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FARALLON LAW GROUP NEWSLETTER

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Key Legal Issues for Start-Ups

Start-up technology companies face a wide variety of legal issues early in their life span. Many of these issues can be resolved effectively and with less effort, if promptly addressed. However, start-ups tend to ignore them in order to focus on building the business. This often results in future problems whose resolution becomes more complicated and costly.

➢ **Delay in Formation.** It is important not to delay setting up the company. The failure to timely form a limited liability entity to operate the business increases personal liability, impacts the valuation upon formation and allows for uncertainty as to the rights/duties of the founders.

➢ **Improper Structures.** The proper entity, type, jurisdiction, capitalization and structure should be anticipated and implemented. A later change to any of these items can be achieved but will cause unnecessary costs and delays. For example, avoid authorizing too few or too many shares or issuing all of the authorized shares to the founders.

➢ **Share Pricing/Valuation.** The value of the shares in a start-up can initially be low (considering there is often nothing more than an idea and some specifications and minimal technology development). As the company grows and develops proprietary technology, the valuation of the company and its shares necessarily increases. This is important since the shares can initially be sold to founders at a nominal fair market value (FMV) price (such as $0.0001/share). Subsequent contributors should purchase shares at the then-current FMV (otherwise they could be deemed to have income). After the initial issuance of shares, companies typically implement a stock plan and issue stock option grants at a FMV exercise price, which generally do not constitute income at the time of grant.

➢ **Vesting of Founders Shares.** Shares issued to founders should vest over some period of time (the standard is monthly over 3 or 4 years with a one year cliff), subject to continuing to provide services to the company. Founders vesting can commence as of when the founder first provided any services, even if it predates formation of the company. Investors will often require vesting so it is prudent to anticipate that demand.

➢ **Section 83b Elections.** To the extent that founders shares vest over time, it is critical that an IRS Section 83b election be considered and timely filed, if applicable. The failure to file an 83b election can result in income (on the difference between then FMV and the acquisition cost) each time that shares vest.

➢ **Incomplete Stock Plan Implementation.** For corporate and securities law reasons, as well as tax efficiencies, stock plans must be properly drafted and adopted by the Board of Directors and stockholders within 12 months of implementation. Restricted stock and stock option grants must be approved by the Board and documented within a reasonable amount of time thereafter. If these formalities are not followed, the significant tax and other advantages can be lost, among other problems.

➢ **Ownership of IP**. Each person developing any intellectual property (IP) on behalf of the company should assign all related rights to the company in a signed agreement. This includes, employees, advisors, founders, consultants and subcontractors. It is very difficult to convince a former founder or consultant to agree to assign IP once they are no longer with the company, particularly a disgruntled founder or consultant. And founders/consultants can't be forced to relinquish IP ownership, even by setting aside equity.

➢ **Protection of IP.** Confidential information and other trade secrets should not be disclosed other than under written non-disclosure or confidentiality obligations, if possible. But understand that many VCs and institutional investors will not agree to such obligations early in any discussions. Consider also filing a (relatively inexpensive) provisional patent for any innovative technology or business method to achieve protection during an initial 1 year period. Any significant product names and branding should be protected by seeking a trademark registration with the US Patent and Trademark Office.

➢ **Financing.** Complete and proper documentation should be used for each contribution of funds, whether debt or equity, to provide clarity of the terms of the investment to protect both the investor and the company. Companies should avoid taking funds from unsophisticated investors, particularly those who do not constitute "accredited" investors, to help prevent claims of securities fraud.

Please feel free to contact Boris Lieberman, Mario Kashou or James Shafer at 415-255-2450 if you have questions about any of the key legal issues facing start-up companies.

This Newsletter is intended as a general guide to law issues and developments. It does not contain a general legal analysis or constitute a legal opinion of Farallon Law Group LLP or any member of the firm on the legal issues described. It is recommended that readers not rely on this general guide in structuring individual transactions but that professional advice be sought in connection with individual transactions.