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Succeed By Not Failing: Common Legal Mistakes Made By Startups, and How To Avoid Them

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Common Mistakes

- Inattention to IP issues
- Attention to university policies
- Hastily choosing advisors
- Inattention to employee issues
- Inattention to taxes (!)
- Misallocation of Equity
- Overthinking dilution
- Overcomplicating
- Too much information too soon
- Haphazard pursuit of investors

Inattention to IP Issues

- Disclosure issues
- University licensing issues
  - Scope
  - Exclusivity
  - Milestone payments: can you afford them when they are due?
  - Royalties
  - Watch out for terms that don’t seem to make sense; they probably don’t
- Protect IP: put it into the company as soon as possible
- Publish or patent?
- Typical founder agreements include:
  - Assignment of all rights in inventions
  - non-disclosure of trade secrets and confidential information (NDA)
  - non-competition (maybe)
  - “Reverse vesting” of founders’ stock
- Be careful of employment agreements (make sure the Company has funds to pay wages)

University Policies

- Need to know, and comply with, IP policies
- Issues with sponsored research and consulting agreements
  - outside activities policies
  - conflicts of interest policies
  - IP ownership issues
- University vs. company: rights to future inventions
  - *Stanford vs. Roche*
- Use of students
  - Undergraduates vs. graduate students
- Distribution of equity

Choosing Advisors

- Lawyers/Accountants/PR
  - Look for the right fit
    - University licensing expertise, industry experience
    - Do you need a big firm or a specialist?
  - Get recommendations
  - <u>don’t delay</u>
  - Don’t overshop, or spread advisors too thin
    - Buyer’s market can be illusory
- Board of Directors: when to form, whom to use
  - Investors may want to limit founders; nominees to board
  - This is (hopefully) a long-term relationship
- Scientific/Strategic Advisory Board
  - What skills, abilities, relationships do you need?
  - compensation

Employee Issues

- Employees vs. Independent Contractors
- Federal “rule” and Massachusetts “rule
  - MA rule: no control over provider, provider holds self out as being in the business, services outside scope of co.’s work
- It is almost impossible to classify most startup participants as independent contractors
- Unpaid internships must meet requirements
  - Must not provide immediate benefit or must “impede”
- Implications:
  - Wage laws
  - Unemployment and WC insurance
  - Personal liability

Tax Issues

- Employment taxes
  - See above slide
- Other sources of income
  - Business plan competitions prizes
  - Grants
  - = taxable income (!)
- Loans and notes
  - Interest income
- Pass-through entity issues
  - Forgiveness/cancellation of debt

Misallocation of Equity

- “Agreements” among founders, or lack thereof, are a great source of litigation
- Don’t issue fully vested shares to anyone, including yourself
- Don’t overcomplicate
- Be aware of unaccredited investors, including founders and “friends and family” investors
  - Can they convert into a later round?
- Watch out for unlicensed brokers and “finders”
- Be careful about promises regarding dilution
  - terminology
  - promising “percentages”
- Use a good advisor

Overthinking Dilution

- Equity is the main, or even the only, currency you have on Day One
  - You need help; you can buy it with equity
- Always use vesting for founders' equity – even yours
- Make a capital plan, and get advice well before engaging with equity investors
  - Dilutive capital, non-dilutive capital, "delayed dilution"
  - Milestone-based valuation levels
  - Every round should put the company at a new development milestone, and a significant valuation increase
- don't focus only on dilution
  - Multi-factor analysis; what is the post-deal enterprise value?

Overcomplication

- Overly complicated business plans add cost and confusion, and seldom survive investment process
  - Too many entities and business plans
    - Trying to split opportunities
    - Trying to retain “platform technology”
    - Joint or split ownership of IP
  - Entity choice
    - Make one choice – forming one entity with a view toward changing it later is seldom worth the expense and complication
    - Delaware C corp. vs. LLC

Too Much Information/Too Soon

- Use the right pitch for the right meeting
  - Elevator pitch/first description
  - Slide deck for first pitch
  - Full business plan for follow-up meetings
    - Address growth
    - Team
    - Capital gap
    - Go to market
    - Always be ready for, and welcome, questions

Find the Right Investors The Right Way

- Use your advisors as contacts
- Have your advisors scrub the slide deck
- Always try to get an introduction
- Don’t use unlicensed finders and broker
- Don’t present to VCs too soon
- Pay attention to all comments and questions
  - But remember First Law of Venture Pitching

Conclusion

- There are many mistakes and traps in the process
- There are many “right” ways to start a company, too
- You can do everything right, and still fail
  - Example: too many to name
- You can do everything wrong, and still succeed
  - Example: Facebook
    - Violated university policies
    - Stole IP
    - Didn’t document founders’ deals
    - Hired questionable advisors
    - No strategic plan
    - Still richest guy

Questions/Comments?

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