

# 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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