AIM-HI Accelerator Session #3
Avoiding Legal Pitfalls

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Raising Funding Puts Your Company Under a Microscope

- Sophisticated Investors will conduct extensive diligence prior to making any investment
- Before diligence can begin, the data needs to be readily available and organized
- Issues that are uncovered during diligence can lead to expensive fixes, delays in closing and even an investor walking away
- Most issues are cheaper and easier to fix the sooner they are caught

Populating a Data Room for Diligence is Time Consuming

- All Board and Stockholder Actions
- All Stockholder Agreements (Charter, Bylaws, IRA, ROFR, VA)
- All agreements touching IP
- All stock/option issuances
- All “material” contracts
- All form agreements (offer letters, etc.)
- All legal and regulatory interactions
- Debt Agreements
- Lease Agreements

Refresher: Who's who in a corporation

The players include:

- Board of Directors
- Officers
- Stockholders
- Employees

Board of Directors

- The Board is responsible for the management of the corporation
  - Board acts only as a body
  - Initial directors are appointed by the incorporator
  - New directors are elected by stockholder vote, or appointed by the existing Board to fill vacancies
  - Fulfill fiduciary duties

Board of Directors

The Board takes action on material things that affect the business. Examples:

- Issuing stock
- Amending the Articles of Incorporation
- Amending the Bylaws
- Entering into major contracts or leases
- Entering into employment agreements with key employees
- Electing officers
- Electing directors to fill vacancies on the Board
- Adopting company policies

Board of Directors

The Board acts

- By voting at a meeting, or
- By unanimous written consent

Corporate Records Pitfalls: Board Documentation

- Even a single founder/Board needs to document the actions taken and in what capacity (Board vs Stockholder vs CEO)
  - Ex: A CEO Founder who owns 100% of the Company and is the sole member is adopting an equity incentive plan to start providing options to new hires. As the Board, they can approve the new equity incentive plan, as the CEO they can extend an offer letter to a new hire and as a stockholder they can approve the grant of incentive stock options (a potentially tax favorable option for employees) under the newly approved incentive plan. <u>**After the employee is hired**</u> the Board needs to approve any equity grant (even if already promised in the offer letter) and determine what the "fair market value" of the stock is on the date of the option grant (which cannot be prior to the employee start date)
  - **If the Board never approves the option grant the exercise price may need to be higher when it finally gets formally approved to avoid negative tax consequences**

Stockholders

Sample stockholder actions include:

- Amending of the Articles of Incorporation
- Amending of the Bylaws
- Selling or transferring of all or substantially all of the corporation’s assets
- Approving contracts with interested directors
- Merging with another corporation
- Electing and removing directors
- Dissolving the corporation

Stockholders

Stockholders act

- By voting at a meeting, or
- By written consent

Check your understanding: Authority

Which of the following are true?

A. Stockholders appoint the Board of Directors.

B. The Board appoints the Officers.

C. Officers act on behalf of the Company.

D. An employment agreement granting an executive level title, such as CFO, automatically makes that employee an officer.

Corporate Records Pitfalls: Stockholders

- If Investors require a legal opinion the law firm will rely heavily on Board and Stockholder minutes/consents to verify actions were validly approved
- Particularly with stock issuances, there can be significant tax or regulatory costs associated with cleanup:
  - **Example**: to issue **incentive** stock options (ISOs), stockholders must approve the equity incentive plan within 12 months of adoption. If this approval is not received and options are misclassified as ISOs instead of non-qualified options (NQSOs) then no tax is withheld upon exercise and there is a hidden tax liability

Officers

- Required officers: President, Secretary, and Treasurer/CFO
- Appointed by the Board
  - Initial officers are appointed by the incorporator
- Responsible for day-to-day management of the company
- Can bind the company to contracts
- Fulfill fiduciary duties

Officer Pitfalls: Due Authority

- As part of a financing (or sale of the Company) the investment documents often contain representations about certain key documents and contracts being "binding" and "legally enforceable"
- Employees do not automatically have the authority to bind the Company to agreements and directors have no authority, absent unusual circumstances, to bind the Company
  - **Example**: A co-founder who sits on the Board signed a key early contract on behalf of the Company. The "title" row on the contract was left blank and the other co-founder was appointed CEO, Treasurer and Secretary at formation with no specific officer role granted to the co-founder who signed. This agreement may not be legally enforceable and may need to be re-approved/ratified at this time. However, the Company would still be fully on the hook for its obligations due to "apparent authority"

Founder/Employee Pitfalls

- Every employee should sign a Proprietary Innovations and Inventions Assignment Agreement (PIIA or sometimes called a CIIA if it includes confidentiality)
- Hope for the best but plan for the worst on founder agreements
- Make sure independent contractors are not employees
- If granting equity in an offer letter or consulting agreement, a fixed number of shares is preferable to a % target
- Employees **must** make at least minimum wage, equity does not count

Stock and Option Issuance Pitfalls

- A Section 83b election is due within 30 days of stock purchase (if there is vesting) and failure to file can have severe negative tax consequences
- Customization drives cost both in setup and in diligence
- Qualified Small Business Stock (QSBS) status is important to many investors and once lost is gone forever
- Options must be priced at or above “Fair Market Value” (FMV)

Check your understanding: Founder/Employee

Which of the following are true?

A. A late 83(b) election can be corrected.

B. Employees must make at least minimum wage without considering equity compensation.

C. Many 1099 Contractors would be considered employees in the eyes of a court, particularly CA, if challenged.

D. An offer letter can lock in a stock option price even if the option is not issued until later.

IP Pitfalls

- PIIAs
  - Not having them
  - Failing to review excluded inventions
  - Not using “present” tense in PIIA (i.e. “will assign” instead of “hereby assign and agree to assign in the future…”)
- Lack of clarity over ownership (academic institution, non-exclusive licenses, former founders)
  - **Note**: this can include confusion over what gets automatically assigned upwards when dealing with subsidiaries conducting research on behalf of parents.
- Wrong entity listed on agreements (i.e. IP owned parent or subsidiary level improperly)
- Confidential Information Definitions
  - Requiring information be “marked as confidential” to be considered confidential
  - Only covering information disclosed after the date of the agreement if materials have already been sent
  - Not covering trade secrets if applicable

Regulatory Pitfalls

- Failing to make state regulatory filings (such as DE franchise tax)
- Failing to file Form D (and related blue-sky filings) when raising capital (**<u>Note</u>**: the SEC has begun imposing penalties on late Form Ds for the first time, so this should be of increased importance)
- Failing to check if states where employees reside require equity incentive plans to be filed before options are issued

Questions?

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