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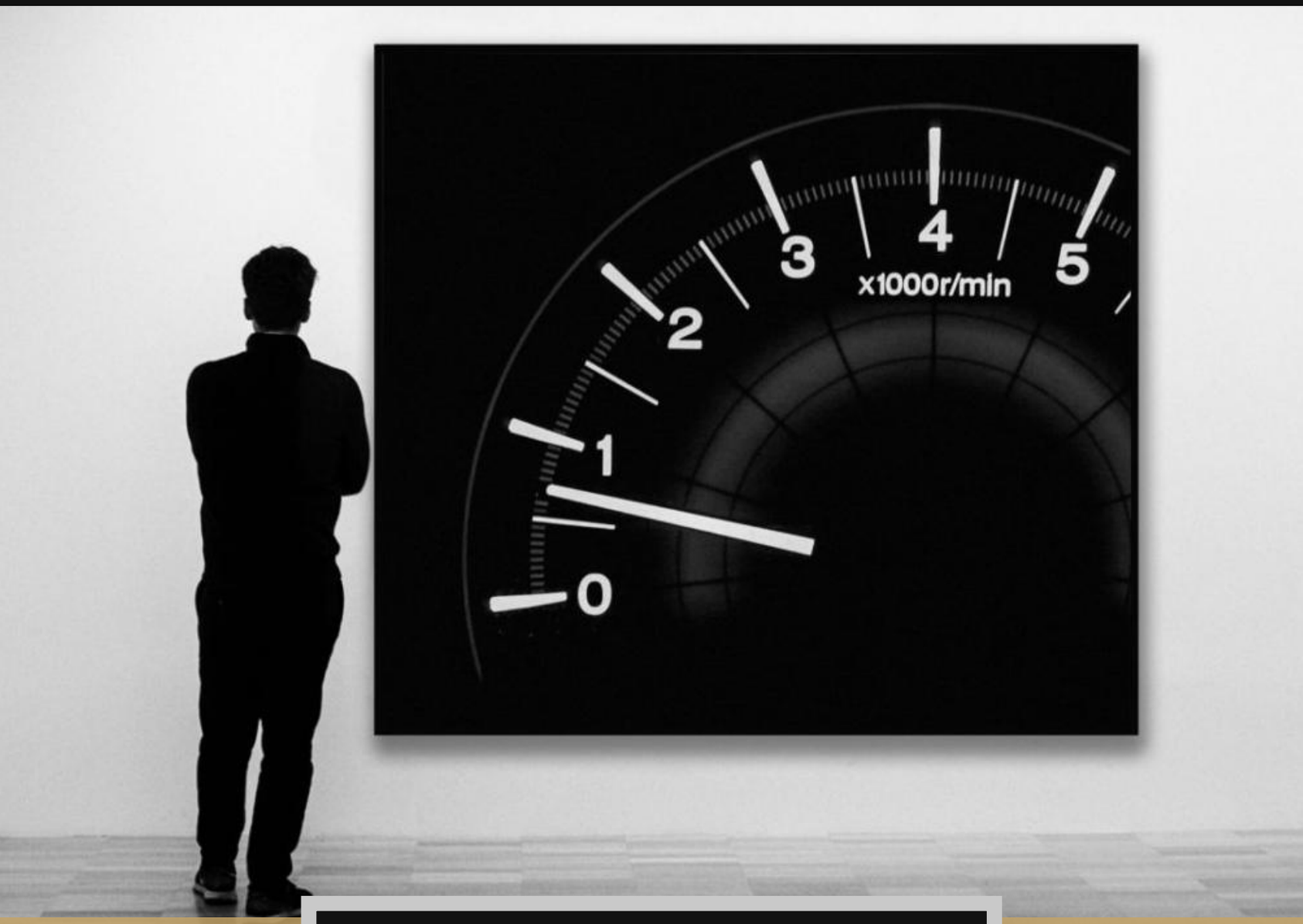


# GUIDEBOOK FOR

# Start-Ups & Emerging Companies

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# Introduction

## A FOUNDER'S GRIT ALONE IS NOT ENOUGH TO GROW A SUCCESSFUL COMPANY.

As corporate attorneys, we come into regular contact with new businesses and have the opportunity to watch as ideas evolve into products, services and creations that better serve society. We also are acutely aware of the challenges that lay ahead for entrepreneurs in transforming their ideas into a company or product. A disruptive idea and a founder's grit, alone, are not enough to grow a successful company. There are many additional components of a business that founders need to address to get an idea off the ground. A little bit of luck never hurts either.

As staunch supporters of entrepreneurs who want to transform their ideas, we decided to band together and create a preliminary discussion on best practice strategies that start-ups and emerging companies can easily leverage. The result of that work is this eBook.

We hope this discussion on navigating the complexities of forming a start-up company is helpful. Mostly, we wish you a future full of success.

*Sincerely.*

Joe 

David 

Sam 

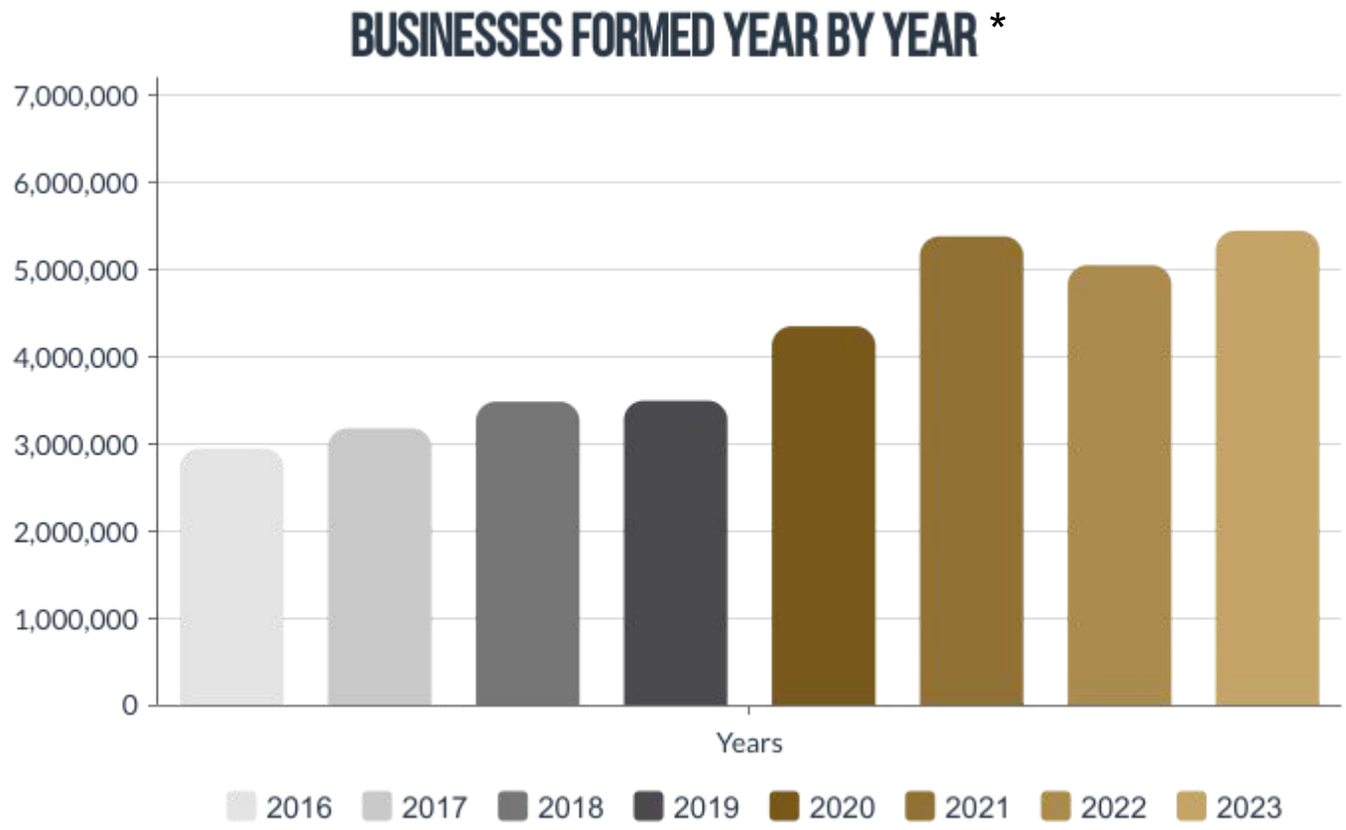
As the law continues to evolve on these matters, please note that this article is current as of date and time of publication and may not reflect subsequent developments. The content and interpretation of the issues addressed herein is subject to change. Cole Schotz P.C. disclaims any and all liability with respect to actions taken or not taken based on any or all of the contents of this publication to the fullest extent permitted by law. This is for general informational purposes and does not constitute legal advice or create an attorney-client relationship. Do not act or refrain from acting upon the information contained in this publication without obtaining legal, financial and tax advice. For further information, please do not hesitate to reach out to any of the attorneys listed in this publication.

# THE JOURNEY IS ON

The Global Financial Crisis in 2008 jumpstarted a number of exciting and disruptive companies across a wide variety of industries. For example, one company manufactured and sold high quality, affordable and stylish eyewear at an affordable price, another created a service for individuals to have a private car service at their fingertips, and another created a whole industry of home-owners transforming their homes into hospitality experiences. Behind each of these companies was a motivated and passionate entrepreneur with a big idea and a powerful conviction to see it become a reality.

In case it isn't obvious, you may recognize these three companies as Warby Parker, Uber, and Airbnb.

We now find ourselves faced with the "new normal". There is no shortage of ideas and talented founders in its aftermath. In fact, from 2020-2023 there were just under 21,000,000 applications for new businesses compared to just under 10,000,000 in 2016-2019.



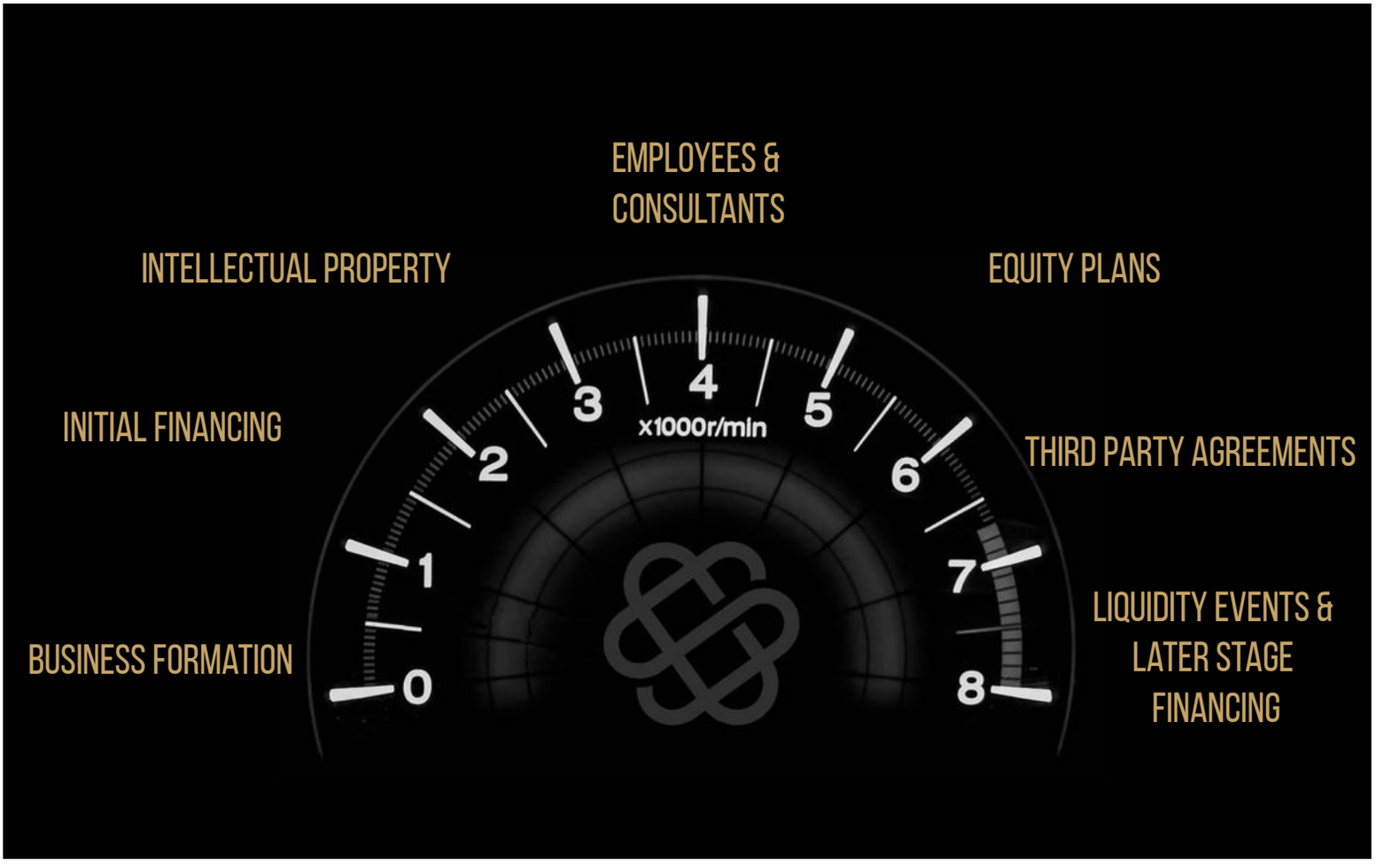

*Data is per the U.S. Census Bureau statistics with respect to Business Formation Statistics. The U.S. Census Bureau defines "business application" as all applications for an EIN except for applications for tax liens, estates, trusts, certain financial filings, applications outside of the 50 states and DC or with no state-county geocode, applications for agriculture, forestry, fishing, hunting, public administration, private households, and civic and social organizations.

READY. SET.

# REV UP

## KEY CONSIDERATIONS

Entrepreneurs and founders must contend with similar issues when preparing to launch a company into a competitive and saturated marketplace. While each business may be unique and the issues faced by each individual entrepreneur will speak to the idiosyncrasies of that business, many start-ups face the same common enemies – a need for funding, increasing overhead, asset protection and help managing an ever-increasing to-do list. Addressing key legal considerations from the get-go is the best way to position your company for success and mitigate ongoing risk. If it were up to us, we would like to see that every business address the following considerations:



# BUSINESS FORMATION

# Business Formation

Great ideas can take many different forms. Maybe it's a simple solution to an every-day problem, or perhaps an idea that will turn a stagnant industry upside down, or maybe it's just something you're passionate about. Congratulations – that's the first step. Now, it is time to form your company. There are many aspects to company formation including entity selection, governing documents, and the composition of ownership and management.

## ENTITY SELECTION

Entity choice is a critical decision to make when forming a company. The four most common entity types are (1) sole proprietorships, (2) partnerships, (3) limited liability companies, and (4) corporations. Depending upon your business objectives, a certain entity type might be more or less advantageous. For example, entity choice can impact whether an owner's liability is limited, the extent to which an owner can participate in the management and operations of the business, tax matters, and the amount and what type (or number) of outside investors are permitted. Due to these complexities, it is recommended that tax professionals be consulted and to work with your legal team in the entity selection process.

Although discussed in some detail below, generally neither sole proprietorships nor general partnerships are recommended. In addition, professional corporations and professional limited liability companies are sometimes required in order to operate certain regulated business.

## SOLE PROPRIETORSHIPS

Sole proprietorships are owned and operated by one person. For taxation purposes, they are considered to be a "pass-through," meaning that the profit or loss from the business passes directly to the owner, and is reported on the owner's personal income tax return. A sole proprietorship is technically unincorporated and therefore treats the business owner and business as one and the same. On that basis, the individual owner is exposed to unlimited personal liability for any liabilities of the business. In other words, if the business is sued, the owner (and his or her assets) is responsible for satisfying the liability. In terms of business growth and potential fundraising, sole proprietorships do not permit outside investors. On that basis, if you intend to raise money from third party sources in exchange for ownership interests, you should consider alternative entity types, including any of the forms described below.

## PARTNERSHIPS

Generally speaking, a partnership is an association between two or more people, typically governed by state law. Like sole proprietorships, partnerships are treated as pass-through entities for tax purposes unless the partnership elects to be taxed differently. However, because a partnership is owned by at least two people, the profits and losses of the enterprise are allocated equally between or among the partners, unless otherwise specified in a written partnership agreement. It is recommended that all partnerships, regardless of classification, have a written partnership agreement in place that sets forth the then-current ownership of the partnership, the governance and management of its business and the rights of the partners with respect to each other and third parties interacting with the partnership.

A partnership can either be a general or a limited partnership. A general partnership is a business or agreement (whether governed by a contract or not) between two or more partners, each of whom are obligated for the business's debts, liabilities, and assets. A limited partnership is an entity created by the filing of a certificate with the appropriate state authority and is governed by state law. A limited partnership requires at least one of its partners to serve as the general partner, but in a general partnership all the partners are considered to be general partners. General partnerships provide little to no liability insulation to its partners. Conversely, a limited partnership offers liability protection to their limited partners, whose role in the business is typically limited to the making of their investment. As a result, the liability of a limited partner is limited to the extent of its investment in the partnership and a general partner is exposed to more substantial liability on behalf of the business and is not insulated from the partnership's liabilities. If, at any point, a limited partner participates in the management and operation of the business, the partner may inadvertently become a general partner. Due to the governance structure and tax benefits of this entity type, limited partnerships are common vehicles for investment funds.

## LIMITED LIABILITY COMPANIES

A limited liability company is an entity that is owned by one or more members, each of which can be either an individual, an entity, or a trust. A limited liability company can be managed by its members, a manager appointed by the members, or a board of managers appointed by the members, in each case, as specified in the organizational documents of the company. Similar to a partnership and a sole proprietorship, a limited liability company is considered a pass-through entity for tax purposes. As the name indicates, a limited liability company limits the liability of its members (and often managers) with respect to acts of the company, such that members are typically liable solely to the extent of their capital contributions to the company. It is highly recommended (and often required by state statute) that the members and/or managers of any business enter into and adopt a written limited liability company agreement or operating agreement to detail the ownership, governance, and operations of the company, and the relative rights, privileges, preferences and obligations of its members. Limited liability companies provide great flexibility in terms of equity structuring, governance terms, transferability of ownership interests, and buyout or repurchase rights. For that reason, the limited liability company is the entity of choice for a variety of different businesses, whether it be a large investment fund, a joint venture, or a closely-held business.

## CORPORATIONS

A corporation is a distinct legal entity owned by a group of individuals or entities that are called shareholders. Corporations are typically governed by a board of directors elected by the shareholders, who in turn may appoint officers to operate the day-to-day business and affairs of the corporation. Unless expressly disclaimed, all corporations provide liability insulation for their shareholders (and often directors). There are two primary types of corporations for tax purposes, S-corporations (“S-Corp”) and C-corporations (“C-Corp”).

A corporation may elect to be treated as an S-Corp for income tax purposes. In doing so, the S-Corp elects to pass corporate income, losses, deductions and credits through to its shareholders, permitting the S-Corp to avoid double taxation on the corporate income. However, S-Corps have stringent eligibility requirements that, if violated, can have adverse tax consequences to the entity and its shareholders. S-Corps can have no more than 100 shareholders, all of which must be permitted holders (i.e., individuals, certain trusts, and estates and must be citizens or legal residents of the United States). Most partnerships and corporations do not qualify as permitted holders, and financial institutions, insurance companies and domestic international sales corporations are specifically excluded. Finally, an S-Corp cannot have multiple classes of stock beyond a voting class and non-voting class. The foregoing restrictions make S-Corps a less attractive option (or a relative impossibility) for larger companies taking on a variety of investors.

A C-Corp is the default corporate form unless a specific election is made (as described above). C-Corps provide many similar benefits to the benefits available to other corporate forms, including without limitation, limited liability for shareholders and a structure conducive to raising capital funds.

However, corporations are generally more expensive to form and operate over time, and have far more requirements with respect to formation, reporting and governance formalities than other entities. Further, C-Corps present a double taxation problem – meaning that the corporation pays taxes, and then its shareholders pay personal taxes on any dividends received from the corporation. Notwithstanding the above, C-Corps are generally the preferred entity type for companies seeking to raise capital via multiple funding rounds from institutional investors, as institutions generally prefer to invest in a corporation (and certain types of investment funds are required to only invest in corporations).

**Entity choice is important for businesses at all stages. Below is a quick-reference chart that highlights some very high-level similarities and differences of the four main entity types.**

| | SOLE PROPRIETORSHIP | PARTNERSHIP | LIMITED LIABILITY COMPANY | CORPORATION |
|---|---|---|---|---|
| **Owners** | 1 Person | 2+ Partners | 1+ Member | 1+ Shareholder |
| **Liability Protection** | None | • General Partner – No<br>• Limited Partner – Yes | Yes | Yes |
| **Management** | Owner | General Partner | Members or Managers | Officers and Directors |
| **Basic Governing Documents** | None | Partnership Agreement | Limited Liability Company Agreement or Operating Agreement | • Certificate of Incorporation<br>• By-Laws<br>• Shareholders Agreement or Founders Agreement |
| **Taxes** | Pass Through | Pass Through | Pass Through | • S-Corp: Pass Through<br>• C-Corp: Double Taxation |
| **Outside Investors?** | No | Yes | Yes | Yes |

# GOVERNANCE

Different entities require different governing documents. For instance, if a sole proprietorship is formed, no governing documents are required; however, in the case of a partnership, the partners often enter into a partnership agreement and in the case of a limited liability company the members often become parties to an operating agreement (and in many cases, it is required). Depending on the type of partnership that is formed (a limited or a general partnership), a state level filing may be required. In the case of a corporation, the entity will at a minimum need to have a certificate of incorporation and by-laws, and may also have other governing documents such as a shareholders agreement to further detail governance and voting arrangements. Commonly, start-up and early stage companies that raise capital from outside investors will also enter into investor rights agreements or voting rights agreements, but those are not necessary at formation.

In circumstances where outside investor funds are used to capitalize a corporation, a founders agreement may be used as an alternative to a shareholders agreement. These are agreements among the founders of a company detailing how the company will be managed and the responsibilities of each founder. These agreements also can have a termination date in place, so that if the business is not being further pursued by a certain date, the parties agree to go their separate ways. In addition to a founder's agreement, intellectual property assignments, entered into by founders, employees and service providers, will ensure that all intellectual property created for the company is actually owned by the company.

Another item for consideration when forming a business is how the entity will be governed. The business of a general partnership is typically governed by a general partner, while the business of a limited liability company may be governed by its members or one or more managers. Corporations are governed by a board of directors, which can be structured in a variety of ways, including staggered boards and the appointment of board members with specific designation rights. A staggered board is a board that consists of directors serving terms of different lengths, so that only a portion of the board is turned over at each election of the directors, rather than the entire board being elected at each election. Staggered boards are intended to ensure some continuity in directorship, and are often used as a tool to prevent hostile takeovers.

**THE GOVERNING DOCUMENTS YOU WILL BE REQUIRED TO EXECUTE WILL BE BASED ON YOUR ENTITY STATUS.**

Another means of controlling composition is by the granting of board designation rights. Board designation rights are rights granted to certain individuals or entities that entitle the holder to serve, or appoint an individual to serve, as a director on a board. These designation rights can be dependent upon the individual serving in a specific role for the company, or the individual or entity maintaining a certain ownership percentage of the company. Designation rights are utilized to help provide key individuals or investors with the ability to guide the business and maintain a vested interest in the entity that they are managing, many times absent the economic control to do so.

Oftentimes, early round outside investors will require a board seat as part of the terms of their investment or, at a minimum, observer rights and information rights. Unlike a board of directors or managers, an advisory board is a group of trusted advisors without decision-making authority. An advisory board can be a beneficial way for a founder to obtain the expertise of outsiders while maintaining control of the company. If advisors receive compensation, advisors may be granted equity interests in the company in return for their services or they may be paid a fee.

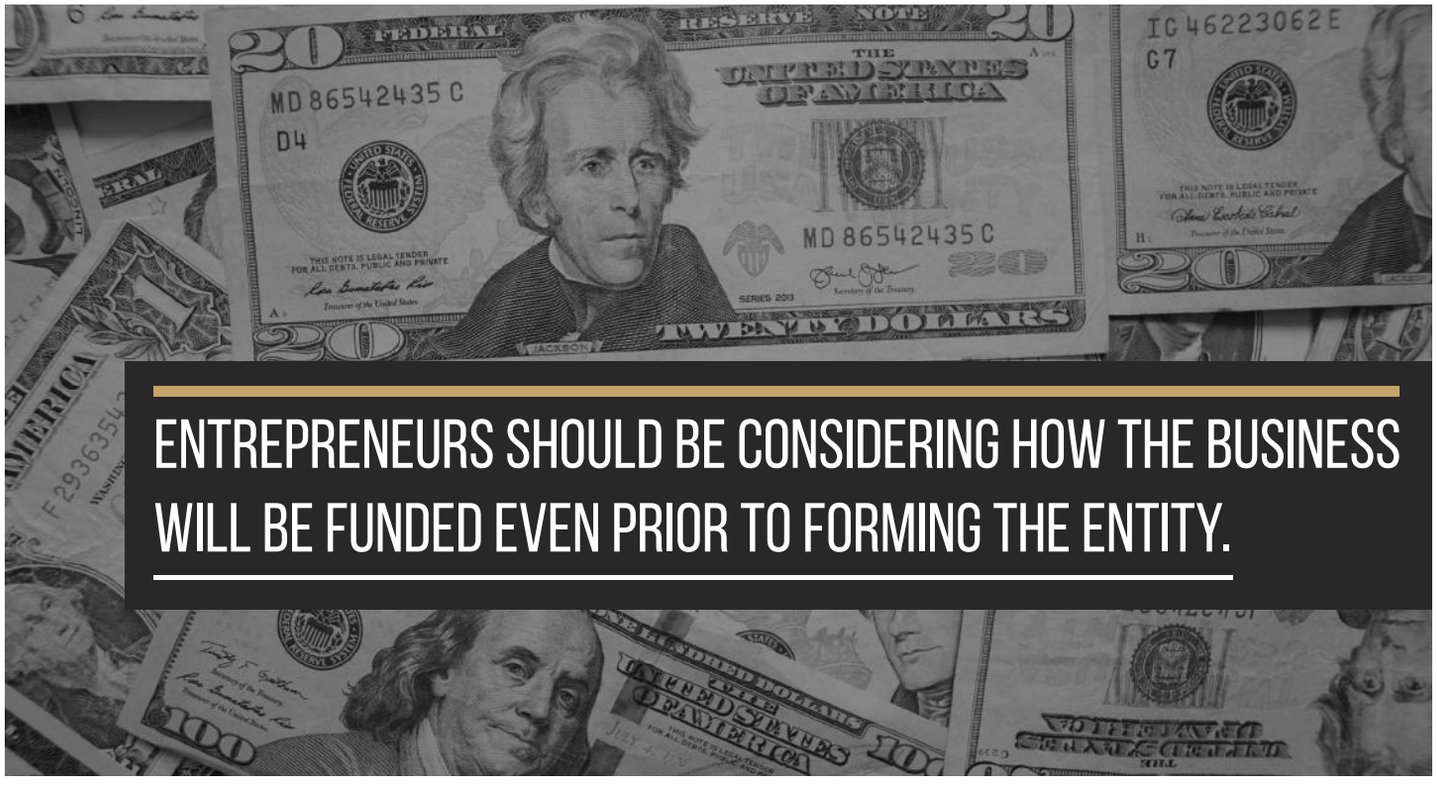
## OWNERSHIP & VESTING

A further consideration is whether the owners of the company will own their interests in the business free and clear from day one, or if the ownership will be subject to vesting. Vesting is when an owner's interests in a company are subject to forfeiture or repurchase events, until a certain time or unless certain requirements are met. Vesting can be performance or milestone based, time-based, or both. Equity ownership may also include restrictions on the transfer of the interests and repurchase or forfeiture provisions upon a separation of service. Vesting may also accelerate under certain agreed upon circumstances, such as a capital or sale event. When there are multiple founders, the founder equity being subject to vesting is not uncommon, as the vesting can help hold each founder accountable to each other, and any potential outside investors. In situations when an entrepreneur is either building the company by themselves, or does not anticipate offering equity to any outside investors, the founder's equity is typically not subject to vesting.

# INITIAL FINANCING

# Initial Financing

Even before formation, it is critical to consider how the business will be funded, both initially and in the long term. A business's initial capital structure can have important implications for the type of financing it is able to pursue in the future, the type of equity that it is able to issue and the investors that it will attract. Companies should be sensitive to securities law considerations, tax impacts and compliance obligations in structuring any financing.



# DEBT FINANCING

One means of obtaining funds is debt financing. Debt financing can be obtained from a number of sources, such as private individuals (including friends and family), investment funds that provide venture debt and traditional institutional lenders. Additionally, the U.S. Small Business Administration and other government-funded entities extend certain loans to eligible companies, including qualifying small businesses. A company can also issue convertible debt in which case debt converts to equity in the company upon the occurrence of certain conversion events (such as a qualified equity financing) and the satisfaction of certain conditions.

# EQUITY FINANCING


In addition to, or in lieu of, debt financing, a company can obtain funds through an issuance of equity. It is important to consider the type of equity issued and the rights, preferences and obligations comparative to the founding members and other investors. Investors will often seek a preferred equity stake in the issuer, which can provide for a priority or preferred return on their investment, and often comes with certain voting and other rights. A priority return or a preferred return entitles the investor to receive their initial investment back and a predetermined percentage return before any other investors receive any distributions or dividends. Other investors will opt to acquire warrants or options, each of which entitle the holder to acquire an equity interest in the company at a future date and, in the case of options, at a pre-determined price. It is important for startup ventures to be deliberate in issuing equity, as the class and nature of equity issued to initial investors will inevitably impact future equity issuances and the type of investors attracted to the company.

# SAFES

Some companies utilize a hybrid and expedited financing method to raise capital called a “simple agreement for future equity”, or a SAFE. The SAFE was created as a way for companies to quickly raise capital. A SAFE does not grant the investor any equity (or debt position) in the company when the investment is completed, but rather gives the investor a right to equity or cash payment in the future upon the occurrence of certain triggering events. Furthermore, SAFEs have largely been standardized and typically have a lower cost for the issuer to produce than other financing documents.

# RECORDKEEPING

Regardless of the type of financing a company receives, it is important for any company to maintain accurate and updated records. This includes maintaining up-to-date capitalization tables and related records regarding investor contributions, ownership percentages, and convertible instruments. Maintaining an accurate capital table allows management to reference the ownership of the company in connection with required consent thresholds for certain actions, and to calculate potential distributions in connection with any liquidity events. By keeping accurate minutes of meetings (whether the meetings are of shareholders, members, the board, or the managers) management is able to clearly reference past actions and is able to provide evidence that corporate formalities were properly followed.

REGARDLESS OF THE TYPE OF FINANCING A COMPANY RECEIVES, IT IS IMPORTANT FOR ANY COMPANY TO MAINTAIN ACCURATE AND UPDATED RECORDS.

# FUNDRAISING CONSIDERATIONS

## INVESTOR RIGHTS

Investors will often request certain rights in exchange for their investment. Depending upon the type and size of the investment and the stage of development of the company, these could include consent rights over major actions, such as the issuance of additional equity in the company, the incurrence of indebtedness or the sale, disposition or dissolution of the company.

Equity investors may also request certain rights relating to the transfer of equity in the company, including rights of first refusal, tag-along and drag-along rights. A tag-along right gives the minority equity holders in the business the right to sell their equity alongside equity holder(s) selling a specific stake of equity, on the same terms and conditions as offered to the selling equity holders(s). A drag-along right gives the equity holder(s) selling a specified stake of equity the ability to force the non-selling minority owners of the business to sell their interests to a third party purchaser on the same terms and conditions offered to the majority equity holder(s).

In connection with debt financings, lenders will often require certain limitations on management's decision-making, including with respect to certain major decisions impacting their investment. Debt is also typically associated with restrictive covenants, meaning that the company has to comply with certain requirements set by the lender. These covenants can be financial (for example, a certain debt to equity ratio must be maintained) or impact operational decisions (for example, purchases above a certain dollar threshold must be approved by the lender). Lenders will also include a default provision with respect to change of control events:  a transfer of all or substantially all of the assets of the company or a change in the majority of the voting interests of a company. Lenders also expect to receive certain remedies upon the company defaulting on the terms of the debt, including acceleration of the debt becoming due or forfeiture of the pledge of equity to the lender.

## SECURITIES LAWS

Any time a company sells securities (including equity, debt (excluding traditional commercial loans) or convertible instruments such as SAFEs), the company must comply with the applicable state and federal securities laws. Generally speaking, unless a securities offering is exempt from being a registered offering, securities must be sold pursuant to a registration statement. There are a number of exemptions from registration that a company can pursue, primarily based on the fact that the offering is not a "public offering" and it is limited to sophisticated investors, including a Section 4(a)(2) offering or a Regulation D offering and certain intrastate offerings. Even in connection with exempt offerings, companies must be aware of filing requirements, such as Federal Form D filings and applicable State blue sky filings. As detailed above, capitalizing a company is a multifaceted process requiring a detailed understanding of investor/lender considerations, tax implications, securities laws and related matters.

# INTELLECTUAL PROPERTY

# Intellectual Property

As technology becomes more prevalent in business, the need to understand intellectual property has become of paramount importance. Broadly speaking, intellectual property describes intangible assets that are subject to ownership and afford the owner of those assets certain rights under law. More specifically, intellectual property rights are the rights that enable their owner to protect assets such as their name, brand, designs, logos, software, inventions, domain names, written works, and trade secrets among other types of intangible assets.

## 4 CATEGORIES OF IP ASSETS

*Intellectual property assets largely fall into four different categories:*

- TRADEMARKS
- COPYRIGHTS
- PATENTS
- TRADE SECRETS

In addition to the different intellectual property asset categories recited above, it is also important for business owners to be aware of the different ways that intellectual property interacts with their business. Depending on the type of a business in which a company operates, non-disclosure agreements should be used, intellectual property assignments from employees and independent contractors should be obtained, and a terms of use and privacy policy should be adopted as well.

It is a common misconception that intellectual property assets are most relevant to certain industry sectors, such as the creative arts, manufacturing, engineering and healthcare. The reality is that most companies have intellectual property assets. In fact, once you have established your company's name, logo and branding, you started to establish intellectual property assets.

IT IS A COMMON MISCONCEPTION THAT INTELLECTUAL PROPERTY ASSETS ARE MOST RELEVANT TO CERTAIN INDUSTRY SECTORS BUT THE REALITY IS THAT MOST COMPANIES HAVE INTELLECTUAL PROPERTY ASSETS.

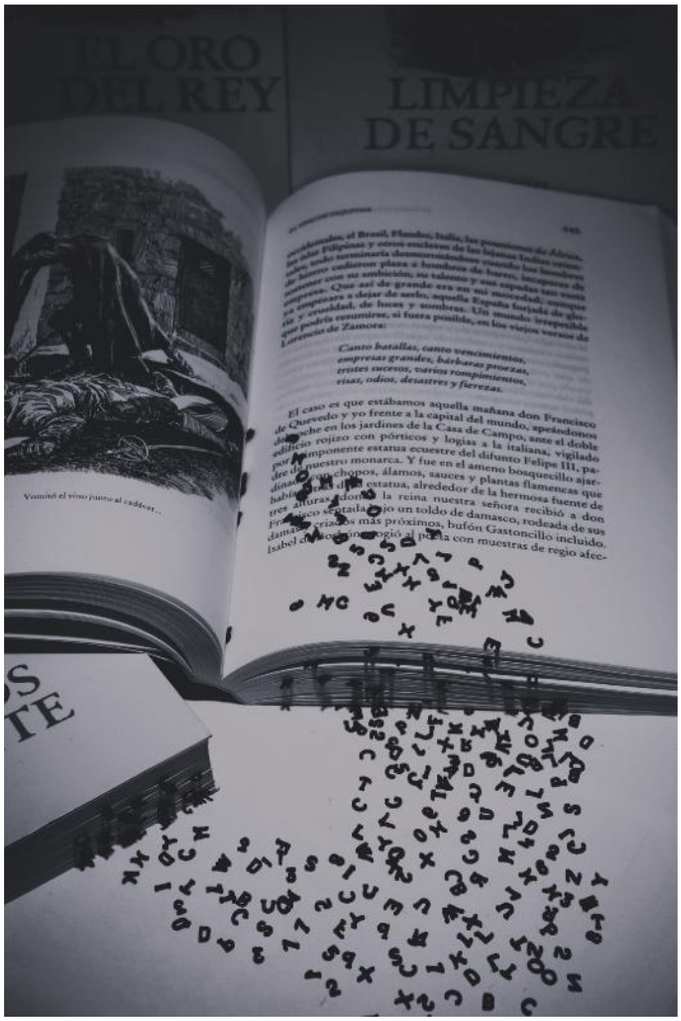
# TRADEMARKS

Chances are that you already are quite familiar with trademarks as they are commonplace in the market. A trademark is a property right associated with a name, brand, logo, design and other items that identify a product or source of a product. If a trademark is eligible for protection, it can be registered with the United States Patent and Trademark Office ("USPTO"). The USPTO is a federal office that regulates the use, registration and enforcement of trademarks. Importantly, domain names can be protected as a trademark as well. Trademark rights begin not when a trademark application is filed with the USPTO, but once the mark is used for commercial purposes. This is true whether the mark is registered or unregistered, but a registered mark puts the public on notice of ownership and provides its owner with enforceable rights to protect their market against infringement by third parties.

An application for a trademark can be filed with the USPTO for either actually using the mark in business or having an intention to use the trademark in business. The more unique and distinctive a mark is, the more likely it is to be granted protection. A registered trademark gives the owner of the trademark the exclusive and enforceable right to use such mark in connection with the goods or services associated with the registered mark. A trademark, once granted, has an indefinite duration; however federal registration is renewable in ten-year increments.

Trademark applications can be denied if the trademark is a generic term. Generic terms are words or symbols that communicate the type of product or service being offered and do not receive trademark protection. Because a generic term cannot obtain a secondary meaning and is a general or common term for the product or service at issue, it cannot receive trademark protection.


A TRADEMARK IS A PROPERTY RIGHT ASSOCIATED WITH A NAME, BRAND, LOGO, DESIGN AND OTHER ITEMS.




# COPYRIGHTS

A copyright is a property right that gives an author the exclusive right to a creative work in a fixed medium. This includes protection for books, magazines, photographs, software, drawings, graphic designs, music, movies, and websites among other assets. A “fixed medium” means the work is stored in a medium that can be copied, accessed, or transmitted. Unlike trademarks, copyrights are regulated by the Copyright Office rather than the USPTO. Copyrights arise not upon application, but immediately once a creative work is memorialized in a tangible medium of expression, and furthermore publication is not required in order for a copyright to take effect.

Although registration of a copyrighted work is not required, it can be beneficial because it puts the public on notice of ownership. Similar to trademarks, registration of a copyright is accomplished via the submission of an application to the Copyright Office. A copyright owner has the exclusive right to reproduce the work, adapt the work, distribute copies of the work, and display the work publicly. The duration of a copyright varies depending on the nature of the work, the creation of the work, when it was published, and if it was renewed. If the work is created on or after January 1, 1978 the duration is 70 years of the authors death or in the case of a work for hire or anonymous work, the earlier of 95 years after publication or 120 years after creation.

# PATENTS

A patent is a property right associated with an invention. There are three types of patents that can be granted:

- **Utility patents:** the most common type of patent, granted for inventions that are novel and non-obvious.
- **Design patent:** granted for new, original, and ornamental designs of manufactured items and protects the way an item looks.
- **Plant patent:** used to protect new varieties of plants.

Patents are obtained via a successful application to the USPTO by the inventor who files the patent application. Inventors usually work with patent attorneys who are admitted to practice before the USPTO as these are highly technical applications.

If a successful application is granted by the USPTO, the patent holder has the right to exclude others from making, using, selling, or importing the patented invention in the US. This also allows the patent holder the ability to license the technology to third parties. Patent applications submitted on or after June 8, 1995, if granted, have a maximum duration of 20 years.

Like Trademarks, patents are regulated by the USPTO.

# TRADE SECRETS

A trade secret is exactly as its name implies, a secret process, device, technique or information that is used by its owner and is not known to the public. Information can be considered a trade secret if it's not generally known or attainable outside of its owner, its owner derives economic value from the information not being known, and its owner takes reasonable efforts to protect the secrecy of the information. Unlike patents, trademarks or copyrights, trade secrets are not registered with a central repository because doing so would no longer render the subject matter a secret. Rather, trade secrets are protected by the owner taking the steps reasonably necessary to protect the information. If a third party acquires the trade secret through improper means, the owner of a trade secret has a cause of action pursuant to federal and state law that it can pursue for damages. In theory, a trade secret is a secret for an unlimited duration provided reasonable steps are taken to maintain the secrecy of the information.

# OVERVIEW OF COMMON IP ASSETS

**Below is a chart showing a high-level summary of the above discussion on the four most common types of intellectual property assets.**

| IP ASSET TYPE | COVERED ITEM | OVERVIEW | DURATION |
|---|---|---|---|
| **Trademarks** | Names, brands, symbols, and designs | • Regulated & granted by the USPTO<br>• Prevents others from using the same or similar mark in a way that is likely to cause consumer confusion | Indefinite unless abandoned, can renew federal registration every ten years |
| **Copyrights** | Works of authorship | • Regulated & granted by the Copyright Office (but not required)<br>• Prevents others from copying, distributing, performing and adapting the work | 70 years after the author's death or if anonymous the earlier of 95 years from publication or 120 years from creation |
| **Patents** | Inventions and designs | • Regulated & granted by the USPTO<br>• Prevents others from making, using, selling the covered item | 20 years from filing |
| **Trade Secrets** | Undisclosed information with economic value | • Governed by federal and state law<br>• Rights are maintained by the owner taking reasonably steps to | Indefinite for so long as the owner maintains the secrecy of the information |

# OTHER CONSIDERATIONS

In addition to the above intellectual property assets and intellectual property rights that can be implemented to protect certain intellectual property assets, there are other agreements that can be implemented to further protect your IP assets. These agreements include non-disclosure agreements, intellectual property assignment agreements, and terms of use and privacy policies.

## NON-DISCLOSURE AGREEMENTS

One way to help protect a trade secret (in addition to any other intellectual property asset) is via the use of Non-Disclosure Agreements ("NDA"). An NDA is an agreement that is entered into by two or more parties which creates a confidential relationship. NDA's are commonly entered into when exploring a business relationship and obligate the party receiving confidential or proprietary information of the counterparty to the agreement to maintain the confidentiality of such information. NDA's can also be required by a company for its employees to sign because employees often times have access to sensitive and proprietary information about the company. NDA's can vary in their length, the manner and scope of what is defined as confidential information, if it's a mutual obligation of non-disclosure or only one party has the obligation not to disclose the confidential information of the party, and the exclusions from the confidentiality requirements.

## IP ASSIGNMENT AGREEMENTS

In addition to an NDA, a company should consider having its employees and independent contractors enter into an Intellectual Property Assignment Agreement. These agreements are used to transfer intellectual property from one person to another (or to a company). These are extremely common to have for employees as the company wants to own anything an employee creates in connection with their role at the company. Furthermore, a company will frequently want their outside software developers as well as their employees and founders to assign any and all prior intellectual property assets to the company if those assets are going to be used by the company. Intellectual Property Assignment Agreements are extremely important for tech focused start-up companies, as the intellectual property used by the company actually needs to belong to the company, and not the individuals who make up the company.

## TERMS OF USE AND PRIVACY POLICY

Two other important documents to consider implementing are Terms of Use and Privacy Policies. The terms of use of a company define the rules of use of a website or the application of a company. Terms of use are important because they help to limit a company's liability to its users, can help limit liability associated with user generated content, help protect the ownership of the company's content, and can outline the dispute resolution process among other items. A privacy policy on the other hand, describes to users of a website or application how the data a company receives from its users is processed and stored. It is important that a company's privacy policy accurately details how user data is processed and stored, and provided it is accurate, it can help manage potential liability associated with user data. If users will be creating accounts, end users should agree to comply with the terms of use and privacy policy via account creation.

## ARTIFICIAL INTELLIGENCE

Artificial Intelligence (AI) is becoming more prevalent in the business world with each passing day. As AI becomes more widely used, new issues will constantly emerge. One of the present-day issues for a company to consider is ownership. Does the company own the items created by the AI model, or does the provider of the AI model own the created items? Another issue to consider is use of the AI model. Has the company determined proper guidelines for using the AI model? Do humans review the outputs from the AI model to ensure its accuracy? How are the prompts that the AI model uses to provide answers created? A third issue to consider is storage. Does the AI model store or share confidential information, or trade secrets, that is provided by prompts? A fourth issue to consider is compliance. Has the company considered how to ensure that its use of the AI model comports with applicable rules and regulations? If the AI model creates something that infringes another's work, is the company responsible for any resulting liability, or is the AI provider? These are just a few of the issues that a company should consider when it is integrating the use of AI into its business.

# IP SUMMARY

As detailed above, there are a number of different intellectual property assets and different rights associated with those assets. Depending on which type of asset is at issue, there are different protections that can be implemented for the asset. It is important to be aware of the proper asset type classification so that you can make sure to use the right type of intellectual property rights to protect the asset. Additionally, a company can enter into certain agreements to further protect the rights and ownership associated with intellectual property assets.

IT IS IMPORTANT TO BE AWARE OF THE DIFFERENT PROTECTIONS AVAILABLE BASED ON THE IP ASSET TYPE OF INTEREST.


# EMPLOYEES & CONSULTANTS

# Employees & Consultants

A COMPANY'S SUCCESS IS OFTEN TIED TO THE LIKE-MINDED AND PASSIONATE INDIVIDUALS THAT JOIN THE TEAM.

A founder's success may hinge on selecting a group of like-minded and passionate individuals to join the business. After all, as Steve Jobs reminds us, "a small team of A+ players can run circles around a giant team of B and C players". The following is a summary of the steps customarily taken to memorialize the relationship between personnel and the company, and certain considerations that should be accounted for when hiring employees and engaging independent contractors and consultants.

## MEMORIALIZING THE RELATIONSHIP

A company can engage its personnel as independent contractors or hire them as employees. Whether an individual is an independent contractor, or an employee, is a state law issue, but generally, an independent contractor: (i) charges fees for the service provided, (ii) is engaged strictly for the term required to perform the specific service, (iii) retains control over how the work is performed, and (iv) is responsible for their own taxes and benefits.

An employee, by contrast, is an individual who is subject to significant oversight by the company, meaning that the company can exercise control in the method and manner of how the work is performed. Additionally, an employee is: (i) paid wages and is eligible for company sponsored benefits, (ii) is employed for a continuous period of time, (iii) pays a large portion of their taxes through amounts withheld by the employer, and (iv) is protected by applicable federal, state, and local employment laws. A misclassification of independent contractors and employees can expose a company to significant liability.

An employment relationship can be established through many forms including an offer letter or an employment agreement. Employment agreements are usually reserved for executives and management-level employees, while an offer letter is more commonly reserved for non-management employees who have more straight-forward employment terms. However, an offer letter can contain the same or similar terms to an employment agreement if so desired.

The engagement of an independent contractor is oftentimes established under the terms of a consulting agreement although an independent contractor arrangement may exist on invoice terms short of a full consulting agreement. While there may be some overlap between the terms of a consulting agreement and an employment agreement, a properly drafted consulting agreement will explicitly state that the independent contractor will not participate or be eligible to participate in a company's employee benefit plans and that the independent contractor shall be responsible for the payment of their own taxes.

# EMPLOYMENT TERMS

Employment agreements address the following: (1) compensation and benefits, (2) title or position, duties, responsibilities, and authority, (3) restrictive covenants and intellectual property assignments, and (4) any other conditions and terms of employment particular to the relationship. In most cases, employment will be "at will" as opposed to a guaranteed term of employment, and should expressly state the same.

### COMPENSATION AND BENEFITS

An employee's agreement with a company in any form should clearly state the base salary or wages of the employee and may include a mechanism for adjustment of such pay during the term of employment. Compensation can also include a commission component, in which case a commission plan should be included or referenced in the agreement.

If the employee is eligible for a bonus, the document should indicate the bonus entitlement and the conditions or objectives that need to be satisfied for any bonus to be paid (e.g., whether the bonus is discretionary, based on individual performance, based on company performance, or any combination of the foregoing).

In some cases, bonuses are offered pursuant to an existing bonus plan for similarly situated employees. A discretionary bonus allows the employer the most flexibility, while a performance-based bonus includes a more defined set of criteria (such as individual and company-wide KPIs or revenue targets). In some cases, a bonus may be subject to claw-back if the employee fails to stay employed by the company for a minimum amount of time (i.e. a signing bonus) or subject to forfeiture if the employee is not employed on the date of payment (i.e. an annual bonus).

Compensation can also include a grant of equity, in which case the offer package should include the amount and type of equity the employee is eligible to receive, the conditions to receipt or ownership of the equity (such as vesting), and that the grant of the equity is subject to the terms of any applicable equity plan and award agreement and the terms of any other documents governing the relationship among owners of the company.

Finally, the employment documents should recite the employee's entitlement to participate in the company's benefit plans. This can be accomplished by detailing each plan or, by generally stating that the employee is entitled to participate in the benefit plans offered to similarly situated employees. Employees may identify certain fringe benefits or "perks" that they would like in addition to any standard benefit package clearly delineated.

## POSITION AND DUTIES

The employment documents should include the employee's official title and a description of their duties and responsibilities. Supervisory and reporting relationships can be addressed as well.

An employment agreement for a full-time employee will require the employee to devote all of their working time to the employer. However, sometimes an employee will need the flexibility to participate in activities outside of work, such as philanthropic activities, serving on the board of another company, or speaking at conferences. Addressing such permitted activities up front will reduce the likelihood of a dispute later in the employment relationship.

## RESTRICTIVE COVENANTS AND INTELLECTUAL PROPERTY ASSIGNMENT

Restrictive covenants can be included in an employment agreement or in a separate restrictive covenant agreement entered into at the time employment commences. Restrictive covenants address the non-disclosure of confidential information, non-competition, non-solicitation of clients and other employees, and non-disparagement.

A non-disclosure or confidentiality provision typically obligates the employee to maintain the confidentiality of, and not disclose, the employer's trade secrets and confidential information. These provisions can last in perpetuity and frequently require the return of all of the employer's information and property upon the termination of employment.

Non-compete provisions impose restrictions on the employee during the term of their employment, and for a period following the employee's termination. These provisions are limited to prohibiting employment in a competing business generally or by a defined group of competitors, in each instance for a defined time-period and oftentimes in a defined geographic area. The breadth of a non-compete can be heavily negotiated and exceptions may be required based on an employee's particular situation. Further, the reasonableness of the duration and scope of a non-compete agreement is something that courts are sensitive to when faced with disputes concerning the enforcement of a non-compete agreement. It is important to note that most states have restrictions, and some have outright prohibitions on the enforceability of non-compete agreements and others have taken this issue under consideration. In fact, in April of 2024, the Federal Trade Commission ("FTC") issued a rule generally banning employee non-compete restrictions, with very limited exceptions. Since then, the rule has been the subject of litigation and courts have stated that the rule is unenforceable, but it is not yet known whether that law or a similar law will ultimately be in effect.

Non-solicitation provisions generally prohibit an employee from seeking to hire, retain, or create a contractual relationship with any employee, customer, client or business partner of the employer. These provisions are intended to help an employer maintain its business and revenue and protect its confidential information and trade secrets, but can have the effect of being a non-compete and thus subject to challenge.

A non-disparagement provision generally restricts an employee from making negative statements about the employer and its officers, employees, customers, clients and business. These provisions typically last in perpetuity. Sometimes, a non-disparagement provision creates a mutual obligation on the employee and the employer from making any negative statement about the other.

Overall, restrictive covenants are governed by state law and can pose challenges in enforcement. Careful attention must be given to the scope and duration of the restriction to increase the likelihood (or the extent) of enforceability.

## TERMINATION

At some point, the employment relationship may expire or terminate, and the employment documents should identify those circumstance. Agreements can expire at the conclusion of a specified term, subject to any renewal options, or be terminated: (i) without cause by the employer, (ii) with cause by the employer, (iii) upon death or disability of an employee, (iv) upon an employee's resignation without good reason, and (v) upon an employee's resignation with good reason. These are all negotiated concepts, especially the definition of cause and good reason, and often involve negotiated severance obligations. Additionally, certain states have laws imposing requirements on termination of employees.

### INTELLECTUAL PROPERTY ASSIGNMENTS

Intellectual property assignment agreements are an important document in the employment relationship and are covered in further detail in the Intellectual Property chapter of this book. As a brief overview, intellectual property assignment agreements are presented to service providers and provide that the service provider assigns to the company all relevant intellectual property rights that have been created or will be created in conjunction with their service to the company, so that the company is the rightful owner of the intellectual property necessary to operate the business. An intellectual property assignment provision can also be directly incorporated into the employment document itself. Intellectual property assignment agreements should be used in connection with both employees and independent contractors.

## EMPLOYEE HANDBOOK

In addition to the documentation setting forth the terms of employment of an employee, many companies will, and sometimes are obligated by state law to, adopt an employee handbook. An employee handbook is an internal document distributed to employees that provides, among other information, an overview of the company's policies, procedures, benefits, and code of conduct for employees. Employee handbooks can include policies on a variety of topics applicable to all employees and the workplace, including without limitation: (i) equal employment opportunity policy, (ii) anti-harassment and anti-retaliation, (iii) disability accommodation, (iv) payroll and compensation, (v) expense reimbursement, (vi) dress code, (vii) code of conduct, (viii) attendance and remote work, (ix) social media, (x) internet use, (xi) vacation and paid time off, (xii) parental leave, and (xiii) Covid-19/communicable illness policies. States may vary on the minimum required components and policies that must be included in an employee handbook.

HANDBOOKS ARE INTERNAL DOCUMENTS THAT INCLUDE INFORMATION ON POLICIES COVERING A VARIETY OF TOPICS APPLICABLE TO ALL EMPLOYEES AND THE WORKPLACE.


# EQUITY GRANTS

# Equity Grants

YOU HAVE A GREAT IDEA FOR A NEW COMPANY, AND ARE READY TO START THE NEW VENTURE.

## NOW WHAT?

YOU NEED TO BRING ON BOARD THE RIGHT PEOPLE TO MAKE THE COMPANY A SUCCESS.

## WHAT'S NEXT?

IT WILL BE A NECESSITY TO INCENTIVIZE EMPLOYEES AND OTHER SERVICE PROVIDERS IN THE LONG-TERM SUCCESS OF THE COMPANY.

## WHAT COMPENSATION WILL YOU OFFER?

YOU HAVE A MYRIAD OF ACTION ITEMS, NEXT STEPS AND UNFORESEEN CHALLENGES AHEAD OF YOU.

## WHAT RESOURCES ARE AVAILABLE?

# EQUITY GRANTS

Funds are typically at the lowest before the idea is launched into the economy, which results in many companies seeking a low up-front cost and a bigger incentive for the initial team of employees. So, how do you bridge the gap between immediate out-of-pocket costs and giving equity in the company to new employees and consultants?

## Enter into the equation — equity grants.

An equity grant is one way to bridge the gap between immediate compensation and long-term incentive compensation. An equity grant is a form of non-cash compensation to key individuals (employees and/or consultants) and can be granted pursuant to an equity plan and equity awards. These grants help keep individuals directly invested in the company's success and align their incentives with that of the company. Depending on the type of entity your company is, the equity incentive plan can be a restricted stock plan, a stock option plan, a profits interest plan, or a phantom equity plan, or you can create an omnibus equity incentive plan, which can include multiple types of equity grants. Regardless of which plan you are going to adopt, it is necessary to reserve either a certain number of shares, or a certain percentage of the company, to be awarded to recipients of equity awards. In connection with an equity grant, a service provider receiving equity that is subject to vesting should be aware of a Section 83(b) election and the reference to Section 409A, which can invoke complex tax law implications in certain situations. This chapter provides a high level overview of some of the different types of equity grants that can be made to service providers and general concepts applicable to any grant.

# GENERAL CONCEPTS

## RESTRICTED VS UNRESTRICTED EQUITY

Generally, if equity is restricted, then it cannot be transferred until certain conditions are met. These can be time-based or performance-based conditions, which are set by the company. Vesting is the process by which the equity becomes unrestricted and is then owned freely (subject to any other restrictions the company has imposed on its equity) by the recipient of the equity. Oftentimes, the vesting process is tied to time intervals and has a cliff date that the company sets. A cliff date means that no equity vests until a certain date. A typical vesting schedule is a four-year vesting period, with a one-year cliff. Under this schedule, the first 25% of the equity grant vests and becomes unrestricted on the one-year anniversary of the grant date (the cliff date), and then the remaining 75% of the equity grant vests each month or each quarter until the fourth anniversary of the grant date at which point 100% of the equity grant has vested, and the previously restricted equity is now unrestricted. An unrestricted grant vests immediately and has no restrictions connected to the grant.

MANY START-UPS SEEK A LOW UP-FRONT COST WITH A BIGGER INCENTIVE REWARD FOR THEIR INITIAL TEAM.

## SECTION 409A

A company that is granting equity to its employees via an equity incentive plan should consider obtaining a 409A valuation. A 409A valuation is an appraisal of the fair market value of the company's equity and ensures that the value associated with the equity grant is compliant with Section 409A of the tax code. Section 409A is a provision of the tax code that regulates deferred compensation and imposes tax penalties if certain requirements are not met. Deferred compensation, in the context of Section 409A, is broadly defined as any compensation that may be paid in a year following the year in which the right to payment arises. This can encompass employment agreements, performance plans, and certain equity award plans.

### SECTION 83(b) ELECTION

A Section 83(b) election is a provision under the tax code that gives a recipient of restricted equity the option to pay taxes on the income associated with the equity grant on the date of the grant as opposed to the vesting date, which can have vastly different outcomes depending on the value of the company at that time. The election form needs to be filed with the IRS within 30 days after the grant date, if the election is made. The amount of the income associated with the equity grant is the difference between the fair market value of the equity and the amount paid for the equity grant by the recipient on the date of the grant. If the value of the equity increases over time, the equity is sold more than one year after the grant date, the gain will be long term capital gain as opposed to ordinary income assuming the equity vests. **Below is a table (for illustrative purposes only) that shows the difference in the taxation upon the vesting of the equity of a grant of 1,000 shares with and without an 83(b) election, assuming both a 37% tax rate and an equity grant worth $1,000 on the grant date subject to a four year vesting period.**

| | VALUE OF SHARE | SHARES VESTED | TAXES OWED UPON VESTING WITH 83(B) | TAXES OWED UPON VESTING WITHOUT 83(B) |
|---|---|---|---|---|
| **Grant Date** | $1,000 | 0 | $1,000 X 37% = 370 | $0.00 |
| **1st Anniversary** | $2,000 | 250 | $0.00 | $2,000 x 25% x 37% = $185.00 |
| **2nd Anniversary** | $4,000 | 250 | $0.00 | $4,000 x 25% x 37% = $370.00 |
| **3rd Anniversary** | $5,000 | 250 | $0.00 | $5,000 x 25% x 37% = $462.50 |
| **4th Anniversary** | $10,000 | 250 | $0.00 | $10,000 x 25% x 37% = $925.00 |
| **Total** | | 1000 | $370.00 | $1,942.50 |

# STOCK OPTIONS

Stock options grant the recipient the option to buy a set number of shares from the company at a predetermined price, once the options have vested. The price is known as the exercise price (or strike price) and is usually equal to the fair market value of the share on the grant date. Holders of stock options will exercise the right to buy the underlying shares if the fair market value of the stock on the exercise date is higher than the exercise price (a/k/a “being in the money”). After the options have vested, they can be exercised at any time during the term of the option (which is normally ten years). Until the options are exercised, the holder of the stock option has no rights as a shareholder. The two types of stock options are non-qualified stock options, and incentive stock options. A key difference between non-qualified stock options and incentive stock options is that incentive stock options have a more favorable tax treatment for the employer, but as a result have many more rules attached to them including eligibility, holding periods, and restrictions on the exercisability of the options, a complete analysis of which is beyond the scope of this chapter.

# RESTRICTED STOCK AND RESTRICTED STOCK UNITS

Restricted stock is equity that is subject to certain restrictions until certain conditions are met. Restricted stock is actual stock so unlike stock options, the holder of restricted stock becomes the record owner of the shares of stock on the grant date and has all the rights associated with being the holder of stock, except for voting rights that might be limited by the company.

The equity is restricted in the sense that it is subject to forfeiture and is non-transferable until it vests. Additionally, vested restricted stock can have a repurchase right associated with it, giving the company the ability to repurchase the vested equity upon the termination of employment, for example. Restricted stock units are not actually restricted stock, but rather grants the service provider the right to receive equity in the company after the restricted stock unit vests. At that point, the holder of the restricted stock unit receives shares of stock in the company, and the value of that stock is treated as compensation. That distinction between restricted stock and restricted stock units is an important one that is sometimes overlooked.

# PROFITS INTEREST

A profits interest is an interest that gives a service provider of a partnership or limited liability company a percentage of the entity's profits in exchange for contribution of services. These interests may or may not have any voting rights, but give the recipient financial compensation that is tied to the performance of the company. Similar to other types of equity compensation, a profits interest can be subject to vesting over a certain time frame and other restrictions or hurdles before becoming effective. For example, profits interests can be structured so that they provide for payment to the holder of the interest only upon a liquidation event of the company.

# PHANTOM EQUITY

Phantom equity is a type of compensation that promises to pay an amount in the future that is equal to a certain number of shares or units of the company. Companies will create a phantom equity plan in part because they allow a private company to incentivize service providers to be aligned with the owners (without being owners). A phantom equity plan provides for a cash payment to the service provider upon the occurrence of certain events, but they are not an equity holder. The phantom equity award agreement details the vesting schedule, number of shares or units, form of payment, and the trigger event that causes the commencement of payments. The grantee is not an equity holder for any purpose, does not receive rights that an equity holder does, and would be taxed at ordinary income rates with respect to payments due upon a trigger event under a phantom equity plan in the future based on the terms of the plan.

# SUMMARY OF EQUITY COMPENSATION

There are a number of different ways to provide compensation to employees and/or service providers other than paying them cash. As with most issues pertaining to structuring a business, the best type of compensation plan for you to adopt depends on the type of entity at issue and the ultimate goals for the company. It is important to remember that there are adverse tax consequences if the plans are not structured the right way, many of which cannot be reversed after the fact – making it essential that you have sought the proper legal and tax planning advice before beginning any plan.

THERE CAN BE ADVERSE TAX CONSEQUENCES IF PLANS ARE NOT STRUCTURED THE RIGHT WAY, MANY OF WHICH CANNOT BE REVERSED.


# THIRD PARTY AGREEMENTS

# Third Party Agreements

Once a company's organizational documents are settled, the day-to-day aspects of the company's operations must be addressed, specifically interactions with its suppliers and customers. Even though the company may be eager to leap into new and exciting business relationships, the terms of any new agreements should be carefully evaluated as they may have a lasting impact on the business. For example, less favorable terms that the business had initially accepted may no longer be appropriate if a business becomes successful and bargaining power increases or such terms may make the business less attractive to future investors or acquirors. This chapter will provide an overview of considerations when entering an initial agreement with any third party.

## PURCHASE ORDER OR A FULL CONTRACT?

Many companies conduct their business on a purchase order basis without any ongoing commitment from its customers or suppliers. If a company is filling a purchase order it should also include, as part of the purchase order package, a set of its standard terms and conditions. Purchase orders can recite order quantity, any applicable specifications, and payment and shipping terms, and the process can offer flexibility as needed. Purchase orders can be accompanied by rebate and discount programs, if desired, as a way to incentive the continued business relationships.

However, some circumstances may favor entering into a more formal contract. This will depend, in part, on the nature of the business and what the company may stand to gain from a contractual commitment. These contracts can take many different forms, including as a manufacture or supply agreement, a master service agreement, a software as a service or license agreement, and the list goes on. Formal contracts will be used for an ongoing relationship and can be useful in situations when the parties desire to agree to guaranteed quantities or pricing for an extended period of time.

Contrary to a typical purchase order for a specific one-time product, a formal contract will include the negotiated expectations and commitments of the parties, including term, "most favored nation" pricing, subcontracting rights, exclusivity, intellectual property ownership, confidentiality, indemnification, limitations of liability, warranties, termination, remedies, and dispute resolution. More specialized contracts may include additional customary provisions, such as, in the software space, provisions related to required maintenance, updates, installation, and "up time" covenants. Oftentimes, a company will want its terms and conditions to apply to all sales, regardless of whether a purchase order or a formal contract is used.

## TERM AND TERMINATION

The term of a contract details the length of time that the parties' relationship will be governed by the agreement. It is important to consider if the length of the relationship will be time or project based, or if the relationship length is dependent upon a related agreement between the parties. Oftentimes, contracts with a set term will allow for either, or both, parties to renew the agreement for an extended term. Sometimes there are certain conditions that are required to be met, other times the agreement automatically is renewed unless one party provides notice that they do not intend to renew. Contracts with a notice provision detail the process (including whether the notice can be given orally or in writing) and timing (including minimum days and maximum days of advance notice) required for one party to provide notice to the other of either terminating the agreement or renewing it.


In connection with detailing the term of a relationship, the agreement also should specify the termination events or actions of a party, as well as the termination procedures, and obligations of each party upon the termination of the agreement. Frequently, advance notice is required by the party desiring to terminate the agreement. In certain cases, an agreement can only be terminated before its term expires if certain actions, like an event of default, occurs. These events may include items like (i) inaccurate representations and warranties, (ii) unsatisfied conditions or covenants, (iii) insolvency, and (iv) a change of control of a party, among others. In connection with termination for an event of default, the terminating party can be required to provide notice of such default and provide the defaulting party with an opportunity to cure the default before terminating the agreement. Additionally, the terminating party can at times be obligated to pay a certain amount to the other party to the agreement.

# PAYMENT AND PRICING

The pricing terms of an agreement detail the fees to be paid or how they will be calculated. In large part, the pricing will depend on the type of transaction. With respect to contracts for the sale of goods or software, the pricing could be fixed for the duration of the contract, other times it will be subject to certain variables like quantity purchased, the seller's costs, and certain costs from third parties including shipping, insurance or taxes.

On the other hand, in a contract for the provision of services, sometimes the price of the services will be based on the time incurred with the provision of the services and other times it will be on a fixed price for the specific service provided. Additionally, pricing for services can be based on a combination of the time incurred and the type of service being provided. These contracts can also have variable pricing based on the length of time the services are being provided for, and how frequently payment is made.

In both contracts, whether it is for goods or services, the contract can also include a "most favored nation" provision. Generally, these provisions state that the purchaser will be able to acquire the goods and services at the best price that is offered to any customer of the supplier, and for this reason suppliers should carefully consider whether to grant a most favored nation right to a counterparty, and appropriate exceptions to it. The inclusion of a "most favored nation" provision largely depends on the bargaining power of the respective parties to the agreement.

In addition to detailing the pricing for the goods or services, agreements with third parties should also detail the payment terms, methods, and dispute resolution for any contested payments. The contract will detail when each payment is due, whether it is at the time of shipping or delivery of the goods, within a certain time frame before or after the goods have been shipped or delivered, and whether in advance or after the services have been provided. The payment provisions should also detail any invoicing requirements of the seller, and whether the purchase can pay for the goods and services by credit card, check, wire, cash or any other payment method.

Further, it is important for these contracts to detail how the parties will handle any payment disputes. Often, the purchaser is permitted to raise in good faith an objection to a certain charge if they do not feel that the good or services were provided in accordance with the agreed upon terms. However, the supplier normally has certain requirements that the purchaser must meet in order to withhold the disputed amounts.

IT IS IMPORTANT TO CONSIDER WHETHER ANY PARTY WILL HAVE AN EXCLUSIVITY RIGHT AND WHETHER OR NOT THOSE RIGHTS WILL BE SUBJECT TO ANY LIMITATIONS, SUCH AS APPLYING TO A CERTAIN GEOGRAPHIC AREA OR SPECIFIC GROUP OF PEOPLE.

## EXCLUSIVITY

An important consideration when contracting with a third party is whether either party will have an exclusivity right, both parties will be bound to exclusivity, or no party will be obligated by exclusivity. A supplier will often want the purchaser to purchase the goods or services exclusively from the supplier as it provides the supplier a guaranteed stream of income (provided the purchaser stays in business). However, these exclusivity limitations are typically coupled with a right for the purchaser to seek out a third party to supply the goods or services if the supplier fails to do so. Sometimes, a purchaser will want to be the sole purchaser of a good or service from a supplier. This situation can occur when a purchaser is concerned about its competitors using similar goods or services from the same supplier. A supplier generally does not want to be subject to an exclusivity obligation to a purchaser, as the supplier will want to be able to sell its goods or services to the largest customer base possible. However, if a supplier is engaged to make a specific product for the purchaser, a supplier might be enticed to agree to mutual exclusivity only for the specific product. Exclusivity provisions can also be subject to a certain geographic area, or a specific group of people.

## INTELLECTUAL PROPERTY, CONFIDENTIALITY & RESTRICTIVE COVENANTS

Many agreements with third parties involve intellectual property rights and assets in one way or another. The provisions dealing with these rights and assets are heavily negotiated, especially when the business is technology focused. The main considerations when addressing intellectual property rights and assets are ownership and right to use.

In certain software development and manufacturing agreements, the parties may agree to use each party's intellectual property to create the goods or perform the contracted services. Additionally, the parties may develop new intellectual property pursuant to the relationship. Typically, the agreement should clearly state that any intellectual property that was created prior to the relationship will remain the sole and exclusive property of the party that owned the intellectual property prior to the relationship.

However, with respect to intellectual property that is created by the joint efforts of the parties during the duration of the agreement, the agreement should clearly detail any intellectual property that is either a work for hire which will solely and exclusively belong to one party, or if there is any work being carved out from any work for hire provision allowing the intellectual property to remain the sole property of the creating party. The ownership of any intellectual property jointly created also depends in part on the nature of the goods or services being created, and each party's anticipated future use of the new intellectual property.

In any contract in which one party is given the right to use the other's intellectual property, the agreement should address the terms of the use of such intellectual property. These terms vary depending, in part, on (i) the type of the agreement and the type of product or service being offered, (ii) the extent to which each party requires the use of the other party's intellectual property, and (iii) each party's bargaining power. Important considerations with respect to a license of intellectual property include:

- who the ultimate beneficiaries are and whether the use is sub-licensable;
- the length of time associated with the license;
- whether the license is exclusive or non-exclusive and any geographical limits;
- the fees associated with the license;
- any limitations on the use or obligations by the licensee to the licensor; and,
- indemnification rights associated with the use of the intellectual property.

Confidentiality goes hand in hand with intellectual property considerations. Oftentimes, confidential information is exchanged by the parties to a contract. The party disclosing the confidential information generally wants to protect the use and disclosure of their intellectual property to the best of their ability. This can be done via confidentiality and non-disclosure obligations that are either embedded into the formal contract with the opposing party or can be a separate stand-alone agreement. In either case, a confidentiality and non-disclosure agreement or provision should:

- clearly (and for the disclosing party, broadly) define the confidential information that is being protected;
- detail the obligations of the receiving party;
- detail the instructions for how to handle the confidential information upon the termination of the agreement; and,
- provide remedies for the disclosing party if the receiving party misuses the confidential information.

CONFIDENTIALITY AND INTELLECTUAL PROPERTY GO HAND IN HAND. OFTENTIMES, CONFIDENTIAL INFORMATION IS EXCHANGED BY THE PARTIES TO A CONTRACT.

Relatedly, companies use restrictive covenants (including non-solicitation, non-competition and non-disparagement provisions) as a means of protecting not only a company's intellectual property, but its personnel and work product as well. Most typically, a non-solicitation provision prohibits the restricted party from soliciting or attempting to hire any employees of the counterparty, but can extend to the customers, suppliers and business relationships of such party as well. A non-competition provision restricts a party from competing with the business of the counterparty for a specified period of time, the duration and breadth of which is often heavily negotiated. Such restrictions can apply on a limited basis (to a specific line of business, limited geographic area or with a specific list of competitive companies) or be broadly constructed to prohibit competition with all current and future businesses of the company, on a worldwide basis. Finally, parties may use non-disparagement provisions to prevent either party from making false or damaging statements about the other parties to the agreement.

## INDEMNIFICATION AND LIMITATION OF LIABILITY

Indemnification is a concept integrated into many agreements pursuant to which the parties agree to hold each other harmless for certain losses arising from certain actions. Indemnification provisions are risk shifting mechanisms to allocate liability among the parties to an agreement for both direct claims, and claims brought by a third-party. Sometimes, the agreement will call for mutual indemnification. An indemnification provision should also address the scope of recoverable losses. The scope depends in part on whether (i) the losses will be limited to third party-claims or include direct claims between the contracting parties, (ii) the losses are limited to actual losses or extend beyond just actual losses, and (iii) if there is a duty to defend. Another consideration is whether to exclude losses arising from a party's negligence or misconduct, or losses below a certain materiality threshold. Oftentimes, certain events can be detailed as indemnifiable. These events typically include (among others):

- breach of representations and warranties or covenants including those with respect to the quality of the contracted goods or services;
- infringement of intellectual property;
- certain acts or failure to take certain actions including failure to provide the contracted goods or services; and,
- failure to comply with law.

The parties can also agree to limit the extent of the liability. Oftentimes, these provisions will limit the scope of recoverable damages solely to direct damages and include carve-outs (meaning losses are unlimited) for fraud, intentional or reckless misconduct, or indemnification obligations relating to third-party claims. Frequently, a liability cap will be included to place a limit on the maximum liability for all damages relating to the contract. This cap can be a flat dollar amount, a multiple of fees paid under the contract, a percentage of fees payable, or some other calculation. Oftentimes, the liability cap can be a heavily negotiated point, and largely can depend upon the bargaining power of each party to the agreement and the risk attendant to the products and services being provided.

# REMEDIES AND DISPUTE RESOLUTION

Parties to a contract often envision a wonderful working relationship, but that does not always end up being the case. For those circumstances, the parties will need to carefully consider their remedies should the relationship begin to unwind.

Remedies can take many forms, including a general right to litigate a claim or more negotiated mechanics. For example, in addition to or in lieu of other available remedies at law or in equity, some contracts may provide for specific equitable remedies or liquidated damages. An equitable remedy provision generally states that, in addition to any remedies available at law, the parties to an agreement agree that monetary relief may not fully or adequately compensate a party for losses suffered due to the other party's breach of the contract and gives the aggrieved party the right to seek injunctive relief from a court to cause the other party to cease their problematic conduct or specific performance of an unfilled covenant. A liquidated damages provision requires the breaching party to pay, as damages, a fixed sum of damages or an amount of damages calculated pursuant to a negotiated formula. Liquidated damage provisions may be useful in situations where it would be difficult to ascertain the amount of damages that the non-breaching party would suffer upon a breach of the contract. Litigation itself can be a time consuming and expensive process. If a judgment is obtained, the parties may still have difficulty enforcing and collecting on the judgment.

In addition to setting forth governing law and a venue for disputes, contracts may have more involved dispute resolution mechanisms. In the right circumstances, remedies short of litigation could result in a more cost effective and expedient resolution of an issue – of course, that is not always the case, even with remedies that are theoretically designed to achieve those goals.

Nonetheless, parties may agree to mediate and/or arbitrate disputes rather than litigate. Mediation can afford the parties an opportunity to negotiate a mutually acceptable resolution in front of a third party mediator. If mediation fails, the parties can proceed to arbitrate or litigate, depending on the dispute resolution provisions. Arbitration, which can be binding or nonbinding, and is very difficult to appeal, is a procedure conducted by one or a panel of arbitrators pursuant to arbitration rules of the applicable arbitration organization, which vary from the rules of a court proceeding.

# LIQUIDITY EVENTS & LATER STAGE FINANCING

# Liquidity Events & Later Stage Financing

After a company is formed and once operations have started, most businesses require additional capital to fund expanded growth. Companies often start with an initial fundraising stage, known more broadly as seed financing, angel investor financing, and/or family and friends financing. From there, a company can obtain later stage financing in a variety of ways, but most commonly through one or more rounds of series financing. Typically, a business conducts several rounds of series financing, beginning with Series A and continuing until there is an exit.  Exits from a business can take multiple forms, including a merger or acquisition transaction, secondary sales, or initial public offerings, among other options.

A COMPANY CAN OBTAIN LATER STAGE FINANCING IN A VARIETY OF WAYS, BUT MOST COMMONLY THROUGH ONE OR MORE ROUNDS OF SERIES FINANCING.

# SERIES FINANCING

As a business continues to grow, it may require additional capital over and above the revenue derived from the sale of goods or provision of services. Sometimes additional funds are contributed by the existing equityholders or obtained via third party financing, including bank debt, member or shareholder loans, and other private or government-funded financing.

Following initial fundraising efforts, some companies will utilize one or more rounds of series financing to infuse additional capital into the business. In a Series A round, the board of directors or managers cause the company to offer for sale a pre-determined percentage of the company at a certain valuation. The various investors usually then purchase the equity in the company via a Series A Purchase Agreement. Documents that are commonly associated with a Series A round also include investor rights agreements, voting agreements, right of first refusal and co-sale agreements, and/or a management rights letters. After a Series A round is complete, and as the company continues to grow, it may consider a subsequent Series B round, which is typically done at a higher valuation. The Series B round will incorporate many of the same documents that a Series A round does, especially for any key investors from the Series A round.

A company may need an infusion of additional capital, and opt for other ways to fund, including bridge or mezzanine capital via debt, or in between, different Series financing rounds. Typically, series financing is associated with venture capital investments, and does not extend beyond Series C rounds as at that point the company is usually preparing for an initial public offering or an acquisition. Outside of private placements, companies may also seek strategic investments or “path to ownership investments” in order to raise capital while fostering business synergies. The latter typically involves an initial minority investment in the company that provides the investor the opportunity to acquire additional equity in the future up to (or in excess of) a controlling interest in the same.

# SECONDARY SALES

A secondary sale is a way to address liquidity demands being raised by founders, early employees, and early-stage investors. This type of transaction involves a sale by an existing owner to a third party that does not occur in connection with the complete acquisition of the company. Secondary sales need to comply with the applicable federal and state securities laws as the equity being transferred is unregistered at the time of the transaction. Additionally, the equity at issue in a secondary sale is usually subject to restrictions on transferability that the company will have to waive, or comply with, in order for the transaction to be completed. Another consideration with secondary sales is the value of the company.

# EXITS

## MERGERS AND ACQUISITIONS

A company may determine that it is time to sell the business. There are a variety of factors that may prompt the equityholders or decision makers of a company to sell, many of which depend on the size and nature of the business or its position within the market. In closely held, family-owned businesses, the equityholders may determine to sell in the event of a dispute amongst family members or upon the retirement of the primary operators of the business. In other cases, market factors or industry competition drive an exit from a business. Frequently, the receipt of an attractive offer or increased interest in the market is enough to drive the equityholders to consider a sale.

In general, the sale of a business can be described as a merger or acquisition. A merger is when two companies come together, combining assets, finances, personnel and other elements, with one entity surviving on a go forward basis and the other entity ceasing to exist. A traditional acquisition is when one company buys all or substantially all of the assets or equity of the target company. Sometimes, an acquirer may decide to purchase a division of a business (and not the entirety of the business), certain specified assets or a controlling interest in a company, among other variations – the possibilities are vast. The right structure for a transaction is guided by the business objectives and legal considerations including with respect to tax efficiency. M&A transactions may also

include types of consideration beyond cash at closing, such as rollover equity, deferred payments, and earnout or other contingent payments. Indemnification escrows (or holdbacks) and net working capital adjustments and related escrows, or similar concepts, are typically requested by acquirers to mitigate risk and ensure a certain level of working capital is in the business at closing. Depending on the financial position and strategic outlook of the acquirer, M&A transactions will often involve financing, such as an acquisition loan from a third party lending institution, a capital call to existing equityholders of the acquirer, or a capital raise to attract new investors for the acquirer.

## INITIAL PUBLIC OFFERING

Another type of liquidity event or exit from a privately held business is an initial public offering, or more commonly called an IPO. An IPO marks the first that the equity of the company is being offered to the public. This is an extremely time consuming and complicated transaction and process. It involves a number of outside parties and factors, including SEC approval. First, underwriters (usually an investment bank) present proposals detailing their valuation method and the structure of the offering. The company also engages lawyers and accountants to help meet all SEC listing requirements, which are met via the preparation of acceptable registration forms. Company management along with the underwriters put together marketing materials that get distributed to help gauge interest in connection with the valuation process. Then, once listed on a public exchange, the company can sell equity directly to the public and use the funds to continue growth or funding operations. Another method of going public is to do a direct listing. A direct listing is a public offering, but does not involve underwriters.

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# BEFORE YOU *Go*

As corporate attorneys and business advisors, we have experience guiding emerging companies through the excitement, challenges and pitfalls of establishing a company and achieving legal compliance. We wrote this eBook to help empower entrepreneurs to make informed decisions, protect their ventures and avoid common business faux pas. There are many components to a healthy business, and we believe by addressing those outlined here, you can lay a solid foundation for your company to establish itself and grow.

# STAY IN *Touch*



Sincere gratitude to the additional Cole Schotz attorneys who provided guidance throughout the creation of this eBook.

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