

Legal Issues for Startups



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Entity Selection



- **Types of entity available**
 - Corporation
 - LLC
 - Limited Partnership
 - Partnership
 - Sole Proprietorship
- **Key questions**
 - Liability shield
 - Management complexity
 - Taxation
 - Filing fees
 - State of Formation

Entity Selection



	Corp.	LLC	LP	P' ship	Sole Prop
Liability Shield	Full	Full	For LPs only, not for GP	None	None
Mgmt Complexity	Complex	Simple	Complex	Simple	Simple
Taxation	Elect S or C	'Check the Box'	'Check the Box'	Flow through	Flow through
State filing?	Yes	Yes	Yes	No	No
Filing fees (TX)	\$300	\$300	\$750	None	None

Entity Formation



- **How do you form a Corp, LLC, LP?**
 - Online: SOS Direct/Texas Secretary of State
 - In Paper: with the Texas Secretary of State
- **Is an online filing enough?**
 - To establish liability shield: Yes
 - To allocate ownership: No, look to:
 - LLC: Operating Agreement
 - Corp: Stock Certificates, Bylaws
 - LP: LP Agreement
- **How do you form a partnership or sole proprietorship?**
 - Partnership: contractual arrangement, through partnership agreement (could be on a napkin). Partnership is the default arrangement for two people doing business together without an entity.
 - Sole Proprietorship: start doing business.

Entity Formation for Startups



- **Typically Corporations**
 - Subchapter C Corp
- **Recommend Simple Capital Structure**
- **Common vs. Preferred Shares**
- **Classes of Stock**
- **Key Documents:**
 - Articles of Incorporation
 - Bylaws
 - Subscription Agreements/Capitalization Table
 - Shareholder and Director Consents
 - Employment Agreements
 - Work for Hire Agreements

Insurance



- Essential to doing business
- Helps manage risk
- Some types of business insurance:
 - Commercial general liability
 - A standard insurance policy issued to business organizations to protect them against liability claims for bodily injury (BI) and property damage (PD) arising out of premises, operations, products, and completed operations; and advertising and personal injury (PI) liability.
 - Business property insurance
 - Business property insurance policies protect your property, as well as inventory or assets, against loss or damage caused by theft, an accident or some other means.
 - Business interruption insurance
 - Covers the loss of income that a business suffers after a disaster while its facility is being rebuilt.

What is a Contract?



- 3 ‘law school’ elements to a contract:
 - 1. Offer
 - the definite expression or an overt action which begins the contract
 - 2. Acceptance
 - an expression by the contractual counterparty to accept the terms of the offer
 - Acceptance of terms other than those in the offer would be a *counter offer*
 - 3. Consideration
 - ‘a bargain for exchange’
 - may be money or may be another right, interest, or benefit, or it may be a detriment, loss or responsibility given up to someone else

Key Contract Terms



- ‘Real life’ contract terms
 - Parties – *who is entering into the contract?*
 - Recitals – *an overview of contract contents, but has limited legal effect*
 - Consideration
 - *Payment terms – how much is being paid? When? What form? Is this what you had negotiated?*
 - Terms and Conditions
 - *Termination clause – what if you want to get out? How much notice? To who? Penalties? With or without cause?*
 - *Representations and warranties – These are the things that you are promising and the counterparty is promising – are they true?*
 - *Indemnity – standard term in which one party makes the other whole for harm arising out of an agreement – is it a mutual indemnity? What are the limits? What is the process to indemnify?*
 - *Remedies for breach – how hard is it to enforce the agreement? What is the cost to enforce?*
 - *Mediation? Arbitration? – alternative dispute resolution methods – mandatory or optional? Which venue? Cost?*

Key Contract Terms (cont'd)



- Competent Parties – *are the parties competent? Was the person who signed the agreement intoxicated or at gunpoint? Burden is on the party challenging the agreement to establish lack of competency – tough to do.*
- For a Legal Purpose – *the contract has to be for a legal purpose – a contract to kill is unenforceable.*

Startup Contracts



- **Non-disclosure Agreement (NDA)**
 - Often used
 - Typically a sign of a rookie entrepreneur
 - Limited enforceability
 - Look out for exceptions
- **Website/App Terms of Use**
 - Sets forth rules for using the site
 - Important when you are engaged in e-commerce
 - Also important if you are hosting content – i.e., website containing user uploaded video
 - Often addresses copyright issues – i.e., DMCA notices
- **Website/App Privacy Policy**
 - Essential if you are collecting any data or engaged in e-commerce
 - Should be specifically tailored for the type of website
 - Be careful if your website targets children

Intellectual Property



- **Trademark/Service mark**
 - Filed with USPTO
 - File trademark on word, symbol or phrase used to identify a particular manufacturer or seller's products and distinguish them from the products of another
 - Mark must be **distinctive**
 - Four categories of distinctive:
 - 1. **Arbitrary or Fanciful** – i.e. Exxon, Kodak, Apple
 - No relationship to underlying product
 - Inherently distinctive
 - 2. **Suggestive** – i.e. Coppertone
 - Name suggests product's purpose but not specifically descriptive
 - Inherently distinctive
 - 3. **Descriptive** – i.e. The Vitamin Shoppe
 - Describes a product's characteristic
 - Not inherently distinctive, must have acquired secondary meaning – i.e. when the consuming public primarily associates that mark with a particular producer, rather than the underlying product
 - Factors: (1) the amount and manner of advertising; (2) the volume of sales; (3) the length and manner of the term's use; (4) results of consumer surveys.
 - 4. **Generic** – i.e. Apple brand apples
 - Describes the general category of the product
 - No protection
 - Remedies for breach: Federal lawsuit, felony for counterfeiting

Intellectual Property



- Copyright

- Copyright is the law that enables people to control the use of their own original creative works.
- Filed with US Library of Congress
- Grants 6 exclusive rights:
 - 1. *Reproduce* the copyrighted work in copies or phonorecords;
 - 2. To *prepare derivative works* based upon the copyrighted work;
 - 3. To *distribute* copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
 - 4. To *perform* the copyrighted work publicly in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works;
 - 5. To *display* the copyrighted work publicly in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and,
 - 6. In the case of sound recordings, to *perform* the copyrighted work publicly by means of a digital audio transmission.
- Remedy for breach:
 - Statutory penalty: \$200 if innocent; \$500-\$20,000 per instance if intentional
 - Criminal penalties

Intellectual Property



- **Patent**

- Requires a filing at the USPTO
- Application discloses and distinctively claims the invention
- Typically 20 years of protection
- a "process, machine, manufacture or composition of matter" may be patented – expanded over time, now "everything under the Sun made by Man" may be patented.
- State Street Bank Case I: transformation of data by a machine through math produces a useful, concrete and tangible result, and is therefore patentable.
 - Set precedent for method of doing business patent
- To be patentable, an invention must be **useful**
 - Low standard
 - Often an issue in biological or chemical patents – can't just patent a mix without a use for it
- To be patentable, an invention must be **novel**
 - Lenient standard
 - First to invent system: inventor can assert he invented something before the prior art became available
 - If you invent something and don't patent within a year of going public, you lose ability to protect
- To be patentable, an invention must be **nonobvious**
 - no patent may issue if "the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to person having ordinary skill in the art."

Investments



- Two (and a half) ways to invest in a company:
 - 1. Debt
 - A loan
 - Lender gives money, company agrees to pay back money over a specified period of time
 - No transfer of ownership
 - Lower risk to lender
 - Key document: Promissory Note
 - 2. Equity
 - Transfer of ownership to investor
 - Also transfers some control to investor
 - Higher risk to investor
 - Key document: Subscription Agreement
 - 3. Hybrid
 - Convertible note: starts as debt, but can be converted to equity by lender instead of being repaid in cash

Private Placements



- Securities and Exchange Commission (SEC) governs securities
- Investing or lending = investment per SEC
- *General rule: Register with SEC or find an exemption*
- Most common exemption is **Regulation D** of the SEC Act
- Reg. D overview:
 - 1. No general solicitation or advertising
 - 2. Limited size of raise
 - 3. Requires accredited investors or at least sophisticated investors
 - Accredited investor:
 - \$200k solo or \$300k joint income in past two years, or
 - \$1,000,000 net worth, or
 - Director, executive or general partner
 - Sophisticated investor: have such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes prior to making any sale that such purchaser comes within this description

Crowdfunding



- Boosted by the JOBS Act of 2012 – loosened regulation
- A way for non-accredited investors to make small investments typically not debt or equity
- See Kickstarter and Indiegogo

Startup Funding Structure



- **Seed Round: Friends and Family Convertible Note**
 - Debt round
 - Usually \$250k-\$500k depending on type of business
 - Will convert to equity at the A Round
 - Common terms: 12-18 months, 6% interest, converts at 15-25% discount
- **A Round: First Venture Capital Money**
 - Equity Round
 - Usually \$750k to \$1.5mm
 - Will convert Seed Round plus accrued interest into equity
 - Preferred Stock
 - Common terms: Board seat for lead investor, liquidation preference, dividend preference.
- **B Round: The Big Time**
 - Equity Round
 - Usually \$2.5mm+
 - Institutional VCs