiny of investors or the financing may not occur. Frequent start-up financing structures are:

Founders, Family and Friends.

Typical initial start-up capital is equity contributed by the founders, family or friends, often equity at a nominal price per share.

Tax Benefit and Cash Flow

Investors. Some investors are interested in obtaining tax losses at the early stage, and cash flow from operations in the future.

Angel Equity. Angel equity is expensive money, as the angel investor will want their shares at a low price, commensurate with their risk for investing at an early stage.

Early Stage Convertible

Notes. Early stage convertible notes are a popular alternative to angel financing, especially in the pre-revenue stage. These are typically convertible into equity at a discount to the

company's next equity offering price.

Preferred Stock. This is a classic VC instrument, but generally not used unless the company has revenues.

Investors may require IP protection to be in place before they invest, particularly if IP assets are key assets of the company. They will likely require ancillary agreements, including tag-along and drag-along rights, possibly preemptive rights, and vesting agreements for the founders. Financing is complex, and critical to the development of the company. Founders should consult with an experienced corporate finance attorney, and IP counsel.

SUMMARY

Forming a tech start-up presents the founders with complicated corporate, financing, tax, securities and IP law issues. All of these must be coordinated and orchestrated to provide a robust legal structure for the protection and success of the business. Founders frequently are not familiar with many of these complex and important issues.

This article presents some issues and concerns to be considered in a tech start-up. It is not an exhaustive list of issues, and it is not a

substitute for advice of experienced counsel. Each tech start-up is different, and presents its own special

opportunities and challenges. Founders are advised to consult an experienced corporate finance attorney

and IP attorney in planning and implementing their tech start-up.

Exploring San Diego Start-Up Week

By Mariana Paula Noli

In our ongoing efforts to work with the startup community, entrepreneurs, small and medium size businesses, we decided to explore local opportunities by attending the San Diego Startup Week (SDSW), which took place from June 14-20 in the heart of downtown San Diego.

Featuring a week of scheduled events, panels, and social events, SDS Week (sandiegostartupweek.com/) brought together the city's brightest entrepreneurs, top-tier regional and national investors, strategic advisors and high profile community, as well as political supporters.



For us, the week kicked off at a sponsored social event at Downtown Johnny Brown's, where my sister Luciana and I

met with existing clients and had a chance to mingle with other entrepreneurs who are part of San Diego's thriving startup ecosystem.

Among the many interesting workshops and events offered throughout the week, I particularly enjoyed the "Growing a Successful San Diego Startup Business" seminar at the Diamond View Tower.



One of the panelists, Austin Neudecker, head of Growth and founder of Rev, shared his experience starting several companies, some successes, and some failures. "You are going to make mistakes, make them fast..." Neudecker said. Other members of this panel were Al Bsaharah, CEO and cofounder of Email Copilot;

Rich Karlgaard, publisher for Forbes magazine and Andrew Clark, Bridgepoint Education CEO. 2008 Ernst & Young Entrepreneur of the Year, all of whom discussed what it takes to grow a successful startup and a thriving tech ecosystem. We had an opportunity to hear firsthand from this expert panel of startup pioneers about their take on solving real-life challenges facing local startups at each stage of the lifecycle (Idea. Development. Seed. Scale).

Spencer Hutchins, CEO and Co-Founder of Reflexion Health started the discussion about "Developing your Team" at EvoNexus, where he talked about the culture of the work environment, the personalities and passion of the members, working for pay or for equity as well as what to take into account while growing a team of staff and interns.

The importance of the relationship between success of startups and the protection of the intellectual property rights was highlighted at the workshop about "Trademarks,

Copyrights, Patents and Phototyping: What is the Difference and When Should you Start?" at the STEAM Maker Workshop.



These were some of the many interesting workshops we attended during the San Diego Startup Weed.

Closing an intense week of learning, mentorship and networking, we shared some interesting conversations with fellow entrepreneurs at Stone Brewing World Bistro & Gardens in Liberty Station. It was an amazing week and a great experience!

At Noli IP Solutions PC, we believe in innovation, as well

as creativity and entrepreneurialism. We consider ourselves a startup company and we understand the many challenges and obstacles you and your business will encounter during the startup lifecycle.

For more information on how the Noli IP team can help you and your business, please do not hesitate to e-mail us at mail@noli-ipsolutions.com.

Business Makes the World Go Around: Ms. Marai in Europe

We at Noli IP Solutions, PC love startups. We have been designated intellectual property legal counsel for several incubators, accelerators and companies devoted to help other businesses, mainly foreign businesses, achieve strategic success in the US.

Giving a workshop at the Startup Chile Office in Santiago, Chile; visiting 500 Startup Mexico City; participating of the San Diego Startup Week are some recent examples of our efforts to reach out to the startup community.

During a business trip to Europe, Ms. Judit Marai reached out to many of our existing clients, visited many companies and entrepreneurs in her home country, Hungary, interested in doing business in the US. Given her background, she understands the challenges faced by eastern Europeans and she is particularly interested in working with them to achieve success in the States.

For more information on our Startup Practice, please do not hesitate to contact us:

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