

# *Startup Launch*

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LIFTOFF WITH LEGAL 101 FOR ENTREPRENEURS



**ENTREPRENEURSHIP  
AT CORNELL**

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# About Entrepreneurship at Cornell and WilmerHale

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## 1. Entrepreneurship at Cornell

Cornell University traces its origins to the vision of an entrepreneur and an educational innovator, Ezra Cornell and Andrew D. White. Today, Cornell continues this legacy by integrating entrepreneurial teaching and learning into all aspects of the university experience.

Entrepreneurship at Cornell is a diverse, university-wide program that finds and fosters the entrepreneurial spirit in participants from every college, every field, and in every stage of life. It is grounded in the belief that individuals who exhibit an entrepreneurial spirit and have acquired entrepreneurial knowledge can add significant value to any working environment from the smallest startup to the largest business, from non-profits to government agencies.

For more information on the Entrepreneurship at Cornell program, please visit our website [here](#).

## 2. WilmerHale

Wilmer Cutler Pickering Hale and Dorr LLP (WilmerHale) is a large international law firm with offices in Boston, New York, and Palo Alto. The firm is recognized for the exceptional quality of its legal work, its broad experience at the intersection of law, business and policy, and its dedication to client service. We are a full-service law firm with almost 1,000 lawyers worldwide in practice areas ranging from general litigation to intellectual property, corporate transactions, and regulatory & government affairs.

WilmerHale's nationally recognized Emerging Company and Venture Capital Practice has helped thousands of entrepreneurs successfully launch their businesses; raise billions in financing; and lead their companies to sale, IPO and market leadership. We offer solution-focused, strategic advice and an indispensable business perspective that is critical to our clients' success. Our team-oriented approach to service gives clients the flexibility to call on numerous experienced lawyers at any time, including our more than 100 dedicated corporate lawyers located in the most active startup markets across the United States.

For more information and resources for entrepreneurs and founders, please visit our website [here](#) or contact us at [whlaunch@wilmerhale.com](mailto:whlaunch@wilmerhale.com).

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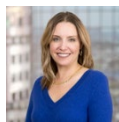
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Jenna Ventorino is a corporate lawyer who provides ongoing counsel to public and private life sciences and technology companies throughout their lifecycle. She advises clients in the biotechnology, medical technology and software industries in complex transactions including intellectual property licensing, private securities offerings and various exit transactions. [View full bio here.](#)



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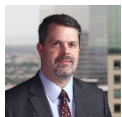
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Gary Schall helps entrepreneurs and emerging companies navigate the many legal issues they face, from formation to equity, safe and note financings through exit events. He also represents venture capital funds in their investments in startups and high-growth companies.

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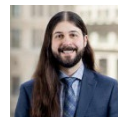


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## Introduction

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The purpose of this booklet is straightforward. We want to get startup founders to think early about key items that will set them off on the right legal track. We are addressing the early, pre-fundraising, basics. We are not addressing fund raising (equity, Safe or convertible debt), exits or hyper growth scaling; there are many resources already available for founders on those and related topics.

Our focus is on the mundane basics that founders face when they first establish their teams and want to start a business.

This booklet was first published in November 2023 and is subject to future updates.

# Entity Formation Basics

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## 1. The Right Type of Entity: Corporation vs LLC

A. **Forming a Legal Entity:** Startups can prosper or they can fail, this is a fact of life. Lawsuits are also a hard reality and startups can get sued. One of the most important reasons for forming a legal entity is to shield your personal assets from claims made by the creditors, employees, other businesses or any number of individuals or entities.

If you operate the business through a corporation or a limited liability company (often called an LLC) then the owners and operators of the business will not generally be responsible for the liabilities of the business (a key exception to this liability shield is the commission of fraud). Other legal structures like partnerships may not offer the same protection for all owners of the business.

B. **Corporation vs LLC:** Between a corporation or LLC, what's the best structure for you? One of the key considerations in choosing the type of legal entity is the tax treatment of the entity. When a corporation is formed, it is by default a Subchapter C corporation. The reference to "Subchapter C" is to Subchapter C of the Internal Revenue Code. Every dollar earned by a Subchapter C corporation is subject to tax at the corporate level. If the corporation then distributes that same dollar (net of the corporate tax) to the stockholders, it is subject to tax a second time at the stockholder level. This so-called "double taxation" is a major cost to any entity that will be generating income and making distributions to its stockholders (think of income as revenue net of expenses). If a corporation elects to be a "Subchapter S" corporation as provided in the Internal Revenue Code, it is treated like a LLC for tax purposes. In contrast to a Subchapter C corporation, LLCs and Subchapter S corporations are referred to as "pass through entities" because corporate income (and other tax attributes like losses)—even if distributed to the owners of the LLC (who are called members) or stockholders of the Subchapter S Corporation — generally are taxed only one time: at the member or stockholder level. Similarly, the members of an LLC or stockholder of a Subchapter S corporation may be able to offset personal income from other sources against losses of the business, thereby reducing their personal tax burden.

So it would seem to make sense that most every business should be structured as an LLC or Subchapter S corporation. Then why is it that most technology and life sciences startups are structured as Subchapter C corporations?

First, most technology and life sciences startups won't generate any taxable income for some time, and when the business begins generating income, that cash is typically reinvested back into R&D and expanding the business rather than being distributed to the owners of the business. So for these startups, there is no "double taxation." Second, most founders of these types of startups devote their full-time to building the business, so they don't have other income that can be offset against the losses of the business.

C. **Other Reasons to Choose a Subchapter C Corporation:** Finally, there are a number of non-tax reasons most technology and life sciences startups are structured as Subchapter C corporations.

Subchapter S corporations can't have more than one class of stock or entities as stockholders, for example. So, a Subchapter S corporation is not possible if the business is to be venture-backed since venture investors typically get preferred stock and are legal entities themselves (typically formed as partnerships).

Similarly, there are sometimes negative tax consequences to the limited partners of venture funds that invest in LLCs. Moreover, tax advantaged incentive stock options can't be granted in LLCs. And, significantly, the legal, accounting and other administrative costs of an LLC typically outweigh the benefits (if any) of operating most high-growth companies as an LLC.

As a result, if you plan to start a business that will rely on outside capital, utilize equity awards to compensate employees and other service providers and seek rapid growth to sale or IPO, the best type of legal entity is most likely a Subchapter C corporation. When deciding what makes sense for your venture, you should speak with a lawyer experienced with incorporating and working with startups.

## 2. Delaware Versus All Others: Formation Jurisdiction

A. **Reasons to Choose Delaware Over Nevada, California and Every Other State:** When you start a company, one of the first decisions that will come to mind will be “where should my company be incorporated.” Often times companies will incorporate in the state in which the company was founded or physically based. While this may seem like the obvious choice, here are several reasons why Delaware will usually be the best state to incorporate your company:

1. **Company Friendly Laws:** Delaware has adopted a set of relatively company-friendly set of laws. Moreover, Delaware has a separate court whose sole job is to try cases under this set of laws and so there are many published decisions interpreting these rules.
2. **Investors / Acquirers and Ease of Doing Business:** Many other companies are already incorporated in Delaware which gives lawyers, directors, investors and future acquirers of your business a solid understanding of the laws governing your company, which makes it easier, more efficient and more comfortable for them to do business with your company (e.g., serve on your board or invest in/buy your company). Venture capitalists highly prefer Delaware corporations over any other jurisdiction.
3. **Well Established Precedent:** Some states have adopted laws that either mimic those in Delaware or that are intended to be even more company friendly. However, Delaware has had a substantial head start with a well-established set of court interpretations and with practitioners, directors, investors and others that understand the rules, so the right choice for most companies will be Delaware.

## 3. Core Corporate Documents: Certificate of Incorporation and Bylaws

A. **Certificate of Incorporation:** The Certificate of Incorporation also known as the “Charter” is a legal document that establishes a startup, specifically a corporation. The Charter is filed with and accepted by a state government agency, for example the Delaware Secretary of State, and serves multiple functions. The Charter states the name and purpose of the corporation, the number of shares the corporation is authorized to issue (to be discussed in more detail later) and the rights of each class or series of stock.

B. **Bylaws:** Most states require corporations to have bylaws. One way to think of bylaws is to think of them as being the rules or regulations of a corporation. The bylaws contain provisions for managing the affairs of the corporation. These affairs include the powers of directors, information related to the stockholders’ and directors’ meetings, director elections, and the powers of officers.

## 4. Authorized Shares: What Are They and How Many Should a Startup Have?

A. **Authorized Shares vs Issued/Outstanding Shares:** Authorized shares are the number of shares of capital stock a corporation is allowed to issue under its Charter or Certificate of Incorporation. Issued and outstanding shares refers to shares that have been approved by the corporation’s board of directors and issued to stockholders and that are held by stockholders at a given time.



B. **The Right Number of Shares:** One common consideration when incorporating is how many shares should be authorized in the Certificate of Incorporation? While 5 to 8 million shares is typical for a corporation's first capitalization table, it is important to note that the number of issued shares cannot be more than the number of authorized shares in the Certificate of Incorporation. There should always be a substantial reserve amount of shares for issuance under the startup's stock option plan or for unexpected needs, such as bringing on an additional co-founder, in case more shares need to be issued. This will save the startup the time and money involved in filing fees and preparing board and stockholder consents and an amendment to the Charter. In addition, when issuing shares, consideration must be given to potential franchise taxes (if incorporated in Delaware) as the number of issued shares has an impact on the amount of tax.

## 5. The Registered Agent: What is a Registered Agent?

A. **What is a Registered Agent and What Do They Do?:** When forming an LLC or a corporation, the formation statute of the state where the LLC or corporation is being formed will require that the entity have a registered agent in that state. The name and address of the registered agent will be reflected in the formation documents for the LLC or corporation that are filed with the secretary of state of that state. A registered agent, also known as a "resident agent" or "statutory agent" in some states, is an individual or company that will be the LLC's or corporation's official point of contact in the state in order to receive legal documents, service of process (such as a complaint filed in a lawsuit) and official communications from the state. The registered agent will then forward these documents and communications to the LLC or corporation for which it is acting as a registered agent. It is critical for the LLC or corporation to have a registered agent not only to comply with the applicable state law, but also to ensure documents are forwarded in a timely manner as certain documents, such as a complaint filed in a lawsuit, has a defined period of time in which the LLC or corporation is required to respond.

If an LLC or corporation wants to qualify to do business in foreign states — that is, any state other than its formation state — it will have to provide the name and address of its registered agent in each such foreign state as well.

To serve as a registered agent, the individual must be a resident of the state, or if using a business, a domestic or qualified foreign business entity with an office in the state. In most states, an LLC or corporation cannot act as its own registered agent. While the approach may vary state by state, if the registered agent changes, a filing is required with the secretary of state of the applicable state.

## 6. Foreign State Qualification: Filings Required for Foreign State Qualification

A. **Defining "Qualified to Do Business" or "Doing Business As":** If your company is incorporated in one state (e.g., Delaware), but you are "doing business" in one or more other states (e.g., California, Massachusetts, New York, etc.), then the laws of the states in which you do business require your company to be "qualified to do business" there.

"Doing business" is defined differently in each state by the laws of that state, and so whether the business your company is conducting requires you to qualify to do business in a particular state depends on the rules of that state. Most states provide guidance on the types of activities that *do not* constitute doing business rather than those that do. For example, in most states, merely having an employee or consultant soliciting or accepting orders or even defending a lawsuit in that state is not enough activity to constitute "doing business." The fact that your company does business online and therefore could reach every state does not, in and of itself, mean you have to qualify to do business in every state. In contrast, having an office or employees regularly and physically located in a state will often mean the company will need to qualify to do business in that state. Unfortunately, it is a state-by-

state analysis, with which the company's legal counsel can assist. It's important to determine whether the company should qualify to do business as there may be severe legal consequences for not qualifying in a timely manner.

Most new corporations take steps to qualify to do business in the state where they are initially headquartered. For example, a Delaware corporation with its principal place of business in New York would likely qualify to do business as a foreign corporation in New York to start (and, as stated above, will have a registered agent in Delaware).

B. **Required Filings for Foreign State Qualification:** To qualify to do business in a state, you typically need to make a simple filing with the Secretary of State's office that describes your business. You will also typically need to file reports, applications and pay a fee (sometimes referred to as a "franchise tax" or other times referred to as a filing fee) in that state annually. Because each state defines "doing business" differently, you should seek guidance from your legal counsel when engaging in any new activity within a state.

## 7. Directors and Officers: Electing the Board of Directors and Officers

A. **The Board of Directors:** A board of directors of a corporation has the ultimate authority to direct the management of the business and affairs of the corporation. Legally, the board of directors will authorize the issuance of stock (to be discussed later), hire (and fire) senior executives, approve compensation arrangements, including the grant of stock options, and authorize the corporation to enter into significant agreements. The board of directors will also be asked to provide advice to management and approve strategic and operating plans, approve and adopt budgets and oversee the corporation's audit and financial statement functions. Most importantly though, the board of directors' most critical function is to help management navigate the myriad of critical business decisions that will determine the ultimate success or failure of the corporation.

In the initial startup stage, a board of directors might consist solely of one or more founders. However, finding an additional board member with insight and experience that no founder has, but who knows the corporation's market or technology particularly well, can be very helpful in building the business. In addition, the right director can provide some independent validation that a corporation's business has promise. Once a corporation raises capital, particularly from venture capital funds, board seats will be a negotiated part of the financing, with a board of directors typically consisting of a combination of founders, designees of the investors and independent directors.

Corporate officers, such as the Chief Executive Officer (or CEO), Chief Financial Officer or treasurer and secretary generally control the corporation's day-to-day decision making, but they must answer to the board of directors, which in turn has responsibility to the corporation's stockholders.

B. **Election of Board of Directors and Officers:** The stockholders of a corporation are its owners. Stockholders are not involved in the management of the corporation. Instead, they vote their shares of stock to elect the board of directors in accordance with the corporation's bylaws and if applicable, Certificate of Incorporation. The board of directors acts a body, not as individual directors. The board acts by a vote of a majority of the then present board members with each director having one vote generally. The board of directors oversees the corporation's management and sets the overall corporate strategy and direction. Directors have fiduciary duties to the corporation and its stockholders, so they generally must act in the best interests of the corporation and its stockholders and be fully informed when making decisions. The corporation's board of directors elects officers, including a CEO, who conduct the day-to-day business operations, and also has the power to remove these officers should such action be necessary and in the best interests of the corporation. The board of directors must also approve certain significant corporate matters, such as stock issuances and material contracts.

When a corporation is formed, all of its outstanding shares are generally allocated among the founders. The sole incorporator of the corporation (whose key role is to file the Charter) usually designates the initial board of

directors, which may consist entirely of founders or may include a key advisor or two. Thereafter, the founders (and other shareholders) vote their shares periodically to elect the board of directors. As the corporation completes equity financings, the investors in the financings will become stockholders, and they may negotiate representation on the board of directors, as well as other control rights. As a result, as corporations mature, the founders' ownership and control rights tend to be diluted, often quite significantly, over time; however, the goal is that although the founders' ownership is diluted, they hold a smaller percentage ownership of a much more valuable company.

## 8. How is Stock Issued

A. **Issuance of Stock:** After incorporating a corporation, one of the first steps will be to issue common stock to the founders, and possibly to other individuals providing goods or services to the company. Common stock is a security, and all securities, including stock options, convertible notes, SAFES and warrants, need to be approved by the board of directors of the corporation prior to issuance. Common stock must also be "duly paid for" under corporate law, which means that the corporation must receive something of value (also known as "consideration") for the stock. Depending on the state where the corporation is incorporated, payment of the consideration can be in the form of cash, property, services already provided, future services and equipment.

To issue common stock, the board of directors should approve a stock purchase agreement and the value of the consideration to be delivered to the corporation for the purchase of the common stock (for founders, this stock purchase agreement is often called a restricted stock purchase agreement and contains key share vesting provisions; this is address below under "[Founders Agreements \(including Pre-Incorporation Agreements\)](#)"). For startups, this approval is typically done through a unanimous written consent of the board. The stock purchase agreement will typically include the number of shares of common stock being issued, the mechanics for purchasing the shares, certain representations (i.e., statements of fact) that the corporation and the purchaser of the common stock will make to the other and restrictions on transferring the shares. This agreement is signed by the corporation and the purchaser at the time of the purchase and the purchaser delivers the consideration to the corporation. The corporation will then issue a stock certificate (which may be in electronic form) to the purchaser to memorialize the purchase of the shares of common stock.

It is important to note is that there are often tax issues associated with issuing and paying for stock, particularly if the stock is being issued for consideration that is less than the current fair market value of that stock. Not being aware of these issues can be very costly down the road. You should always consult with a lawyer prior to issuing stock.

## 9. When to Issue Stock to Founders

A. **Early is Best:** Equity allocation (i.e., ownership of the company) discussions among founders can be emotional and difficult, but it is critical to have an honest and robust discussion early. Allocating too little equity to a founder whose role will be key to the startup creates an obvious challenge. However, allocating too much equity to a founder whose ultimate contributions will be less significant than others can have equally devastating consequences, as doing so has the tendency to create a lot of ill will among the other founders over time ("I have more responsibility than s/he does, so it isn't fair that s/he has the same ownership as me"). It's important to think through these allocations very carefully.

You may decide that splitting up the pie equally among the founders is the easiest way out to avoid the friction that often is part of these discussions. However, studies show that companies that divide founder equity based on what is fair and thoughtful (rather than what is simple, frictionless or expedient) are more successful in the long run. When deciding what is "fair," you should consider what each founder brings to the table, including their skillset,

future time commitment and role. Did one of the founders, for example, develop the idea and devote a significant amount of time to it before forming the company and bringing on the other founders? If so, then that contribution should be recognized.

In the end, there's a lot of variability when it comes to founder equity allocations. Every company, every situation and every group of founders will look at this issue differently. Calibrating all of the factors is a difficult exercise and may evolve over time. It is therefore equally important that the allocations are socialized early enough to obtain input from all co-founders. What is critical is that each founder provides input and then agrees that the allocation among the founding team is fair. Once the founding team generally agrees on allocations, legal counsel can further fine-tune exact equity holdings by implementing vesting requirements such as vesting cliffs, vesting time periods and vesting commencement dates.

## 10. The Corporate Minute Book

A. **What are Minutes/Minute Book:** At every meeting of the board of directors of a corporation, the secretary of the meeting will be responsible for drafting written notes (the "minutes") which record the discussions the board engaged in and set forth any formal resolutions adopted (i.e., formal actions taken) at the meeting. These minutes will be reviewed and approved by the board at a subsequent meeting and signed by the secretary of the meeting and placed in a document called the "minute book", which is divided into several sections and contains an accompanying index. The minutes of every meeting of the board of directors are signed by the secretary of the meeting once those minutes are approved. It's important to keep a record of meetings of the board of directors as it not only shows good corporate governance, but also provides evidence that corporate formalities are being followed. This helps protect directors, officers and stockholders from corporate liability under certain circumstances.

In addition to minutes from meetings of the board of directors, the minute book should also include actions by the board taken by unanimous written consent, which is very common for early stage companies and can be efficient when the board of directors needs to act quickly on an action that doesn't necessitate a meeting. While stockholders of early stage companies rarely hold stockholder meetings, they do take actions when required under corporate law, typically by written consent. As with board consents, stockholder written consents should also be included in the minute book. Note that written stockholder consents need not be unanimous.

Keeping a comprehensive and up to date minute book can save time when the corporation engages in certain transactions, such as a venture capital financing or potential acquisition of the corporation, and avoid potential issues in the future. Your lawyer can help you put together a comprehensive minute book.

## 11. How to Amend the Certificate of Incorporation

A. **Certificate of Amendment:** In order to make changes to its the Certificate of Incorporation, a corporation must file a certificate of amendment. The certificate of amendment requirements will depend on the corporation's state of incorporation, but the requirements will generally include the name of the corporation, the section number of the provision(s) being amended, the wording of the revised provision(s) and a statement by the board of directors and, depending on the kind of amendment, the stockholders approving the amendment. The certificate of amendment must also be signed by an authorized officer of the corporation. If the certificate of amendment is being filed in Delaware, then the board of directors and the holders of a majority of the corporation's outstanding voting stock generally must approve the certificate amendment prior to filing it.

B. **Amended and Restated Certificate of Incorporation:** Sometimes the corporation would like to make changes and have all of those changes reflected in one document. When this approach is taken, the Certificate of

Incorporation is said to be amended and restated. The reason for amending and restating a Certificate of Incorporation, rather than just amending, is that a person seeking to understand all of the rights, powers, preferences, privileges and restrictions with respect to the corporation and its stock need only review one document. It is typical to see an amendment and restatement when the changes being made are extensive, such as in a venture capital financing. The approval process is generally the same as for a certificate of amendment.

# Founders Agreements (including Pre-Incorporation Agreements)

## 1. Pre-Incorporation Agreement

Before we review some of the key areas that good initial founders agreements should cover, there is one timing aspect that is important to understand. Ideally, if the founders anticipate doing substantial work on the startup prior to setting up a legal entity for the startup then they would enter into a “pre-incorporation” agreement. The pre-incorporation agreement would at least cover roles and responsibilities, proposed equity split and proposed equity vesting provisions. These same topics are included in the founders’ agreements, which would supersede and replace the pre-incorporation agreement. Importantly, once a legal entity is formed, then each of the founders’ agreements is a legally binding agreement that the founders and the legal entity execute.

A. **Role and Responsibility Division:** A pre-incorporation agreement should specify the roles of each founder. Who will be CEO, who will be president, who will CTO, etc. The specific titles are not that important (though a Delaware corporation needs to have a president, secretary and treasurer for statutory purposes). And the agreement should make it clear who is full-time and who is not. Likewise, it is smart to specify in the pre-incorporation agreement which of the founders will be on the startup’s board of directors (assuming the legal entity is a corporation).

B. **Equity Ownership Split and Vesting:** A pre-incorporation agreement should provide what percent of the company each founder will own. As the legal entity does not yet exist, it is not possible to issue shares. Once the startup legal entity is formed, then shares should be issued to the founders immediately.

Before we explain vesting, it is helpful to understand that the equity split of the founders is negotiated amongst the founders (see above “[Entity Formation Basics: When to Issue Stock to Founders](#)” above). It could be an even split or it could be weighted more towards one or more of the founders, etc. Factors to consider include: whose idea forms the basis for the startup, who plans on being full-time vs. part-time, who is putting in cash initially, who is playing what role, etc. A good corporate lawyer can discuss these factors with the founders and hopefully they can reach a fair equity split. Amicably setting on the equity split is a good test of trust and an early test of how the founders work through difficult issues together.

After finalizing the equity split, the vesting concept is crucial. Simply put, in the context of founders, vesting means earning the right to keep shares issued to the founders. The simplest and most common metric to measure vesting is time spent working for the company. As time progresses, the founder earns the right to keep more shares. We recommend a 4-year vesting period, measured monthly, with the first 25% earned on the first anniversary of the vesting start date. This might seem long, but frankly, it needs to be significant to avoid unfair enrichment of founders who leave the company prior to full vesting. For example, if a founder holds 1,000,000 shares of the company and those shares vest over 4 years, then if the founder leaves the company after month 27, s/he would keep 562,500 shares (i.e.,  $27/48 \times 1,000,000$  shares) and the balance would be repurchased by the company at cost (which is typically nominal for founders) and then returned to the authorized but unissued status. The repurchased shares would not go to the other founders but would increase the other founders’ ownership percentage as the repurchased shares would no longer be outstanding (see “[Capitalization Tables](#)” below). In simplest terms, vesting protects founders from each other, and it is fundamentally important. From our perspective, any team of founders who does not set up meaningful vesting for the founders’ equity is making a big mistake.

Vesting of shares should cease as soon as the founder leaves the company for any reason – death, termination for cause, termination without cause, disability, etc. We encourage this bright line rule to avoid any gray area arguments. And, it is very fair.

Related to vesting is a founder's filing of a Section 83(b) election with the IRS. By default, the IRS taxes vesting shares based on the current fair market value of the shares at the time the risk of forfeiture lapses less what the founder paid for those shares (we call this the "spread"). In other words, as the shares vest, the IRS taxes the spread during the tax year of vesting. This could result in a very large and unexpected tax bill if the startup experiences increased valuations during the vesting period! To eliminate this result, the IRS allows recipients of stock subject to vesting to elect to have the current fair market value of all the stock (regardless of vesting) be taxed as of the day the founder purchases the shares. Typically, a founder is purchasing the shares for the current market value, which, on the day vesting is put into place, is nominal, and the total purchase price paid for the shares equals the total current fair market value of those shares. As a result, there is no income and no tax. This is why the 83(b) election is so important to file in a timely manner (within 30 days of the shares being purchased).

The founders sometimes agree that each founder will vote his/her shares in favor of the election of the agreed to board members (let's call this the "Board Voting Provision"). The Board Voting Provision would be in a Stockholders Agreement signed by the founders and the company. Basic legal concept - stockholders elect board members. Note that initially, it is fine for all founders to be on the board of directors (this will most likely change if the startup raises outside capital). Critically, the board of directors appoints and terminates officers of the company. This means that, for example, if the startup has 4 founders and all 4 are on the board, then 3 of the 4 could, in their capacity as board members, fire the CEO in his/her capacity as CEO. Board votes are by a majority of a quorum (which is defined as a majority of the total number of directors under Delaware corporate law and most other states laws. So think about what happens if the founders do not enter into a Stockholders Agreement; the 3 founders in our example could then, as stockholders of the corporation, also vote to remove the fourth founder who was CEO from the board of directors. We recommend that a Stockholders Agreement specifically acknowledge that the board of directors can terminate founders from the company in their capacity as officers. This is basic corporate law, but often not understood.

C. **Financial Contributions:** If the founders will be making financial contributions to the company, then those should also be specified in the pre-incorporation agreement. Sometimes those financial contributions are treated as investments (like a simple agreement for future equity, or SAFE) and sometimes the contributions are treated as payment for founders shares. The agreement should address this nuance as it is important. Note that we do not recommend issuing shares of preferred stock for founders contributions unless the company is actually doing a preferred stock financing with outside investors at the same time (in which case, the founder's cash contribution can just be part of that financing round). Instead, if a founder is making a financial contribution, he or she should be treated like an investor and the company should issue the founder a SAFE that will convert into shares of preferred stock in a future financing with outside investors. As a general rule though, founders should not receive shares of preferred stock in the company.

D. **Intellectual Property Ownership:** In a startup all intellectual property should be owned by the legal entity and not the founders and other individuals working at the startup. This is particularly true if the startup plans to raise outside capital. We have seen situations where a founder retains ownership of a key piece of intellectual property (like a patent) and licenses it to the startup legal entity in exchange for an ongoing royalty. This will be a red flag for outside investors that will need to be rectified. It is best to set things up the right way from the outset, particularly if you plan on raising outside funding.

Intellectual property is any know-how, technology, concepts, patents, trademarks, etc., that the startup needs to carry out its business. Think of intellectual property in the broadest possible terms. When the founders create a new startup, they should all assign all related intellectual property to the startup legal entity needed by the startup. The pre-incorporation agreement should provide that each founder agrees to assign all rights to all related intellectual property to the startup once the legal entity is formed.

E. **What Happens When a Founder Leaves the Company:** Founders leave their startups all the time. Sometimes they get into disputes with co-founders, sometimes they get tired of the startup grind, sometimes they

jump ship to another company and sometimes they get terminated by the board of directors (see above). The termination saga is probably the one scenario that gets the most attention, particularly after the startup raises outside capital and the board composition shifts away from the founders. By definition, raising outside capital means having less control over the company. As mentioned above, that control rests with the board of directors, and as outside investors end up with board seats, the founders ability to protect their respective positions decreases. If a founder leaves prior to the company being incorporated, the pre-incorporation agreement should provide that each founder agrees that the departing founder is not entitled to any equity in the startup.

## 2. Post-Incorporation Founder Agreements

A. **Role and Responsibility Division:** After incorporation, the roles of each founder that had been agreed to and specified in the pre-incorporation agreement should be implemented through the action of sole incorporator and the organizational board consents (assuming the legal entity will be a corporation). The action of sole incorporator will specify how many directors will constitute the board of directors and who those initial directors are. The organizational board consent will provide for the election of the officers of the company. Both of these documents should ideally reflect what was specified in the pre-incorporation agreement.

B. **Equity Ownership Split and Vesting:** After incorporation, each founder should enter into a restricted stock agreement (also known as a restricted stock purchase agreement), where the founder purchases the number of shares of common stock of the company that reflects the agreed upon percentage ownership specified in the pre-incorporation agreement. In addition, the restricted stock agreement should specify the vesting schedule and vesting start date that was agreed to in the pre-incorporation agreement. As mentioned above, the founder will have 30 days from purchasing the shares to file an 83(b) election with the IRS. It's a good idea for a founder to check with a tax adviser before making the filing to be sure it makes sense for the founder's personal situation.

C. **Financial Contributions:** After incorporation, if a founder will be adding capital to the startup beyond the purchase of his or her shares, the board of directors will need to approve the purchase of the security being sold to the founder for the capital (i.e., a SAFE or convertible note). By purchasing a SAFE or convertible note, the agreed upon ownership of common stock is not impacted, while the company receives the capital from the investing founder.

D. **Intellectual Property Ownership:** After incorporation, intellectual property related to the startup is assigned to the company via an invention and non-disclosure agreement, which typically also covers confidentiality, non-solicitation and non-competition concepts as well (so you might see this agreement also referred to as a "Proprietary Information and Invention Agreement"). Note that in states where non-solicitation and non-competition clauses are not enforceable (such as California), those provisions should not be included in the agreement.

In addition to intellectual property initially contributed to the startup, the founders and all other employees also need to agree that all intellectual property developed during employment is owned by the startup legal entity. The same agreement covers this concept as well. Think about it this way – if you work for Google as a software developer and develop a new search algorithm, Google owns it (not you!). Google is paying you to develop things and those things are owned by the company paying you. Thus, not surprisingly, when a new employee joins your startup they immediately sign an intellectual property agreement as part of their welcome paperwork.

E. **What Happens When a Founder Leaves the Company:** After incorporation, when a founder leaves the company for any reason, vesting on their shares should cease. We have seen situations where a founder, as part of their termination, negotiates an extension of his/her vesting period (for example, for an additional 6 months through acceleration of vesting) in exchange for a release of claims against the company. This is not unusual, but typically not ideal as not as much of the terminated founder's unvested shares are then available for new future hires.



The circumstances surrounding a founder's exit from the company will dictate other actions. Is the exit amicable, acrimonious, disputed, etc.? In a tense exit, there are a bunch of action items that are important to implement right away such as cutting off access to the legal entity's bank accounts, computer servers (think about terminating a founder who is CTO!), email access, etc. In an amicable split, while it is important to limit the exiting founder's ability to access information and bank accounts, it might be desirable to continue letting the founder use his/her company email address and have limited interaction with customers to help with any necessary transition. Every instance of a founder leaving the company is different, and it is best to discuss the situation immediately with the company's legal counsel, make an action plan and follow through on it.

## Equity Incentive Plans

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Equity incentive plans (often referred to as stock option plans) are used to give employees and other service providers, such as advisors and consultants who are natural persons, equity-related benefits in a company. These types of awards are used in both public and private companies, though our discussion will focus only on private startups. An equity incentive plan (EIP) is typically set up early on in a startup's existence assuming the founders want to grant equity incentives to employees.

An EIP is authorized by the board of directors, and under the EIP a designated number of shares (for example, 1,500,000) is expressly established as shares available to be issued under the EIP. This "shares available for issuance" under the EIP is an important concept as the number cannot be exceeded. This number can be changed in the future as more shares are needed by amending the EIP. Alternatively, a new EIP could be put into place (after which both the old EIP and new EIP would coexist).

The EIP is a written document. As far as legal documents go, it is not overly complex and is typically 12-15 pages long. Every well-established law firm that does startup corporate work has a form of EIP that they use (modified for particular situations). So, the good news is that EIPs are not difficult or expensive to create.

After the board of directors approves the EIP, the plan is typically submitted to stockholders for approval as well. Timely stockholder approval (currently within one year of board approval) enables the plan to grant incentive stock options (ISOs) to employees. We discuss ISOs below.

A. **Granting Equity Incentives under the EIP:** Every grant of equity under an EIP must be approved by the company's board of directors. In short, a CEO or other executive does not have the authority to make binding grants. This is an important concept that startup founders often do not understand. The board approval needs to specify the individuals receiving grants, the applicable vesting periods, and, in the case of stock options, the strike price. Vesting periods are typically 3 or 4 years, and often have a one-year cliff vesting feature so that the first year of vesting only occurs after the one year period from the vesting start date (this protects the company from short term employees). After that one-year cliff vest, the option would then typically vest monthly or quarterly (and even sometimes daily) over the rest of the vesting period. Note that unlike founders stock subject to vesting (the right to keep shares), stock option vesting equates to earning the right to purchase shares under the option. These are similar concepts, but critically, under a stock option, the option recipient does not own the underlying shares until the option is actually exercised.

Stockholder approval for the specific grants under the EIP is not normally required. And all grants under the EIP should be expressly shown on the company's cap table (see "[Capitalization Tables](#)" below).

Each grant under the EIP needs to be documented in a separate written agreement with the recipient. This means that with respect to any specific grant there will be two written governing documents, namely the specific grant agreement and the EIP.

B. **ISOs vs. Non-ISOs:** The most common form of grant under an EIP is a stock option grant. As mentioned above, only the board of directors has authority to grant options. Stock options come in two basic flavors, namely incentive stock options (ISOs or statutory options) and non-incentive stock options (non-ISOs or non-statutory options). The terminology is confusing as both are certainly incentivizing and can provide meaningful returns if the startup does well and is later sold or goes public.

The terminology comes from the Internal Revenue Code statutory code sections. ISO grants meet certain statutory requirements and can only be granted to company employees. Non-ISOs do not have to meet the statutory requirements and may be granted to both employees and non-employee service providers (for example, an

outside director would get a non-ISO grant as s/he is not an employee of the company). The tax treatment of ISOs can be more favorable to the grant recipient as described below.

C. **Basic Tax Concepts:** When an employee is giving something of value in exchange for work services, the IRS considers that “something” to be taxable compensation. The most common example is cash salary, and no one typically questions that cash compensation is taxable by federal and state governments.

When the board of directors grants a stock option to an employee, that grant will only be taxable if the grant represents something of value at the time of grant. In simplest terms, a stock option is the right to buy stock in the future (dependent on vesting) at a set price (i.e., the strike price). For example, if the company’s stock value per share is determined to be \$2.34 a share (most startups rely on Section 409A third-party assessments to determine stock valuation at a certain point in time), and the company grants a stock option to an employee with a strike price of \$.10, then the IRS will consider that employee to have earned \$2.24 per share (\$2.34 minus \$.10) in taxable compensation. So, if the grant covers 10,000 shares, then the employee would have taxable income measured on the grant date of \$22,400 regardless of the vesting schedule. Typically, this type of non-cash taxable compensation is undesirable unless the company agrees to pay the related tax (which rarely happens at a startup). The most common solution to this undesirable tax issue is to make sure that the option strike price is equal to or greater than the established Section 409A fair market value. That way the employee is not receiving anything of value on the grant date (if the strike price is \$2.34 per share and the fair market value is also \$2.34 per share, then the employee would have to pay \$2.34 to receive something worth \$2.34). Importantly, with an ISO grant, the strike price may not be less than the determined fair market value.

Instead of stock options, sometimes startups grant restricted stock. Restricted stock is actual stock and the right to keep the stock vests over a set time period. With restricted stock, the company is giving something of value and there will be tax owed. An 83(b) election can help minimize the tax (see “[Founders Agreements \(including Pre-Incorporation Agreements\)](#)” above), but there will be some tax due. The company could pay the tax or the employee will have to find the funds to pay it. This tax issue is an important aspect of restricted stock grants that founders often overlook.

After the grant of an equity incentive such as a stock option, the recipient must also consider the tax implications of exercise. Often stock option holders do not realize that the actual exercise of a stock option can trigger tax. When an option holder exercises a stock option, it pays the aggregate strike price and acquires the shares. If the value of the shares acquired exceeds the strike price, then the profit is potentially taxable even if the stock acquired continues to be held by the option holder exercising the option. This is not the most logical result.

Generally, the exercise of a non-ISO is a taxable event. This can be significant and needs to be well planned. It is a main reason that non-ISOs are typically not exercised in advance of a sale or IPO of a startup. Either a sale or IPO will create liquidity to pay any tax due.

Alternatively, the exercise of an ISO grant is not taxable. This may seem random, but it is a statutory benefit of an ISO and counterbalances some of the restrictions that are imposed on ISO grants. Due to the exercise not being taxable, an ISO holder may desire to exercise vested portions of the option “early” and then hold the shares acquired. If those newly acquired shares are held for at least one year, then the later disposition of those shares will result in a long-term gain (hopefully) or loss. Long term gains are currently taxed at lower rates compared to short-term gains, which are taxed at ordinary income rates.

D. **Contracts vs. Ownership:** It is important to understand that a stock option is a contract. It must be in writing to avoid future legal issues. Thus, a recipient of a stock option grant should receive a stock option agreement from the startup. Both the recipient and the company sign the agreement to form a binding contract.

Contra wise, a stock option grant is not ownership of the stock until the option is exercised. This means that option holders do not vote as stockholders, do not receive dividends (which are rare at startups) and do not receive company information that might be shared with stockholders.

Note that an option holder may exercise an option in whole or in part depending on how much of the grant has vested. There is typically no requirement to exercise an option in full. Once exercised, then the option holder becomes an actual stockholder.

With restricted stock (as opposed to options), the recipient is a stockholder from the time of grant. But there will be an agreement signed between the company and the recipient regarding the vesting requirements and other key provisions of the grant as described above in this booklet.

E. **What Happens When Option Holder or Restricted Stock Recipient Leaves the Company:** An employee or other equity incentive holder (like a non-employee director or service provider) may cease providing services to the company for a variety of reasons, with the primary events being termination (with or without cause), voluntary departure, disability, or death. Upon a departure:

(i) ***Vesting of the award should cease.*** Sometimes with executive terminations without cause the parties negotiate some additional vesting. With a restricted stock grant, the vested shares remain with the recipient and the unvested shares forfeit back to the company (technically, back to the company's EIP). The agreement might provide that if the recipient was terminated for cause that the vested shares forfeit back to the company as well. With a stock option, the unvested shares simply revert back to the EIP.

(ii) ***With an option, the holder needs to consider exercise.*** When the recipient leaves the company, vesting on a stock option will cease as stated above. But then the option holder needs to make a decision to exercise or not within the time period specified in the option agreement for "post termination" exercise of any vested options. This is a critical concept that often gets overlooked. For an ISO grant, the post termination exercise period may not exceed 90 days (or one year in the case of death). For a non-ISO grant the period is whatever was negotiated at the time of grant (the recipient will benefit from a longer period as a longer period will give more certainty regarding the company's prospects). Regardless, having exact knowledge of the post termination exercise period is very important. Making an investment decision (in other words paying the exercise price) is typically risky unless the company is already publicly traded. Note that if the option holder is terminated for cause, typically the option agreement will block exercise completely by not providing any post termination exercise period.

F. **Key Stock Option Provisions:** There are a handful of key provisions in a stock option grant, some of which are touched on above. The written EIP and separate grant agreement will control the provisions of the award.

(i) ***Strike price.*** An option's strike price is the price per share that must be paid to acquire the stock underlying the option. The stock option agreement will specify the strike price, and it often is determined using a Section 409A valuation from an independent third-party firm. Strike price and exercise price are synonymous terms.

(ii) ***Number of shares.*** The stock option agreement will specify exactly the number of shares covered by the option. It will not (and should not) specify a percentage. Note that stock options rarely have anti-dilution protection. Sometimes anti-dilution provisions are included with senior executives or founder grants, but they are a red flag for venture investors.

(iii) ***Vesting schedule.*** As mentioned above, the vesting schedule for grants is typically between 3 and 4 years. This is negotiated, but don't expect to have much negotiating leverage unless you are a senior executive. Sometimes, the vesting period will be expressed in months (for example, 48 months instead of 4 years). Vesting increments vary by company (daily, weekly, monthly, quarterly, and yearly). The shorter the increment the better for the recipient.

(iv) *Change of control acceleration.* EIPs typically define a change of control to include the sale of a company, but not the company going public (this makes logical sense). If an option or restricted stock grant accelerates on a change of control it means that the vesting accelerates. Acceleration may be to 100% vesting or some lower amount. Vesting acceleration benefits the option holder as s/he can then capture more upside on a sale of the company if the price per share on the sale exceeds the strike price. Vesting acceleration also benefits a restricted stock holder as s/he may sell the underlying shares without regard to remaining at the company going forward after the acquisition. There are many flavors of acceleration (for example, double trigger) so it is important to understand the exact provisions of any particular grant agreement and the terms of the overall EIP itself.

## Tax Issues Basics

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A. **Obtaining an EIN / Federal Taxpayer Identification Number:** An EIN (Employer Identification Number), or Federal Taxpayer Identification Number, is an identification number used by the IRS in the administration of U.S. tax laws. EINs are typically required for corporations, partnerships, and LLCs with multiple owners. EINs will also be required for sole proprietorships and single-member LLCs that have employees or file certain U.S. tax returns. EINs are also used when opening financial accounts and paying bills and other debts.

To obtain an EIN, you must prepare an IRS Form SS-4 for the business. The form will ask for general information such as the legal name of the business, the legal name of the responsible party, the social security number or individual taxpayer identification number of the responsible party, the business's mailing address, the state or country of incorporation or organization, the number of members (if the business is an LLC), the type of business entity (corporation, partnership, etc.) and the primary activities of the business. U.S. businesses can generally submit the Form SS-4 online on the IRS website. To avoid potentially costly tax mistakes down the road, consult with your lawyer or tax advisor before filing for an EIN.

B. **Delaware: Filing the Annual Report, Paying the Filing Fee, and Paying Franchise Taxes:** Every year by March 1<sup>st</sup>, each Delaware corporation must submit an annual report called the Domestic Corporation Annual Report to the Delaware Division of Corporations and pay the required filing fee. A corporation that is domiciled in a state other than Delaware but that files (or "qualifies") to do business in Delaware (a "foreign corporation"), must file its annual report with the Division of Corporations by June 30<sup>th</sup> of each year and pay the required filing fee. The filing fee is \$50 for Delaware corporations (or \$25 for certain exempt corporations) and \$125 for foreign corporations. The annual report includes the name of the company, the company's address, the name and address of each director, and the name and address of at least one officer of the company. A Delaware corporation must file its annual report electronically. The corporation's registered agent will send an alert that the report is due.

While LLCs, limited partnerships and certain other non-corporate entities (whether formed in Delaware or registered to do business in Delaware) are not required to file an annual report, such entities must pay a \$300 flat annual tax. The annual tax payment for a calendar year is due by June 1<sup>st</sup> of the following year.

In addition to the annual report filing fees described above, Delaware corporations are required to pay an annual variable franchise tax. The franchise tax represents a corporation's payment for Delaware's recognition under its corporate law and the limited liability and separate personhood such recognition confers, among other special rights and obligations. The franchise tax for a Delaware corporation is usually determined by the number of shares issued by the corporation and its total gross assets on December 31. However, there are other methods to determine the franchise tax, with some methods resulting in a higher tax than others. Generally, registered agents will receive franchise tax information from the state with respect to their customer companies in December, which they then send to their customer companies.

If a Delaware corporation fails to file a timely annual report and pay its franchise taxes, the state will impose a penalty of \$200 plus 1.5% interest per month on the amount of the penalty and any unpaid tax balance. For a foreign corporation, the penalty for failing to timely file the annual report is \$125. If the corporation does not pay the appropriate taxes and fees, the corporation will be out of "good standing" with the state. A certificate of good standing is usually required as a precondition enter into many corporate transactions. Consulting a lawyer or tax advisor is one of the best ways to avoid costly and time-consuming mistakes when filing an annual report and paying franchise taxes.

C. **Federal, State, & Local Taxes:** Just like the typical individual taxpayer, businesses are also subject to various federal, state, and local taxes. Federal and state taxes are collected by the federal and applicable state governments, respectively, while local taxes are collected by the applicable local government (e.g., city or county).

A business's liability for state and local taxes will vary based on a number of factors, including where the business, its employees, and its customers are located. Federal, state, and local taxes will also vary depending on the legal form of the business entity (LLC, corporation, limited partnership, etc.), the business's tax classification (C corporation, S corporation, partnership, etc.), whether the business has employees, and the type of securities the business issues. Tax laws and tax compliance are complicated. Consultation with your lawyer or tax advisor is critical to avoid costly tax mistakes when starting and running your business.

D. **Collecting Sales Taxes and Filing Sales Tax Returns:** Whether your business is required to collect sales taxes and file sales tax returns in a state depends on a number of factors, including the applicable state law, the types of products and services offered by your business, and your business's contacts with the state. You may be able to contract with a certified service provider ("CSP") to outsource certain of your business's sales tax responsibilities. Rules applicable to the collection of sales taxes, remittance of sales taxes to the applicable taxing jurisdiction, and filing of sales tax returns vary by state and can be very complicated. You should consult with a tax advisor or lawyer to determine your business's sales tax responsibilities (particularly if your business will engage in online sales).

## Bank Account Set-Up

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A. **Where to Bank/Choosing a Bank:** When choosing where to open a bank account, a company should consider several factors including the bank fees, how well capitalized the bank is, the online user interface, integration with accounting software such as QuickBooks, startup focused products such as credit cards and loans and good customer service. Since the fall of Silicon Valley Bank, the premier startup bank, investors have been increasingly requesting that startups use more than one bank account to safeguard deposits. While you should do your own diligence to make sure you are choosing the right bank for your startup, some popular banks that startups often use include Bank of America, JP Morgan Chase, Citizens Bank, Mercury Bank, PacWest Bank and Bridge Bank.

B. **Board Authorization to Open a Business Bank Account:** When a company is formed, the board of directors will need to adopt board resolutions authorizing the opening of one or more business bank accounts. The resolutions will include the legal name of the corporation, the date of the resolution and the specific individual(s) authorized to open the account on behalf of the company and other banking actions these individuals may take on behalf of the company. Banks often provide a form that contains the necessary corporate resolutions. Depending on the rules of the bank, you may be required to fill in an additional proprietary bank form before creating a business bank account.

C. **Opening a Business Bank Account:** The founder(s) will need to open a business bank account early in a company's existence. Once your startup begins accepting or spending money, you should make sure that all company expenses and deposits are separate from the founder's personal bank accounts by opening a business bank account. Moreover, you should never have investors wire investment money for your startup into a personal bank account. In order to open a business bank account, your bank may ask for the company's EIN, the business's formation documents (for example, a certificate of incorporation), a business license (if applicable) and any ownership agreements. As mentioned in the previous section, opening multiple business bank accounts may be beneficial when the startup grows and raises more than \$250,000, since FDIC insurance only covers \$250,000 per depositor, per account type, per bank. Spreading funds across multiple banks in increments of \$250,000, provides your company with more protection in the event one of the banks fails and the company loses its funds. It also results in more administrative burden of managing multiple accounts.



## Accounting and Financial Statement Basics (Chat GPT assisted with this section)

Startups need to keep track of their finances. This sounds rudimentary, and it is. But, we cannot stress enough the importance of getting off on the right track so that your startup will be able to sail through due diligence when it raises its first round of financing. Here are some accounting basics for startups:

A. **Chart of Accounts:** Startup entities need to have a chart of accounts, which is a list of all the accounts that it uses to track its financial transactions. This will include assets, liabilities, equity, revenue, expenses, etc. It is best to use an entry level accounting software package such as QuickBooks. Your startup must maintain accurate records of all financial transactions (invoices, receipts, bank statements, etc.)

B. **Does your startup need to file tax returns:** Once you form a legal entity for your startup, it must obtain a tax identification number (called an Employer Identification Number or EIN as explained above in this booklet) and then file a tax return for the year of formation and thereafter (and obviously pay any taxes that are due). It makes no difference if it is in stealth mode or pre-revenue. It makes no difference if the entity is a corporation or LLC (except that a LLC owned by one person does not generally need to file a tax return).

We highly suggest getting an independent accountant for your company. Let the accounting firm prepare your startup's tax return, and seek your accounting firm's advice when setting up your chart of accounts and accounting software. Ideally, the accounting firm would have direct access to the software system. Your accounting firm can also help you understand cash and accrual methods of accounting. You will likely be more concerned about cash and more importantly, use of cash, which establishes your startup's monthly burn rate. Your startup's monthly burn rate will by definition determine its fume date (cash balance divided by monthly burn rate equals the number of months before running out of cash!).

C. **Financial Statements:** The basic financial statements are the income statement, balance sheet, and cash flow statement. Once you form your entity you should:

- (i) Prepare monthly financial statements and understand what they are saying about the financial position of your company.
- (ii) Prepare quarterly financial statements.
- (iii) Prepare yearly financial statements.

Luckily, if you are using reputable accounting software for your startup, preparing these statements is relatively easy and outflows right from the software.

D. **Operating budget model:** Once you get your startup up and running you should prepare an annual budget at the end of a given year that covers the following year. It is useful for the budget model to include monthly statement projections for the income statement, balance sheet, and cash flow statement. This way, you can track actual monthly statements compared to the budget model each month. If you plan on raising outside capital, the budget model is one of the first things that your potential investors will look at in their due diligence. And, after you raise outside capital, your investors will require delivery of an annual budget model and monthly reporting against it.

E. **Audited financial statements:** At the early stages of your startup it is not likely that you will need to have prepared audited or reviewed financial statements by an independent accounting firm. Audited statements are more in-depth in terms of accounting due diligence and cost compared to reviewed statements, which are simpler for the accounting firm to produce. However, once you raise outside capital, particularly from venture capitalists or other institutional investors, your startup will most likely be required to deliver annual audited statements. This is in addition to the unaudited monthly statements discussed above.

In summary, it is best to start with a tight financial practice ship. Your investors will ultimately require it and it will make fund raising much easier if your financial statements are in order prior to kicking off the fund-raising process.

## Capitalization Tables

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Capitalization tables (typically referred to as cap tables) are a fundamental necessity for a startup company. Simply put, the cap table shows in detail who owns the company.

It is important to understand some basic information about shares, and for this discussion, we are going to assume that the startup is a corporation. The same concepts would apply to a LLC, but LLCs have interests or units (not shares).

“**Authorized shares**” is the number of shares that the corporation has the ability to issue. The authorized share number is set forth expressly in the company’s Certificate of Incorporation. For example, the Certificate of Incorporation could provide that the corporation has 10,000,000 shares of capital stock. Then, the Certificate of Incorporation will typically divide up those 10,000,000 shares into authorized common and authorized preferred. For example, the Certificate of Incorporation might provide that 7,000,000 are designated common stock and 3,000,000 are designated preferred stock. Then, as the company issues individual series of preferred stock, the 3,000,000 preferred shares in our example would be used to create each series and those series would be reflected in the Certificate of Incorporation. Here is an example of Certificate of Incorporation language:

The total number of shares of capital stock (the “**Capital Stock**”) that the Corporation is authorized to issue is 10,000,000 shares of which (i) 7,000,000 shares shall be common stock with a par value \$0.001 per share (the “**Common Stock**”), and (ii) 3,000,000 shares shall be Preferred Stock with a par value of \$0.001 per share (“**Preferred Stock**”), of which 1,700,000 shall be designated Series Seed Preferred Stock (the “**Series Seed Preferred Stock**”).

This authorized share language in the Certificate of Incorporation changes, by necessity, with each financing round. It is good to note that changing a Certificate of Incorporation (often called amending the Certificate of Incorporation) requires both board and stockholder approval as previously noted in this booklet. With each round of financing, the Certificate of Incorporation gets amended, and often amended and restated. Also, note that designating a par value is a statutory requirement that serves mostly an accounting function; shares may never be issued for less than par value.

“**Issued and outstanding shares**” is the number of shares actually issued and held by third parties (could be by founders, consultants, board members, investors, etc.). The number of issued and outstanding shares cannot exceed the number of authorized shares, including for any preferred series. In our example, the number of issued Series Seed shares cannot exceed 1,700,000, which is the number of authorized Series Seed shares.

“**Fully diluted shares**” is the number of issued and outstanding shares plus the number of shares represented by stock options and warrants that are actually issued or reserved for issuance under the company’s equity incentive plan. Options and warrants represent the right to purchase shares. They are not outstanding shares. The number of fully diluted shares should not exceed the number of authorized shares as defined in the Certificate of Incorporation. One area that often causes confusion is that preferred stock has the ability to convert to common stock, and the fully diluted share number needs to account for this conversion. While preferred stock often starts out with a 1-1 conversion ratio, that ratio can change over time depending on anti-dilution provisions. In addition, because the preferred stock can convert to common stock, there needs to be enough common stock authorized for issuance upon that future conversion.

“**Treasury shares**” are shares that have been repurchased by the company from a stockholder. It is mostly an accounting designation. Treasury shares do not count for outstanding ownership and do not vote. With startups, treasury shares are usually just returned to the “authorized shares” pool by a simple board resolution.

A. **What should the cap table show:** The cap table should show who owns equity in the company. It is most helpful if the cap table is detailed:

- It needs to list out people by full name and email address (physical mailing address is also a good idea);
- It needs to show ownership by class of stock (common and preferred);
- It needs to show option and warrant ownership;
- It needs to include percentage ownership calculations for (i) issued and outstanding shares, (ii) fully diluted shares and (iii) preferred shares only if they have special voting rights, which is completely normal;
- Ideally, the cap table will show how much each investor paid for his/her/its stock; this is needed for any sort of exit return modeling;
- A cap table that includes a simple exit analysis is very useful, even if it includes some assumptions, which will be necessary (like transaction fees and advisory fee guesstimates); and
- A cap table would not normally include information on authorized shares or treasury shares as both are irrelevant to ownership and return analysis.

B. **Certificated vs non-certificated shares:** Under Delaware and many other state corporate laws, share ownership does not need to be certificated. In other words, an owner does not need to physically have a stock certificate. The board of directors of the company can authorize having uncertificated shares, and this often makes things easier to administer in terms of share tracking. With uncertificated shares, keeping the company's cap table completely up to date all time is very important.

C. **Best format:** To start, using Excel to create your company's cap table is a good idea. It forces an understanding of how cap tables work and draws important attention to some important areas such as voting power among and between investors, founder ownership and employee option potential ownership. This blog post includes an Excel model with additional explanation of some of the key elements of the cap table: <https://ithacavc.com/2014/04/25/model-cap-table/>. As startups grow, sometimes they switch to a cloud-based cap table modeling service (such as Carta or Shoobx). But we have seen companies keep their own cap table models very successfully right through an exit.

D. **How to handle convertible debt:** Convertible debt financing is very common for various stages of financing, and with early-stage companies importantly punts the pre-money valuation negotiation down the road. When issuing convertible debt, the cap table should include a separate tab that lists out who exactly owns the convertible debt, conversion discount, interest rate for accruing interest, the purchase power of the debt at conversion and change of control multiples that might apply. All of this information is critical, eventually, and should be available real time. The concept of purchase power is particularly important to track as it shows the dollar amount of stock "purchasable" by a given convertible debt holder factoring in the conversion discount and accrued interest. The aggregate purchase power of all the convertible debt normally gets subtracted from the negotiated pre-money valuation of the future equity round triggering the debt conversion (see <https://ithacavc.com/2013/01/24/building-convertible-debt-into-the-premoney-valuation/>) to ensure that the investors in the new equity round get the percentage of the company for which they bargained. For founders, the aggregate purchase power can get painful as the number grows as they bear the dilution impact (along with other prior investors). The cap table model referenced above has a separate convertible debt tab and illustrates these points directly.

## Hiring and Terminating Employees

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A. **Offer Letters (Not Employment Agreements):** Hiring talent will probably be among the most important decisions each startup will have to make. During the hiring process, the company should ensure that it does not ask any questions that are not permitted by applicable law (including in a number of jurisdictions, questions about how much a candidate is currently making). Once an individual has been selected for hire, they should be provided an offer letter that sets forth the general terms and conditions of their employment including their title, salary, equity, bonuses, schedule (full-time/part-time) and any contingencies such as demonstrating authorization to work in the United States or passing a background check. An offer letter should also state that the employee's employment is "at-will." This means that the employee can end the employment relationship with the company at any time for any reason (although their rights to retain their shares or exercise their options will depend on the vesting terms), and that the company can terminate the employee's employment relationship with or without cause, at any time, with or without notice. Generally, we do not recommend that startups give employees separate employment agreements as such agreements typically inure only to the benefit of the employee. When hiring senior executives, it is not uncommon to utilize separate employment agreements that address some key "pro-executive" areas like severance pay.

B. **The Invention and Non-Disclosure Agreement:** The most valuable asset a startup has is usually its intellectual property. To best protect your startup's most valuable asset, it is crucial to have all employees, founders, interns, contractors and anyone else involved in developing the startup's products or services assign their intellectual property rights in those products and/or services, and with respect to other relevant work product developed during employment and/or engagement with the Company, to the startup. This is the purpose of the Invention and Non-Disclosure Agreement. When hiring a new employee or engaging a new consultant or intern, this agreement will include a "present assignment" clause that assigns everything they invent or create, whether it's patentable or not, to the company, effective on their date of hire. The agreement should also include a "further assurances" clause, in which the employee agrees to cooperate in the future, if needed, to assist with showing that the startup owns the intellectual property. As is often the case with employment-related agreements, companies should be aware that a number of states have particular requirements regarding inventions assignment provisions, and they should ensure that their agreements comply with those laws. To top it off, the agreement should include confidentiality or non-disclosure obligations, requiring the employee to only use or reveal confidential information for the startup's benefit.

C. **Non-Compete and Non-Solicitation Covenants:** Employers often require employees (typically at the outset of the employment relationship) to enter into agreements containing non-competition and non-solicitation covenants. Non-competition covenants are provisions in an agreement precluding an employee from engaging in business activity that is competitive with their current employer while employed and for a period of time after the employment relationship has ended (typically 1 to 2 years). Non-solicitation provisions – typically contained in the same agreements (i.e., a non-competition and non-solicitation agreement) – prevent a former employee from poaching or soliciting customers, contracts or other employees from the company.

The enforceability of a non-compete provision will depend mostly on the jurisdiction where the company and employee are located and the terms of the restriction. Non-competes are much more common on the east coast: the majority of technology companies located in Massachusetts and New York require at least some employees to sign non-compete covenants that typically prohibit competition for at least one year after the end of the employment relationship. In fact, if a company receives venture capital financing, the VC investors will most likely insist on including a covenant in their investment documents that require the portfolio company to maintain non-compete covenants with their employees. Post-employment non-compete restrictions have, except in certain limited instances (such as in connection with the sale of a business), been deemed against public policy and non-enforceable in California and are therefore not used for employees based in California. California similarly prohibits non-solicitation covenants with respect to the solicitation of customers, and recent case law suggests that no-poaching covenants regarding the solicitation of employees are similarly prohibited. While non-competes are lawful

in Massachusetts, there are specific legal rules that must be followed for such provisions to be enforceable. The New York legislature has recently approved a bill that would prohibit non-competes, though this bill has not been signed into law by the Governor of New York as of early October 2023. You should be aware that in addition to California the states of Minnesota, North Dakota and Oklahoma also prohibit non-competes. So, consult your company's own startup lawyer to navigate this tricky area.

Even where not *per se* unlawful, whether a non-compete covenant is enforceable depends on the specific facts and circumstances and language in the agreement such as the consideration (value) given in exchange for the agreement, the reasonableness of the restrictions in the agreement and the remedies for violating the non-compete. Again, consult legal counsel when you are planning on asking a potential employee to sign a non-compete or if you believe one has been violated by a current or former employee.

D. **Withholding Taxes:** When you hire employees for your startup, you will need to begin withholding taxes from your employees' wages and send those taxes to the appropriate federal, state and, if applicable, local tax agencies. This is the case for both full-time and part-time employees. Each employee must fill out a Form W-4 listing his or her withholding exemptions, marital status and other information in order to determine the employee's year-end tax liability. The IRS provides many resources on its website to help you figure out the exact amount. A portion of the taxes you withhold will include Federal Insurance Contributions Act taxes (which cover social security and Medicare contributions) and Federal Unemployment Tax Act taxes. Depending on where your startup and employees are located, you may also need to withhold state and local taxes, which tend to use reporting methods similar to those used for federal purposes. After federal tax is withheld, it is deposited electronically using the Treasury Department's free Electronic Federal Tax Payment System. You should consult with a tax professional or lawyer in order to ensure compliance with federal and state/local tax withholding laws. You may also consider engaging a payroll services provider to assist with payroll compliance.

E. **Employment Laws:** For various reasons including the limited resources and experience of an early-stage startup, startups are more likely than later stage companies to fail to comply with federal and state employment laws. The federal Fair Labor Standards Act (FLSA) regulates wages, labor standards, record-keeping and many other aspects of the employer-employee relationship, including who may qualify as an independent contractor and who must be classified as an employee. Importantly, the FLSA requires that employers pay their employees hourly wages or a salary. Compensation in equity alone is insufficient, and an employee cannot voluntarily agree to defer wages until the company receives additional funding. However, in addition to the FLSA, there are myriad other federal, state and local labor laws that govern employers. Employment law violations can lead to hefty fines, costly lawsuits and can damage the company's reputation. In addition to complying with employment law, it is in the startup's interest to demonstrate to their employees and customers that they are committed to treating their employees ethically and fairly. Given the complexities of employment law, it is very important to consult with an employment lawyer early on in order to avoid very costly mistakes.

F. **Employment Policies and Handbooks:** While an employee handbook likely won't make sense for an early-stage startup with a handful of employees, employee and company policies are important for proper and efficient company and employee governance once a company advances past its initial employee base (there is no bright line, but typically 5+ employees would be a good time to consider). A typical set of employment policies addresses topics such as at-will status, harassment, discrimination, and retaliation, paydays and timekeeping, travel reimbursement, paid time off like vacation days, leaves of absence, workplace safety and violence, and drugs and alcohol. Which policies are required will depend on the state where the startup and its employees are located. For example, California requires companies to maintain written policies on harassment, discrimination and pregnancy disability leave after the company grows to five employees (including the founders).

While most other written policies are usually not legally required, having written policies provides numerous benefits. Written policies communicate critical information, standards and expectations, save time and money, promote fairness and may also avoid hostile disputes and even legal hassles such as lawsuits. Written policies will

also need to fit your company's needs, desires and strategic goals. It also makes good management sense to routinely review your policies and make sure they are current, comply with the law and relate to the company's current trajectory.

G. **Terminating Employees:** One of the more difficult decisions a startup may have to make is deciding whether and how to terminate employees. There are a multitude of reasons to terminate an employee including cost-cutting measures, elimination of certain roles, restructuring, violation of company policies, poor performance and more. While employment in the United States is typically "at-will," there are laws that govern the termination of employees. It is generally unlawful for a startup to terminate an employee on the basis of the employee's race, religion, disability, sexual orientation or gender, and in some cases, age. A startup could also face legal action if it violates whistleblower or retaliation protections, or if it breaches contractual commitments. It is good practice to record employee performance and compliance with company policies and to meet and discuss with the employee (and document accordingly) when he or she fails to meet performance requirements or comply with company policies. This approach supports a future decision to terminate the employee should the performance or compliance fail to improve. In addition to complying with the law, a startup should be tactful in communicating terminations, and it should consider whether to offer a severance package (see below). Terminating an employee may impact the morale of other employees, so it is important to think critically about the impact that decision will have on the rest of your team. It is important to consult an employment lawyer when deciding to terminate employees to make sure you are complying with the relevant laws and regulations and to limit potential legal risk.

H. **Severance Package:** Severance is compensation (and/or other benefits) given to an employee that has been terminated or has otherwise parted ways with the company, typically (as we would recommend) in exchange for the exiting employee signing a release of claims against the company. Severance is meant as a way for a company to alleviate employee hardships associated with finding new employment while at the same time both protecting the company against a lawsuit filed by a former employee and helping the now-former employee with their transition from employment with the company. The compensation a company offers in a severance package, if any, will typically depend on how long the employee has been with the company, the employee's salary, benefits and value to the company and may often consider the level of potential legal risk associated with the termination. The severance will usually include cash, reimbursement for medical benefits and sometimes accelerated vesting on equity. Severance may sometimes be negotiated well before the employee's exit, such as part of an offer letter or employment agreement (see above). Some companies include a standard severance package available to all employees in the company's employee handbook. We recommend carefully thinking about not over-sizing any standard severance, particularly when the company is small and has little revenue. Often, startups pay no severance other than continuing to pay during a short notice period given to the terminated employee.

Bottom line: it is critical to consult with an employment lawyer when putting together a severance package in order to comply with applicable employment laws and to ensure the release of claims will be enforceable.

## Policy Basics

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A. **Terms of Service for the Company Website:** The terms of service of a website is a written contract between the company and the users of the company's website, which governs the relationship between the website and the user. When drafted and implemented properly, a terms of service policy helps protect the company from legal claims that might arise from the operation of the website or users use thereof. If a company only offers information on its website, its terms of service can be relatively simple. More complex and customized terms of service will be required when the company provides products or services through its website. In that case, the terms of service should be a far more customized services agreement that addresses the issues raised by the applicable products and services, and the company's business model, in detail. The benefits of a well drafted terms of service are defining what misuse of the website is, disclaiming warranties regarding certain functionality or outcomes, protecting intellectual property against claims regarding infringement of others' intellectual property, protecting the ability to terminate any part of a service or any user accounts and setting the terms of how disputes will be handled. In the end, the terms of service must be relevant and accurate for the business.

Additionally, where users are submitting content to the site, or the site contains content contributed by third parties (including site developers, site owner employees and/or independent contractors), the terms of service should include terms necessary to comply with available "safe harbors" under US federal law, particularly the Digital Millennium Copyright Act, which establishes specific processes (referred to as a "safe harbor") which, if followed, enable website operators to reduce exposure to liability for copyright infringement arising from content provided by users of the website. Contact an attorney to help put together your startup's terms of service.

B. **Company Website's Privacy Policy:** A privacy policy is a written document, typically made available through the company's website, that tells the user how the company will collect, use and disclose their personal information. The privacy policy establishes the guidelines the company must follow when collecting, using and disclosing information from users. When drafted properly, a privacy policy helps protect the company from claims that it has misused information or misled the user about the company's collection, use or disclosure of information. Privacy policies need to reflect the specifics of how your company will collect, use and disclose personal information. As a result, you need to carefully consider your current and future plans when drafting the company's privacy policy. The privacy policy should address not only the company's current practices in collection, use and disclosure of personal information, but also permit the activities that the company intends to engage in over time, as it is far simpler to start off with a proper privacy policy than to amend it later.

It is important to know that privacy laws differ significantly from country to country and within the U.S., from state to state. The European Union, for example, has adopted a very restrictive data protection directive that limits how sites may collect and use personal data and that requires user consent before a website can use cookies. So if your business or website operates or plans to operate in different countries or different states, you will need to ensure that your privacy policy accounts for these different laws. Privacy is a particularly complex area of law, and you should always consult with a privacy lawyer when drafting a privacy policy for your startup.



## Licensing

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A. **Definition of a License Agreement:** A license agreement is a contract in which the licensor (the party granting the license) grants another party (the licensee) certain rights to use the licensor's intellectual property. Startups will often obtain licenses from other entities in order to develop their product or software. A startup may also use their license from a valuable partner such as a major university or government entity to attract investors. The license will specify the specific terms under which the licensee is permitted to use the licensor's IP, and may place limits on the field, duration and/or territory in which the licensee is permitted to operate. Often licenses contain payment obligations in the form of cash, ongoing royalties, equity, or a combination thereof. Licenses can be complex legal documents, and compliance with licenses is often critical for a company's ability to operate. You should consult an experienced licensing lawyer before entering a license agreement.

B. **License Agreement Key Terms:** License agreements come in many different shapes and sizes, depending on the nature of the licensed technology and the terms of the business arrangement underlying the license. The following are a handful of the key terms included in most licenses, though there are many more details negotiated in each license agreement and each such agreement is unique:

1. **Licensed technology.** What is the licensed technology? Is the licensed technology comprised of patents, copyrights, trade secrets, software, designs, materials, compounds or other intellectual property? Define the scope of the licensed technology clearly. Consider whether to include rights in future-developed technology that arises for some time period after the date of the license agreement.
2. **Exclusivity and field of use.** Will the license be exclusive? If so, in what geographic territory, and in what field of use? If you are licensing technology core to your business from a university, hospital or other institution your investors may require that the licenses be exclusive in all fields of use throughout the world, but the result depends on the context. What level of royalties must be paid, or sales of covered products made, in order to retain exclusivity? If an arrangement is exclusive, it is critical to define that exclusivity as clearly as possible, particularly from the perspective of the licensor.
3. **Sublicensing.** The license grant should make clear whether a license is sublicensable or non-sublicensable. The affiliates of a licensee may be permitted sublicensees, even if other third parties are not. Even if sublicensing is permitted, there may be restrictions on the type of sublicense or customer, and the terms under which the licensee can grant a sublicense. Depending on the anticipated business model, sublicensing is often required in order to effectively utilize a license.
4. **Fees, royalties and milestones.** How much will be paid up front, in ongoing royalties and/or upon achievement of development or commercial milestones? The royalty rate is usually a significant topic of negotiation, with rates varying depending on many factors, particularly the value of the intellectual property and the additional work or third-party intellectual property required to develop a commercial product or service. It is important to carefully define the net sales, gross revenues or other triggers of any ongoing royalties or milestone payments.
5. **Equity.** Some licensors will require equity in the licensee, depending on the context. Such equity grants are fairly common, for example, in license grants by universities and hospitals.
6. **Confidentiality.** Many license arrangements require the licensee to keep the licensed technology, and/or the deal terms, confidential.
7. **Indemnification.** Indemnification is commonly used to define the scope of each party's responsibility for third-party claims that arise from the license agreement. The proper scope of that indemnification is highly context specific.

C. Licensing IP from a University or Hospital: Many companies are built on intellectual property licensed from academic or research institutions, such as universities and hospitals. Companies may also license technology from those types of institutions to supplement their existing intellectual property. These licenses are typically patent licenses, but may also be licenses to software, materials or other intellectual property. Many institutions have their own licensing offices dedicated to commercializing intellectual property of those institutions. Some of the key points to consider when licensing intellectual property from these types of institutions include:

1. Identify the relevant intellectual property. Often a licensee will know of research being conducted at the institution and have determined that the results of that research are of interest. You may also identify intellectual property owned by an institution from academic publications or presentations by the applicable researchers, records available at the US Patent and Trademark Office (or foreign equivalent) or in materials made available by the institution's licensing office.
2. Establish contact with the institution. Prospective licensees of institutions' intellectual property may have initial contact with the researchers involved in inventing the relevant technology, and those researchers can often be useful to help navigate the institution's requirements to establish a license. However, the institution's licensing office typically is the key gatekeeper for negotiation and execution of the license agreement.
3. Prepare your business plan. In order to negotiate a license agreement, you must be prepared with a business plan for your company and your proposed development and commercialization of the technology. The institution will want to maximize the use and value of their intellectual property. You must be prepared to make a compelling case that your company is prepared to do so and/or the optimal licensee for sought-after technology. You must also be prepared, in many cases, to discuss granting to the institution some equity in your company, which will require a realistic assessment of the value of your company and of the relevant technology.
4. Academic and research institutions are not built to keep secrets. So, in all of your discussions with a university, hospital or similar institution, keep in mind that they are generally built on a principle and culture of knowledge sharing, not on preservation of trade secrets. While the institution may be able to license materials or data, carefully consider whether those materials or data will in fact be accessible to the public generally. Consider to what extent inventors may be disclosing important details in their academic publications. And keep in mind that universities and hospitals often retain the right to continue using the licensed intellectual property for ongoing research purposes.
5. Negotiate the license terms. Institutions are often faithful to their form license agreements, but there are numerous potential variations on those forms which your counsel should have experience negotiating with the institution. Your legal counsel will often be experienced in negotiating licenses from the institution and should be able to provide relevant information on likely deal terms as well.

# Intellectual property

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## 1. Patents

A. **Patents:** A patent will often be the backbone of an early-stage startup's intellectual property. Usually when people refer to a patent, they are referring to a utility patent, which is the most common form of patent in the United States, though there are also design and plant patents. In order to be apply for a patent, you must file a utility patent application (also known as a non-provisional patent application) that includes a detailed specification describing your invention, claims that define the scope of your invention, and drawings that illustrate your invention. That filing must contain enough detail to show someone skilled in your field distinctly what your invention is and how to make and use the invention. If you don't have all of those details ready for filing or you are on a limited budget, you can file a provisional patent application instead, which doesn't need to include all of the formalities and details required for a utility application. In fact, most startups file a provisional patent application so the company can establish a priority date for having the invention for less money and more quickly than a non-provisional patent application. A provisional patent application provides the benefit of putting a stake in the ground for a filing date, but is only effective for one year. In addition, a provisional application will not be examined by the United States Patent and Trademark Office ("USPTO"), and, thus, cannot mature into an issued patent. If you filed a provisional patent application and want to apply for a patent that can be examined and may be issued, you must file a related utility patent application within one year of the filing date of the provisional application. While beyond the scope of this booklet, you also consider whether your intellectual property strategy should include protection outside of the United States (such as a PCT filing).

Provisional applications help you make the most of a limited budget early in the life of your company. The money saved can be invested in exploring the invention's commercial potential, continuing R&D, and/or finding investors. Meanwhile, you can use the phrase "Patent Pending" in connection with the invention to put the world on notice and deter copycats. Also, if your invention is one that is likely to be more profitable near the end of the patent's life as opposed to early in its life (as is sometimes the case for medical devices and pharmaceuticals), a provisional application gives you the advantage of the early filing date without counting against the 20-year life of the patent, which does not start counting until the utility or non-provisional application is filed.

Although a provisional application avoids many of the filing formalities required of a utility application, don't cut corners on the material you put into the provisional application. The provisional application must disclose enough detail to show others what you invented. You will only be able to benefit from the early filing date of the provisional application for claims that cover subject matter that is supported by the disclosure in the provisional application, so it is important to be as complete as possible and to consider what will ultimately be claimed in the utility application when drafting the provisional application. Your patent attorney should work closely with you to help put high quality, descriptive material into a provisional application so you get the most value out of your early filing date in addition to help you think through the company's intellectual property strategy.

B. **Determining if an Invention is Patentable:** The USPTO will issue patents for an invention that is a process, a machine, a manufacture or a composition of matter so long as the invention is new, useful and non-obvious. Also, while abstract ideas cannot be patented, a particular application of an abstract idea can be patent eligible.

The test for whether your invention is new and non-obvious involves comparing it to all of the knowledge that was available before you filed your application (called "prior art"). Prior art is made up of all of the patent applications filed before your application was filed, non-patent literature (e.g., scientific papers, textbooks, and so on) published before your application was filed, and the knowledge of those working in the field at the time your application was filed. The core question for what is "new" is relatively simple—is your invention different from what has come before? In other words, if the combination of elements in your claim does not appear as a combination in the prior art, your invention may be new. Meanwhile, the core question for what is "non-obvious" is this: if your invention is

different from what came before, is it different enough? In order to be non-obvious, a person having ordinary skill in the field of your invention must look at your invention as a whole, including all of the differences, and conclude that he or she would not have come up with your invention based on the prior art available. For example, a trivial combination of items found in the prior art is not patentable. After you file a utility or non-provisional patent application, an examiner at the USPTO will search for prior art to evaluate whether your invention is new and non-obvious.

You can come a long way in answering whether your invention is new and “different enough” by looking at prior art via searching the USPTO patents and publications database (<http://patft.uspto.gov>) and via Internet search engines. You may indeed find parts of your invention in the prior art, but looking through the eyes of the other authors and inventors may help you arrive at convincing reasons for why a person of ordinary skill would not have brought all of the parts together. Keep in mind that any prior art you identify through your own searching or otherwise become aware of before you file your patent application will need to be disclosed to the patent office when you file. When considering whether an invention is patentable, you should consult with an experienced patent lawyer. This step is worth the cost when viewed against the cost of pursuing an invention that is ultimately determined (many years and thousands of dollars later) to not be patentable.

C. **The Costs of Filing and Maintaining a Patent:** A patent application filing may be one of the costliest initial expenses for any startup. Depending on the type of patent application (provisional vs. non-provisional) and the complexity of the invention, a patent application can cost anywhere between \$5,000 to well over \$15,000. These figures include the patent search, the filing fee to the USPTO, the professional illustrations, and legal fees associated with drafting, preparing, and filing the application. Additional legal fees can be incurred if the USPTO rejects the applied-for claims and preparation of a response or appeal is required. Patent owners must also pay maintenance fees approximately four, eight, and twelve years after a patent is issued to keep their patent in force. It's no surprise that legal fees are the most expensive component of these costs. However, patent applications are sometimes extremely important for a startup's future. Small mistakes can jeopardize patent allowance and patent lawyers are essential in making sure your patent application has the best chance for success, both in getting issued and being enforceable down the road. They will also often have training in technical degrees such as computer science and biotechnology, which allows them to understand the details of your invention, patent landscape, and where your patent application may stand in that landscape.

## 2. Trademarks

A. **Definition of a Trademark:** According to the USPTO website, “a trademark can be any word, phrase, symbol, design, or a combination of these things that identifies your goods or services. It's how customers recognize you in the marketplace and distinguish you from your competitors.” The term “trademark” is used for both trademarks and service marks while the term “service mark” is only used for services. Selecting and using a protectable trademark is beneficial because it identifies the source of your goods or services and builds value in consumer recognition, while also allowing your startup to pursue counterfeiters or to stop companies from using confusingly similar trademarks that may hurt your brand in the marketplace.

B. **The Benefits of Registering Your Trademark:** Under U.S. common law, simply using your trademark with your goods and services in commerce makes you the trademark owner. However, your rights to that trademark only apply in the same market area and geography in which you offer your products or services. To prevent others from using the same trademark (or a confusingly similar trademark) elsewhere in the same state or nationwide, you should consider registering your trademark. Federal and state laws provide a registration process that allows trademark owners to document their exclusive ownership of, and right to use, a trademark. Federal registration with the USPTO is particularly valuable because it provides for nationwide notice and protection, a federal forum for enforcement, and penalties against infringement not available with common law protection or a state

registration (where protection is limited to the borders of that state and can be very narrow in scope). Note that trademark protection may last indefinitely!

C. **The Costs of Registering a Trademark:** The costs associated with filing a patent are much higher than those for registering a trademark. The application for a federal trademark with the USPTO is also far simpler than an application for a patent, though for a trademark to be registered, you will need to provide evidence to the USPTO that the trademark is used in commerce. If you are only filing for one or two classes of goods or services with respect to a single federal trademark, it is likely the total filing cost (excluding legal fees) will be less than \$1,000. You should consult the USPTO website or a trademark lawyer to get a more accurate estimate of your total costs.

### 3. Copyright

A. **Definition of a Copyright:** According to the U.S. Copyright Office, a “Copyright is a type of intellectual property that protects original works of authorship as soon as an author fixes the work in a tangible form of expression.” A copyright protects literary, dramatic, musical and artistic works. These works often include presentations, company operating/instructional manuals, whitepapers, computer software, screen displays and graphical user interfaces. Copyright does not protect facts, ideas, systems or methods of operation (you should consider a patent application for these items if patentable), although it may protect the particular manner in which these things are expressed. For example, while the actual facts in a company manual may not, themselves, be protectable with copyright, the manner in which the facts are expressed in the manual is likely protectable (for example, the particular word choice and particular arrangement on the page).

Copyrights give the creator exclusive rights in the copyrighted work. At a basic level, a copyright holder has the right to control reproduction of the work and the right to display the work publicly. Additionally, the copyright holder has the right to determine who may adapt the work to other forms, as well as to determine who may perform the work. With certain exceptions, the term of the copyrighted work created on or after January 1, 1978 starts when the work is created (i.e., fixed in a tangible medium) and expires (i) 70 years after the author's death, for a work created by a single author and not as a work made for hire, (ii) 70 years after the last author's death, for a work of joint authorship that is not a work made for hire and (iii) for works made for hire, and pseudonymous and anonymous works, the earlier of (A) 120 years after creation; or (B) 95 years after first publication.

B. **Registering a Copyright:** In many cases, you do not need to register your copyright with the U.S. Copyright Office, because rights automatically vest upon fixation of the work in a tangible medium, for example when words are put to paper or graphics are put to a slide. Regardless of whether you register your copyright, however, you should provide a copyright notice in the work. A copyright notice informs the public of the company's claim to copyright ownership in the work and can be used as a deterrent against infringement. Therefore, the company should make it a practice to include copyright notices on websites, manuals, brochures and other documents (including source code), especially on materials that are published or provided to third parties. For published works, a copyright notice includes the word “Copyright” or the C-in-a-circle symbol ©, the year of first publication of the work, and the name of the copyright owner.

Registration with the Copyright Office, while not required, does provide some advantages. If a third party infringes a registered copyright, registration provides access to statutory damages of \$750-\$30,000 per occurrence without proving actual damages, which can increase to \$150,000 per occurrence for willful infringement. Further, if registration occurs before, or within five years of, publication, it is considered prima facie evidence of proof of ownership and validity of the copyright.

C. **The Costs of Registering a Copyright:** The filing fee to register a copyright with the Copyright Office is only \$45-\$65 if filed online, or \$125 if filed by paper. However, the exact fee will depend on the nature of the copyright.

It is best to consult the Copyright Office website or a copyright lawyer to get a more precise estimate, but the government fee will likely not exceed \$500. Since the cost is relatively modest, it is often beneficial to register a copyright. Most companies do not file registrations for all works. Often, companies only file for copyright registration if a work is a publicly facing document or for computer code that is released to the public, and often only for the original version and for major revisions of the document.

## 4. Trade Secrets

A. **Definition of a Trade Secret:** A trade secret can be any secret information from which the company derives independent value by virtue of the fact that it is a secret such as a formula, code, recipe, or a manufacturing technique. A popular example of a trade secret is Coca Cola's recipes. In order to qualify as a trade secret, the information must not be generally known or readily ascertainable in the company's industry, it must be commercially valuable and derive value from its secrecy and the owner must take reasonable steps to protect the trade secret such as using confidentiality agreements or even physical barriers such as a locked safe. Thus, the critical factors in determining whether a trade secret exists are the value of the information to the business owner (and competitors) and the amount of effort made to maintain the secrecy of the information. Trade secrets can last indefinitely as long as these safeguards are followed.

B. **Protecting Trade Secrets With an NDA:** Trade secrets are protected under both federal and state law. The unauthorized acquisition, disclosure or use of trade secrets can be a trade secret protection violation giving rise to lawsuits and damages. As mentioned in the previous section, secret information must be reasonably protected in order to qualify as a trade secret. A non-disclosure agreement (NDA), also known as a confidentiality agreement, is an agreement between two or more parties to not disclose to third parties the confidential information exchanged between the parties and to use such information for limited purposes for which the information is disclosed. These types of agreements protect non-public business information. The agreement can be one-way, where only one party is disclosing confidential information to the other, or two-way/mutual, where both parties are disclosing confidential information to each other.

You should use NDAs when you plan to disclose confidential, non-public information to third parties outside of your business, for example, customers, clients, investors (to the extent they are willing to execute an NDA), consultants, contractors and anyone else with whom you plan on sharing confidential information. The NDA should be a formal, written agreement that clearly describes the confidential information, defines the permitted uses of the confidential information and also specifies the length of time the parties agree not to disclose the other's confidential information.

NDAs generally contain a list of standard exceptions, so be on the lookout for exceptions to the NDA that are out of the ordinary or that create ambiguities or broad exceptions to the confidentiality obligations. Also be sure that the term of the NDA is long enough to protect the anticipated duration during which it will be important that your confidential information is not in the public domain. Finally, the NDA should be limited to what it is—an agreement about confidentiality. Provisions purporting to cross-license confidential information of one or more parties, address ownership of jointly developed intellectual property or similar matters have no place in an NDA. If those provisions make business sense, they should be carefully reviewed and negotiated as part of a separate agreement specific to that purpose.

C. **Other Steps for Protecting Trade Secrets:** In addition to NDAs, trade secrets are protected by limiting access to such information to only those employees or consultants, as applicable, who have a need to know such information to perform their services to the company and who are under confidentiality obligations to the company, such as through an NDA. In addition, the company should put such employees on notice that they will have access to trade secrets, that the trade secrets are important to the company's business and that they have obligations to maintain the secrecy of such information. The same notice applies to any third parties who may be given access to

trade secrets. Further, documents that contain trade secrets should be marked “Confidential” and passwords should be used to prevent general access to trade secrets. Depending on the value of the trade secret, stricter access control and monitoring may be warranted. Some companies hold trade secrets deemed to be so valuable and proprietary that they do not share them outside of the company, even under NDA.

## Business Insurance (Chat GPT assisted with this section)

Business insurance is essential for startups to protect against various risks and potential liabilities. Note that institutional investors often require certain types of insurance to be in place prior to investing. Here's a summary of the types of business insurance typically needed by a startup:

- A. **General Liability Insurance:** This insurance covers bodily injury, property damage, and personal injury claims that may arise from your business operations. It helps protect your startup from lawsuits and related legal expenses. This is a must have.
- B. **Property Insurance:** Property insurance covers damage or loss of physical assets like office space, equipment, inventory, and furniture due to events such as fire, theft, or vandalism. It ensures that your startup can recover or replace valuable assets. Many startups won't need property insurance, particularly if they have no physical office spaces.
- C. **Professional Liability Insurance (Errors and Omissions Insurance):** Particularly important for service-based startups or those offering professional advice, this insurance protects against claims of negligence, errors, or omissions. It can cover legal defense costs and damages if a client alleges financial losses due to your services.
- D. **Workers' Compensation Insurance:** If your startup has employees, workers' compensation insurance is usually mandatory in most states. It provides coverage for medical expenses and lost wages for employees who are injured on the job. Put this one in the must have category.
- E. **Business Interruption Insurance:** This insurance helps cover lost income and operating expenses if your startup is forced to temporarily close due to a covered event, such as a natural disaster. It ensures your business can continue to meet financial obligations during downtime. Many startups do not get this type of insurance as it adds extra operational costs. But if your company is physically located in a natural disaster zone (like hurricane exposure), then good to consider.
- F. **Cyber Liability Insurance:** In an age of digital data and online transactions, this insurance protects against data breaches, cyberattacks, and the resulting costs, including legal fees and notification expenses. The need for cyber liability insurance will depend on what type of business you are operating.
- G. **Commercial Auto Insurance:** If your startup uses vehicles for business purposes, you'll need commercial auto insurance to cover accidents, property damage, and injuries related to company vehicles. Common sense!
- H. **Product Liability Insurance:** For startups manufacturing or selling physical products, this insurance protects against claims arising from product defects or injuries caused by your products. A must have for physical product companies.
- I. **Directors and Officers (D&O) Insurance:** D&O insurance covers legal costs if your startup's executives or board members face lawsuits related to their decisions or actions on behalf of the company. Institutional investors who take board seats almost always insist on D&O coverage.
- J. **Employment Practices Liability Insurance (EPLI):** This insurance protects your startup against claims of wrongful termination, discrimination, harassment, or other employment-related issues. As your company grows, EPLI coverage becomes more important. The more employees you have, the higher likelihood of a claim. Again, common sense!
- K. **Commercial Umbrella Insurance:** Commercial umbrella insurance provides additional liability coverage beyond the limits of your other policies, offering extra protection when claims exceed your primary policy limits. Again, as your company grows, an umbrella policy could start to make sense.



L. **Health and Disability Insurance for Employees:** Providing health and disability insurance can help attract and retain talented employees. Health insurance coverage is a common employee benefit.

The specific insurance needs of your startup may vary depending on your industry, size, location, and activities. It's essential to work with an insurance agent or broker who can tailor coverage to your startup's requirements. Proper insurance coverage can safeguard your business from financial hardships and legal expense exposure in the event of unforeseen circumstances and events.

## **ENTREPRENEURSHIP AT CORNELL**

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