

Legal Issues for New Businesses

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Starting a Business Selling a New Technology

- Creating a corporate entity
- Partnerships and Strategic Alliances
- Protection of Intellectual Property
- Signing Contracts
- Hiring Employees and Independent Contractors
- Dealing with Law Firms

Different Forms of Entities

- Corporation (“S” and “C”)
 - “S” Corp:
 - Shareholder must be citizen or resident alien of the U.S.
 - No more than 100 shareholders
 - Pass through taxation
- Limited Liability Company (“LLC”)
- Partnership (“general” and “limited”)
- Sole proprietorship

Corporation

- Public company or privately-owned
- Capitalization; Shareholder Buy-Sell Agreement
- Limitation on liability
- Formal structure
 - Annual election of directors
 - Minimum number of directors
 - Single shareholder

\$600 Off-the-Shelf Corporations include some risks:

Such Services do not ensure that You are:

- Adequately capitalizing the corporation
- Issuing securities in compliance with all applicable laws
- Preparing share certificates with proper legends, markings and signatories
- Adequately conducting board and shareholder meetings,
- Complying with all corporate, tax, and securities regulations.

Limited Liability Company

- Provides limitation on liability as a corporation
- Member may be an individual, corporation, etc., whether domestic or foreign
- No limit to number of members
- Only private - No public LLC.
- Less formal structure
 - Operating Agreement
 - Member or Manager managed
 - Share of profits independent from capitalization
- Pass through taxation

Corporation & LLC - Taxation

- Federal & State level of taxation
- Franchise Tax (\$800 per year in California)
- "C" Corporation double taxation
- "S" Corporation "pass through"
- LLC "pass through"

Limited Liability Companies

If the total income is:		The fee amount is:
Equal to or More than	And Less Than	
\$250,000	\$500,000	\$900
\$500,000	\$1,000,000	\$2,500
\$1,000,000	\$5,000,000	\$6,000
\$5,000,000 or more		\$11,790

Corporation & LLC

- Advantages
 - Corporation
 - Credibility, familiarity, established law
 - Financing, IPO, Employee SOP
 - LLC
 - Flexibility, ease of operation
- Disadvantages
 - Corporation
 - Increased formalities
 - LLC
 - Unfamiliarity, newer law
 - Cannot avoid income tax by retaining profits in company
 - CA annual fee based on total income

Recap Comparative Chart

Type of Entity	Limited Liability Protection	Flow Through Tax Advantages	Ownership Flexibility	Favored By VC Investors
C Corporation	YES	NO	YES	YES
S Corporation	YES	YES	NO	?
Partnership	NO	YES	YES	NO*
LLC	YES	YES	NO	NO*
Sole Proprietorship	NO	YES	YES	NO*
* These entities may be converted into another form such as a “C” corporation for funding purposes.				

Corporation - Delaware or California?

	Delaware	California*
Efficiency	Efficient and Responsive State Authorities	Slower turn around time for corporate formalities
Annual information statement	Not necessary	Annual filings necessary (but not very cumbersome)
Future financings - VC, IPO	Favored by VCs, good choice for IPOs	Favored by VCs, may also support an IPO
Location of business activity	Useful if the corporation does business in several states	Delaware not necessary if the corporation only does business in California
* If the corporation is incorporated in Delaware and has its main business office in California, both sets of Delaware and California laws will be applicable		

Legal Aspects of Corporate Financing

- Eliminate Obstacles
 - Clear and familiar legal structure
 - Intellectual property well protected
 - Corporate records well-maintained
 - Due Diligence
- Future Capitalization
 - Authorized/issued shares
 - Common/preferred stock
 - Amendment to Certificate/Articles of Incorporation
 - “Fully diluted shares”

Thinking about your Exit

- IPO
- Merger
 - Governed by Federal and State statutes governing “tax free” reorganization.
 - One entity ceases to exist.
 - Paid for by issuance of surviving or parent stock.
- Acquisition
 - Asset or stock purchase
 - Asset purchase more burdensome/time-consuming
 - Consideration in cash or stock
- Common Issues
 - Earn out
 - Indemnification
 - Continuation of key employees/founders
 - Employment Agreements
 - Stock Options and ESOPs

Joint Ventures – Partnerships

- Types of Partnerships
 - General Partnership
 - No formal agreement necessary.
 - All members personally liable.
 - Limited Partnership
 - Must file certificate of limited partnership with the state.
 - general partner manages, limited partners invest, have limited liability, are not involved with management.
- Joint Venture usually structured as General Partnership. Corporation may also be formed.
- Specified period of time.
- Specific project.
- Few parties, often only 2.

Strategic Alliance

- No creation of separate entity
- Based on contracts
 - Joint Development
 - Distributorship
 - Licensing or sales
- May lead to future merger or acquisition

Patents

- Monopoly rights to prevent exploitation in the territory of registration
- Provisional Patents
- 20 years from filing of application with the United States Patent & Trademark Office (USPTO)
- Two types: Design or Utility
- Must be: 1) novel, and 2) not readily apparent to person in field.
- European Patent Office (Special Software Patent not yet available)
- Patent Cooperation Treaty
 - E.U. and U.S. are parties
 - Priority registration date in U.S. relates back to foreign date if filed in U.S. within 12 months from foreign registration.

Trademark

- Exclusive rights to trademark, service mark, trade dress, logo, or slogan
- 10 years from registration date with USPTO
 - Renewable if use continues
 - "TM" and "®"
- May not be 1) confusingly similar to another in same class, 2) generic, or descriptive (without secondary meaning), or 3) immoral or deceptive
- Domain Name reservation
 - Include similar or derogatory names
- OHIM* (European Community Trademark Office)
- Madrid Protocol (World Intellectual Property Organization - WIPO)
 - E.U. and U.S. are parties
 - Streamlined filing process

*Office for Harmonization in the Internal Market

Copyright

- Protects software as a “literary work” and applies to the code, manuals, any other documentation
- 70 years longer than life of author
- Work for hire
- Must be 1) original, and 2) fixed in tangible form
- Exists from date of creation without any formality
- Registration with U.S. Copyright Office Recommended
 - Statutory damages only available if registered before infringement (unless registered w/in 3 months of initial publication)
 - Need attorney to determine what portions of code to make available
 - Must be done prior to litigation - if not previously done, can hinder ability to seek immediate injunctive relief
- Registration with U.S. Customs Agency to prevent imports of illegal copies
- Digital Millennium Copyright Act (DMCA)

Contracts

- **Trade Secret Protection**
 - “NDA” with potential business partners
 - Employee Confidentiality Agreements
- **License Agreements**
 - Exclusive or Non-exclusive
 - Irrevocable or Revocable
 - Perpetual or Limited duration
 - Sub-licensable or Not
 - Transferable or Not,
 - Restrict Access to Certain IP
 - Cover Upgrades, Improvements, Modifications, Derivative Works and Subsequent Versions
- **Distribution Agreements**
- **Joint Development**
 - Co-ownership of IP difficult to manage

Office Leasing

- Full Gross Lease
 - Base rent with no “additional rent.”
 - Base rent is best estimate to include all expenses and taxes.
- Gross Lease with Base Year
 - Base rent with no “additional rent” during base year.
 - Increases in operating expenses & taxes over those of base year paid by tenant in subsequent years as “additional rent.”
- Net lease
 - Expenses estimated each year; tenant pays difference at end of year as “additional rent.”
 - “fully” or “triple” net: all operating expenses & taxes.
 - “modified” net: some operating expenses & taxes excluded.

Office Leasing

- Term, termination and renewal of lease
 - Possibility to renew at pre-negotiated price
 - More likely - ability of landlord to increase rent
- Improvements
 - Guarantees on timely and complete performance
- Subleasing
- Hazardous materials

Hiring Staff

- Confidentiality and Invention Assignment Agreement
- Employment Agreements
 - EDD filings, taxes
 - Outsourcing payroll
 - State and Federal Regulatory Issues
- Independent Contractors
 - EDD and IRS criteria for requalification in Employment relationship
- Stock Options/Restricted Stock
- Visas

Litigation

- Discovery System: All your documents, records, emails etc. are discoverable
- Litigations costs in the US are generally higher than in other countries
- Liability Insurance is recommended

Legal Costs

- **Average Incorporation Costs**
 - Organization of founders
 - \$3,000 to \$5,000 (First meeting, counsel on structure, filing, corporate binder)
- Minimal 1-year Legal **Budget**
 - \$15,000 - Incorporation, registration of TM, Contracts
- **Billing**
 - 1/10 of an hour
 - Minimum of 0.3 hour for some firms
 - Rare: Project billing
 - Possibility of contingency billing in litigation

What To Expect from a Lawyer Assisting you in the Incorporation Process

- Filing of Articles of Incorporation that establish the Corporation and reduces officer and director liability
- Employment Identification Number (TAX ID Number) as required for bank transactions, tax filings and payroll compliance
- Bylaws
- A Founders Stock Purchase Agreement whereby the founders properly contribute cash and/or assets to the Company
- An Inventions Assignment Agreement whereby related IP transferred to the Company
- Board and Shareholder minutes which authorize the Company's officers to perform various corporate actions
- An Indemnity Agreement that further reduces officer and director liability for corporate activities
- Regulatory filings with Secretary of State, Department of Corporations, and the Internal Revenue Service.
- An additional "S" election with the Internal Revenue Service for "S" Corporations
- Minute books containing all documents and filings, share certificates and stock ledgers
- Detailed information on the legal aspects of doing business as a corporation providing easy to follow, simple guidelines to observe the corporate ritual and preserve limited liability.

An Attorney Should Help You Understand Everything You Sign

- Not understanding a contract can lock you in to terms that are contrary to your intent.
- A Good Business Lawyer can save you far more than the fees incurred by (1) obtaining better terms for you in your contracts and by (2) limiting your company's business risks.