

Start-Ups: what you should know & your lawyer should tell you

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Agenda/Topics To Be Covered

- ▶ Background & Experience
- ▶ Company Set Up
- ▶ Who Owns What
 - Company Ownership
 - IP Ownership
- ▶ Licensing
- ▶ What Will You Get?
- ▶ Basic Documents
- ▶ Common Mistakes

Background & Experience

- ▶ Over 20 years of financial and legal experience in early stage company and venture capital representation
- ▶ Finance: GE Financial Management Program and Corporate Audit Staff
 - Domestic and international financial and business process reviews at financial services, manufacturing, aerospace and real estate businesses
- ▶ Legal: Drinker Biddle & Reath, The Judge Group and Safeguard Scientifics, Inc., Keating Mara & Associate LLC

Background & Experience

- ▶ Safeguard Scientifics, Inc. (NYSE:SFE)
 - Managed investments in life science and technology companies;
 - Involved in the initial public offerings many companies, including Internet Capital Group (now);
 - General Counsel to a portfolio of companies involved with all financing, licensing, procurement and sales
 - Act as outsourced General Counsel of Novitas Capital, L.P. (formerly PA Early Stage Partners)
- ▶ Founded Keating Mara & Associates LLC in 2005.
 - ▶ Recent representations include over 20 life science and technology companies, hedge funds, registered investment advisers, venture capital funds, large pharmaceutical companies and the Commonwealth of Pennsylvania

Company Set Up

- ▶ What do you want to do?
 - Start company to apply for grants and commercialize technology?
 - Advise/Consult?
- ▶ Entity Type
 - C Corp., S Corp. or LLC
 - Once you file with a state, you will have reporting obligations even if you do not have income
 - Governance Issues
 - Bylaws and stockholder agreements in C Corps and S Corps
 - Operating Agreement in LLC
 - These documents will govern how you interface with your partners

Company Ownership

- ▶ How will start up costs be financed?
 - Contribution of Capital
 - Loan
- ▶ How will the equity in your company be allocated?
 - Compliant with Jefferson policies?
 - Proper documentation for legal and tax purposes
 - Organizational minutes or consents
 - Subscription Agreement
 - Accounting records

Licensing

- ▶ Option Agreement
 - Low cost way to secure exclusivity while business plan is developed and other key contributors secured
 - May be sufficient to attract initial angel capital
 - Delays payment of expense which may be due under the Licensing Agreement
- ▶ License Agreement
 - Key Terms
 - Field of Use – broad enough to grow the business and attract strategic and financial partners
 - Ownership of IP developed at Company
 - Patent Costs
 - Reimbursement of incurred costs
 - Assumption of on-going maintenance expenses

Licensing – Key Terms

- Consideration for License
 - Equity
 - How much?
 - Anti-dilution protection?
 - Related rights
 - Pre-emptive rights
 - Co-Sale, Drag along, voting
 - Royalty
 - Rate often dependent intended Field of Use
 - Stacking clauses
 - Ability to Sublicense
 - Fees
 - Milestone

How Much Will You Get?

- ▶ Founders Shares
 - Subject to dilution
 - Can receive additional grants in the future for new contributions/engagement
 - Be mindful of the need for 83(b) Elections for future grants
 - Junior to securities issued in subsequent financings
 - Consider claw back provisions
- ▶ Consulting Fees
- ▶ Royalty/Equity distributable under Patent/Equity Policy
- ▶ Tax implications

Common Mistakes

- ▶ Issuing securities without complying with organizational documents and Federal and state securities laws
 - If you are issuing an option, warrant, stock, membership interest, profits interest, convertible debt, *call a lawyer with securities law experience*
 - Why it matters –
 - U.S. Securities & Exchange Commission and state securities department can pursue civil and criminal remedies for violation of securities laws
 - Exemptions for issuances under equity compensation plans need to contain certain terms to qualify
 - Avoid equity issuance to anyone but key employees and advisers
 - Investors will require you to represent that all your securities have been issued in compliance with all applicable laws
 - Due Diligence will include a review of your organizational documents and will uncover any securities not issued in accordance with the law

Common Mistakes

- ▶ Granting Equity to Individuals without a way to get it back
 - You need to engage people to help you develop the company but lack cash
 - Business Development people always think they can raise money for you – about one of out ten actually does
 - You cannot pay them on commission unless they are a registered broker dealer
 - Business Development people will want the equity as early in the process as possible in order to minimize the tax impact of the grant
 - This is fine – as long as you have a way to get the equity back in the event of a termination of the relationship
 - Buyback provisions in the granting document and/or operating agreement
 - Cliff vesting (at the end of each year) so if you terminate before the end of the year, most of the grant has not vested and can be used to

Common Mistakes

- ▶ Failure to Manage IP issues
 - Wearing multiple hats
 - Need clear delineation of IP creation
 - Separate computers, equipment, lab, lab books, records, etc.
 - Performed on personal time (per Jefferson policies)
 - Failure to make offers of employment or consulting contingent on signing Assignment of Invention agreements

Common Mistakes

- ▶ Agreeing in writing to pay someone a salary without having committed funding
 - Failure to pay compensation – even if you do not have the cash – can be deemed “deferred compensation”
 - Often done by startups that lack cash resources
 - Rule 409A of the Internal Revenue Code imposes severe penalties – on the company and the recipient – for failure to account for deferred compensation correctly
 - Solution:
 - Founders’ equity grant should be sufficient to account for “sweat equity” necessary to bring the company to positive cash flow
 - Keep fixed compensation at a minimum amount you know you can pay

Common Mistakes

- ▶ Paying full time contributors as 1099 consultants
 - Requires a thoughtful review of whether a contributor should be categorized as a contractor or an employee
 - IRS test
 - Department of Labor
 - If contributor works under the supervision and at the direction of company personnel in an office with regular hours and does not have any other clients, he/she should be an employee
 - Control of how, when and what the individual does is key to this analysis
 - Minimum wage requirements
 - Overtime will apply unless the employee qualifies as an “exempt” employee
 - Withholding and other obligations

Basic Documents

- ▶ Article of Incorporation or Certificate of Formation
- ▶ Bylaws or Operating Agreement
- ▶ Employee/Consultant offer letters
 - With attached Confidentiality/Assignment of Inventions/Non-Solicitation/Non-Compete agreement
- ▶ Non-Disclosure Agreements
 - Bilateral
 - Unilateral

Thank you

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