Starting Up Without Screwing Up: 10 Common Non-IP Founder Pitfalls and How to Avoid Them

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1. Wrong Choice of Entity

- AKA, why you shouldn’t just use an online service to set up a MA LLC.
# 1. Wrong Choice of Entity

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<th>C Corp</th>
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<td>“Normal” stock options</td>
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1. Wrong Choice of Entity

- The vast majority of startups that aspire to be venture funded should be set up as Delaware corporations initially (whether C or S)

- Which state?
  - Massachusetts (or other state where the company is located)
  - Delaware (or Nevada)

- Don’t over think it, but get it right the first time
2. Casual Distribution of Stock

- AKA, don’t treat your cap table like an ATM machine.
2. Casual Distribution of Stock

- Founder Stock
- Federal and state securities laws
- Tax considerations
2. Casual Distribution of Stock

**Founder Stock**

- No legal definition of “founder” or “founder stock”
- Issued at incorporation or shortly thereafter when there is no tangible “value” to the company yet (important for tax reasons)
- Avoid “Forgotten Founder” problem-- lots of litigation about promises made among founders
- Issue founder’s stock early, before there are disagreements and before you get angel or VC term sheets
2. Casual Distribution of Stock

- Dividing the Pie among Founders
  - Define group of “founders” to receive stock – keep it small and exclusive
  - Consider past and future relative contributions of co-founders, and what feels “fair”
  - Dividing equally is often sub-optimal (Apologies to King Solomon)
  - Use “vesting” – even for your own equity
  - Avoid “percentages” – speak in terms of actual shares
  - Avoid (inadvertently or overtly) giving antidilution protection to founders and employees
2. Casual Distribution of Stock

- Securities Laws
  - Securities Act of 1933; state “Blue Sky” laws
  - No sale of securities without registration, *unless* there is an exemption available
  - Rule 10b-5 applies to “private placements”
2. Casual Distribution of Stock

- Tax Considerations
  - Issue founders’ stock early to avoid cheap stock problem
  - Don’t forget to file 83(b) election
3. Employment Law Violations

- AKA, why you can’t build a company on free interns.
3. Employment Law Violations

- No employees until you can pay at least minimum wage
- Employee/Contractor/Intern Classification
- Deferred Compensation
- Required withholdings
- Document things carefully
4. Too Complex Too Early

- AKA, keep it simple stupid (KISS).
4. Too Complex Too Early

- Complexity will scare off investors and drive up transaction costs
- Avoid:
  - Holding company for IP
  - Royalties for consultants
  - Joint or split ownership of IP
- Antidilution protection for early investors or employees
5. Too Greedy Too Early

- AKA, Gordon Gekko worked on Wall Street, not at a startup.
5. Too Greedy Too Early

- Be careful with other people’s money (especially friends and family)
- Milestones/Tranches: “Take what you can get” v. smaller increments
- Pre-money valuation isn’t the only important term in Term Sheet—liquidation preference and control terms can be just as or more important
- Know what’s market and don’t waste your bullets (and look naïve) on things that are not
- Good VCs offer more than just money—pick the best long term partner, not just the best economic terms
6. Fear of Dilution and Losing Control

- AKA, don’t be too paranoid to be successful.
6. Fear of Dilution and Losing Control

- There is a trade off between getting capital and losing some level of control.
- Voting dilution is not the same as economic dilution (would you rather have 100% of a $1m business or 10% of a $100m business?).
- Negotiate for some control protections now even if you don’t need them until down the road (e.g., founder board seat).
- “CEO” and the “three envelopes.”
7. Cold Calling VCs

- AKA, why no one is returning your calls.
7. Cold Calling VCs

- Be mindful of who specializes in what
- Don’t try too soon—you only get one first impression
- Not necessarily a plus to have signed licenses
- Get an introduction from a trusted source
- Short executive summary or pitch deck
8. Failing to Maintain Proper Records

- AKA, don’t let due diligence kill your deal.
8. Failing to Maintain Proper Records

- Accurate stock records are vital
  - Avoid disputes
  - All issuances must be approved by the board
- Need minutes of all board meetings
- Need all legal agreements and documents well organized and available for review
- Poor organization increases risk and reduces the confidence of your investors
9. Failing to Read the Fine Print

- AKA, if you can't read this don't sign below

Sign Here:___________________
9. Failing to Read the Fine Print

- If you won’t read things yourself, involve your lawyers early
- Example: Amazon Web Services Customer Agreement http://aws.amazon.com/agreement/
  - “During and after the Term, you will not assert, nor will you authorize, assist, or encourage any third party to assert, against us or any of our affiliates, customers, vendors, business partners, or licensors, any patent infringement or other intellectual property infringement claim regarding any Service Offerings you have used.”
10. Careless Selection of Advisors

- AKA, just because your uncle is a lawyer does not mean he is the right lawyer for your startup
10. Careless Selection of Advisors

- Lawyers: Practice area and industry experience is essential
- Finders/Brokers: Can attract regulators and scare away VCs
- Advisory Board: Validation often comes with a price
Questions?

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