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Representing Startups: Choice of Entity, Protection of IP, Employment Agreements, Equity Compensation and More

WEDNESDAY, JULY 17, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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July 17, 2019



REPRESENTING STARTUPS:

Selection of business entity—
tax, finance and other
considerations



LLC vs. Corporation

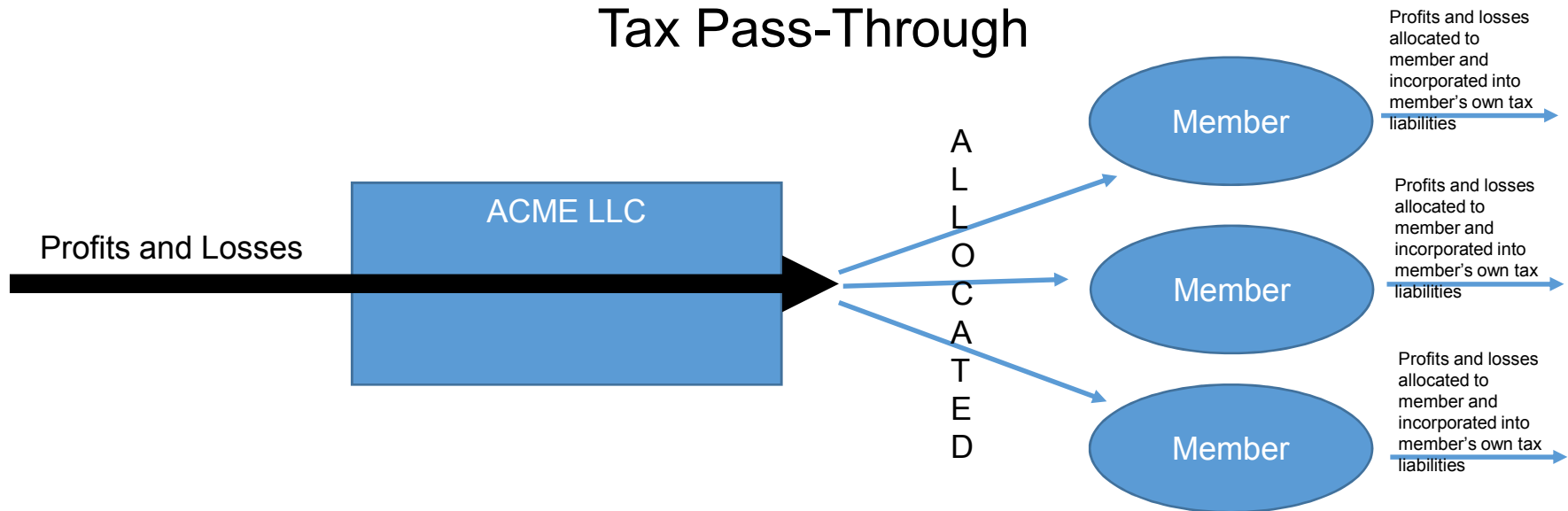
LLC =
Tax Pass-Through

Corporation =
“Double Taxation”*

*Does not apply to Subchapter S
Corporations

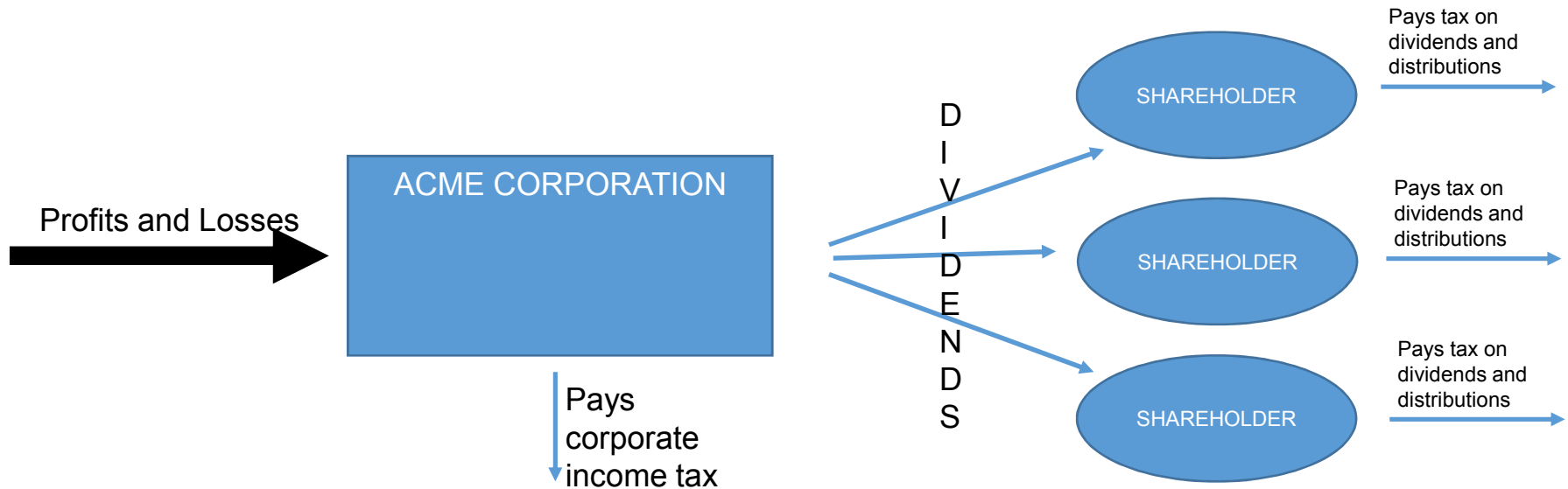
LLC vs. Corporation

LLC =
Tax Pass-Through



LLC vs. Corporation

Corporation =
“Double Taxation”





LLCs

- Best where no expected additional owners
- Allows for special tax allocation
- Easy to grant profits-only interest
- Not as easy to administer when adapted for special needs of startup



Corporation

- Easy to administer
- Best if seeking traditional VC funding



What About S Corporations?

- Pass-through taxation (like an LLC)
- Self-employment tax issue
- Allows for granting restricted stock subject to vesting, options, etc...
- Certain limitations:
 - < 100 shareholders total
 - Individual shareholders must be U.S. citizens or permanent residents
 - Must have single class of stock



Qualified Small Business Stock (QSB)

- IRC Section 1202
 - Historical benefit – *partial* exclusion
 - Change with Small Business Jobs Act of 2010
 - 100% of the gain realized (up to \$10 million) is excluded from federal income tax
 - Only available for C-corps



REPRESENTING STARTUPS:

Equity structure and
compensation of founders
and employees

Equity Structure: Startup Capitalization

Common Stock	
Total Authorized	10,000,000
Total Issued	6,000,000
Shareholder #1	2,000,000
Shareholder #2	2,000,000
Shareholder #3	2,000,000
Available	4,000,000

$$\% \text{ Fully-Diluted Capitalization} = \frac{\# \text{ of Shares Held}}{\text{Total Issued Shares}} = \frac{2,000,000}{6,000,000} = 33 \frac{1}{3}\%$$

Equity Structure: Dual-Class Common Stock

Class A Common Stock		Class B Common Stock	
Total Authorized	10,000,000	Total Authorized	200,000
Total Issued	6,000,000	Total Issued	200,000
Shareholder #1	2,000,000	Shareholder #1	200,000
Shareholder #2	2,000,000		
Shareholder #3	2,000,000		
Reserved for conversion of Class B	200,000		
Available	3,800,000	Available	0

Shareholder #1 Voting Power =

Class A Shares + (30 * # Class B Shares) =

2,000,000 + (30 * 200,000) =

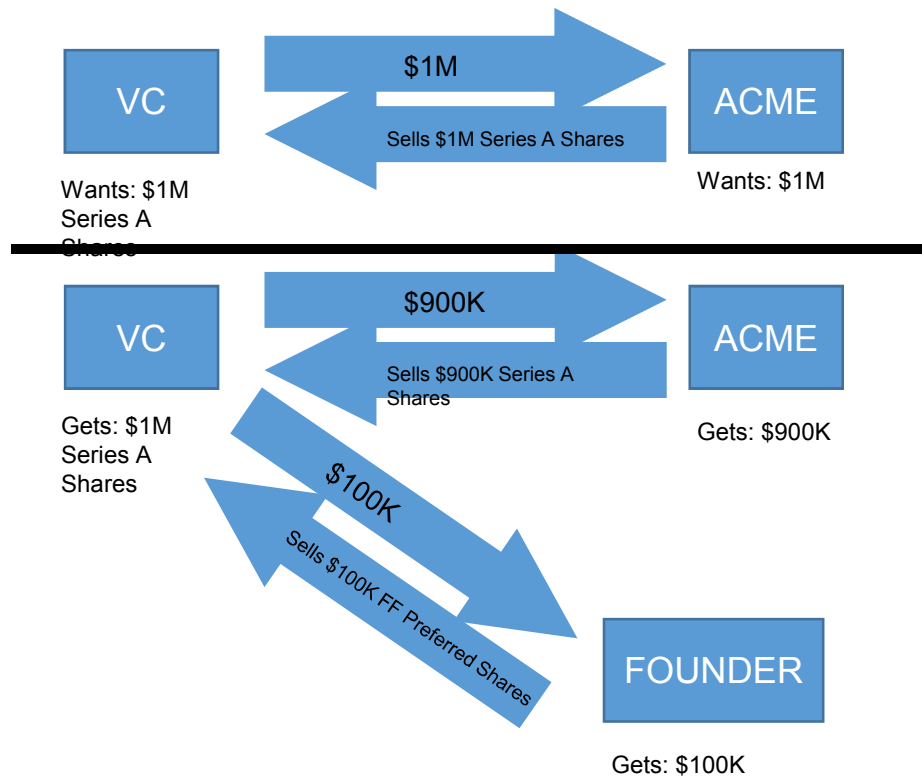
2,000,000 + 6,000,000 = 8,000,000

Pro: Gives founder control

Con: Unlikely to survive first equity financing

Bottom line: May be best for lifestyle companies

Equity Structure: Series FF Preferred Stock



- Allows founder to obtain liquidity for their stock
- Functions like common stock when held by original owner
- When sold directly to investor in financing round, converts to that series of preferred stock bought by investor in the round



Equity Compensation for Founders/Employees: Startup Compensation

- Equity vs. Cash
- Stock grants subject to “vesting” or “sweat equity”



Equity Compensation for Founders/Employees: Equity Compensation for Employees

Restricted Stock

- Benefit – tax treatment
- Drawback – procedural hassles



Equity Compensation for Founders/Employees: Equity Compensation for Employees

Stock Options

- Benefit – easier to administer
- Drawbacks – tax treatment; 409A issues



Equity Compensation for Founders/Employees: Shareholder Agreements

- Provides for various contingencies
- Not typical in startups
- Best for small businesses with little ownership dilution potential

Employment Law for Startups

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Common Employment Issues for Startups

- Worker classification
 - Independent contractor v. Employee
 - Exempt v. Non-exempt
- Equity
- Leave policies
- IP ownership
- Founder's pay
- Advisors
- Distributed workforces
- Internships

Classifying the Relationship

- Independent Contractor v. Employee
- Exempt v. Non-Exempt

Independent Contractor Test (Federal)

- IRS has a 20-factor test to determine if a worker is a contractor or employee, though states sometimes use a different standard
 - Factors include: setting of work hours, continuing relationships, furnishing tools and materials, working for more than one client at the same time.
 - Main factor is who has control over the work being done.

States using this or similar test: New York, Texas, and Michigan

Independent Contractor Test (ABC test)

A person will be considered an independent contractor only if the hiring entity can prove all three of the following:

(A) The worker is free from the type and degree of control and direction the hiring entity typically exercises over its employees; and

(B) The worker performs work outside the scope of the hiring entity's business, and whose work therefore would not ordinarily be viewed by others as working in the hiring entity's business; and

(C) The worker is customarily engaged in an independently established trade, occupation, or business, taking such steps as incorporating his business, getting a business or trade license or advertising.

States that use this test include: California, Massachusetts, Illinois, Washington, Connecticut, and New Jersey.

Some state use variations of this test, including the "AC" test (ex: Pennsylvania, Oregon)

Exempt v. Non-Exempt

- Overtime and breaks
- Salary is not enough to make an employee exempt
- Exemptions:
 - Professional
 - Administrative
 - Executive
 - Additional ones can include: highly-compensated workers (not applicable in some states, including California), outside sales

Do Founders Need to be Paid?

Leave and Other Employee Benefits

- Startups and tech companies often lead the way in employee-friendly company policies
- Need to have competitive policies to attract the best applicants
- Unlimited Leave policies can often result in less time off for employees and no payout when they leave
- Ensure compliance with other state, federal, and local laws

Bringing on Advisors

- Advisors often paid in equity and treated as contractors
- Be sure that Advisors are truly contractors/consultants and that they shouldn't be properly classified as employees
- The same applies for consultants!

Misclassifying Advisors, Consultants, and Employees

- Steep penalties – back wages, tax withholdings, missed meal and breaks, overtime, fines/penalties
- Claims can be brought by individuals or it can be the result of a worker classification audit
- If a business model depends on contractor classification, it's important to get it right from the start!

Documenting the Relationship

- Offer Letter
- Confidential Information and Invention Assignment Agreement
- Stock Option Agreement
- Stock Option Plan
- Employee Handbook

Distributed Workforces

- The number of companies with employees working remotely is rising
- Make sure to know where all employees are located and to follow all local employment laws
- Business expenses: may be expected to pay for home office expenses, cost of internet/utilities/phones for distributed employees
- May need to register for state or foreign entities if you have workers there

Takeaways

- Cash-strapped startups benefit from investing in employment legal compliance early on
- Startups do not have special exemptions to employment laws
- Distributed workforces present additional legal compliance issues

Protecting Intellectual Property

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What is Intellectual Property?



Four types of legal protections for IP:

Patents:

- protect new and useful inventions.

Copyrights:

- protect original, literary, dramatic, musical or artistic works, including software;
- protect expression of the idea, not the idea itself.

Trademarks:

- protect words and design used to distinguish goods and services from those of others in market.

Trade Secrets:

- protect information that is commercially valuable because it is not generally known.

Intellectual Property **rights** allow owners to benefit from their investments in innovation and prevent others from improper use.



What is a Trade Secret?



- Source code
- Customer lists
- Sales forecasts and pipeline
- Business and marketing strategies
- Skills and work histories of other employees
- Product road maps



Risky Business...



- Risk that a **new hire** will bring confidential information that could lead to a lawsuit
- Risk that a **departing employee** will take valuable trade secrets to a competitor
- Triage “high risk” employees



Employee Agreement



- Non-solicitation covenant (customers? and employees)
 - typical duration one year
 - obligation to notify company of new employers
 - questionable enforceability
- Non-disclosure covenant
- Inventions Assignment
 - Post termination obligations
 - Labor code 2870





- Obligation to search for and return all company and third-party confidential information and property upon termination
- Waiver of privacy interest in IT assets, company computers and networks, and data
- Conflict of interest
 - Duty of loyalty
 - No violation of agreement with prior employers
 - No use of information from prior employers



- Employee use of computers, networks, and IT assets
- Employee personal and work use of:
 - electronic storage devices
 - cloud-storage accounts
 - web-based e-mail accounts
- Privacy policies that permit software monitoring
- Conflict of interest policies
- BYOD policies
- Work from home and remote access policies?



- Prohibit or regulate BYO device, computer, cloud policies
- Identify and control “core IP”
 - Monitor check-ins and check-outs
- Limit remote access
- Ongoing monitoring?
- Terminate all user access promptly upon resignation



Cloud Usage Policies



- Electronic designation of confidential data or digital watermarking
- Segregate secure project folders
- Electronic encryption
- Limit admin rights and user access. Maintain highest level of audit trail.
- Keep “Core IP” off the cloud

How do Employees Steal?



The majority of employees...

- Believe there is nothing wrong with transferring employer data to personal devices and accounts

62%

- Said it is acceptable to use competitive data from a previous employer

56%

- Use email, USB devices, remote network access, and cloud-storage to steal IP in the month before departure



Personal cloud-based accounts are increasingly the most widely-used method of data ex-filtration

Protection of IP From Departing Employees



Departing Employees – How to Protect/Collect Company Trade Secrets:

Employment agreements: define and agree to protect company assets

- Carve out claims for injunctive relief /trade secret theft from arbitration provisions

Employee training & monitoring via secure check-ins and internal audits

- Regular reinforcement of need to protect IP/CI
- Internal audits often can be “invisible” and conducted electronically and systematically
- Labeling where appropriate

Standard procedures when employee gives notice of departure

- Image laptop and other devices (or pull emails and .pst files from servers)
- Monitor electronic and real-time activities regarding CI through log-ins
- Depending on circumstances, restrict access to CI or escort off site and place on paid leave
- Exit interview process
- Written reminder to former employee and new employer of obligations to protect AMAT CI





REPRESENTING STARTUPS:

Financing Business Operations



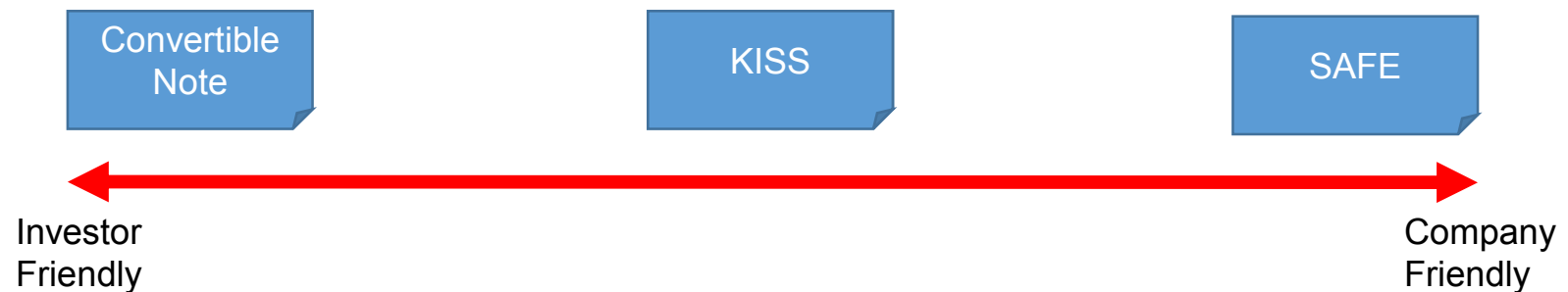
Financing Business Operations: Determining Source of Capital

Convertible Security or “Bridge Financing”

- Easy to administer
- Avoid pricing common stock for 409A purposes

Financing Business Operations: Determining Source of Capital

TYPES OF CONVERTIBLE SECURITIES





Financing Business Operations: Determining Source of Capital

Key Considerations in Convertible Security Financing:

- Valuation cap
- Discounts



Financing Business Operations: Determining Source of Capital

Equity Financing

- Common vs. Preferred
 - Downside to Common – Mispricing 409A price
 - Downside to Preferred – Preferences, board seats, protective provisions



Financing Business Operations: Positioning Company for Raising Capital

Documenting Share Allocations

- More expensive to fix later
- Tax risk from delay
- Avoiding potential disagreements



Financing Business Operations: Positioning Company for Raising Capital

Due Diligence

- Document all share and option issuances
- Obtain proper IP assignments
- Properly documented corporate governance

Terms of Service

- For many startups, the only contact they have with their customers is through their website/app/platform
- Want to enter into a contractual relationship with users
- Sometimes want users to enter into contractual relationships with each other
- One solution: Terms of Services

Marketplaces

- Prime example of startups where the Terms of Service often serve as the only contract between the company and its customers
- Special considerations:
 - Employee v. contractor
 - Users under 18
 - In-person meetings
 - Dispute policy
 - Guarantees and warranties

Some provisions to include in Terms

- Limited liability
- Choice of law
- User conduct
- Arbitration provision
- General information about the services offered
- IP ownership

Revising Terms

- Be sure to update users when your Terms are updated!
 - Often the only way to enforce updated Terms
 - Best way is to get proof that user agreed to new Terms, but not always practical
 - Failure to properly notify may result in Terms being unenforceable