

# Entrepreneurial Businesses: Getting the Legal Part Right

David Peteler

Tuesday, March 26, 2019

Inventors and Entrepreneurs Club



# Key Elements

- Entity
- Team
- Equity
- Agreements
- Intellectual Property
- Financing

# Choose the Right Entity

- Entity Type (C-Corp, S-Corp, LLC) and Location (e.g. DE or MN) are Tax Driven and Investor Driven
- DE C-Corp is “Standard” for VC and institutional financing

A Minnesota C-Corp or LLC will work for many entrepreneurs



# Chose the Right Entity cont...

- Sometimes LLC or S Corp (Pass Through Entity) is A Better Choice
  - S Corporation (save FICA and Self Employment Tax)
    - No Corporate Investors. No Foreign Investors, Less Than 100 Shareholders
    - Single Class of Stock – Trap for the Unwary: Preferred Distributions
  - LLC
    - ✓ Good for Waterfall Distributions
    - ✓ Good if Liquidity Achieved Mainly Through Distributions
    - ✓ Ability to Deduct Losses On Personal Taxes (subject to limits)



# Set It Up Right - Equity

- Multiple Founders Require Thoughtful Consideration
  - Vesting of Shares
  - Buy Sell; Restriction on Transfer, ROFR; Drag Along, Tag Along
  - Equity Split Among Owners
    - Cash vs. Assets
    - Part/Full Time
    - Ideas vs. Implementation
    - Capital vs. Sweat Equity
  - Do Not Avoid Difficult Conversations about Potential Disagreements, Break Up or Firing Co-founders



# Set It Up Right - Admin

- Keep All Your Documents Organized and in One Place
  - DropBox?

## Maintain Corporate Formalities

- Separate Entity Bank Account and EIN
  - Don't Use Entity Accounts for Personal Expenses
  - Keep Your Receipts

## Insurance

## Permits and Licenses



# Get Employee Hiring Right

- Offer Letter
  - Sets out Compensation (Cash, Equity)
  - Includes Non-Compete, Non-Solicitation and Assignment of Inventions Agreements
  - Specifies Termination (At Will or for Cause)
- Employees (W-2) v. Consultants (1099)
  - Having Non-Exempt Employees Work Without Pay for Potential Equity Creates Tax and Wage and Hour Issues
  - Treating Full Time Employees as Consultants Creates Tax Issues
- Equity Grants Must Be Properly Documented
  - Restricted Stock with 83(b) Election
  - Grant Options Pursuant to Stock Option Plan
  - Board Approval of Equity Issuance or Stock Grant Required



# Have an IP Strategy

- Intellectual Property includes:
  - Patents
  - Trademarks
  - Copyrights
- Trade Secrets : Information That Gives Competitive Advantage That You Use Reasonable Efforts to Keep Secret - Source Code, Formulas, Methods of Manufacturing, etc.

## Have a Plan

Decide What to Patent and What to Keep as a Trade Secret

Trade Secret is Strategy: Use Reasonable Efforts to Keep Secret and Don't Disclose Without NDA

Trademark: Logos, Product or Service Names

Unless the mark is consumer related – “brand” – don't spend too much effort early on





# Secure Your IP Position

- Get Pre-Existing IP Into the Company
  - Founders Must Contribute Pre-Existing IP to Company at Formation, in exchange for Equity
- Do Not Permit Founder, Employee or Third Party Create New IP Without Assigning it to the Company



# Basic Agreements You Want To Have

## Founder Agreements

Service Providers: Employment or Consulting Contracts

IP Assignments / Work for Hire

Confidentiality Agreements

Stock Acquisition Agreements

Vesting and Repurchase

Options / Option Plan – ISO or NSO

Vesting

Shareholders Agreement (Corporation) - Operating Agreement (LLC)

Pre-Emptive Rights

Restrictions on Transfer

Rights of First Refusal

Drag Along

Tag Along

# Financing – Some Alternatives

## Equity Financing

1. Founders
2. Friends and Family
3. Outside Investors
  - Term Sheets
  - Convertible Notes
  - Common Stock
  - Preferred Stock
  - SAFE
  - Due Diligence
  - Watch Your Cap Table
4. Crowd Funding

# Equity Financing - cont.

- Disclosure Documents
  - Business Plan
  - Financial Projections
- Investment Documents
  - Don't Make Oral or “Handshake deals”
  - Use Note, SAFE, Subscription Agreement
  - Honestly Disclose Business Plan, Risks
- Sophisticated Investors will perform legal due diligence
  - You get one chance to show them:
    - You are prepared
    - Where they fit in the capital structure
    - What they will get for their investment



# Crowd Funding

## Turning Social Capital into Equity

- Federal Crowdfunding
  - JOBS Act - 2012
  - SEC Regulations – Effective 2016 – Regulation CF (Crowdfunding)
  - Any US company can take investment from any US investor in any state
- 1. **Limits on Sales.** A company may not sell more than \$1,000,000 of securities in a 12 month period under Regulation Crowdfunding.
- 2. **Limits on Purchases.** A purchaser's amount is limited. Anyone can invest up to \$2,000. To invest more than \$2,000, you need to meet requirements based on percentages of annual income and net worth. The maximum an investor can purchase is \$100,000 in a year.
- 2. **Disclosure Statement.** The company must make an initial filing with the SEC, which includes a disclosure statement, and must provide the disclosure statement to investors. The disclosure statement must contain information and financial statements similar to that required in a Regulation A filing.
- 3. **Financial Statements.** The disclosure statement must include financial statements. For capital raises of more than \$100,000 but less than \$500,000, the financial statements must be reviewed by an independent accounting firm. If the company is raising capital under Regulation Crowdfunding for the first-time, and the amount is over \$500,000, the financial statements need only be reviewed; but for subsequent offerings over \$500,000, the financial statements must be audited by an independent accounting firm.

# Federal Crowdfunding - continued

- 4. **Target Amount.** The company must state, in its disclosure document, the target amount it wants to raise. If the target amount is not raised, the money that was raised must be returned to the investors. The disclosure statement must include a description of what happens if the company receives more than the target amount.
- 5. **Progress Reports.** The company must file with the SEC, and provide to investors, an update on the progress towards meeting the target offering amount, when the company reaches 50% and again at 100% of the target amount.
- 6. **Ongoing Reporting Requirements.** The company must file with the SEC, and post on the company's website, an annual report containing required disclosure information and financial statements. The annual reporting requirements continue until one of several termination events occurs.
- 7. **SEC Registered Intermediary.** The Crowdfunding must be done on a platform of an intermediary that meets the SEC intermediary requirements. Intermediaries must be registered with the SEC as a broker or as a funding portal.
- 8. **Advertising.** Any advertising about the offering must comply with Regulation Crowdfunding requirements.

# Crowd Funding - continued

- **MINNESOTA CROWDFUNDING – MNVest**
- Law passed in 2015, final regulations passed in 2016, first offering done in 2016
- Restrictions:
  1. Only MN Companies (Headquarters / doing business in MN)
  2. Only MN residents can invest
  3. Both Accredited (no limit) and Non- Accredited (limit to \$10,000 per offering) Investors
  4. Can raise up to \$1M with internal financial statements; up to \$2M with audited financials
  5. Offering must be sold through a registered portal MNstarter - Silicon Prairie
  6. Escrow Required
  7. Advertising must comply with MNVest rules

Need Offering Documents that track MNVest legal requirements

Most companies raising money on MNVest are breweries

Average Raise – Less than \$500k

# Other Financing Alternatives

- Bank Loans
- SBA Loans
- Region 3 Development Office Alternatives
- Asset Based Financing
- Receivables Financing
- Hard Money lenders
- Rich Uncle



# Some Additional Resources

- Inventor's Network [www.inventorsnetwork.org](http://www.inventorsnetwork.org)
- 1 Million Cups
  - Eden Prairie [www.1millioncups.com/edenprairie](http://www.1millioncups.com/edenprairie)
  - St. Paul [www.1millioncups.com/stpaul](http://www.1millioncups.com/stpaul)
  - Minneapolis [www.1millioncups.com/minneapolis](http://www.1millioncups.com/minneapolis)

Safe Place for Entrepreneurs

Ability to Network, Present

# Do we really need all this legal stuff?

1. Identify and deal with common startup issues.
2. Impose discipline and manage expectations
3. Investors will ask for legal documents in due diligence
  - They will require them before they invest
  - You look good if you have your house in order
  - Hard to get signatures at the last minute
4. Depends on how much of your backside you don't mind losing...

# Do I need a lawyer?

I can just get forms off the internet, right?

This stuff is complicated

Who wrote the form? Company Side? Investor Side?

Multiple agreements have to interface correctly

Think of a good corporate lawyer as a team partner

Work with them on payment terms

**Do you feel lucky?**



# Thank You!

David Peteler

[dpeteler@avisenlegal.com](mailto:dpeteler@avisenlegal.com)

952-237-8700

