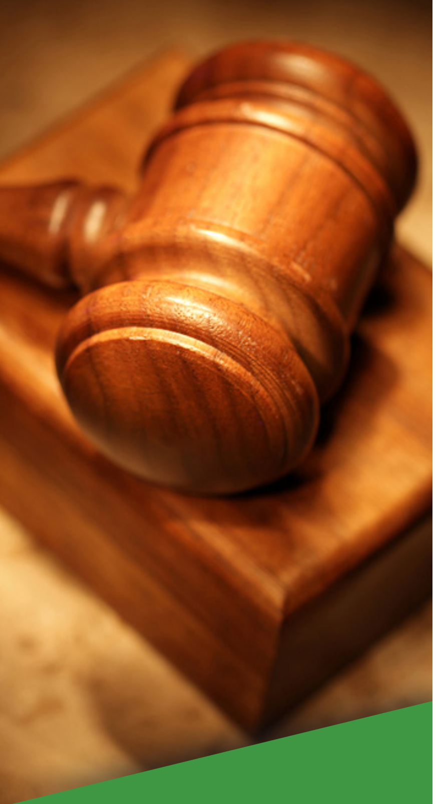

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Founder Fundamentals

Ten Legal Issues Founders Need to Know

By Terrence M. Kerwin

Founders make countless decisions regarding their startup. Below is a list of ten legal issues that founders need to know.

1. Choice of Entity

A startup may choose to offer an employee or independent contractor the right to purchase stock in the company as a part of the service provider's total compensation package. Stock options have the benefit of aligning the employee with the success of the company.

Although many factors go into determining whether to form a startup as a corporation or an LLC, two important aspects are the startup's funding and hiring plans. A startup will typically form as a corporation if founders expect to raise venture capital (generally $2 million or more), as VC firms often prefer to invest in a corporation to avoid the pass-through profits and losses of the LLC being attributable to the individual partners of the VC firm. Further, if founders intend to incentivize employees through the issuance of stock options, a startup will typically form as a corporation, as a stock option plan of a corporation is typically less expensive to put in place and easier to administer than a profits interest plan of an LLC.

2. Jurisdiction of Formation

Although forming a startup where its headquarters is located is generally fine, the most popular jurisdiction in which to form a startup is Delaware, primarily because:

- Investors are most comfortable with investing in Delaware entities.
- Delaware has flexible business statutes.
- There is extensive business law precedent in Delaware.

Founders should also consider the costs associated with engaging a registered agent in a state of formation where the startup is not located and qualifying to do business in other states.

3. Vesting of Equity

Founders should consider whether their equity should be subject to forfeiture over time (commonly referred to as "vesting"). For instance, if one founder leaves the business, the other founders may not want the departing founder to keep all of his or her equity. In connection with receiving shares subject to vesting, however, the founders must be sure to make a timely election (within 30 days of issuance) under Section 83(b) of the Internal Revenue Code to avoid adverse tax consequences when such equity vests.

4. Stockholders'/Operating Agreement

With multiple founders, a vital document to put in place in connection with the formation of the entity is a Stockholders' Agreement (for a corporation) or an Operating Agreement (for an LLC). Such agreement will typically address

- The management of the entity
- The right of founders to participate in future equity issuances
- The rights and obligations of founders with respect to equity transfers

5. Restrictive Covenants

Founders and investors in a startup certainly do not want to see a founder leave and form a competitor or solicit customers or employees away from the startup. Therefore, whether it is in the Stockholders'/Operating Agreement described above or in a separate agreement, each founder should be bound by reasonable restrictive covenants.

6. Assignment of Inventions

Founders, employees, developers, suppliers, and other contractors should all be bound by written agreements that provide that all intellectual property created in connection with the services performed for the startup is assigned to the startup Absent a written agreement, the individual or entity providing the services will generally have ownership rights in such intellectual property, which will cause problems for the startup when it is looking to raise capital or be acquired.

7. Patent Protection

Filing a patent application early in the development of a technology is often very important, as:

- The U.S. operates on a first-to-file basis (meaning that the first person to file a patent application has rights for protection of the invention).
- A patent application must be filed before the first sale or public disclosure of the technology, otherwise it will not be eligible for protection in most countries. (A one-year grace period may be available in the U.S., but that grace period applies only to the inventor's own disclosures.)

8. Equity Incentive Plan

In order to incentivize key employees and consultants to help grow a startup, the startup may grant such individuals stock options (in a corporation) or profits interest (in an LLC). These grants need to comply with IRS rules in order to be tax advantageous to the startup and the grantee, but are a very effective way for the startup to incentivize employees without having to expend cash.

9. Debt or Equity Financing

Founders often consider whether to raise funds through a debt or equity financing Many factors go into determining what type of financing is most appropriate and likely to succeed. However, if founders would like to raise seed capital without having to value the startup, they can raise capital pursuant to a debt financing (convertible notes) which provides that the debt will convert to equity at a discount to the price offered in the next equity raise.

10. Recordkeeping

Founders should stay well organized from the start, and keep all important or executed documents of the startup in one place. Investors and acquirers will need to review all such documents in connection with a transaction, and therefore the startup will save time and money if such documents are well organized.

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