



**EVERYTHING YOU WANTED TO KNOW...BUT WERE AFRAID
IT WOULD COST TOO MUCH TO FIND OUT**

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The purpose of this short booklet is to provide you with some basic idea of some of legal issues which may arise during the early stages of your company's life. By giving some thought to these issues in advance you will save yourself time and money when it comes to getting legal advice, leaving you more time to get on with your business.

This booklet is for informational purposes only. Please bear in mind that the questions we have posed and the answers we have suggested are, of necessity, generic in nature. The answers will vary depending on the precise facts and circumstances of each case. The suggestions made in this booklet are not intended, and cannot be considered as, legal advice or opinion under any circumstances. Use of the information in this booklet does not create an attorney-client relationship.

Q. I want to leave my employer and start up my own company - is there anything I should worry about?

A. Be sure you are aware of all the restrictions which are placed on you by your existing employer with regard to your outside activities. Check the employee handbook as well as your own individual contract of employment.

Remember:

- Ideas you develop while working for your employer will generally belong to the employer if it is within the scope of your employment:
- You will not be allowed to use trade secrets or information which is confidential to your employer.
- You may be exposing yourself to liability if you harm the interests of your current employer while you are still an employee, so soliciting work colleagues to leave with you or customers of your employer to switch to your company should be delayed until after you leave.

Q. What type of company should I form?

A. The answer largely depends on what is going to happen with your fund raising. If you ever get to an IPO, a Delaware C corporation is the most common form, but you do not need to start there. If your initial investors (friends and family) want to have initial tax losses passed through to them, then an S corporation or a limited liability company may well be the best answer. If you expect to have venture capital or similar investors, you will almost certainly want to have a C corporation (whether California or otherwise) in which losses will be retained and used to offset future profits further down the line.

Q. Will a company protect me from personal liability?

A. The answer should be yes, provided you respect the fact that the company is a separate legal entity. You must however separate the company's affairs from your own and attend to the formalities required for the operation of a company to prevent the corporate veil from being pierced.

Q. My friends and I want to form a company - do we need to have a separate shareholder agreement between us?

A. The answer is yes and no! No, because there is no legal requirement to have such an agreement; yes, because it is a good idea to have one. The best of friends may not always stay the best of friends so you should have some agreement as to what will happen if there is a falling out. For example, in the absence of an agreement:

- If someone leaves the company (for whatever reason) and keeps their shares, those who carry on will be working for the benefit of that person too.

- If there is a divorce, the spouse of the shareholder may end up with an interest in the company whether the other shareholders like it or not.
- Shares may be freely transferable to unconnected third parties without other shareholders having a right of first refusal.
- A shareholder who is also a director and officer may be removed from office against his or her will by a vote of the majority even if all parties have equal shares.
- The majority of shareholders may be able to sell their shares without ensuring that the minority shareholders get the same offer.
- A small minority may be able to block a sale of the company to a third party who will only proceed if all shareholders agree to sell on the same terms.

Q. How can I get money from a bank for my start-up?

A. With difficulty! Banks are not really into this market. They may be prepared to help out if you can offer them plenty of collateral and show you can repay the interest and capital by some other means. Unlike a VC, a bank will not take a risk on a start-up being successful. However, you may qualify for a Small Business Administration loan which is designed for small businesses to which banks traditionally refuse to lend. Ask your bank about this program, whether they participate in it and whether your company will qualify.

Q. My wife's best friend's uncle has some friends who want to invest in the company - any problems with taking their cash?

A. The whole issue of selling stock to people who do not have a close relationship with the promoters of the company is fraught with pitfalls. If you ever get to your IPO, the underwriters are going to crawl all over every single stock issuance to ensure that it was made in compliance with applicable securities laws. The basic rule to remember is that the wider you spread the net and the less you know about the individuals, the riskier it is, so be cautious from the outset. There are plenty of exemptions with which you should be able to comply, but it does require careful attention to detail.

Q. What information do I have to give to potential investors?

A. The SEC has rules about what you must tell investors if you are going public. In other cases, it depends on the type of share offering you are making and what securities laws exemptions you are relying on. If all the investors are "accredited" (i.e. assumed to be able to look after themselves) then there is no formal disclosure obligation. However, if you do give information to investors there are two golden rules:

- any information you give must be accurate and not misleading; and
- you must not exclude information which, had it been disclosed, would have a material impact on the investment decision.

Q. What are the key things I need to negotiate when it comes to VC funding?

A. The most important aspect is of course valuation. In the current climate, VCs will also be looking not just at the technology but its real revenue generating potential and the timing

of that revenue. This will have a major impact on the ability to secure further financing. Additional issues include:

- vesting of founder stock
- composition of the board of directors
- anti dilution provisions
- restrictions on issuing further stock
- employment agreement with founders
- exit strategy

Q. What is venture debt?

A. This is typically a loan at a higher rate of interest but which, overall, represents a lower cost of capital than venture capital. The lender will take a warrant to purchase stock in the company at a later date which forms part of the overall return on the capital advanced. Venture debt can often act as a bridge between financing rounds. However, to get venture debt, you tend to need to have some collateral and revenue stream to start with.

Q. Do I need to apply for a patent for my idea?

A. The answer depends on what sort of idea you are talking about. Applying for a patent may be the best solution but there are plusses and minuses. A cost-benefit analysis should be undertaken because the process is certainly neither cheap nor speedy. An alternative may be to maintain the idea as a trade secret. Properly protected, this may be a less expensive and a more practical way to proceed. Make sure you explore all the possibilities.

Q. I have registered a domain name – does that entitle me to a trademark too?

A. The answer is no. The two are separate and distinct rights. If somebody already has a valid trademark, your use of the domain name may well be a violation of those rights and you may be required to change the domain name. If you have a distinctive domain name, always check the trademark situation before you invest too much time in promoting the domain name.

Q. I have a friend who is going to help me with some software development – any problems?

A. There are a number of issues to be careful about in this situation:

- Make sure your friend signs a confidentiality agreement. You cannot be too careful.
- You must have a written agreement which makes it clear that anything he develops for your company will belong exclusively to your company.
- Make sure your friend agrees not to infringe third party intellectual property rights when he is doing development work for you.
- Unless you want your friend to be an employee, the terms of the arrangement must meet the independent contractor tests, otherwise you may be liable for payroll taxes and all sorts of other unintended consequences.

Q. What can I do to stop people who work for me from competing against me if they leave?

A. In California, employee non-compete obligations are generally not enforceable. There are however some things you can do:

- Make sure everyone signs confidentiality agreements. You can protect against misuse of information that is generally confidential or constitutes a trade secret.
- Reasonable non-compete agreements may be enforceable against significant shareholders after they have sold their shares.
- Directors and officers have a range of fiduciary duties to the company. Do not enter into agreements or engage in practices which allow these duties to be compromised.

Q. I have to give my key people options or else they will all walk - anything I need to know first?

A. Quite a lot really! A stock option plan is just one part of overall compensation and should be designed to fit in with the wider objectives of the company. Many employees realize little or no value out of options for all sorts of reasons and yet the lure of options seems irresistible. There are numerous accounting, tax and securities laws issues which need to be fully appreciated and thought through before any stock option plan is implemented. Venture capitalists are usually reluctant to see more than 20% of the company under options so do not be too cavalier when it comes to handing these out.

Q. I have signed a lease for some space – what do you think?

A. Too late! So here are a few things you might want to have thought about first:

- Does the term of the lease match your business model? How soon will you run out of space? Will the space be suitable for your long term needs?
- Have you provided for adequate “build-out” of the space?
- Is the space properly networked for your IT systems? If the landlord says it will be, what are the consequences if he fails to deliver?
- Have you checked out the hidden extras (service charges and the like)? Are you sure that you are not in for a shock?
- Did you personally sign the lease or have to sign a personal guaranty? Would the landlord have accepted a rent deposit instead?
- Did you get references on the landlord? What do some of his other tenants think of him?
- What restrictions are imposed on your ability to assign the lease and/or sublease your space if you need to move out?

Q. Should I agree to provide a letter of credit to back up a contract to buy certain equipment?

A. Assuming you will not be able to proceed without the letter of credit, remember:

- The bank which issues the letter of credit will want you to put up collateral for its commitment, usually a cash equivalent. Are you sure you cannot negotiate a better deal with a vendor on a cash basis?
- Try to make sure that the letter of credit obligation (and therefore the collateral) reduces in line with the payments you make. Otherwise you may be tying up cash collateral which far exceeds the amount you owe.

Q. Should I agree to give a warrant to purchase a stock in my company to a vendor who is providing me with a leasing line of credit?

A. The answer obviously depends on how much you want that particular vendor's equipment and whether a third party leasing line might be available to you as an alternative. If you have to go with this vendor and his line of credit, try to ensure that the number of shares covered by the warrant bears some relationship to the utilization of the line. If you end up not using the line because the equipment turns out to be not quite what you wanted, you should be able to cancel a line and the warrant. If you do use the line, make sure the terms are really competitive with third party leasing. The value of the warrant, while clearly speculative, may mean that the overall return to the vendor turns out to be excessive unless the potential upside of the warrant is reflected in a discount on the line of credit. If this is a genuine partnering arrangement, consider asking the vendor to invest in the company's stock instead, not just in its upside.

Q. What dangers lurk in the realms of the standard terms and conditions of my vendors?

A. Too numerous to mention, but here are a couple:

- What liability does the vendor really have if the stuff does not work? Is the vendor trying to exclude all liability in reality?
- Is the reality of the post installation support obligation a contractual illusion?
- Has the vendor retained the right to terminate or renegotiate the deal if you want to sell the company?

Q. How can I get my product out into the market more quickly?

A. Appointing distributors or agents to sell your products may be one solution. Distributors purchase your stock which they resell to the customers on their terms. The distributor is your credit risk. An agent sells to your customers on your terms and those customers are your credit risk. When you provide back-up or other support services to end users the situation becomes more complicated. Careful thought needs to be given to how the customer relationship will be handled in practice. Whenever appointing distributors or agents, you will have to address the issue of exclusivity which can be very contentious. The most important thing is to be able to terminate the relationship if the distributor or agent is not performing to your satisfaction. If you are appointing distributors or agents in foreign countries make sure you know the local rules. Many jurisdictions, for example, do not allow you to cancel an agency agreement without paying compensation.

Q. What do you think about joint ventures?

A. Joint ventures (JVs) may be a way to get your products to market, particularly overseas markets. Often local investment capital can be used to jumpstart the business. However, JVs are notoriously difficult to negotiate and many do not work because the compromises made to secure agreement mean that the decision making process is less than ideal and hinders effective management growth. Always consider whether, at least initially, some other business relationship may be a better solution.

Q. Giant Corp, Inc. wants to have a strategic alliance and take an equity stake - any thoughts?

A. Plenty! A strategic alliance may well be of significant advantage to a company. It may offer easier access to new markets as well as greater credibility and financial and market viability. An equity stake may allow Giant Corp to provide development funding without incurring an expense for accounting purposes as well as building goodwill and acting as a prelude to an ultimate acquisition. A few issues to ponder however:

- Consider whether it is appropriate for Giant Corp to have a board seat. If Giant Corp is a key customer or supplier, you may want to restrict access to sensitive information about pricing or margins which may be discussed at the board level.
- Equally, provisions in investor rights agreement, which require a regular flow of financial and other information to investors may not be appropriate as regards Giant Corp if there are any competitive concerns.
- Venture capital documents do not usually require 100% of investors to waive certain rights or agree to certain changes so as to ensure flexibility. A corporate investor however is unlikely to want any of its rights changed without its approval, irrespective of the percentage it holds.
- Consider whether the existence of Giant Corp as an investor may have a chilling effect on sales of products to competitors of Giant Corp.
- A standstill agreement which prevents Giant Corp from increasing its stake in the company without board approval should be considered so Giant Corp does not build up a stake which results in the company being unattractive as a takeover of a target. Giant Corp may seek a buyout option or right of first refusal in return for this type of commitment.

Q. Should I have my accounts audited?

A. If you go public, you will need to show audited accounts. Otherwise there is no requirement for an audit. However, you may want to consider having your accounts audited as a matter of course since it will impose discipline on the way the financial affairs of the company are handled and third parties (banks, leasing companies and the like) may draw extra contacts. If you are planning to sell out, the buyers are likely to have more confidence in what they are buying and this may simplify and add value to the sale process.