



AIM-HI Accelerator Session #1

Starting Your Company & Preparing for a Fundraise: The Legal Basics

Billy DuVal
&
Lila Inman

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Roadmap

- Formation Basics
 - Why incorporate?
 - Entity and Domicile Choice
- Founder Basics
 - Founder Relationships
 - Ownership and Equity
- Other Important Considerations Pre-Financing



Formation Basics

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Why Incorporate?

- Provides limited liability
- How to avoid stockholders being directly liable for the company's liabilities ("piercing of the corporate veil"):
 - Record approvals by the Board of Directors and the stockholders
 - No comingling of funds (keep a separate bank account!)
 - Ensure the company is the party to the contract
 - Ensure the company is not undercapitalized

True or False:

I have the domain name, that means I should be clear to use the name, right?

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Naming your company



Hello
my name is

- Check corporate law requirements/limitations
- Check name availability with the Secretary of State in state of formation
- Check name availability in key jurisdictions where corporation will qualify to do business
- Give consideration to trademark/tradename issues

Forming an Entity

- Basic and most common options are:
 - “C” Corporation
 - LLC
 - “S” Corporation
- Except in rare cases our recommendation is a “C” corporation
 - Simple and low-cost formation (including DIY, although be careful)
 - Favorable employee equity
 - Preferred vehicle for venture investors
 - “Qualified small business stock” (QSBS) - may result in the ability to defer up to \$10M in gain

The LLC Alternative

- Many angels will suggest an LLC
- They are excited by pass-through losses for tax reasons
- LLC's increase direct costs to the startup (and its founders) in most cases
 - Formation is not “turnkey” in the same way
 - Employee equity is complicated
 - Most VC's cannot invest into them (so have to convert later, which can be complex and \$\$)
 - Cannot take public on US markets
 - No QSBS option for LLC units – “may” have QSBS on conversion later, but maybe not

The “S” Corporation Alternative

- Some tax advisors will suggest an “S” Corporation (again, pass through losses) but beware
 - Cannot ever have QSBS
 - Legally can only have one class/series of stock
 - Will de facto become a “C” corporation after outside financing
 - Many investors care about QSBS for early investments and this will block that opportunity
 - Cannot “undo” that aspect and so very short-term benefit.
 - If fixed on “pass through” you are marginally better off with LLC for the QSBS reason, but stuck with all the downsides noted on prior slide

Classic C-Corp Formation

Why Delaware?

- Why Delaware?
 - Generally favorable and well-known body of law
 - More “certainty” on outcomes
 - VCs prefer
 - Most public companies domiciled there (save time/money later)
 - Substantially all “form” and “sample” docs assume Delaware (so lower cost)
 - Helpful Secretary of State’s office for things like filings and efficiency

Formation: Delaware

Which of the following are **true**?

- A. Delaware permits stockholders to act by written consent.
- B. In a Delaware company, a person must be a stockholder to serve on the company's board of directors.
- C. In a Delaware company, one person can act as sole officer, director, and stockholder.
- D. Delaware does not charge state income tax to companies formed in Delaware unless they do business in the state.

Founder Basics

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Founder Interactions

- Founder relationships are meaningful and dynamic – they can make or break a startup
 - This does not mean enter into a stockholder / founder agreement
 - Non-standard documents / terms can give pause to prospective investors
- Transparency is key
 - Agree openly about:
 - Board composition
 - Officer titles / roles
 - Equity allocation and vesting/acceleration

True or False:

My co-founder hasn't left his lab at Stanford yet.
That's not a problem, right?

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Founders' Stock

- Stock v. Options
 - Cheap (minimal capital outlay/risk)
 - Holding Periods for Tax, Securities, QSBS
 - Voting Power
- Restricted Stock
 - Co-Founders and Venture Investors Concerns—leaving pre-maturely and not “earning” stock
 - Venture Investor Concern—investing in people as much as concept; ensure commitment of founders with proper incentives
 - Repurchase right
 - Consideration
 - Cash or IP Assignment

True or False:

Can't we just wait until we have investors before we subject our shares to vesting?

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Ownership Matters

- Issue stock to founders – take care of this ASAP
- Impose vesting (makes the best impression to investors) & file 83(b) elections
- Stay away from unusual terms – do not create red flags
- MAKE NO PROMISES outside what is written in the agreements
 - Memorialize anything that touches equity. Anything. Get it in writing.
- Embrace dilution...or at least expect it
- Breakups happen – what happens when it does not work out?

Other Important Tips

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Get It In Writing

- **Principle 1:** If everything always went as planned in the business world, we would never need a contract. Ever.
- **Principle 2:** It is unlikely you will be the first entrepreneur for whom everything goes as planned.
 - See our earlier discussion of breakups
 - Early “help” often values their input more than you do and/or claims ownership
- **Principle 3:** If it is not in a signed agreement, you can plan on a problem...and possibly an expensive one
 - Clean records will help you later
 - Your diligence process will thank you
 - Yes, this applies to pretty much everything

Avoid these “Gotchas”

- **Run a name search** – Before incorporating, see if your company name is available. You can also reserve the name in DE.
- **Bylaws** – VC Investors will expect that your bylaws contain *transfer restrictions* and *a right of first refusal*.
- **File your 83(b) election** – There is a 30 day window of time in which you can file an 83(b) election with respect to restricted stock (i.e., stock subject to vesting) this can save you thousands of \$\$\$.
- **Franchise Taxes** – Pay your franchise taxes which are due March 1 every year. DE corporations can pay online.
- **Vesting Schedules** – Set up a standard 4 year vesting schedule with a one year cliff for your founding team. VC investors will almost always require it so setting it up right at the beginning is imperative to ensure you get “credit” for time spent working on your company.
- **Equity** – Awarding equity is a great way to incentivize your early founding team, employees and advisor without having to pay them a salary. However, you should pay particular attention as to the type of equity you grant (restricted stock vs. options) and make sure it is subject to some vesting.

Get Advice... And Follow it

- Mistakes on the legal front cost more than you would have spent on fees to have done it right the first time
- It's not as simple as it looks, and is easy to get wrong
- Find advisors you trust, and then actually trust them



"My standard consulting fee is \$1000, but I can give you some harebrained ideas for \$250."



IP Assignment Imperative



- You have a vision – protect it
 - IP is NOT limited to “patents”
 - The business plan, ideas, financial model, etc., are all “IP”
 - For founders, contribute anything that pre-dates the company in exchange for stock at incorporation
- Post formation assignments
 - Founder and employee invention assignment agreement
 - Contractor / consultant / advisor agreements
 - An NDA is NOT an assignment of rights
- Keep it confidential. Do not share your great new idea with everyone. Use NDAs where you can (note that investors will typically NOT sign one).

Build Your Team

- Hire trusted folks, but be sure to get it in writing, including inventions assignment
- No pay = Potentially big legal issue (even for founders)
 - Document in an offer letter how much is being paid
 - Each state has a statutory minimum wage (hourly for “non-exempt” and annually for “exempt”)
 - Business owner exemption (20%+ equity interest *plus* active engagement)
- That individual is an employee if the law says so, regardless of what you and your paperwork say
 - It is harder than ever to classify folks as consultants
- Getting a release of claims means getting release of pain, but...guaranteed severance is a guaranteed headache
- Non-competes are generally unenforceable in California (and many other states)
- The offer letter IS NOT the document that actually grants equity – discuss with counsel

Questions?

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