



# Common Startup Mistakes

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# Choosing the Proper Entity

## Chose The Proper Entity

Three choices: S corp, C corp and LLC

Areas of differences:

- Tax
- Ownership
- Fundraising
- Governance/Structure
- Employee compensation

## Choice of Entity -- Tax

- C corp: two layers of tax
- LLC: flow through with tax at member level
- S corp: flow through with tax at member level
- LLC vs. S corp -- flexibility (or lack thereof) in allocating income and losses

## Choice of Entity -- Ownership

- C corp – no limit on number of shareholders (but you don't want to accidentally become a public company). No limits on the type of shareholder
- LLC – effectively a 100 member limit. No limits on the type of member
- S corp – no more than 100 shareholders. Shareholders must be individuals, with limited exceptions. Shareholders must also be US citizens or residents

## Choice of Entity -- Fundraising

- VCs and institutional investors prefer to, and often only, invest in C corps
- LLCs work well when there are only a small number of investors. LLC agreements can be quite complex
- Most institutional investors are not eligible shareholders in an S corp

## Choice of Entity -- Governance

- Corporations (both C and S) have a well-defined governance structure
- LLCs can provide for a wide range of governance constructs

## Choice of Entity – Employee Compensation

- Stock options to employees of a corporation
- If an S corp, be mindful of limitations on number and type of shareholders
- LLCs can issue profits interests, which add complexity (and confusion)





# Founder Stock/Option Grants

## Not Making Founders' Stock Subject to Vesting

- What if one of your co-founders doesn't stick around?
- Subject the stock to vesting
  - Company has a repurchase right if the person leaves
  - Typical vesting period is 4 years (usually with acceleration if the employee is terminated without cause or leaves for good reason after a CIC)
- A VC may come in later and impose it

## Failure to Make an 83(b) Election

- Default rule is that stock subject to a substantial risk of forfeiture is taxed when the risk lapses (i.e. vests)
  - could result in a big tax bill with insufficient cash and illiquid stock
- 83(b) election accelerates tax to year of purchase (which is a good thing)
- Must be filed within 30 days

## Be Careful About Promising Stock to people

- Choose your co-founders carefully (obviously).
- If it's your company and you are considering adding a co-founder, be clear with that person that you are considering him or her as a potential team member - but that you are making no promises of any equity - and, if that person is contributing at all to your idea, make sure you get a confidential information and invention assignment agreement from him or her and pay him or her some consideration for signing it.
- Form your entity, agree on how you are going to slice up the equity pie with your co-founders and make all co-founders' shares subject to vesting.

# Granting Stock Options: Be Mindful of Section 409A of the Internal Revenue Code

- Generally, the strike price of stock options must at least equal the fair market value of the underlying common stock.
  - Avoid “in the money” stock options.
  - Consider getting at least a written valuation report prepared by a qualified individual (need not be a professional appraiser).

## Be Mindful of Securities Law Compliance Issues

- Don't commit fraud (obviously).
- Easiest way to comply with securities laws when fundraising is to only offer and sell securities to “accredited investors.”
  - The “rich”
  - Executive officers of your start-up
  - Directors of your start-up

## Be Mindful of Securities Law Compliance Issues (continued)

- Don't engage in "general solicitation" or "general advertising," e.g., don't say on your website that you are "looking for investors," unless pursuant to a SEC Rule 506(c) offering, i.e., "accredited investor crowdfunding"
- If you want to do a Rule 506(c) offering, you first need a game plan for legal compliance - put the plan in place before you engage in any general solicitation or general advertising.

## Be Mindful of Securities Law Compliance Issues (continued)

- If you are raising money the traditional way, confine your offers to persons whom you already know and reasonably think are accredited investors.
  - Getting introduced to accredited investors through informal, personal networks of angels is generally fine.
  - Limit your public statements to what your company does and why people should buy your products, and avoid mentioning that your company needs money and that you'd like people to buy your stock.





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# Misclassifying Employees/ Independent Consultants

# Misclassifying Employees

- California AB 5 Test
  - the worker is free from control and direction of the hiring entity in connection with performing the work, both under contract and in fact
  - the worker performs work outside the usual course of the hiring entity's business
  - the worker customarily engages in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity

## Misclassifying Employees – Control Manner & Means

- Does the employer control:
  - What days to work
  - Hours of work
  - Where the work is performed
  - How the work is performed
  - When to take breaks and for how long
- Does the employer establish/provide:
  - Code of conduct/behavior rules
  - Dress code
  - Tools and supplies
- Company must not have the right to control or direct, or actually control or direct, the means or manner of how the work is performed.
- Employer control of precise manner/details of the work ≠ necessary to be an employee.

## Misclassifying Employees – Employer's Normal Course of Business

Independent contractor ( work is outside the normal course of business)

- Outside plumber hired by retail store to fix a leak.
- Electrician hired by retail store to install new wiring.
- Historic restoration specialist hired by general construction company.
- Computer technician hired by law firm to fixed crashed server.

## Misclassifying Employees – Customarily Engaged Independent Trade

Has the worker:

- Established a corporation/sole proprietorship
- Obtained business cards/letterhead
- Leased and paid for office space
- Obtained licensing
- Advertised the business online/in print
- Offered the same services to the public or to a number of potential customers

# Misclassifying Employees- Certain Exemptions

- **Business-To-Business Exemption**
  - “Bona fide business-to-business contracting relationships” where a contractor “acting as a sole proprietor, or a business entity formed as a partnership, limited liability company, limited liability partnership or corporation contracts to provide services to another such business.”
- **Single-Engagement Business-To-Business Exemption**
  - individual businesspersons who contract with one another “for purposes of providing services at the location of a single-engagement event.”
- **Professional Services Exemption**
  - doctors, lawyers, dentists, licensed insurance agents, accountants, architects, translators, engineers, private investigators, real estate agents, hairstylists, appraisers; registered foresters; and home inspectors
- **Referral Agencies**
  - exempts the relationship between an individual operating as a sole proprietor or a business entity and a business that refers that individual’s services to clients, including, but not limited to, consulting, youth sports coaching, caddying, wedding and event planning, and interpreting services



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# Use of Form Agreements

## Use of Form Agreements

- Consulting Agreements
- Non-Disclosure Agreement (Mutual/One-Way)
- Restricted Stock Purchase Agreements
- Stock Incentive Plans
- Employee Proprietary Invention and Assignment Agreements



## Use of Form Agreements

- Cover key terms, including payment and limiting liability
- Base the agreement on industry examples
- Use of form agreement should be limited to its intended purpose



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# Protecting IP

## Types of IP

- Inventions and Know-How
  - Commercial or Competitive Advantage
    - Exclusivity
    - Consumer Preference – Good Will
  - Generate Revenue -- Licensing, Merchandising
- Defensive Value -- If they sue us, we'll sue them!

## Examples of IP

- Marketing and business plans
- Computer source code
- Unique product or design
- Secret recipes, formulas
- Product development efforts, including “negative information”

# The Basics: Types of IP to Protect Your Technology

- Patent/Copyright
- Trademark/Trade dress
- Copyright
- Contract (e.g., License) Rights
- Trade Secrets

## Protection of Trade Secrets

- A trade secret will only be protected by the courts if a business takes care to keep it secret!
- How do you keep it secret?
  - Employment agreements
  - Security and secure handling of information
  - Non-Disclosure Agreements with third parties
  - Limited Access
  - Avoiding infection

Questions?



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