



**STARTUPS:**

**AVOIDING KEY LEGAL MISTAKES**



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Focuses on entrepreneurial growth  
companies

Provides “big firm experience  
without the marble and mahogany”

Fixed Fees



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# Navigating the Legal Traps



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# Establish the Company Early

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# WHY Establish Company Early?

- Secures limited liability
- Starts the capital gains tax holding period
- Avoids cheap stock issues
- Gives the project some credibility



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# Select the Right Type of Legal Entity

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# Common Types of Legal Entities

## Corporation

- Limited liability
- Rigid capital structure
- Rigid governance structure
- Tax treatment (C vs. S corporation)

## Limited Liability Company (LLC)

- Limited liability
- Flexible capital structure
- Flexible governance structure
- Tax treatment

## S Corporation

- A regular corporation that has made special tax election
- Must meet strict requirements



# Corporation vs. LLC

LLC's capital and management structure flexibility is **less important**

Choice is **driven** by tax consideration





# LLC Tax Advantages

## No entity level income tax

LLCs are classified as partnerships for tax purposes and do not pay income taxes

## Flow-Through of income and losses

Taxation occurs at the owner level, with income and losses passing through to the owners



# Illustration: Tax on Distributions

## C Corporation

- ⦿ Combined federal (at 39.6%) and state (at 6%) corporate tax rate: 43.2%
- ⦿ Combined federal (at 20%) and state (at 6%) individual tax rate on income distributions: 24.8%
- ⦿ Effective tax rate on distributions: 57.3%

## LLC

- ⦿ Combined federal (at 39.6%) and state (at 6%) corporate tax rate: 43.2%
- ⦿ Distributions are not taxed
- ⦿ Effective tax rate on distributions: 43.2%

**Tax savings as compared to corporate distributions: 14%**



# LLC Tax Advantages

- Ability to make tax-free distributions
  - A C corporation's shareholders generally must pay tax on the cash dividends and other distributions paid to them.
  - A corporation may not distribute built-in gain property to its shareholders without triggering one (if it is an S corporation) or two (if it is a C corporation) levels of tax
- Ability to provide equity compensation through issuance of “profits interest shares”
- Flexible exit - A buyer is able to purchase assets and allow for the adjusted tax basis of the entity's assets to be stepped up to their fair market value usually with little or no additional tax to the entity or its owners



# Corporation Tax Advantages

- ◉ A C corporation may qualify as a “Qualified Small Business,” which may allow the shareholders the following additional benefits:
  - 100% gain exclusion for investments made after September 27, 2010 (IRC Section 1202)
  - Gain deferral if the investor “rolls over” the gain by purchasing additional QSB stock (IRC Section 1045)
  - Re-characterization of capital gain losses as ordinary losses (IRC Section 1244)
- ◉ Members who are active in an LLC may be subject to self-employment taxes
- ◉ Venture funds will generally not invest in LLCs
- ◉ Foreign investors and tax-exempt institutions prefer not to invest in LLCs
- ◉ Shareholders in a corporation can defer recognition of gain in certain liquidity events (tax-free reorganizations)
- ◉ LLCs may not issue “Incentive Stock Options”





**C corp**

**S corp**

**LLC**







# Entity

## Metamorphosis

Many states permit easy **conversion**  
from one type entity to another

Be aware of **tax** consequences



# Where to Organize the Company

## ○ Delaware

- Almost all investors, regardless of where they are located, are familiar with Delaware corporate law
- Complying with procedural formalities is easy and efficient
- Directors are afforded a high degree of protection
- Can easily go public or get acquired
- Predictable, fair and well-developed body of corporate law
- Delaware franchise taxes are high

## ○ Home state



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# Agree on and Document Founders' Roles and Responsibilities

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A large, jagged iceberg floats in the ocean under a cloudy sky. The iceberg is the central focus, with its sharp peaks and ridges clearly visible. The water is a deep blue, and the sky is a pale, overcast grey. The overall mood is somber and contemplative.

# Incorporation

is the tip of the iceberg



A large iceberg floats in a blue ocean under a cloudy sky. The visible tip is small, while the massive, textured base is submerged underwater, illustrating the concept of hidden potential or a company that is not fully established.

Company must be **fully**  
**established**



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Two open, light purple shells are shown on a sandy beach. The shells are slightly curved and have a smooth, glossy interior. The sand is a mix of light and dark grains, with some small pieces of shell and organic matter scattered around. The lighting is soft, highlighting the texture of the shells and the grain of the sand.

**What does incorporation give you?**

# Founder Share Subscriptions

- ⦿ How many shares should be issued to the founders?
- ⦿ Have formal subscription agreements
  - Securities law representations
  - Evidence of IP contribution





Founders **must enter** into  
a shareholders' or operating agreement

# Key Founder Relationship Issues

- Governance
- Transfer restrictions
- Founder vesting
- Right to maintain
- Drag along rights





# Governance

How is the entity governed?

Super majority

Veto rights

Dead locks







# Dilemma

Shares are freely transferable

Yet a startup is a  
partnership among its  
founders



# Protect against the unexpected

## Your co-founder dies

- His shares are passed on to his wife, children or other heir who may have no clue about the business

## Your co-founder sells his shares

- You may not be comfortable working with your new co-owner



# Transfer Restrictions

- ◉ Initial transfer prohibition
- ◉ ROFR and co-sale
- ◉ Permitted transfers
- ◉ Separating economic rights from voting rights





# Founder **Vesting**



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# Illustration: Founder Vesting

## Issue: A Founder terminates his employment

### The Problem

- Two 50/50 founders receive 1,000,000 shares each
- One founder terminates his employment
- Company needs to find a replacement executive and issues the new executive 500,000 shares
- Consequences
  - Terminated founder keeps his shares
  - Non-terminated founder's ownership interest is reduced to 40%

### Solution

- A portion of each founder's shares vests monthly during the startup period
- Vesting may create tax problems, which may be mitigated through a Section 83(b) election





# Why founder vesting?

## Issue: Vesting tax consequences

### The Problem

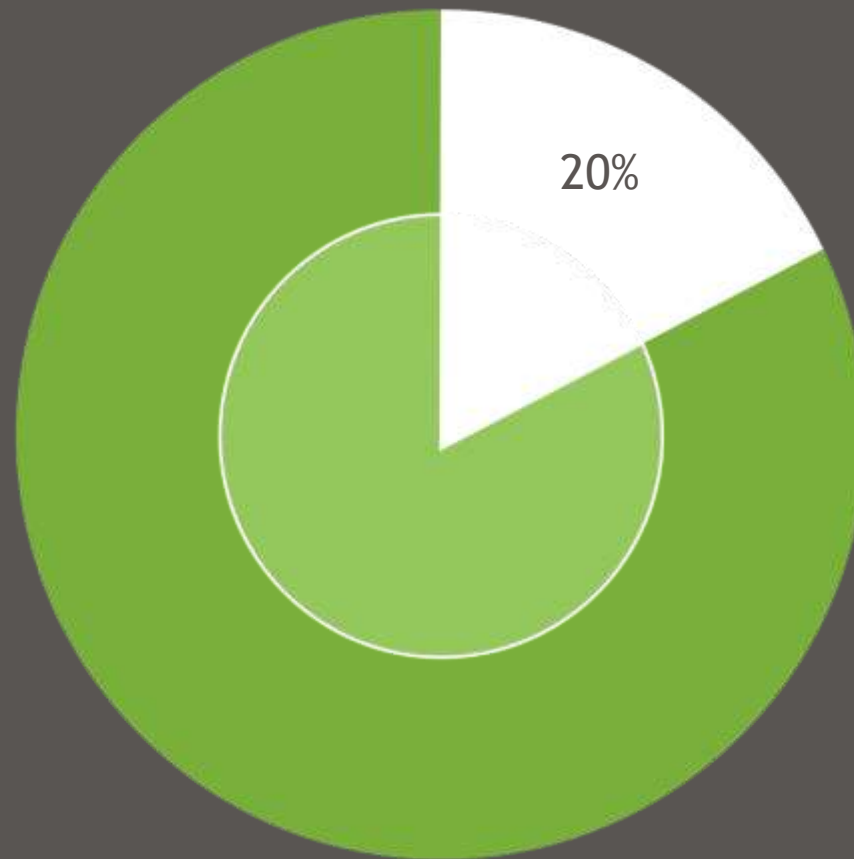
- Founder receives 1,000,000 shares subject to two-year vesting (41,667 per month)
- At the end of first year, the company raises money at \$1 a share
- Founder incurs **\$41,667 of taxable income every month** after the first year

### Solution

- Section 83(b) election

# Anti-Dilution Protection

Right to Maintain



# Drag Along Rights



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# Clear and Protect the Use of Brand Name, Logo and Domain Name

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# Trademarks

- What is a trademark?
  - A trademark or "brand name" comprises "anything" that identifies the source of goods or services from those of another when used in commerce
- A trademark can be:
  - a word or group of words
  - a sound
  - a scent
  - a color
  - a shape of a container or packaging

# Coined Word





# Real Word/Arbitrary Usage



**CAMEL**



*Genuine Taste*



# Suggestive



*Holiday Inn*



**PLAYBOY**



**GREYHOUND**



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# Descriptive



# Trademarks

What are the benefits of federal registration?

- Provides presumptive evidence in court of your ownership
- Provides exclusive right to use the trademark throughout the United States – even in parts of the United States where the mark is not yet in use.



# Trademarks

How long does a trademark last?

- Common law trademark: as long as the mark is in use in commerce.
- Federal registered mark: as long as the mark is in use in commerce, subject to 10-year renewals.



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# Develop and Implement Intellectual Property Strategy

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# IP Protection

- Ensure that core IP contributed by founders, employees, and third parties is owned by or at least securely licensed to the company
- Determine the appropriate kind of IP protection for technology developed by the company
- Protect the company's IP

# Illustration: software developer dispute

**Issue:** Failure to have a proper software development agreement

## **Problem**

- Company wanted to raise money
- Company had spent \$1m on software development
- Company disputed the developer's fee
- Developer refused to release the source code
- They could not resolve the dispute

## **Consequence**

- Company went under

# IP Protection

- ⦿ Patents
- ⦿ Trade secrets
- ⦿ Copyrights



# Patents

- ⦿ A patent grants the owner the right to “exclude others from”:
  - Making the invention
  - Using the invention
  - Selling the invention
  - Offering the invention for sale
  - Importing the invention
- ⦿ Territorial coverage
  - US patent covers only the US



# Patents

## ○ One-year rule

- An inventor has one year from the date of the first public disclosure of the invention to file a patent application in the U.S. Patent Office
- But, if the application is filed after the disclosure, the inventor is not able to file for patent protection in most foreign countries

## ○ Life of patent

- 20 years from the filing date of a utility application (no rights during "Patent Pending")



# Trade Secrets

- ⦿ A trade secret is information:
  - that derives independent economic value from not being known to the public
  - Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.





# Trade Secrets

- ◎ Types of trade secrets:
  - Formulae
  - Manufacturing processes or techniques
  - Business strategies
  - Business management information
  - Compilations (e.g., customer lists)
  - Design concepts, etc.



# Trade Secrets

## ◉ Example trade secrets

- **Campari:** A blend of natural ingredients, mostly herbs, spices, bark, fruits and fruit peels
- **Coca Cola:** The exact formula of Coca-Cola's natural flavorings is a trade secret
- **Google's PageRank:** A link analysis algorithm used to assign a numerical weighting to each element of a hyperlinked set of documents, to measure its relative importance



# Trade Secrets

## ◉ Protection of trade secrets

- In the U.S. trade secrets are generally protected under state law that varies from state to state
- Every state recognizes some form of trade secret protection
- Most state legislatures have passed a trade secret law, although some states rely solely on common law principles
- Uniform Trade Secrets Act has helped create a more uniform body of law



## **NDA's**

Potential investors  
Potential consultants  
Potential partners and customers

## **Independent contractor agreements**

Ownership of work product & IP  
Confidential information

## **Employee proprietary information and invention assignment agreements**

Proprietary information and use limitation covenants  
Ownership of work product & IP  
Non-compete covenant  
Non-solicitation covenant



# Copyrights

- Protects original works of creative expression in a tangible medium, including:
  - literary works
  - musical works
  - dramatic works
  - pantomimes & choreographic works
  - pictorial, graphic, and sculptural works
  - sound recordings
  - architectural works
  - software code

# Copyrights

- ◎ Copyright holder has exclusive right to:
  - to reproduce, make copies
  - to prepare derivative works -- recast, transformed, or adapted
  - to distribute copies
  - to perform or display publicly
- ◎ Length of protection
  - Individual: life of author +70 years
  - “Work for Hire” (including employee-created works): shorter of 95 years from publication or 100 years from creation.





# Copyrights

- ◉ Why register:
  - Copyright “attaches” automatically upon a work’s creation in a fixed tangible medium.
  - Registering a claim of copyright with the federal Copyright Office ([copyright.gov](http://copyright.gov)) provides many benefits, including:
    - the ability to legally enforce your exclusive rights
    - if a work is registered prior to an infringement or within three months of initial publication, the copyright owner is entitled to enhanced damage awards

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# Properly Structure Equity Compensation

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# Equity Compensation

- Commonly used types of equity compensation
  - Restricted stock
  - Stock options
    - Incentive Stock Options (ISOs)
    - Non-Qualified Stock options (NSOs)
  - Profits interest shares (LLC)
  - Restricted stock units (RSUs)



# Don't defer the implementation of equity compensation arrangements



# Restricted Stock

- ⦿ What is it?
  - Grant of shares of stock subject to vesting
- ⦿ Taxation
  - Taxed at ordinary rates on vesting date unless the recipient makes a Section 83(b) election
- ⦿ Common Usage
  - Most commonly awarded to a startup company's funders or during the initial startup phase of a company

# Stock Options

- What is it?

- The right to purchase a designated number of shares of stock at a fixed price over a specified period





# Stock Options

## ○ Taxation

- NSOs

- Compensation income upon exercise taxed at ordinary rates

- ISOs

- No compensation income upon exercise taxed at ordinary rates – taxed at sale at capital gains rate

- Subject to a number of restrictions, including:

- Issuer must be a corporation
- Recipient must be an employee
- Must be granted under a stockholder approved plan
- \$100,000 annual limit on fair market value of options granted one employee



# Stock Options

## ○ Common Usage

- Once restricted stock grants are no longer feasible, stock options are the most common form of equity compensation granted to employees and service providers



# Profits Interests Shares

## ○ What is it?

- Shares that do not participate in the liquidation proceeds until the common shares have received an amount equal to the common shares' fair market value at the time of the grant of the profits interests shares

## ○ Taxation

- No taxation at grant
- Taxed at capital gains rate at sale
- No compensation element taxed as ordinary income
- Tax is deferred until sale

# Profits Interests Shares

- Advantages over stock options
  - No compensation element taxed as ordinary income
  - Tax is deferred until sale
  - Capital gains holding period start when they are awarded
  - No need to exercise



# Profits Interests Shares

## ○ Disadvantages over stock options

- Recipient's salary and bonus payments will be reported as "guaranteed payments" on a Schedule K-1 rather than a Form W-2
- Recipient will be obligated to compute and remit quarterly estimated tax payments on his "guaranteed payments"
- The company will no longer pay the employer share of Social Security and Medicare taxes
- Recipient will be required to file tax returns in every state in which the Company does business



# Restricted Stock Units (RSU)

## ○ What is it?

- The right to receive from the company, after the satisfaction of vesting requirements, either:
  - A specified number of shares
  - Cash equal to the value of a specified number of shares

## ○ Taxation

- Generally taxed at ordinary income rates at settlement

## ○ Common Usage

- RSUs are usually granted by mature, highly valuable companies typically when the fair market value of the common stock is too high for stock options to be motivating to employees



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# Comply with Labor and Employment Laws

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# What is an Independent contractor?

- An Independent Contractor typically:
  - Charges fees for service
  - Is engaged only for the term required to perform an identified service or task
  - Retains control over the method and manner of work
  - Retains economic independence
  - Is responsible for paying his income, Social Security, and Medicare taxes
  - Is not protected by most federal, state, or local laws designed to protect employees





# Consequences of misclassification

- A company that misclassifies employees as independent contractors may be liable for:
  - Back wages and overtime pay
  - Employee benefits, including stock options, retirement benefits, and health plan coverage
  - Disability payments and workers' compensation
  - Tax and insurance obligations
  - Liquidated damages
  - Civil monetary penalties



# Independent contractor fallacies

- We're not ready to hire employees – we'll just use independent contractors
- They're only working part-time – so they must be independent contractors
- Startups don't need formal employment relationships
- Startups all use independent contractors (“everyone else is doing it”)



# Tests for independent contractor status

- Numerous tests
  - The Economic Realities Test: The FLSA Standard
  - The Control Test: The IRS Standard
  - Common Law and Other Tests
  - State Law Tests



# independent contractor tests and factors

- Most common factors indicating employee status
  - Day-to-day control over the worker's tasks, hours, and work location
  - Worker is integral to the business
  - Worker does the same work as others who are classified as employees
  - Worker uses company's equipment, email, and office to perform services
  - Business reimburses worker for expenses
- Common factors tipping the scale toward independent contractor status:
  - Worker performs services for multiple entities
  - Work is project-based and worker controls manner of work
  - Company pays worker on a project basis, not an hourly or salary basis
  - Contract specifies independent contractor relationship (not dispositive)
  - Worker performs services through worker's own corporate entity (also not dispositive)



# Tests are difficult in the on-demand economy

- ◉ Car Service (Uber, Lyft and Sidecar)
- ◉ Accommodations (Airbnb)
- ◉ Grocery Purchase and delivery (Instacart)
- ◉ Food Preparation and delivery (SpoonRocket)
- ◉ Home cleaning and handyman services (Handy)
- ◉ Personal assistant and concierge services (Fancy Hands and Task Rabbit)
- ◉ Dog-walking services (Wag)
- ◉ Laundry and dry-cleaning services (Washio and Rinse)





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