
# Get Up and Go – Navigating Startup Issues

Andrew M. Ray | Andrew M. Arthur | Maria F. Natera

# Biography


**Andrew M. Ray**
Washington, DC
andrew.ray@morganlewis.com
@AMRAYESQ


Andrew Ray represents public and private companies, financial sponsors, investors, including venture capital and private equity firms, entrepreneurs and management teams in cross-border mergers and acquisitions (M&A), financings, and growth equity transactions. He has transactional experience in a broad range of industries, including technology, financial services, government contracts, life sciences, real estate, energy and the not-for-profit sector. Various industry publications and credentialing organizations recognize Andy as a leader in both M&A and in technology, media, and communications law, among other fields. Andy currently serves as a leader of Morgan Lewis's financial technology (fintech) industry team, and he previously served as the leader of the firm's interdisciplinary corporate practice in Washington, DC.

# Biography

**Andrew M. Arthur**
Washington, DC
andrew.arthur@morganlewis.com
@AArthurESQ

Andrew Arthur represents public and private companies and institutional investors in a variety of corporate transactional matters, including mergers and acquisitions, commercial contracts, and corporate governance, across various industries including technology, telecommunications, and professional services companies. Andy began his career at Morgan Lewis with a focus on real estate transactions, where he helped clients with acquisitions, dispositions, and financing of properties across multiple asset classes. He leverages that experience to advise clients on real estate issues that arise in the course of corporate transactions.

# Biography

**Maria F. Natera**
Washington, DC
maria.natera@morganlewis.com

Maria Natera is part of a team of lawyers that advises clients in a variety of corporate transactional matters, including mergers and acquisitions, commercial contracts, and corporate governance across various industries. Maria advises clients ranging from Fortune 500 companies to emerging companies. She is fluent in Spanish.

# Key Considerations in the Formation Process

- **Selecting Professional Advisors**
- **Choice of Entity**
- **Founder Agreements and Corporate Governance**
- **Protecting Intellectual Property**
- **Contracts and Commercial Agreements**
- **Early Stage Financing**

# Selecting Professional Advisors

**LEGAL COUNSEL**

**ACCOUNTING AND FINANCIAL**

**OTHER ADVISORS AND ADVISORY BOARDS**

# Selecting the Appropriate Entity is Critical

| Consideration | C-Corporations | Limited Liability Company |
| --- | --- | --- |
| General | More regulated; well-developed case law and statutes | Flexible; case law less developed |
| Tax | Generally subject to two levels of tax on income (entity level & stockholder level) | At member-level only |
| Liability | Stockholder generally insulated from liability | Members and managers generally insulated from liability unless set forth in the Operating Agreement. |
| Management | Governed by a board of directors | Flexible |
| Fiduciary Duties | Directors and officers owe fiduciary duties | Default is that managers owe duty of care and loyalty |
| Expense | Lower | Higher |

# Founder Agreements and Corporate Governance

**1** **Determine Equity Ownership**

- Voting/Nonvoting Stock

**2** **Determine Vesting and Equity Terms**

- Restricted Stock and 83b Elections
- Voluntary Termination and Termination without Cause
- Repurchase Rights
- Termination with Cause

**3** **Board of Directors and Corporate Governance**

# Protecting Intellectual Property

- Proprietary Information and Inventions Agreements
- Non-Disclosure Agreements
- Consider Importance of Trademarks and Branding
- Develop Patent/Intellectual Property Strategy
    - Consult with Patent Counsel
    - Understand Patent Traps for the Unwary

# Contracts and Commercial Agreements

Website Terms and Conditions / Privacy Policy

Regulatory Matters and Compliance with Law

Form Customer Contract

Change of Control / Assignment Provisions

Consulting Agreements

# Common Legal Mistakes and How to Avoid Them

**Handle Founder Decisions Early.** Navigate choice of entity, equity split, governance and immigration considerations. Use vesting provisions and transfer restrictions to protect the equity issued. Execute founder agreements and stockholder agreements.

**Follow Corporate Formalities.** Understand tax implications and corporate law requirements. Keep good corporate records. Plan and prepare for regular board meeting to involve board members and advisors.

**Build Good Hygiene Habits.** Obtain, compile and store all signed documents. Keep track of amendments to agreements.

**Understand Regulatory Landscape.** Pay attention to employment, securities, corporate, tax, & other laws governing regulated industries and your business generally. Regulatory compliance will be important to investors, so know the answers.

**Choose Partners Carefully.** Be careful about bringing in outside investors too soon and not thinking about the right investors with proper view of company and its business strategy. Be optimistic, but do not over promise to investors.

**Avoid Showstoppers.** Eliminate or mitigate prior employer IP, confidential information or non-compete entanglements. Appropriately consider any applicable University IP policy and rights.

**Develop Your IP Strategy.** Obtain proper IP assignments from all who touch IP. Also consider IP protection strategy and options early. Implement IP protection options based on cost-benefit analysis, taking into account stage of venture, cash position, industry and relationship of IP to long-term success.

**Be Careful About Promising Equity.** Specify amounts, not percentages, when discussing equity. Be clear that all equity discussed will be subject to vesting and actual execution of grant documents. No napkins!

**Read and Understand Documents.** In the frantic world of growing a start-up, it is easy to gloss over documents. Read and understand the business implications of all documents, even if reviewed by counsel or other advisors.

**Pay Attention to Privacy, Data Protection and Cyber Security.** Privacy, cyber security and protecting customer data are critical issues and must be thought about in the context of your business.

# Early Stage Financing Considerations

| | |
|---|---|
| Term sheets | **Term sheets** are an essential part of any corporate financing transaction – whether angel or venture capital financing. |
| Key information includes: | – Amount to be Raised<br>– Minimum Amount Accepted<br>– Qualification of Investor<br>– Documentation of Investment<br>– Special rights of Investor<br>– Confidentiality<br>– Exclusivity<br>– Governing Law |

# Early Stage Financing Considerations

| | |
|---|---|
| Convertible Note | An interest bearing note that convertible into future equity in the company's next financing or upon the meeting of certain agreed upon terms (but if the terms are not met, it must be repaid in cash at the agreed upon maturity date). |
| Simple Agreement for Future Equity (SAFE) | An equity alternative to convertible debt instruments, generally considered equity but are not really either debt or equity. A SAFE will result in the issuance of shares at the next equity financing, if no equity financing occurs, typically no trigger for repayment or conversion results. |
| Preferred Equity | An equity instrument issued at a per share price determined based upon an agreed upon pre-money valuation of the company. Entitled to a liquidation preference, which may be participating or non-participating. Includes other rights negotiated among parties. |

# Key Characteristics of Convertible Debt

Debt, not equity, with stated maturity date

Interest will accrue on principal balance

Convertible into a "Qualified Financing" at a discount or price determined with reference to a valuation cap

Not subject to prepayment

May be voluntarily converted by an investor

# Early Stage Financing Considerations

## Advantages of Convertible Debt

- Allows company to defer establishing a valuation.
- Valuation cap is typically higher than what could be achieved in a priced round.
- Typically a faster (and also a less expensive) option to a more traditional equity investment.

## Areas of Concern

- Determining appropriate maturity date, valuation cap and discount rate.
- Company has a limited time frame before the note needs to be repaid; if the conversion event has not occurred at maturity, the investors could elect to renegotiate terms (rather than accelerate) but company is at a disadvantage in terms of negotiating leverage.

# Key Characteristics of SAFEs

Essentially works like a convertible note, but is never repayable and can be considered and be treated like equity.

A SAFE is not a debt instrument and largely considered to be equity.

A SAFE is treated like other convertible securities, i.e., warrants and options.

Converts to "SAFE preferred stock" when any amount is raised in a preferred equity round. Conversion is automatic and terminates the SAFE.

Allows for a discount to be applied to the future valuation associated with the preferred equity round.

# Early Stage Financing Considerations

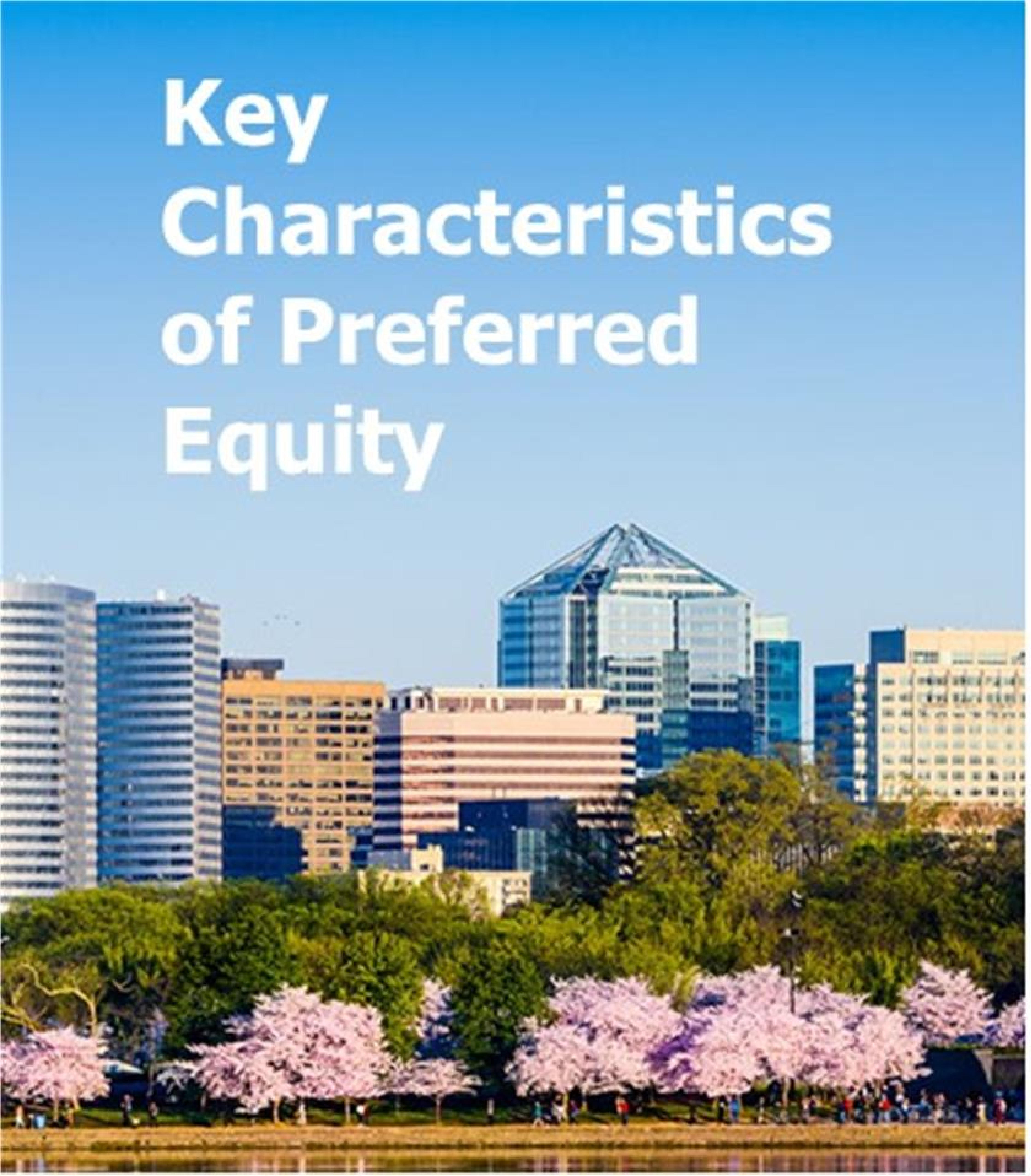
## Advantages of SAFEs for Company

- Not debt on balance sheet. No termination, maturity date or interest payments.
- No interest payments to investors, but the company can choose to make discretionary dividend payments.
- Also a faster (and also a less expensive) option to a more traditional equity investment

## Areas of Concern

- Generally, SAFEs are an advantageous way to raise early stage capital.
- Often, not as attractive to investors, so may be more difficult to raise additional capital with this instrument.

# Key Characteristics of Preferred Equity



**1** **Issued at a price based upon an agreed upon valuation.**

**2** **Entitled to a liquidation preference, participating or non-participating.**

**3** **Generally includes a variety of additional terms which must be negotiated**

- Board of Directors
- Protective Provisions
- Size of Equity Pool
- Information, Preemptive and Other Investor Rights
- Redemption Rights
- Drag-Along Rights
- Transfer Restrictions

# QUESTIONS?

## Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

## Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore*
Tokyo
Washington, DC
Wilmington

Morgan Lewis

# THANK YOU