

**Morgan Lewis**

# **THE LIFE SCIENCES GROWTH SERIES**

**Making a Clean Start: Avoiding Common Legal  
Mistakes Made by Life Science Entrepreneurs**

**Scott D. Karchmer | October 16, 2018**

# 1. Make a Clean Break from your Employer

- Avoid disputes with your employer on intellectual property, confidential information, non-solicitation and noncompete covenants
- Understand your obligations to your current and former employers
  - Review agreements and company policies
    - Non-solicitation covenants
    - Noncompete covenants
    - Confidentiality and use of information obligations
    - Invention ownership promises
    - Moonlighting policies
- When and how to leave your employer
  - Timing of departure from employer
  - Moonlighting
  - Take nothing, use nothing
  - Abide by non-solicitation obligations

# 1. Make a Clean Break from your Employer (Cont.)

- Special Consideration for Professors and University Employees for Spin-Outs
  - Understand the university process
    - Licensing office will have process by which it makes intellectual property available
    - Limitations on involvement of professors in negotiations and spin-out company
    - Disclosure requirements for professors about equity and any other compensation received

## 2. Choose Your Form of Entity Wisely

- Choice of entity and tax treatment
  - Primary tax choices – C corporation, S corporation or Limited Liability Company
  - Jurisdiction of formation – Delaware vs. others jurisdiction
- Default for an Emerging Growth Life Science Company – Delaware C corporation
  - On occasion other choices are appropriate – but it is a fact specific analysis.
  - International structures present special challenges for start-ups

## 3. Incorporate Early

- Incorporating sooner rather than later to avoid several potential pitfalls
  - Entity provides liability protection
  - Avoid clouds on title to intellectual property
    - Creates a vehicle to hold intellectual property, including business plan
    - Intellectual property created by a founder prior to incorporation is owned by founder. This technology and intellectual property will need to be manually transferred to the company
    - Departure or separation with a co-founder will create a cloud on the title to the intellectual property unless a transfer of the intellectual property can be negotiated
  - Opportunity to specify in writing the arrangement among founders (see Item 4)
    - Failure to specify before a departure can lead to disputes
  - Avoid tax issues relating to issuance of stock to the founders
    - Issuance of stock to founders close in time to the initial financing creates risk of taxable income

## 4. Address the Founding Team Equity Issues Early

- Discuss and decide early on
  - Delicate discussion that does not get easier with passage of time
  - Information will never be perfect
  - Discussing roles and expectations is essential in order to navigate the intensity and stresses of the initial years
  - Equity awards should be reflection of these agreed upon roles and expectations
- Vesting
  - Investors will require it
  - Founders should require it
    - Early days are filled with optimism and great expectations
    - But founders will depart
    - Vesting arrangement is the “pre-nup”. Protects the company and the founders who carry the business forward. Replacement for founder will require equity. Avoids the free rider effect

## 5. File Your 83b Election

- Failure to file leads to significant tax problems
- Founders stock subject to vesting is subject to “a risk of forfeiture”. Upon lapse of risk of forfeiture, tax is imposed on spread between price paid (nominal) and fair market value at the time of lapse
- Must be filed within 30 days of issuance
- Need to retain proof of filing of election
- Provide a copy to the company

## 6. Own and Protect the Assets of the Business

- The entity is the vessel in which all of the intellectual property (ownership or right to use) must reside
  - Intellectual property created by founders prior to incorporation must be transferred to the entity, usually in exchange for issuance of founder stock
  - Employees (including founders) must sign customary proprietary information and invention assignment agreements (PIAAs)
    - Adopt a good process for obtaining PIAAs from all employees
      - Condition to start work
      - Review all exceptions taken for existing inventions
  - Consultants and advisors must enter into appropriate written agreements that specifically address ownership of intellectual property created by consultants or advisors on behalf of the company



## 6. Own and Protect the Assets of the Business (Cont.)

- Engage patent counsel early to commence analyzing effective patent strategy (on an out-of-pocket cost, value to investors and value to business basis)
- Obtain confidentiality agreements before disclosure of inventions and trade secrets
  - Necessary to protect your ability to enforce trade secrets and the patentability of an invention
  - If venture capital firm or other investor is unwilling to sign confidentiality agreement, then adjust your disclosure and timing of disclosure

# 7. Comply with Employment Laws and Related Tax Laws

- Avoid misclassifying your employees
  - Employee vs. consultant
    - Substance governs
    - Classifying an employee as a consultant leads to tax exposures for the company for failure to withhold
  - California and certain other states have requirements governing hourly vs. salaried employees
- Deferring cash compensation is complicated
  - Deferred compensation rules apply (409a)
  - Minimum wage laws may apply

## 8. Raise Seed Capital without Creating Problems

- Sales of securities must comply with securities laws
  - Sales to non-accredited investors
- Balance size of raise, effort and costs
  - SAFEs and other seed financing instruments
- Burden of friends and family members as investors

## 9. Maintain Proper Documentation; Avoid Capitalization Errors

- Maintain basic legal records
  - Complete and retain organization records
    - Board minutes
    - Stockholder minutes
    - Stock records
    - Option records
  - Track and retain agreements (e.g., nondisclosure agreements, commercial agreements, consultant agreements, supplier agreements). Obtain signatures of all parties

## 9. Maintain Proper Documentation; Avoid Capitalization Errors (Cont.)

- Frequent Capitalization mistakes
  - Handshake deals often lead to disputes - reflect equity promises clearly in writing
  - Avoid promises for percentage of ownership – open to varying interpretations
  - Do not promise non-dilutable equity
  - Issuance of equity requires certain contemporaneous board/shareholder approvals

# 10. Hire an Experienced Start-Up Lawyer Early

## When?

- Once you are committed to launching the start-up
  - If you start making material investments of time and energy
- Before material intellectual property is created
- Before you start having serious discussions with investors

# 10. Hire an Experienced Start-Up Lawyer Early (Cont.)

## Why?

- There are a lot of traps for the unwary
- A very experienced entrepreneur will form 3-5 start-ups over a period of 10-15 years. An experienced lawyer and his team (associates and paralegals) will assist with the set-up of hundreds of emerging growth businesses
- An experienced lawyer knows the customary practices for start-ups as well as the underlying law which ranges from corporate to tax to intellectual property to employment law. This will allow them to help you set-up and launch your start-up with the appropriate balance between customary practice and customized to your facts and circumstances

# 10. Hire an Experienced Start-Up Lawyer Early (Cont.)

## How?

- Get referrals
  - Experience is critical
  - Local?
- Focus on maximizing the relationship
  - Leverage lawyers substantive knowledge and experience
  - Avoid using attorney for tasks that others can accomplish
- Understand the cost
  - Avoid doing too much too early
  - Focus on key issues, avoid subtle traps
- Work out appropriate fee arrangement
  - Deferrals
  - Estimates and fixed fee arrangements



# Biography



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Scott D. Karchmer counsels emerging and established companies in business transactions. Representing clients in the biotechnology, medical device, software, data analytics, and networking and storage industries, he advises companies at critical junctures in their lifecycles. Scott handles formation, raising funds from venture capitalists, initial public offerings, mergers and acquisitions (M&A), and other issues organizations confront. He also advises venture capital firms and other investors in connection with investments in private companies.

Counseling public companies on securities law, governance, and general corporate matters, Scott represents clients in capital markets transactions. He advises on private investments in public equity (PIPEs), registered direct offerings, convertible debt offerings, 144A offerings, and underwritten offerings.

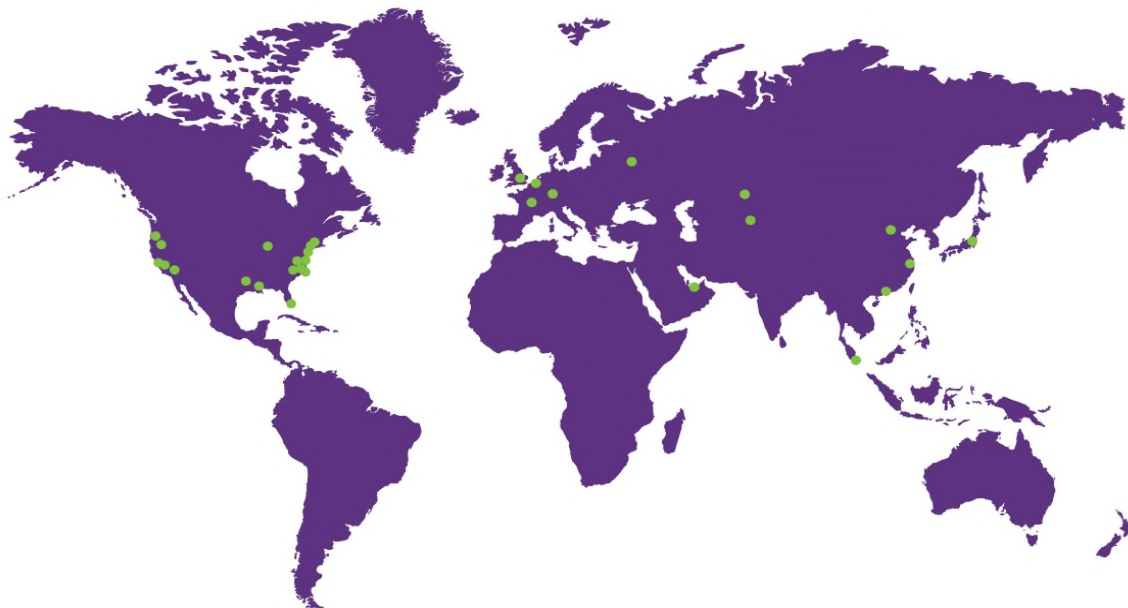


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