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The United States

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There are many reasons that starting a company in the United States (US), especially a technology-based business, is a good idea. In global rankings of start-up ecosystems, the US is consistently ranked first for the breadth and depth of the resources available to entrepreneurs. It is also the home of many of the successful unicorns that are now globally known and the location of many experienced and well-funded investment vehicles.

The US legal framework that governs the formation, operation, taxation, capital structure, and possible dissolution of start-ups is comprehensive and sophisticated. Complying with all the applicable laws and regulations can be expensive and time-consuming, but the cost of not complying can result in the death of a start-up.

In the sections below, we have provided an overview of the laws that govern a start-up through its life cycle. First, we address issues that affect the legal formation of the business. Next, we lay out the legal considerations that come into play once a business is formed and operating. These legal requirements can impact how the business is run and managed.

A new business often needs outside sources of funding to grow, so we have delineated below the common forms of financings available to US start-ups and the legal considerations of each type. In a separate section, we describe the implications for the founders as well as the company of being subject to US tax laws.

The protection of intellectual property is an important concern for many start-ups. This area of law in the US is well developed, and we lay out the legal framework for patents, trade marks, copyrights, and trade secrets available in the US. In the last sections of this chapter we outline the law as it applies to operational liabilities, including compliance management,

and to the dissolution of a company if necessary. Finally, we go into some detail about the characteristics of the ecosystem already in place in the US that will support a business founded here.

A decision to start or move your business to the US should be made only after a thorough understanding of the costs and benefits of doing so. We have tried to lay out some of the factors you should consider by describing the legal infrastructure start-ups operate in when based here and the start-up ecosystem that flourishes in many parts of the US. Before a final decision is made, however, entrepreneurs should factor in the personal costs and benefits of living in the US as well.

7.1 Establishing a company

In this section, we will explore the advantages and disadvantages of various corporate structures in the US. But, before beginning our discussion, it is worth noting that there is no legal requirement to formally establish a company before starting a business. You do not need to formally create a company before you begin selling your service or product. In fact, the vast majority of businesses in the US operate informally as sole proprietorships.¹ These businesses, often known as sole traders outside the US, have no legal existence distinct from their owners.²

While it is cheaper and easier to begin operating as a sole proprietorship,³ there are several good reasons to create a distinct business entity. By choosing to incorporate, entrepreneurs reduce their personal liability, allow for outside investment, and signal their professionalism. Of these, the most important reason to incorporate is risk reduction. While sole proprietors are personally responsible for the debts and obligations of their businesses, a corporation provides limited liability to its owners. Incorporation also allows entrepreneurs to reduce the business risk by

¹ Scott Hodge, 'The U.S. Has More Individually Owned Businesses than Corporations' (*Tax Foundation*, 13 January 2014) <https://taxfoundation.org/us-has-more-individually-owned-businesses-corporations/> accessed 9 July 2019.

² See, e.g., *United Parcel Serv. of Am., Inc. v Net, Inc.* [2005] E.D.N.Y. 225 F.R.D. [416], [421]; *Providence Washington Ins. Co. v Valley Forge Ins. Co.* [1996] 42 Cal.App.4th [1194], [1202].

³ U.S. Small Business Administration, 'Sole Proprietorship' <https://www.sba.gov/content/sole-proprietorship> accessed 9 July 2019.

attracting outside capital. Serious investors will not invest in an unincorporated entity. In fact, most prefer to invest in a structure known as a C Corp for reasons we will discuss in Section 7.6.

7.1.1 Forms of business entities

There are many types of business forms entrepreneurs can choose from when forming a company in the US. In this section we will discuss sole proprietorships, general partnerships, limited partnerships, limited liability partnerships, closely held corporations, limited liability companies, and corporations. The choice of a particular business form will impact potential tax benefits, compliance and corporate governance requirements, and your operational flexibility. While it is helpful to anticipate future needs early on, it is always possible for a company's structure to evolve as it matures. Facebook, for example, began as a limited liability company (LLC) before converting to a C Corp.⁴ That being said, it is easier – and cheaper – to get it 'right' the first time, especially if outside investment is being sought.

7.1.1.1 *Sole proprietorship and general partnership*

The sole proprietorship and general partnership are the most basic business forms in the US. A sole proprietorship requires no formal formation process, is governed by basic contract and tort law, and is an unincorporated business. The debts and liability of the sole proprietorship and debts and liability of the owner are one and the same. There is also no personal protection from liability. The benefit of a sole proprietorship is pass-through taxation,⁵ so profits are not double taxed. However, if the business grows there is no formal way to divide the ownership interest, or 'equity', in the business.

A general partnership is the same as a sole proprietorship, except that it includes two or more owners. Unlike a sole proprietorship, a partnership

⁴ Nicholas Carlson, 'EXCLUSIVE: How Mark Zuckerberg Booted His Co-founder out of the Company' (*Business Insider*, 15 May 2012) <https://www.businessinsider.com/how-mark-zuckerberg-booted-his-co-founder-out-of-the-company-2012-5> accessed 9 July 2019.

⁵ As discussed in detail in Section 7.7.

can exist on its own separate from its founders.⁶ Forming a partnership can be written, oral, or implied. Notably, a partnership can be formed without intent as long as there are two or more people that have control as co-owners of a business and are sharing profits.

There are no formal requirements to set up a partnership, but there are 'default' rules that state what will apply in the absence of any formal partnership agreement. Some examples of the default rules include sharing profits and losses equally between partners, at-will dissolution, and equal right to control and management decisions, also known as actual authority. Partnerships can create agreements that supersede these default rules as long as they are clearly agreed to by the partners in a formal agreement.⁷

Additionally, partners have joint and several liability. This means that each partner is on the hook for the debts and obligations of the partnership. But creditors must exhaust partnership assets before going after individual partners. As such, it is important that entrepreneurs are aware of the general partnership laws in the US since a general partnership may be formed without intent, and by default the law recognizes each partner as having actual authority.⁸

For example, a scenario may arise in which Partner #1 finds herself in a position where Partner #2 makes a decision in the course of working with Partner #1 that makes Partner #1 liable for Partner #2's actions. This will be true even though Partner #1 may have been unaware of Partner #2's decision – or even unaware of the fact that Partner #1 and Partner #2 were partners in the first place since a formal agreement is not required.

7.1.1.2 *Limited partnership*

A limited partnership is very similar to a general partnership, with the exception that there is one general partner that is personally liable and any number of limited partners that have limited liability. This struc-

⁶ Constance Bagley and Craig Dauchy, *The Entrepreneur's Guide to Law and Strategy* (5th edn, Cengage Learning 2017) 63.

⁷ See generally, Revised Uniform Partnership Act (1997) (US).

⁸ *ibid.*

ture allows for passive investors, whose risk is limited to their capital investment.⁹

7.1.1.3 *Limited Liability Partnership (LLP)*

A Limited Liability Partnership, or 'LLP', follows the traditional formation requirements of a general partnership, with the caveat that an LLP must also formally register with the state and include 'LLP' or Limited Liability Partnership in the company name. The major benefit of an LLP as opposed to a general partnership is the fact that partners in an LLP are not personally liable 'solely by reason of being a partner'. Specifically, in LLPs only LLP assets are at risk, not personal assets. Often times, because of this limited liability and other tax and management flexibility, a general partnership will transition to an LLP.¹⁰ To accomplish this conversion, a unanimous vote of the partners is required.¹¹

7.1.1.4 *Closely held corporation*

A closely held corporation is a corporation that has a small number of shareholders, no ready market for the corporate stock, and a substantial majority of shareholders who participate in management, direction, and operations of the corporation.¹² Closely held corporations allow founders the benefit (protection) of a corporation but allow for the flexibility of a partnership. A closely held formation is not a 'formal' business type; rather it describes a scenario where a contract outlines agreed upon practices on how the company will be run. The agreement can practically eliminate the need for a board because the agreement predetermines how shareholders will vote on certain issues. Courts will often treat closely held corporation like partnerships.¹³

⁹ Bagley and Dauchy (n 6) 64.

¹⁰ Andrew Beattie, 'Limited Liability Partnership (LLP): The Basics' (*Investopedia*, 30 June 2019) <https://www.investopedia.com/articles/investing/090214/limited-liability-partnership-llp-basics.asp> accessed 9 July 2019.

¹¹ See Revised Uniform Partnership Act (1997) (US).

¹² *Managing Closely Held Corporations: A Legal Guidebook* (2003) 58 *Business Law* 1073, 1081.

¹³ F Hodge O'Neal and Robert B Thompson, *O'Neal and Thompson's Close Corporations and LLCs: Law and Practice* (3rd edn, Thomson Reuters 2004) § 8:5.

7.1.1.5 *Limited Liability Corporation (LLC)*

Similar to partnerships, Limited Liability Corporations, or ‘LLCs’, are not double taxed. There are two different types of LLCs. The first type is a ‘member managed’ LLC and the second type is a ‘manager managed’ LLC.

A ‘member managed’ LLC model is one in which each member is involved in management.¹⁴ This creates a mechanism in which decisions are made by a majority of the members. The default rule is that each member receives an equal vote. But, if desired, this can be changed in the Operating Agreement that lays out how the LLC will run. All members can be agents of the LLC to carry out decisions in the ordinary course of business that would not normally require a vote. The ‘member managed’ LLC is very similar to the general partnership model.¹⁵

In contrast, the ‘manager managed’ LLC model has more in common with the LLP model. In a ‘manager managed’ LLC, not all members of the LLC are designated as managers. Under this structure, the members are more passive owners, and the majority of decisions are made by the managers. Additionally, members are not automatically agents; only the managers can act as agents of the LLC.¹⁶ The driving force behind a ‘manager managed’ LLC is that the managers are usually designed to be the specialist involved in the day-to-day operations, and the members are acting as passive investors to the business. The ‘manager managed’ LLC model is similar to the corporate model we will talk about next.

An LLC’s existence begins when it files articles of incorporation with the secretary of the state in which it chooses to locate. The articles must include the basics such as the LLC name and address, and it must also designate whether the LLC is ‘member managed’ or ‘manager managed’. Additionally, almost all LLCs will create an Operating Agreement that governs the organization. All LLCs must provide the members access to records and copies of the Operating Agreement. The Operating Agreement can specify what type of corporate decisions require member approval.

¹⁴ James D Cox and Thomas Lee Hazen, *Treatise on the Law of Corporations* (3rd edn, Thomson Reuters 2018) § 1:11.

¹⁵ *ibid.*

¹⁶ *ibid.*

An LLC is an entity that is liable for its members' conduct. A member or manager is not personally liable for an obligation of the LLC just by virtue of their position as a member or manager.

7.1.1.6 Corporations

Generally speaking, corporations are uniquely suited to start-ups because they are great tools for assembling capital; there is a clear and efficient divide between labour/specialization and capital; there is limited liability for investors; and there is a way to limit the power of minority shareholders while avoiding exploitation by officers and directors.¹⁷

It is important to note that in the US, many, but not all, corporations are incorporated in Delaware. This is important because the 'internal affairs rule' says that all matters relating to the internal affairs of the company (i.e. the relation between officers, directors and shareholders) are governed by the state where it is incorporated.¹⁸ Delaware is traditionally the choice of incorporation because Delaware laws have historically been 'pro-management'. Additionally, Delaware laws are considered more predictable due to the Delaware Court of Chancery, which describes itself without modesty (yet accurately!) as 'the nation's preeminent forum for the determination of disputes involving the internal affairs of the thousands upon thousands of Delaware corporations and other business entities through which a vast amount of the world's commercial affairs is conducted'.¹⁹

Prior to incorporation, a 'promoter', who is usually the person creating the corporation, may sign an agreement with a 'subscriber', who is typically an investor or creditor, contingent on a completed incorporation. But anyone appearing to act on behalf of corporation before it is incorporated is jointly and severally liable for the agreement. In order to bind the corporation and release the promoter, parties may execute a novation, which is a three-party agreement where all three parties agree that the corporation is substituted for the promoter and becomes responsible for the terms

¹⁷ A corporation is managed by officers and directors. The directors act as a group, known as the board of directors, which is responsible for high level business and policy decisions. Officers are appointed by the board of directors and are responsible for the day-to-day decisions of the business.

¹⁸ *Fletcher Cyclopedia of the Law of Private Corporations* (Forgotten Books, 2018) § 4223.50.

¹⁹ 'Court of Chancery', Delaware <https://courts.delaware.gov/chancery/> accessed 9 July 2019.

of any contract entered by the promoter. As such, with a newly formed corporation it is important for directors to act fast to reject or adopt any contracts in order to accurately predict the corporation's liability.

Corporations can be structured as an S Corporation, or 'S Corp', or a C Corporation, better known as a 'C Corp'. The letters refer to separate sections of the federal tax code and reflect the different tax treatment afforded the two entities. S Corps are taxed similarly to a sole proprietorship or partnership.²⁰ The profits are 'passed through' to the shareholders and only taxed on their individual tax returns. This differs from a C Corp, which has its profits taxed and reported on a corporate tax return. Then, any after-tax profits that are distributed to the shareholders must be reported on their individual tax returns and taxed again. This is referred to as 'double taxation'.

All corporations begin as C Corps. To become an S Corp, you must file a form with the Internal Revenue Service electing to be a 'Small Business Corporation'. As the form name indicates, S Corps are more appropriate for small businesses. While you gain tax benefits, you lose organizational flexibility. Specifically, S Corps cannot have more than 100 shareholders, the shareholders must all be individuals, there must only be one class of stock, and there can be no shareholders who are not residents or citizens of the US.

A corporation's existence begins once an incorporator (usually a lawyer) files a Charter in the state of incorporation. It is important to note that different jurisdictions have different names for the Charter. For example, Delaware calls the Charter the Certificate of Incorporation, and California calls it the Articles of Incorporation.²¹

Generally, the Charter must include:

1. Name of Company;
2. Business Purpose (In Delaware, this can be very broad, e.g., 'any lawful business');
3. Registered office/agent (almost always a lawyer/3rd party);

²⁰ Bagley and Dauchy (n 6) 61.

²¹ 'How to Form a New Business Entity' (*Delaware.gov*) <https://corp.delaware.gov/howtoform/> accessed 9 July 2019 and 'Corporate Filing Tips' <https://www.sos.ca.gov/business-programs/business-entities/filing-tips/filing-tips-corp/> accessed 9 July 2019.

4. Name/address of incorporator;
5. Description of the different types of shares and number of authorized Shares; and
6. Capitalization of the company (usually a nominal par value but more than zero).

After the Charter is filed, there is usually an Action by Unanimous Written Consent of the Board that ratifies the Charter. The Unanimous Written Consent of the Board adopts the by-laws of the corporation (which are not filed publicly), sets the board size, elects the board officers, ratifies the prior actions by the sole incorporator, finalizes the sale of common stock to the founders, and determines other miscellaneous actions.

Practically speaking, the Unanimous Written Consent of the Board is designating the directors who immediately issue the initial stock to the stockholders and elect the officers. Typically, the directors, stockholders, and officers are all the same people when the company is first formed. The initial stock of the company may be given to the founders in consideration for transferring intellectual property ownership from the founder to the corporation. This transfer can be accomplished through an inventions assignment agreement.²²

Figure 7.1 shows two organizational charts that help to visualize the corporate structure during and after incorporation.

The company by-laws flesh out the operating procedures the company must follow. For example, the board size may be included in the by-law. Additionally, the by-laws may also include required notices prior to holding a meeting, thresholds to approve actions, appointment/removal of directors and officers, duties of officers, fiscal year schedule of the company, quorum requirements, and much more. For example, Delaware permits the by-laws to include any provision relating to the business of the corporation, its administrative affairs, or to the rights or powers reserved to the corporation, its stockholders, directors, officers, and employees, as long as it is consistent with the certificate of incorporation and state laws.²³ It is important to note that the provisions in the by-laws will be

²² Ryan Roberts, *Acceleration: What All Entrepreneurs Must Know about Startup Law* (Lioncrest Publishing 2019) 76.

²³ See Delaware General Corporation Law.

Figure 7.1 Corporate structure during and after incorporation

governed by state laws from the state of incorporation. As such, there are many provisions that must be included in the by-laws in order to satisfy state law.

Quorum sets out the minimum number of voters that must be present in order to consider an action. For example, assume there are five people on the board and a provision that says majority quorum is required. In order to satisfy quorum, there must be three people present to hold a vote. Furthermore, if the action that is being voted on requires majority approval, then only two votes would be needed to bind the entire board.

A voting agreement is separate from the by-laws and the Charter. Unlike the Charter, a voting agreement is not public and is in the form of a contract. The voting agreement highlights terms that are so fundamental that they are negotiated and agreed upon before purchasing stock. A voting agreement includes pre-negotiated terms between shareholders that provides more predictability for things like approving a merger, amending the Charter, or adding additional board seats. For example, a voting agreement may include provisions that predetermine how shareholders must vote for board seats or outline what stockholders vote for a specific board seats.

Additionally, voting provisions may include 'drag along' provisions. Drag along provisions are an increasingly common component, as investors view them as a way to ensure a clean exit. A drag along provision is a predetermined agreement that forces shareholders to affirmatively vote for a provision in the event of a 'trigger'. Usually a 'trigger' is in the form of approval from preferred stockholders, the board, and sometimes the common stockholders. If the drag along provision is approved, then other stockholders must approve the transaction. Drag along provisions are sometimes necessary because if a small number of shareholders dissent to a deal, then it may slow down the entire process and increase costs. A drag along provision makes sure everyone is in agreement and prevents minority shareholder action.

The voting provisions may also include a 'tag along' provision, which has the opposite effect of a drag along provision. Tag along provisions are intended to protect the interests of minority stockholders. When a majority stockholder sells shares to a third party without giving notice to other stockholders, a tag along provision will enable the minority stockholder to

tag along with the majority stockholder and sell their shares for the same price and on the same terms and conditions.

Founders should look for any drag along or tag along provisions and be prepared to negotiate their terms. In situations where the founder is a majority shareholder, a drag along provision can be useful to avoid obstruction by minority shareholders. Of course, the opposite is true when the founder has been relegated to being a minority shareholder. In that case, the founder might want to avoid drag along provisions and include tag along provisions.

7.1.2 Vesting

As mentioned in the previous section, when a corporation is formed, the founders may receive equity in the corporation in consideration for transferring intellectual property ownership to the company. The details of this agreement are outlined in a Stock Purchase Agreement. The agreement contains details on what the founder must do for all the shares to fully vest. The agreement also usually includes language around if and how a shareholder can sell or transfer shares to another party.

The idea behind vesting is to incentivize founders to keep working for the company. Initially, the intellectual property is purchased for a near nominal amount, usually fractions of pennies per share. (Note that, for reasons discussed in Section 7.7, it is important for the founder to *immediately* file an 83(b)-election recognizing the sale for tax purposes.) Once the sale is complete, the founder's shares are placed in escrow with the company retaining the right to repurchase the stock at a price equal to the initial consideration amount. A schedule included in the Stock Purchase Agreement outlines when the stock will be released from escrow and given to the founder, at which point the company loses the right to repurchase the shares. Vesting refers to the moment shares are released from escrow and the company no longer has the right to purchase them from the founder.

Vesting schedules are not uniform and differ depending on what is included in the Stock Purchase Agreement. Usually a founder will receive an initial chunk of shares (called a cliff) after one year, and the remaining shares will be released from escrow (vest) over an agreed amount of time (usually four years). Shares may vest monthly, weekly, quarterly,

bi-annually, or annually depending on what is agreed upon in the Stock Purchase Agreement.

The Stock Purchase Agreement outlines all the scenarios in which the company has a right to repurchase the founder's shares from escrow. Usually, Stock Purchase Agreements include a Lapse of Repurchase Right, or 'Acceleration' section that protects the founder by forcing all or some of the founder shares to immediately vest in response to a qualifying event. For example, the company may lose the right to repurchase all or a percentage of the founder's remaining shares in the event the company is purchased, or the founder is involuntarily terminated.

It is important to note that many investors recognize founders as one of the company's most important assets when they are looking to invest in companies. Often times, investors will invest in a company contingent on a founder(s) resetting their vesting schedule. Resetting a vesting schedule means that a founder will have to keep their shares in escrow for a longer amount of time, creating a financial incentive for the founder to continue working with the company so they do not lose their shares.

7.1.3 Types of shares

There are two main categories of stock, common and preferred stock. The rights associated with common stock are based on state statutes. For example, in Delaware, one share of common stock is associated with one vote.²⁴ The rights associated with preferred stock are not based on state statutes and are included in the Charter instead.

There are multiple ways to structure preferred stock to give different stockholders different rights. It is also important to note that there can be multiple classes of preferred stock for the same company with each class having different associated rights. For example, Class A Preferred Stock could have vastly different rights to Class B Preferred Stock.

Some companies set up special shares of preferred stock that are entitled to a dividend payout. In this case, the Charter would highlight things like the dividend amount, who approves the dividend payment if approval is needed, how often the dividend payment is issued, and in what form.

²⁴ Delaware Code, Title 8, § 212.

A liquidation preference highlights what happens in the event of an exit. There are generally two different ways to structure a liquidation preference. One option is to have all the outstanding stock convert to common stock, at which point each common stock holder is paid a percentage of the sale consideration equal to the percentage of outstanding common stock. A second option is to associate a liquidation preference for one or more classes of stock. Usually preferred stockholders will have the option to choose the liquidation preference that is most economical for them.

A liquidation preference usually means that in the event of a sale the shares with a liquidation preference are *first* entitled to a return equal to the initial amount of the purchase price of the share(s). Once the liquidation preference has been paid, the remaining consideration is divided among the remaining common + preferred stockholders proportional to the amount of all the outstanding preferred + common stock. Usually, in this scenario preferred stockholders who have a liquidation preference will have a cap placed on their return, typically in the range of 3x–5x.

The Charter determines the ratio by which preferred stock may convert to common stock (i.e. one preferred stock may equal five common stock). This is known as the ‘conversion ratio’. Additionally, the Charter lays out if and what is required in terms of obtaining approval to convert from preferred stock to common stock. There may also be laid out qualifying events, where preferred stock automatically splits to common stock such as an initial public offering (IPO).

Some classes of shares may have protections built in to protect the shares from being diluted in the event of later ‘down round’ investment that would allow a later investor to purchase more shares at a cheaper price. These are known as ‘dilutive issuances’. For example, a ‘down round’ may automatically trigger an earlier class of stock to convert automatically into more shares based on the price of the same or similar shares purchased during the ‘down round’.

7.1.4 Protection of minority shareholders

There can be instances where minority shareholders become diluted by other shareholders with greater shares and more voting power. However, there are ways to protect minority shareholders. For example, a Charter can set up a cumulative voting structure as opposed to a straight voting

structure. In the instance of electing directors, a straight-line voting structure allows each shareholder to vote once for every director equivalent to the number of shares they own. Imagine a scenario where five board members are concurrently up for election and shareholder 'A' has 600 shares and shareholder 'B' has 500 shares. Using straight voting, shareholder A can vote 600 times for each of the five board members and will always be able to suppress shareholder B's 500 votes. Alternatively, cumulative voting allows shareholders to pool all of their votes together so shareholder B would have 500 votes times five directors for a total of 2,500 votes that do not need to be distributed across all the board seats. As such, Shareholder B can cast all of his votes for one board member (and not vote at all for the other board seats) and will usually end up with one board seat.

The Charter and voting agreements can also be structured to protect minority shareholders. The Charter could create a specific class of stock that is only held by a minority of the shareholders but has more powerful voting rights. Additionally, a voting agreement could explicitly specify what class of stock votes for which board, which could allow a minority investor to still have representation in the board selection process. For example, imagine a situation where preferred shareholders may have majority control of a company in terms of outstanding stock. The Charter or voting agreement could specify that one remaining board seat is to be voted on exclusively by the outstanding common stockholders.

7.2 Future debt/equity considerations

Once formed, companies can raise capital in numerous ways. At the core of any fundraising round, however, the company is either taking on debt or selling equity. Debt is a fixed claim that must be paid back over time. Equity is an ownership interest in the company. When trying to raise capital, entrepreneurs will want to consider what option is best for them.

In the early stages, many entrepreneurs may not be able to raise much capital in the form of debt because lenders look to revenue to guarantee a return on the loan and young companies usually have little to no revenue. As such, many young companies consider selling equity for cash as a way to finance operations early on.

Interest paid on debt is a tax-deductible expense. It is important, however, to note the difference between equity and debt. If it is clear an agreement is classified as debt just to avoid dividend tax, then debt may be classified as equity. This can happen, for example, if the corporation does not attempt to communicate to a stockholder that interest will not be paid on time. Interest is the borrowing cost incurred by the company during a certain period against the funds borrowed by it from the lender, whereas, dividend refers to the portion of profit which is distributed to the shareholders of the company as the reward for their investment in the company.

As will be discussed in Section 7.6, there are different approaches companies can take to help fund their business such as angel investing, crowdfunding, 'Simple Agreements for Future Equity', or 'SAFEs', Convertible Notes, and Series A financing.

7.3 Running a business

Once a company has formed, it can turn its focus to running and growing its business. This section focuses on building a team to help the new company succeed. At the top, the company will be managed by a board of directors who are responsible for all corporate powers. The board is responsible for selecting the officers who will be entrusted with managing the day-to-day operations of the company. The directors, in turn, are typically responsible for hiring employees and independent contractors as the company grows.

7.3.1 Corporate governance

Corporate governance is the set of rules that govern a corporation. Generally, directors and officers owe a special duty, called a fiduciary duty, to the corporation and the shareholders.²⁵ Because of their fiduciary duties, directors and officers must act in good faith and with loyalty to the corporation and its shareholders. This means they must always put the interests of the corporation and its shareholders before their own interests.

²⁵ *Fletcher* (n 18) § 837.50.

7.3.2 Management body and board of directors

All corporate power ultimately lies with the board of directors. The board can delegate but never surrender power to others. It does so, for instance, when hiring officers to run the company. At first, when a company is in start-up phase, the board and the employees of the company may be one and the same. As a company matures, board members may no longer partake in the 'day-to-day' operations of the company, and instead the board will leverage specialists and officers of the company to help them make informed decisions. Initially, the board will likely consist of the founders of the company, but as a company receives money from outside investors, the company will sometimes create additional board seats to allow the outside investors representation on the board. In making decisions for the company, the directors owe a fiduciary duty to the company.

There is no dilution of this fiduciary duty even when an outside investor sitting on the board 'holds dual or multiple' fiduciary obligations.²⁶ Such a conflict of interest can arise when an investor has a separate fiduciary duty to a partnership or venture fund that made an investment in the company. In such a case, the long-term best interests of the company can conflict with the desire of the venture fund to maximize its rate of return through an early exit. In Delaware, there is no safe harbour for such divided loyalties and the director must still act in the best interest of the company and its common stockholders.²⁷

Ideally, board members are individuals who have diverse experiences and skills that can help the company make informed decisions. Initially, the board typically consists of individuals who have a close interest in seeing the company succeed, including the founders and early investors. But it is important to note that as companies mature, investors are also interested in having 'independent' board members that are selected because of a 'unique skill' they bring to the company outside of a personal financial interest in seeing the company succeed. Recently, California passed a law that requires publicly traded companies to maintain a diverse board with two female directors if the company has five directors and three

²⁶ *Weinberger v UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

²⁷ *LC Capital Master Fund, Ltd. v James*, 990 A.2d 435, 452 (Del. Ch. 2010).

women if the company has six or more directors.²⁸ It is customary for board members to be compensated in company stock or equity in the company.

There are many different ways to structure the selection of board members. The directors are generally elected by the shareholders. However, there may be situations where board members are appointed or given a seat by agreement between the company and investors. Sometimes, an investor will ask for a board seat as a condition to making an investment in the company. This can be done by creating a class of shares that vote exclusively for a specific board seat. As an example, one board seat might be voted on exclusively by the holders of Series A Preferred shares. If the Series A investment corresponds heavily with a specific investor, then that investor could have a majority of votes for that board seat.

7.3.2.1 *Officers*

Officers are agents of the corporation and, like the board of directors, have a fiduciary duty to the corporation and its shareholders. Officers are usually the face of the organization and have been delegated corporate powers by the board of directors. There can be many different officers working for the company and are commonly referred to by an alphabet soup of acronyms: CEO (Chief Executive Officer); CTO (Chief Technical Officer); CFO (Chief Financial Officer); COO (Chief Operating Officer); CMO (Chief Marketing Officer); etc. Officers report directly to the board of directors.

7.3.2.2 *Duties and liabilities*

As mentioned above, directors and officers owe a fiduciary duty to the organization and its shareholders. This fiduciary duty of the board is usually broken into the duty of care and the duty of loyalty.

The duty of care imparts an obligation to make reasonable business decisions in the best interest of the company and its shareholders. Whether a decision is 'a reasonable business decision' is based on whether a direc-

²⁸ 2017 California Senate Bill No. 826, California 2017-2018 Regular Session; see also Cydney Posner, 'California's Board Gender Diversity Mandate: Will It Matter?' (Cooley, 4 April 2019) <https://cooleypubco.com/2019/04/04/californias-board-gender-diversity-mandate/> accessed 9 July 2019.

tor's actions falls within the bounds of the 'business judgement rule'. This rule gives deference to decisions of directors and officers but sets a minimum requirement that they must be informed and have a reasonable process for decision making. The decision must be made in good faith but does not have to meet some objective standard of 'good' or 'correct'. In other words, courts will not substitute their own notions of what might constitute sound business judgement for the decisions made by the directors and officers.

In a well-known case that highlights the deference and flexibility of the business judgement rule, the shareholders of the Chicago Cubs, a professional baseball club, were upset that they were losing out on revenue based on the fact that the directors refused to install lights in the stadium to host night games.²⁹ The court held that as long as the directors had 'a valid business reason' for their decision then the court would not get involved. Here, even though night games may have resulted in more revenue, the directors were concerned about the impact those games would have on the neighbourhood and also the fact that they believed baseball was meant to be played during the day. The court held that those were valid business reasons under the 'business judgement' standard of review.

Directors and officers also have a duty to monitor the activities of the company. This duty requires a vigilant corporate compliance structure. It is not enough to begin monitoring only after something occurs that puts the directors and officers on suspicion that something is wrong. The duty to monitor is also breached when they have either 'utterly failed to implement any reporting or information system or controls', or 'having implemented such a system or controls, consciously failed to monitor or oversee its operations'.³⁰ In the wake of several accounting scandals in the US around the turn of the millennia, federal legislation known as Sarbanes-Oxley³¹ now requires publicly traded companies to implement monitoring systems. These require compliance protocols including independent audit oversight and protection for whistle-blowers in order to protect the interest of the shareholders.

²⁹ *Shlensky v Wrigley*, 95 Ill. App. 2d 173 (Ill. App. Ct. 1st Dist. 1968).

³⁰ *Stone ex rel. AmSouth Bancorporation v Ritter*, 911 A.2d 362, 370 (Del. 2006).

³¹ Sarbanes-Oxley Act of 2002, 116 Stat. 745.

Directors and officers also have a duty of loyalty and good faith. The duty of loyalty is the most rigid of all the fiduciary duties and does not have the deference and flexibility of the business judgement rule. Board members and officers must place the interest of the corporation and its shareholders before any personal interest. The duty of loyalty usually arises when a director or officer is faced with a conflict of interest. Examples of conflicts may include self-dealing and competing with the corporation, taking corporate opportunities for personal gain, and setting one's own compensation. If a potential conflict of interest arises, a director or officer must inform the board. For example, in 2016, David Drummond stepped down from Uber's board of directors because he was also serving as Alphabet's Chief Legal Officer. The conflict arose because the two tech behemoths had begun competing in the self-driving vehicle space.³² However, the board may choose to sanitize the conflict in the event that the board determines a transaction is fair even though a conflict exists. In the event a conflict is not disclosed to the board, a court may allow a conflict of interest transaction to stand if it is 'fair to the corporation'.

7.4 Employee considerations

When running a start-up, it is difficult to compete with established companies for talented employees. A start-up with limited resources typically cannot pay market rate salaries to its employees. Instead, to incentivize its employees, a start-up can offer equity as compensation. Equity is an ownership stake in the company.

7.4.1 Employee equity compensation

Stock options are equity compensation that are designed to attract and incentivize non-founder employees. A stock option plan allows employees to buy stock in the future at an agreed upon price per share, called the 'strike' price. Unlike the restricted stock issued to founders, the shares are not actually issued until the option is exercised. In other words, the option

³² Johanna Bhuiyan, 'Alphabet's David Drummond Has Left Uber's Board over Conflict of Interest on Self-driving Cars' (*Vox*, 29 August 2016) <https://www.vox.com/2016/8/29/12701626/uber-google-david-drummond-steps-down> accessed 13 November 2019.

holder does not vote, receive any dividends, or have any other rights of a shareholder prior to exercise.

For tax reasons, the strike price should be set at the fair market value of the shares on the day the option is granted. If the stock price goes up, then the employee can purchase the share at the strike price but receive a share with a higher value. For example, if the fair market value of a share is \$0.10 when granted and then the employee sells the share for \$1.00, the employee will make \$0.90 per share. This profit is referred to as the 'spread'.

Stock options are usually subject to a vesting period. Unlike founders' stock, where the company loses the right to repurchase shares held in escrow, here employees gain the right to purchase shares from the 'option pool'. However, the practical effect is the same: equity is earned over time.

7.4.2 Independent contractor vs. employee

There is a distinction in employment laws in the US between employees and independent contractors. Employees have their activities at work substantially controlled by the firm. Contractors are operating their own independent businesses and happen to have the firm as a client of their business; their relationship with the firm is more similar to that of a vendor with their client than an employee with their boss. Examples include freelancers, consultants, and third-party contractors. These independent contractors have more control over their own schedule and the manner in which they complete their work.

An employee is a person who is subject to the control and direction of the principal, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished. An independent contractor is a person who contracts with a principal but is not controlled by the principal nor subject to the principal's control with respect to his physical conduct. The difference between an employee and independent contractor is not always clear or obvious.

An employee is an agent to the principal, and thus the principal is responsible for the torts of the employee. Employees are subject to the Fair Labor

Standards Act (FLSA),³³ and as such, non-exempt (hourly) employees must be paid overtime (time-and-a-half) for every additional hour over 40 that is worked in one week. Exempt employees (employees who are paid a salary as opposed to an hourly rate) are not entitled to overtime for every additional hour over 40 that is worked in one week. For an employee, a company (as the employer) is required to submit withholding taxes and to pay one half of employee taxes (such as Medicare, social security and unemployment tax). Employees are entitled to any benefits offered by the company such as a pension plan, insurance, and paid time off.

An independent contractor is not an agent to the principal, and thus the principal is not (usually) responsible for independent contractors torts. Independent contractors are not subject to FLSA, and as such no overtime wage is required. A company is not required to pay any taxes on behalf of an independent contractor, and it is the full responsibility of the independent contractor to pay 100 per cent of his taxes to the Internal Revenue Service (IRS). Independent contractors are not entitled to any benefits through the company.

Often times, companies/employers prefer to hire independent contractors as a way to limit potential liability and reduce expenses from paying additional employee taxes, benefits, and overtime. Some individuals also prefer to be independent contractors so they can control the amount of tax that is withheld from each pay cheque. As such, companies may *label* a worker as an independent contractor when in reality the only difference between someone being an employee and a contractor is the label. Classifying an employee as an independent contractor with no reasonable basis for doing so may make an employer liable for employment taxes and potentially other obligations and liabilities.

The difference between an employee and contractor is not always clear, and in fact can be very confusing. When deciding if someone is an employee or a contractor, intent does not matter. As such, a company may face sanctions for not complying with the federal labour or tax rules even if the individual is labelled an independent contractor. The IRS lists a number of factors to consider when determining if someone is an employee or contractor such as behavioural control, financial control,

³³ Fair Labor Standards Act of 1938, § 1 et seq., 29 U.S.C.A. § 201 et seq.

and relationship.³⁴ Also, in some states, including California, employers are subject to a penalty if they misclassify employees as independent contractors.

When an employee is under contract the employee cannot be fired or quit until the term of the employment ends (unless both parties mutually agree to split). However, when an employee is 'at-will' they can be fired or quit at any time. Different states may have stronger laws about when employees can be laid off even for an 'at-will' term. For example, it is more difficult to lay someone off in California without cause. California courts have carved out an exception to the general rule of at-will employment for instances in which an implied contract has arisen.³⁵ An implied contract need not be memorialized in writing to be legally binding. If an implied contract is found to exist, courts can find that the job was supposed to last for a certain term or that the employee would not be fired without good cause.

To reduce liability, many companies offer severance agreements to departing employees. A severance agreement exists between an employee and a company and releases the company from any potential future liability in return for an agreed upon amount of consideration. A severance agreement may also include a 'non-compete' clause if allowed in the state. In California, however, non-compete agreements are not allowed.³⁶

Start-up companies should be aware of legislation such as the Family and Medical Leave Act (FMLA),³⁷ FLSA,³⁸ Americans with Disabilities Act (ADA),³⁹ National Labor Relations Act (NLRA)⁴⁰ and Title VII of the Civil Rights Act.⁴¹ The FMLA entitles eligible employees of covered employers

³⁴ 'Understanding Employee vs. Contractor Designation' (IRS, 20 July 2017) <https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation> accessed 9 July 2019.

³⁵ An implied contract is an agreement that was not memorialized in writing but that nonetheless is legally binding. In employment cases, courts will often find that an implied contract existed between an employer and an employee that the job would last for a certain term, or that the employee would not be fired without good cause.

³⁶ Cal. Bus. & Prof. Code § 16600.

³⁷ Family and Medical Leave Act of 1993.

³⁸ Fair Labor Standards Act of 1938.

³⁹ Americans with Disabilities Act of 1990.

⁴⁰ National Labor Relations Act of 1935.

⁴¹ Title VII of the Civil Rights Act of 1964.

to take unpaid, job-protected leave for family and medical reasons such as child birth. The ADA prohibits discrimination against people with disabilities and requires companies to make reasonable accommodations to perform essential job functions. The FLSA establishes standards such as minimum wages, overtime pay, and child labour standards for full time and part time employees (as opposed to independent contractors). Finally, the NLRA protects employees by allowing them to join unions and speak out about working conditions.

7.5 Foreseeing the unforeseeable

When trying to prepare for unforeseen circumstances, a shareholder agreement is a very important tool. It can add predictability and clarity to many unforeseen circumstances. For example, a shareholder agreement may include who a shareholder can sell their shares to, what happens if a shareholder sells their shares without getting the proper approval, what happens if a shareholder gets divorced, and what happens if a shareholder dies.

A shareholder agreement may require shareholders to take action in the event of a ‘trigger’. For example, a shareholder agreement may include a trigger that requires all remaining shareholders to buy the outstanding shares of a deceased shareholder. This is common in closely held corporations because there may not be a market interested in purchasing the shares of the deceased shareholder. In closely held corporations the shareholder agreement will commonly provide an agreed upon price per share or formula that will be used to determine the price per share. Some shareholder agreements may even require each shareholder to take out a life insurance policy for the other shareholder(s) to ensure there will be capital to pay the value of the outstanding shares to the estate of the deceased.

A prenuptial agreement is an agreement made before marriage that outlines what should happen to assets in the event a marriage fails. It is important to consider what would happen to any assets that are acquired after marriage. With no prenuptial agreement in place, the assets will be divided pursuant to the laws of the jurisdiction where the couple lives. For example, in California any shares issued after marriage are presumed

to be owned equally between spouses. As such, it may be wise to consider how the ownership and control of a company may be affected in the event of a divorce. Including a 'trigger' in a shareholder agreement may help add predictability in the event of a divorce.

A will outlines what happens to assets after death. It is important to plan how assets might be allocated in the event of someone's death and how ownership and control of a company might be affected depending on how assets are divided. As mentioned earlier, a shareholder agreement can add clarity around what happens in the event of a death by creating a 'trigger' that requires the remaining shareholders to pay the estate of the deceased the agreed upon value of the deceased outstanding shares.

When shares are not split evenly the majority shareholders can essentially control all of the corporation while minority shareholders have no control. Oppression is most noteworthy in closely held corporations where there are a small number of shareholders, no ready market for the corporate stock, and a substantial majority of shareholders who participate in management, direction, and operations of the corporation.

Some courts have held that in closely held corporations the majority shareholders owe minority shareholders a fiduciary duty.⁴² Other courts have held that the majority shareholders must demonstrate a legitimate business interest for their actions to show they are not purposefully trying to oppress minority shareholders.⁴³ In the event the majority shareholders are able to show a majority business interest, the minority shareholders have the option to demonstrate that there was a less oppressive option.

Generally, board members cannot agree in advance as to how they will carry out the position of a board member because it may force a director into a position to choose between adhering to a contract and acting in the best interest of the corporation. However, in closely held corporations where the court treats the corporation like a partnership, courts *may* allow agreements to dictate a director's actions. Courts have recognized that in closed corporations it is often crucial to have an agreement in place for board members so the company can leverage the benefits of the corporate

⁴² *Donahue v Rodd Electrotpe Co.* (MA 1975).

⁴³ *Wilkes v Springside Nursing Home Inc.* (MA 1976).

structure but also operate with the flexibility of a partnership if there are only a small number of shareholders in the corporation.⁴⁴

Sometimes there are foreseeable situations where one or two minority dissenters may have the power to prevent a deal from going through. Sometimes a minority shareholder(s) may act strategically and oppose a transaction to make their vote 'more influential'. As such, a drag along provision may be included in a voting agreement that usually applies to Mergers and Acquisitions (M&A) transactions and sometimes rounds of financing. A drag along provision lays out predictable scenarios ('triggers') that require a specific approval of voters (usually preferred stockholders plus the board and sometimes the common stockholders). Once the required approval is met then those being 'dragged' (the remaining dissenting stockholders) must sign the M&A docs and agree not to seek appraisal rights, etc.

Companies may indemnify (reduce personal liability and risks) the board of directors. This is typically included in the articles of incorporation or by-laws. Usually it takes approval from other members of the board to indemnify (it is not an automatic right). For example, a board member may get sued because of a 'risky' decision, but the other board members may vote to indemnify the board member(s) because they believe it was the right/necessary decision at the time. As such, the company would pay for the legal fees and judgment if necessary. Typically, a corporation will also carry liability insurance for directors and officers. These insurance policies usually apply only to acts of negligence, not criminal acts.

7.6 Financing

To successfully scale, a company needs capital to build its team, improve its product, and increase the reach of its marketing. For this reason, many start-up founders spend their early days worrying about raising money. Instead of concentrating on their core product or service, they fixate on building the perfect pitch deck to attract venture capital (VC). But before

⁴⁴ See, e.g., *Galler v Galler* 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (allowing a closed corporation with a 50/50 share split to make an agreement on how each director would vote in the event the other director died).

spending too much time refining a pitch based on what a VC firm might want to hear, it can be helpful to consider other funding options. VC is often not easily accessible nor the best fit for most companies. Other alternatives in the US include bank and government loans, crowdfunding, and angel investing.

While banks usually offer competitive terms and interest rates, it can be difficult to receive a loan for an early stage start-up company that lacks appreciable assets or demonstrated revenue. Often, to overcome these hurdles, a founder will need to personally guarantee a bank loan. This means the founder will need a good credit score to get the loan and to receive favourable terms. By requiring personal guarantees, the business risk is shifted back to the founder, who will be required to personally repay the loan if the company fails.

Another option is to seek a loan from the Small Business Administration (SBA),⁴⁵ which is a federal agency that supports small businesses. The SBA backs loans issued through its lending partners, which brings down rates, eases qualification requirements, and reduces the personal risk to entrepreneurs. Immigrants and non-citizens are eligible for small business loans through the SBA. For both traditional bank and SBA sponsored loans, the long application cycle can be a deterrent to start-ups. But if you can successfully fund your company through a loan, you avoid giving up any equity, and you can deduct the interest you pay on the loan from your taxes.

Crowdfunding is a relatively new approach some companies are taking to raise capital. Crowdfunding involves taking a small amount of money from a large number of people. Requests for crowdfunding typically take one of three forms. First, a start-up can ask for donations, for which the contributors expect no financial return. Second, a company can promise a reward – typically the product or service it is developing – in exchange for a contribution. Third, the company can offer an equity stake for a contribution from an investor. This third option received a boost in 2012 with the passage of the JOBS Act,⁴⁶ which amended the Securities Act of 1933 to allow companies to exchange equity for crowdfunded capital without having to register or comply with many burdensome

⁴⁵ Available online at: <https://www.sba.gov/> accessed 9 July 2019.

⁴⁶ H.R. 3606, 112nd Cong. (2012).

regulations.⁴⁷ However, not all companies qualify for this exemption to federal registration and greater regulatory oversight. This includes foreign companies, i.e., those that are not organized under the laws of any US state or territory.⁴⁸

Normally, crowdfunding is done through a website that provides a platform for investors to find companies and invest small amounts of money, sometimes as little as \$10. Crowdfunding has gained traction with the growth of social media because companies are able to spread awareness around their campaign and attract donors from outside of the typical VC community. Examples of prevalent crowdfunding websites include gofundme.com, Indiegogo.com, and kickstarter.com. Oculus is an example of a company that started by raising USD 2.4 million via a kickstarter.com campaign. Just two years later, it sold to Facebook for USD 2 billion.⁴⁹

During the early stages of a company, VC funds are often hesitant to invest money if a company has not yet generated any traction. As such, companies must find ways to fund the company until they have enough footing in the market to get more capital from a VC firm. Founders usually look for money from individual investors such as friends, family, or angel investors. These angel investors may be successful former entrepreneurs. Early-stage funding and support is also available from incubators, which are organizations that provide a mix of financial support and business expertise to help kick-start an early-stage business.

Once a company has generated enough traction a VC fund may invest capital into the company in return for equity. Typically, VC funds receive equity in the form of Preferred Stock, also commonly referred to as VC Preferred Shares.

VC funds can raise money to invest in early-stage companies from various sources, including pension funds, high net worth individuals, and university endowments. Currently, most venture capitalists place a goal

⁴⁷ Joseph C Long, Michael J Kaufman and John M Wunderlich, '12 Blue Sky Law' (Thomson Reuters, June 2019) § 5:31.

⁴⁸ *ibid.*

⁴⁹ Peter Rubin, 'The Inside Story of Oculus Rift and How Virtual Reality became Reality' (*Wired*, 20 May 2014) <https://www.wired.com/2014/05/oculus-rift-4/> accessed 9 July 2019.

of around a 20 per cent return per year and will only invest through funds with a 10 year life.⁵⁰

Working in the VC industry is very competitive and the 'standard wisdom' in Silicon Valley is that if a VC fund invests in 10 start-ups, after 10 years, five will have no value, four will break even, and one will be a success. For a VC fund to meet its goal of averaging a 20 per cent annual return over 10 years, the one company in the VC fund that is a success needs to be a *major* success to make up for the other companies that failed or broke even.

When evaluating whether to invest, VC funds will research the company, including the company's products, potential markets for the products, potential risk, company management, intellectual property, and financial projections. Many VC firms are interested in investing in a person or team as much as they are interested in investing in the company itself. VC firms often place a big emphasis on investing in a founder they believe in, which is why founder's stock is initially subject to a vesting period. The VC firm sees the company as less valuable if the founder(s) leave, so the vesting period helps ensure the founder stays with the company once funding is secured.

If a founder knows they will be seeking VC funding, they should choose to organize as a C Corp. VC firms look to invest exclusively in C Corps because they allow the company to issue multiple classes of stock (e.g. common stock vs. Series A Preferred, vs. Series B Preferred etc.), as well as incentive stock options. While it is possible to convert from an LLC to a C Corp, it is time-consuming and expensive. A founder that initially sets up their company as a C Corp can be a strong signal to a VC firm that the company is familiar with the VC landscape and a strong fit for an investment. Additionally, an S Corp is not preferred because S Corps limit a company to one class of stock, which can make it very difficult to assign different rights among different groups of investors and founders.

Rather than buying stock outright, early investors often invest money into the company in the form of a convertible note. Convertible notes have traditionally been preferred during the early stages of a business because it can be very difficult to calculate the value of a young company.

⁵⁰ Bagley and Dauchy (n 6) 152.

Convertible notes can also be completed more quickly and for a lower cost than a full round of financing. They also provide an investor with more downside protection if the company dissolves.

A convertible note is a debt instrument that has the right to be repaid in the future; however, it also allows the note to convert into stock at a specified rate when/if the company secures a later round of financing. A convertible note allows an angel investor to 'piggy back' a Series A investment and convert the amount of the note into Series A shares. Often times, the investors will receive a discounted price per share when they convert as a reward for investing early.

For example, if an angel investor invests \$500,000 into a note and one year later the start-up sells Series A Preferred shares to a VC firm for \$1/share, then the angel investor would be able to convert the note for 500,000 Series A Preferred shares (\$500,000 note divided by \$1/per share Series A price). If the convertible note includes a discount (say 10 per cent for this example), then the angel investor would be able to purchase the shares for \$0.90 per share and thus convert the note into 555,555 shares (\$500,000 note divided by \$0.90/per share Series A price).

In recent years, an alternative to the convertible note, called a Simple Agreement for Future Equity (SAFE), has come into vogue. It was developed by Y-Combinator,⁵¹ a prominent incubator, and challenged the notion that convertible notes are cheaper and easier than a financing round. A SAFE is very similar to a convertible note, but it is not debt and does not come with a repayment obligation. A SAFE is built with the assumption that a maturity date on a convertible note for an early-stage company serves almost no practical purpose because even if the maturity date is reached, neither party expects the note to be repaid, given the convertible note is probably the only capital the company has.

A SAFE is not a debt instrument and does not come with a repayment obligation. The language of a SAFE makes this clear: 'The holder of a SAFE has a contractual right to convert the SAFE purchase price into an eventual Series A Preferred stock financing, just as the holder of a convertible note would have a right to convert the note balance into a Series A Preferred stock financing. But under a SAFE, in no event is the

⁵¹ Roberts (n 22) 193.

company required to repay the purchase price (in other words, there is no maturity date).’

Even more recently, Series Seed Documents have emerged as another alternative to convertible notes.⁵² Series Seed Documents are a standardized set of documents that can be quickly and easily deployed for a seed investment and are not meant to favour either the investor or the entrepreneur. These documents are intended to be ‘plug and play’ to reduce the time and money involved in a financing. The documents are ‘open source’ and are meant to ‘represent a consensus as to what should be in seed round documents’. The idea behind Series Seed Documents is that they will be broadly adopted and create a standard uniform approach that will in aggregate reduce the cost and time associated with an angel investment.

In short, a Series Seed financing is a standardized and a much simpler version of a full VC Preferred Stock financing. However, Series Seed still includes many of the essential features of VC Preferred, such as a liquidation preference and a right to convert into common stock.

Table 7.1 offers a comparison of the main features of a convertible note, a standard SAFE, and a Series Seed.

Ultimately, the goal for VC firms is to complete an exit, or sale of the company, so they can recognize the gains from their investment. Sometimes this process can cause tension between founders and venture capitalists. For example, a founder may become so attached to the company they founded that they do not want to sell it out of fear that the company will no longer embrace the same principles and values it was founded on. On the other hand, VC firms want to take advantage of the exit opportunity to recognize their gains (or limit losses) so they can take the capital and reinvest it in a new company.

Generally, selling a company is a long and expensive process. There are many different ways to sell a company. A merger is when two corporations combine into one corporation. An asset purchase is an acquisition in which a corporation may acquire the assets of another corporation instead of the corporation itself. This may allow the buyer to avoid acquiring the liabilities and debts of the predecessor. Finally, a stock purchase

⁵² Available at: <https://www.seriesseed.com/posts/documents.html> accessed 9 July 2019.

Table 7.1 *A comparison of convertible note, a standard SAFE and a Series Seed*

	Convertible note	Standard SAFE	Series Seed
Repayment?	Yes	No	No
Interest?	Yes	No	No
Convertible into	Next equity financing (alt: common)	Next equity financing	Common (but at holder’s option)
Conversion discount?	Yes	Sometimes	N/A
Valuation cap?	Maybe	Yes	No
Delays valuation	Sort of	Sort of	No
Liquidation preference?	N/A	N/A	Yes
Change in control	Varies	\$ back or convert to common at cap	Liq pwwf or convert to common (1-for-1)
Voting rights?	No	No	Yes + protective provisions
Board spot?	No	No	Yes
Participation rights	No	Yes	Yes

is when one buyer purchases all the outstanding shares of stock from the outstanding shareholders.

Typically, the first step is to perform research on the company, commonly called diligence. During this phase, the buyer inquires into the company to understand its business model, financials, assets, and liabilities. This process validates whether there is any real interest from both parties. Once diligence is completed then negotiations begin.

During the negotiations the seller tries to induce the buyer by making representations (statements of fact about the company) and warranties (an assurance of the existence of a fact). For example, the representations and

warranties make promises to the buyer, such as ‘I have no debt’, ‘I have 10 million shares of stock outstanding’, or ‘I have no ongoing litigation’. In theory, the representation and warranties should confirm all the work that was done during the diligence phase. Representations and warranties are very important because a seller is liable after the sale for any misrepresentation included in their representations and warranties.

There are two main types of representations and warranties: fundamental and general. Usually, both sides will agree on a date when the representations and warranties expire (also called a ‘survival period’), and the seller no longer has to indemnify the buyer for a misrepresentation. Fundamental representations and warranties are so foundational to the agreement that they are treated differently than general representations and warranties. Fundamental representations often cover the authority to enter into a sale, capitalization, taxes, and intellectual property. Fundamental representations and warranties may have a longer survival period than general representation.

General representations are generally treated differently from fundamental representations. The longer survival period makes fundamental violations more costly than general violations. General representations may only last one year and fundamental representations may be much longer or even indefinite.

7.7 Tax considerations

US tax law is complex and sophisticated, yet it is an integral part of doing business in this country. The general rules that apply to US business entities and to individuals who move to the US to start a business (which requires a specific type of visa) are laid out below.⁵³ For purposes of the decision to move here, the tax implications for individuals who are not either US green card holders (also referred to as ‘permanent residents’) or US citizens are described.

⁵³ Federal tax laws are contained in the nearly 75,000-page long Internal Revenue Code. Regulations pursuant to these laws can be found in Volume 26 of the Code of Federal Regulations. Each state also has its own tax laws for individuals and businesses that reside within its borders.

US tax law has many exceptions, but to avoid confusing the reader, we will only go into detail about them if they are commonly applied to entrepreneurs or companies. Therefore, the description of tax law below has been simplified to make a general overview possible. All entrepreneurs deciding to locate to the US should review their specific situation with a tax adviser knowledgeable about US tax rules.

7.7.1 Basic concepts in US tax law

There are four important concepts consistent throughout US tax law that are important to understand before diving into more specific rules: (1) basis, (2) realization of income, (3) recognition of income from tax purposes, and (4) fair market value.

1. **Basis** is the amount one paid for the property, or in other terms, the cost of acquiring such property. However, in most cases, tax law uses 'adjusted basis' when determining gain and loss. Adjusted basis is the cost of such property increased by additional investment in the property and minus depreciation deductions. For the purpose of this chapter, we will use adjusted basis unless otherwise stated.
2. **Realization** occurs when an asset is sold or services delivered, not when the market value of assets or services fluctuate. With respect to an asset, the amount realized is the difference between the sale amount and the asset owner's adjusted basis in that asset. If the value is positive, it is a realized gain. If the value is negative, it is a realized loss. Generally, the value of the services delivered is the amount received by the service provider.
3. **Recognition** refers to the amount of realized income that is actually subject to tax. It is important to understand that, in US tax law, even though there is an amount of income realized, that amount may or may not be immediately recognized (i.e. taxed). An example familiar to start-up employees of income that is 'realized' but not 'recognized for tax purposes' is the receipt of stock not yet vested (see definition of vesting in section 7.1.2). In exchange for services provided, the employee has realized gain, but that gain will not be recognized until the stock has vested. This means that tax is not imposed at the time that the employee receives the unvested stock unless treatment under § 83(b) of the Internal Revenue Code has been elected.
4. **Fair Market Value** is the value of assets and/or services provided as measured by the amount that a willing purchaser would pay a willing owner or provider to acquire the asset or services in an open market.

7.7.2 Taxation of individuals operating a trade or business

In general, individuals who are US citizens hold a green card (also called 'permanent residents'), or have a 'substantial presence' in the US (spend more than 183 days in the US in a three-year period) are subject to tax on their worldwide income. For those individuals who do not fit within any of the three categories above, the tax laws treat them as 'non-resident aliens'. Non-resident aliens are taxed only on their US source income. Again, consultation with a US tax adviser is critical to understanding a specific individual's US tax situation.

As a general rule, individuals who qualify as 'non-resident aliens' must file a tax return with the IRS but are taxed only on amounts earned in connection with the operation of a trade or business in the US. Income can be earned as an employee who is paid wages, as an independent contractor who is paid for services provided, or by the receipt of proceeds from sale of assets such as stock or other property in the US.

The overall takeaway from these rules is that any entrepreneur who is able to reside in the US to start a company and is present in the country for more than half of the year will pay US taxes on both active income (from performing services) and passive income (from investments) earned anywhere in the world. A tax treaty with the entrepreneur's country of citizenship may impact these general rules to some extent (by lowering the rate or allowing a credit for taxes paid in foreign countries), but the framework of US tax rules will remain the same.

7.7.3 Taxation of individuals who create a partnership or LLC

If a partnership or LLC has been created, all income and losses of the operating entity are attributed not to the entity itself, but to each owner in proportion to their share of ownership of the entity. The basis in each ownership interest is increased by the attribution.

Each owner is then responsible for any tax consequences of that allocation, whether or not cash or other assets have been distributed to cover those taxes.

Distributions of cash or property to a partner or member of the LLC are generally not taxable so long as they are in proportion to the owner's interest in the entity. Transactions that result in a change of an owner's

percentage of ownership, however, can produce a gain or loss to the owner, depending on whether it is found that the distribution of cash represented a sale of the owner's portion of their interest in the receivable and inventory of the partnership or LLC in exchange for a portion of the cash. Under sections 731 to 737 of the Internal Revenue Code, that portion of the cash will then be taxed as ordinary income.

There are additional tax consequences under sections 741 to 743 of the Internal Revenue Code if an owner sells their shares or if the entity is liquidated. Upon sale, gain or loss is recognized and calculated by reducing the value received (in cash or property) by subtraction of the owner's adjusted basis. An entity will be treated as terminated for tax purposes if the entity ceases doing business or if more than 50 per cent of the entity's capital and profit interests changes hands by sale or exchange within 12 consecutive months. Gain or loss is again measured against the adjusted basis of the owner's share in the business but most often will be treated as capital gain or loss. The rate at which such gain or loss is taxed will depend on the length of time it has been owned by each individual.

7.7.4 Taxation of individuals who create corporations

Founders deciding to locate to the US to set up their company should also be aware of the potential tax consequences if they decide to set up their company as a corporation. The taxation of a division of equity depends on whether there is an exchange of stock for property or of stock for services.

Under a property for stock exchange, the shareholder recognizes no gain or has no tax consequences as long as (1) no additional property or value is received by the shareholder along with the stock, and (2) the shareholder has control immediately after the contribution. Control of the corporation is defined as holding greater than or equal to 80 per cent of the voting stock and non-voting stock immediately after the exchange. It is also possible to make a group transfer or property in exchange for stock, in which case the control by the group will be measured at the end of the last transfer. As long as the transfers occur as a result of an integrated plan, the transfers do not need to be simultaneous.

Stock received in exchange for the promise of services is more complicated. In general, compensation for services under US tax law is treated as

income to the service provider and taxable upon receipt.⁵⁴ However, when the receipt of stock is subject to a vesting schedule (and therefore at risk of forfeiture if the service provider does not stay with the corporation for the amount of time specified in the vesting agreement), then the service provider only pays taxes as each portion of stock becomes vested. As the value of stock initially granted in a young start-up may increase substantially as time passes, a founder may elect under section 83(b), within 30 days of the grant, to be taxed immediately on the entire value of the stock. Although the acceleration of the time to pay taxes is unusual, it is beneficial in this context, when the value of the shares received at each vesting date may have increased rapidly during the vesting period (as can happen in a successful start-up).

The tax consequences of distributions to shareholders depend on whether the distribution is a return *of* capital, (which reduces the amount of investment a shareholder has in the corporation) or a return *on* capital (which is a sharing of corporate profits with shareholders, e.g., a dividend paid to all shareholders). A return *of* capital reduces a shareholder's basis in their shares owned, and is only taxable if the distribution is in the excess of the shareholder's adjusted basis in the stock prior to the distribution. A distribution that is a return *on* capital is taxable as income to the recipient.

7.7.5 Taxation of businesses located in the US

US business taxation has two primary regimes, the corporate regime and the partnership – or pass-through – regime. The differing tax implications for the founder under these two tax regimes might influence a business' decision to be classified as a corporation or a pass-through entity. It is useful to look at the tax consequences in the context of the business life cycle: (1) formation, (2) operations, and (3) exits (sale of the business, merger or liquidation). Corporations, partnerships, and LLCs go through each of the stages of the business life cycle. However, there are different tax consequences for corporations and pass-through entities at each stage.

⁵⁴ Sections 1 through 11 of the Internal Revenue Code contain the general rules and applicable definitions for the taxation of those subject to US taxation.

7.7.5.1 *The taxation of partnerships and LLCs*

As described in Section 7.1.1.5 above, LLCs are created under a specific state's laws. For federal tax laws, LLCs and partnerships are considered 'pass-through entities' with no income tax paid at the entity level and with all gains and losses passed-through to the owners⁵⁵ of the entity. LLCs can elect to be taxed as corporations for tax purposes instead, but partnerships cannot.

The formation of a pass-through entity involves owners contributing their property or services to the entity in exchange for an interest in that entity. With a few exceptions, neither the contributing owner nor the entity recognize any gain or loss in the exchange. After the exchange, each owner has an adjusted basis in their share of the entity calculated upon the total adjusted basis of all property or services contributed. For example, under sections 722 and 723 of the Internal Revenue Code, if three individuals, A, B, and C, form a partnership, with A contributing \$100 in cash, B contributing \$400 worth of supplies, and C contributing property that has an adjusted basis of \$100 but is currently valued at \$500, A receives a 10 per cent share in the partnership (adjusted basis of \$100), B a 40 per cent share (adjusted basis of \$400), and C a 50 per cent interest in the partnership with an adjusted basis of \$100. The partnership will have a basis of \$100 in the property contributed by C.

There are many reasons and situations in which a founder may decide to leave a company. From a tax perspective, the best way for someone to exit a corporation is generally by qualifying for a redemption or through a liquidating distribution. Both ways provide basis offset so the shareholder is only taxed on the value of property in excess of the shareholder's adjusted basis in the stock he or she is giving up.

A redemption occurs when a corporation buys back stock from the shareholder. If the buyback meets the IRS's complicated rules, including the attribution of stock ownership through related parties, and is considered a redemption, not a dividend or other return on capital for tax purposes, then the shareholder will be taxed only if the amount received from the corporation exceeds the shareholder's adjusted basis. In such a situation

⁵⁵ Owners of partnerships are referred to as partners and owners of LLCs are referred to as members. For purposes of this section, the distinction does not matter, and therefore they will be referred to collectively as owners.

the shareholder pays tax on the gain. The rate of tax applied depends on the length of time the shareholder has owned the stock. If instead the buyback is considered a return on capital, the entire value of property that the shareholder receives in exchange for stock will be taxable as income.

Liquidating distributions occur when the corporation distributes its property to shareholders and, after all distributions are complete, the corporation ceases to exist. A shareholder will only have to recognize gain on such a distribution to the extent they receive property in excess of their adjusted basis on the company's stock.

When a company fails, it either distributes assets to shareholders or sells assets and distributes the proceeds from the sale to the shareholders in proportion to the shareholders' stock. With a cash distribution, the shareholder recognizes gain or loss for the difference between the cash received and the shareholder's basis in the stock. Whether the gain or loss is long-term or short-term depends on how long the shareholder has held the stock.

Under the property distribution model, the shareholder recognizes gain or loss for the difference between the fair market value of property received and his or her adjusted basis in the stock. The same rule applies as above when determining whether the gain or loss is long-term capital gain/loss or short-term capital gain/loss.

7.7.5.2 The taxation of corporations

1. Formation

At the time of formation, a corporation generally recognizes no gain or loss on the issuance of its own stock and receives a basis in the stock equal to the adjusted basis the founder(s) had in that property at the time of transfer. If services are provided instead of property, the fair market value of the services is rendered from the corporation's basis in the stock.

2. Operations

Once operations begin, corporations themselves are taxed at a flat 21 per cent of income (revenues minus expenses and other allowed deductions). Unlike the taxation of partnerships and LLCs, there is no pass-through of corporate income to shareholders, who are taxed only upon distributions

of funds to them from the corporation (see above). The corporate tax regime in the US is often called a double tax framework because corporate profits and gains are taxed at the corporate level when they occur and then again when those profits are distributed to shareholders.

There are many funding mechanisms available to corporations, such as VC, venture debt, and traditional bank loans. The classification of these sophisticated financing vehicles is not always clear but ultimately depends on whether the IRS considers it a loan (a debt) or an investment in the corporation (equity). The classification is important because, although there is no taxable event for the corporation upon the initial receipt of funds regardless of its classification, it produces very different tax consequences in future years for the corporation.

A debt is an unconditional promise to make the payment at a fixed amount and fixed time, and it is independent of the corporation's performance or income. The creditor who lends the debt to the corporation does not have a say in the business nor does it share in the profitability of the company. When the interest on the debt is paid by the corporation, the corporation generally may deduct the interest payment as an ordinary and necessary expense against its ordinary income. Any unused interest deduction will be carried forward to the following years. If interest is not paid when due, a creditor may sue the corporation in court for the amount of the debt and any unpaid interest. If the company liquidates before the debt is paid off, the creditor will have a superior interest to shareholders in the assets of the corporation.

From a tax perspective, a corporation generally prefers classifying an investment as debt because it allows the corporation to deduct the interest payments from its tax liability while any payments made to shareholders in an equity investment are paid from after-tax income. In addition, as mentioned above, a creditor is not involved in the operation of the business.

3. Exits

There are three ways for investors and founders to exit a company:

1. a merger with another company,
2. an asset purchase, or
3. a stock purchase.

For tax purposes, mergers are classified as asset purchases. For that reason, the tax consequences of selling a company are treated one of two ways: as an asset acquisition or a stock acquisition. In an *asset* acquisition, either (1) the corporation to be acquired will sell their assets directly to the acquiring corporation for cash and then the company to be acquired will exchange cash for its stock; or (2) the corporation to be acquired will sell its assets to its shareholders in exchange for its stock and then the shareholders will sell the assets to the acquiring corporation for cash. Asset acquisitions create taxable events, once when there is an exchange of cash for assets and again when there is an exchange of stock for either cash or assets. Moreover, in either case the corporation will be taxed if appreciated property is either sold or distributed to shareholders as part of the transaction. Thus, the choice by the company of the method of asset acquisition will be based on economic goals rather than tax goals. In a *stock* acquisition, the acquiring corporation acquires the stock of the acquired company. In this situation, the acquired company continues to live on as a subsidiary of the acquiring corporation. The shareholders of the company that is acquired generally receive a cash distribution, and pay tax only on the amount received in excess of their adjusted basis. There is no tax paid by the acquired corporation; therefore, only one level of tax imposed in this type of acquisition. Under Internal Revenue Code section 368, mergers are generally treated as taxable acquisitions unless the transaction complies with very specific rules. Shareholders of the acquired corporation must receive at least 40 per cent of the acquirer's voting stock, the acquirer must continue the business of the target company, there must be a relevant business purpose for the merger, and the transaction meets the stringent definitional requirements of a 'reorganization'.

If a corporation is successful and there is interest from the public in owning its stock, the company can plan its IPO and subsequently be traded on one of the US stock exchanges. Essentially, an IPO is the equivalent of selling the company to the public and can be viewed as selling the C Corp stock to the public. After six months, founders and early investors may sell all or a portion of their stock on the stock exchange. The seller will recognize gain or loss (either long-term or short-term depending on the length of time the shares have been held) for the difference between the selling price and his or her adjusted basis. The corporation recognizes no gain or loss upon the sale of its equity.

If a corporation is not successful and ceases operation by liquidating, the corporation will recognize gain or loss on property distributed in complete liquidation as if the property were sold at fair market value. If instead the corporation sells its property and distributes cash, the corporation will pay tax on the excess of funds received over its adjusted basis in the property.

There is one final aspect of US tax laws that founders should consider. Since 2015, there has been a Research and Development tax credit available to start-ups who meet the criteria. The credit is aimed at research that develops or designs new products, processes, prototypes, or software or enhances any existing product, process, prototype, or software. Importantly, the credit is available for the current year or any of the five prior years in which the company has less than USD 5 million in gross receipts and no more than five years of gross receipts. However, claiming the credit requires contemporaneous documentation and credible employee testimony, so any start-up thinking that the credit may be available to them should check with their US tax adviser before beginning any research or development.

As is clear from the above discussion, the tax laws of the US are complicated. It is very important to consider the impact they may have in determining whether to form your company in the US. If you decide to do so, then the tax implications of each business decision should be taken into consideration before a course of action is finalized.

7.8 Protecting an idea or a product

For many early-stage businesses, intellectual property is one of their most valuable assets. Long before a company has secured its first round of financing or closed its first sale, it has already developed its own intellectual property portfolio. Even if the founders are not aware of it, at the same time they are developing their business plan and perfecting their products, they are also building their intellectual property portfolio. To take full advantage of this asset, it is important to understand the full scope of your intellectual property and how to protect it.

The US has a long history of providing incentives to entrepreneurs to develop new, creative, and useful inventions. In fact, it is even written

into the Constitution, which grants Congress the power to ‘promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries’. While this section of the Constitution provides the framework for patent and copyright protection, companies in the US also enjoy broad trade mark and trade secret rights. In this section, we will review the various categories of intellectual property rights available to companies operating in the US.

7.8.1 Patents

Because it is rooted in the Constitution,⁵⁶ patents are covered by federal law. This provides nationwide uniformity across the country and makes it easier for start-ups to apply for and protect their patents. There are two types of patents that can be issued by the Patent and Trademark Office⁵⁷ – utility patents and design patents. Utility patents protect the way an article is used and works, while a design patent protects the shape, configuration, and ornamental appearance of an article.

Utility patents can be issued to the inventor of any new and useful ‘process, machine, manufacture, or composition of matter’.⁵⁸ In general, this means you cannot get a patent on laws of nature, abstract ideas, or natural phenomena. In recent years, these limits to patentability have made it more difficult to obtain patents on software.⁵⁹ While the law in this area is evolving, it is worth noting that the more functionality a piece of software imparts to a computer or machine, the more likely it is to qualify for a patent.

Additionally, you can only get utility patent protection for an invention that is useful, novel, and non-obvious. Each of these elements of patentability has its own nuances, but the general idea is to encourage and accelerate innovation that will benefit society. As part of the application process, an inventor is required to disclose her invention with great enough detail that someone else skilled in her field would be able to

⁵⁶ U.S. Const. Art. 1, § 8, cl. 8.

⁵⁷ Available at: <https://www.uspto.gov/> accessed 9 July 2019.

⁵⁸ 35 U.S. Code § 101.

⁵⁹ See Timothy K Armstrong, ‘Symbols, Systems, and Software as Intellectual Property: Time for Contu, Part II?’ [2018] 24 *Mich. Telecomm. and Tech. L. Rev.* 131, 134.

recreate it. In exchange, if the patent is granted, the inventor effectively receives a monopoly to use the invention. But this monopoly is limited to the duration of the patent, which is 20 years for utility patents. After the patent expires, the invention can be used by anybody.

In 2011, the US updated its patent laws to bring it into greater conformity with the rest of the world. For applications submitted before that time, patents were awarded to the first person to invent an article or process. This meant that even if the applicant was the first person to file, and even if she was not aware that anybody else had already come up with a similar invention, her application could be denied and the patent awarded to the first to invent. While the idea behind this system was to reward the actual first inventor, it proved to be difficult to administer and conflicted with most other countries, which award patents to the first person to file the patent application. Now, for applications filed after 2011, the Patent and Trademark Office will typically award the patent to the first person to file.

Design patents are awarded to an inventor of a new, original, and ornamental design. Like utility patents, the applicant must show that the design is new and non-obvious, but it must be primarily ornamental. If the design is governed by function, it is not eligible for design patent protection. A good example of a design patent is Apple's claim for the shape and appearance of the iPhone. In 2011, Apple sued Samsung for what it claimed was a blatant copy of its design. After litigation that lasted over seven years and included one verdict in favour of Apple for more than USD 1 billion that was later reduced, the case settled for an undisclosed amount in 2018.⁶⁰

Design patents have a shorter life than utility patents. If the application was filed before 13 May 2015, it lasts for 14 years. If the application was filed after that date, it receives 15 years of protection. And like a utility patent, once it expires, it can be freely used by the public.

⁶⁰ Jacob Kastrenakes, 'Apple and Samsung Settle Seven-year-long Patent Fight over Copying the iPhone' (*The Verge*, 27 June 2018) <https://www.theverge.com/2018/6/27/17510908/apple-samsung-settle-patent-battle-over-copying-iphone> accessed 9 July 2019.

7.8.2 Copyright

Like patents, copyright protection in the US can be traced to the Constitution.⁶¹ This means that copyright protection is enforced by the federal government and is uniform across the country. Although copyright is typically associated with the arts, it can be used to protect any original work that is fixed in a tangible medium of expression. But both of those elements are critical for copyright protection. You must establish that you independently came up with a work that (1) required at least some creativity on your part, and (2) is fixed to a tangible object. By way of examples, a poem printed in a book, a song recorded and pressed into a vinyl album, and a piece of software code stored on a hard drive can all be protected by copyright.

It is important to understand, however, that copyright protects only the actual expression; it cannot protect the idea behind an expression. So, for the example of a piece of software, only the expression (i.e., the actual code language) is protected. If somebody else could write a different piece of code to accomplish the same idea, that would not be protected by copyright.

The duration of copyright protection is much longer than patents. Copyright lasts for the entire life of the person who created it, plus 70 years after their death.⁶² But for works created either anonymously or made for hire (for example, in the course of one's work for an employer), the duration is generally 95 years from first publication. This latter duration is of interest to start-ups, since any copyright protection for works made by its employees will last 95 years under US law.

Unlike patents, there is no need to file a formal application for protection. Instead, copyright protection attaches automatically to any creative works once they are fixed to a tangible medium. For works created by an employee in the scope of her employment, the copyright automatically becomes the property of the company as a 'work made for hire'. For works created by an independent contractor or under a commission, figuring

⁶¹ U.S. Const. Art. 1, § 8, cl. 8.

⁶² 17 U.S. Code § 302.

out who owns the copyright requires a complicated analysis absent an express agreement.⁶³

7.8.3 Trade mark

A trade mark is a word, name, symbol, or device that is used by a company to identify and distinguish its goods from those of others. It also indicates the source of the goods. Like patents and copyright, trade mark protection is based in the Constitution.⁶⁴ But trade mark protection is rooted in the commerce clause of the Constitution. While patents and copyrights generally promote progress and protect the inventor or author, trade marks are intended to protect the consumer by providing information about the quality and source of a product.

The term trade mark does not cover another closely associated type of business identifier, the service mark. Service marks provide the same purpose as trade marks, but they are used to identify services rather than goods. So, if a start-up company is providing a service rather than a good, it would file for a service mark. The application procedure, requirements, and corresponding protections are the same for both service marks and trade marks. Trade mark law also protects trade dress, which is the design and packaging of products. It can also include the design and shape of the product itself. Trade dress is only protectable if it serves the same source identifying function as trade marks.

Trade names, or business names, cannot be registered under federal law unless they function to identify the source of particular goods or services, rather than merely identifying the company's name. For example, 'Unclaimed Salvage & Freight Co.' was found to serve 'merely as a commercial, business, or trade name serving to identify applicant as a viable business entity; and that this is or would be the general and likely impact of such use upon the average person encountering this material under normal circumstances and conditions surrounding the distribution there-

⁶³ See United States Copyright Office, 'Works Made for Hire' <https://www.copyright.gov/circs/circ09.pdf> accessed 9 July 2019.

⁶⁴ United States Patent and Trademark Office, *Trademark Manual of Examination*, (Introduction) ('The authority of Congress to provide for the registration of marks which are used in commerce stems from the power of Congress under the commerce clause of the Constitution of the United States to regulate commerce.') <https://tmep.uspto.gov/RDMS/TMEP/Oct2013#/Oct2013/introduction1e1.html> accessed 9 July 2019.

of.⁶⁵ A determination of whether a trade name can also serve as a mark requires consideration of the way the mark is used and its probable impact on consumers. If a trade name is presented distinctly from other text, for example with a larger font, in a different style, or accompanied by a design feature, it is more likely to qualify for trade mark protection.⁶⁶

Whether an identifying name can serve as a trade mark depends on the strength of the mark. Not all words or phrases can be trade marks, and not all trade marks are afforded equal protection. This is because trade marks are judged on a spectrum of distinctiveness. On one end of the spectrum are completely fanciful or made-up words, like Clorox for bleach. There is little risk for customer confusion when no similar word existed prior to the trade mark. On the other end of the spectrum are generic words that would be impossible to serve to identify a particular product. For example, 'laptop', 'bike', 'TV', and 'mattress' cannot be trademarks because they are just the normal word for the product they represent.

On the other hand, those generic words could potentially serve as trade marks for products that they do not represent. As an example, 'Apple' is an arbitrary term when applied to computers, so it can serve as a trade mark when referring to computers. Likewise, 'Bike' can serve as a trade mark for helmets, but not for bicycles.

Lying between the fanciful and generic ends of the spectrum are suggestive terms and descriptive, geographic, and personal names. Suggestive terms, like Coppertone for a suntan lotion, are merely evocative of the nature of the goods they represent. But descriptive, geographic, and personal names are more literal invocations of their namesake goods. For that reason, it is necessary to establish 'secondary meaning' to achieve trade mark protection. Secondary meaning arises when consumers come to identify a trade mark with a certain product over time. When this happens, a descriptive, geographic, or personal name mark that a business would not have been able to register initially may achieve trade mark status.

For companies just starting out, it is worth taking the time to select a distinctive name that can be easily protected without needing to establish secondary meaning – which can take years. It is important to conduct

⁶⁵ *In re Unclaimed Salvage & Freight Co.*, 192 USPQ 165, 168 (TTAB 1976).

⁶⁶ United States Patent and Trademark Office, Trademark Manual of Examination (1202.01).

a trade mark search to make sure the company's proposed marks are clear from confusing use by competitors before registering the marks.

Before a trade mark application can be approved by the Patent and Trademark Office, it must be used in interstate commerce. But once it is approved, it will remain in effect as long as it remains in continuous use. If, however, a company stops using a trade mark to identify its product or service, it will lose trade mark protection. Non-use of a mark for three consecutive years creates a legal presumption that the mark has been abandoned.⁶⁷

7.8.4 Trade secrets protection

Unlike patents, copyright, and trade mark, the law supporting trade secret protection cannot be traced directly to the US Constitution. For that reason, it has traditionally been governed by the common law of the state in which a business is operating. In 2016, however, Congress passed a federal trade secret law,⁶⁸ which provides some nationwide protections. Now, trade secret cases can be pursued in both state and federal court. This means companies can avail themselves of both state and federal trade secret protections, choosing whether to pursue their claims in state and/or federal court.

A trade secret is information, including a formula, pattern, compilation, program, device, method, technique, or process, that derives its value by remaining a secret. Most companies have trade secrets. They are perhaps the easiest form of intellectual property to obtain as they require no formal registration process. In fact, trade secrets only remain protectable as long as they remain a secret. As soon as they are revealed to a party outside the company, they lose protection. But if the trade secret was misappropriated or stolen, the company can claw back the secret and receive damages.

For subject matter to qualify as a trade secret, it must be information that (1) is not generally known; (2) is not readily attainable (although this element is not true in California); (3) is subject to reasonable commercial efforts to maintain its secrecy; and (4) holds commercial value. Given

⁶⁷ 15 U.S. Code § 1127.

⁶⁸ The Defend Trade Secrets Act of 2016.

these elements, it is important for start-up companies to develop a trade secret protocol to maintain the secrecy. This can include periodic audits, non-disclosure agreements, exit interviews with departing employees, and non-compete agreements where allowed. (Non-compete agreements are unenforceable in California, but non-disclosure agreements with departing employees can serve to maintain the status of the trade secret.)

Trade secret law can be used to protect inventions that do not meet the requirements for copyright or patent protection. For example, databases compiled in the course of business can be protected as a trade secret, even when the data is derived from publicly available information. This is particularly true when a proprietary process is used to compile or search that information. Trade secret law also offers the longest potential duration of any form of intellectual property. As long as the secret is maintained, the protection lasts indefinitely. As an example, the recipe for Coca-Cola has been protected as a trade secret for over a century.

Founders should also be aware of the California Consumer Privacy Act of 2018 (CCPA), which is the most comprehensive data privacy legislation passed in the US so far. The CCPA, which takes effect 1 January 2020, affords consumers protections over how their personal information can be used by for-profit entities. In a nutshell, the CCPA grants consumers (1) the right to request disclosure of their personal information collected by a company; (2) the right to request the deletion of their personal information; (3) the right to opt out of the sale of their personal information; and (4) the right to sue if a business fails to implement and maintain reasonable security measures that result in the unauthorized disclosure of their personal information.

7.9 Operational responsibilities, compliance management and insurance

Once a company is formed and begins to operate, it is important for entrepreneurs to be aware of the many possible laws in the US that may apply to the day-to-day functioning of the business. The consequences of not complying with applicable rules can have a crippling impact on a fledgling business – whether it comes in the form of a regulatory injunction, a lawsuit from a customer or competitor, or some other legal action.

Many of these risks are generally evident in the discussions in prior sections of this chapter. However, there are additional federal, state, and municipal laws that can apply, depending on the type of product sold, the locations where it is sold and/or purchased, and the internal operation and nature of the business. For that reason, it is helpful to have the advice of a knowledgeable attorney as the company begins to operate so that the founders can make business decisions with a full understanding of the legal risks involved.

As the company continues to grow and gain traction in the marketplace, many businesses create a compliance management department or system to ensure that all applicable laws as well as the terms of contracts signed by the business are met in a timely and appropriate way. The compliance department can also be responsible for setting up notification systems and employee training programmes to reduce the chance that there will be violations. Examples of laws that a company may monitor over the course of its life include state and federal laws governing the treatment of employees and the classification of workers as employees instead of independent contractors, the laws being passed by each state and the federal government concerning the collection of data and the level of security required to guard that data, product liability laws, financial transaction rules, securities regulations, anti-competition laws, and environmental regulations.

In the US, there are many forms of insurance that a business may purchase to reduce the risk of operations. Most businesses purchase insurance to protect against damage or loss of its property due to fire, theft, or flood. It is also possible to purchase business interruption insurance that protects against lost revenues from an earthquake or other disaster.

In addition, a business can purchase insurance that covers third parties. This type of insurance can protect the business from claims made by persons harmed by the products sold by the business or on the premises of the business itself. This type of coverage can be extended to the officers and directors of the company through an additional policy (often referred to as D&O Insurance) for negligence or breach of fiduciary duty. This sort of insurance can be quite expensive, and a knowledgeable insurance broker can help founders determine which policies would be most beneficial given the specific nature of the business.

7.10 Dissolution and bankruptcy

Recent statistics in the US indicate that 75 per cent of all start-ups that have received VC funding fail.⁶⁹ Therefore, another factor that entrepreneurs should consider when determining where to locate their business is the difficulty of dissolving a company and ending all personal and business liability from the operation of the company.

All businesses that determine that continuing to operate is not possible, whether the reason is financial or personal, must take certain legal steps to close the business:

1. There must be a formal decision made. The governing documents of the business will normally stipulate how this must be done, which is often by a majority vote of the directors, members or partners (depending on the type of entity that was formed).
2. The state in which the company is formed, and every state in which the company had filed to transact business there, must be notified of the company's dissolution. Each state has different requirements and forms for this purpose.
3. All employees, customers, vendors, landlords, and anyone else the company does regular business with must be notified. Some states require that this be done before the state papers for dissolution are filed.
4. A final tax return for the federal government and each state in which the company was doing business must be filed, and all outstanding taxes owed must be paid. All taxes withheld on behalf of employees must be sent to the appropriate agency.
5. All permits, licences, and other contracts to which the company is a signatory must be cancelled, and any penalties must be paid.
6. All creditors must be notified in writing (usually by mail and sometimes in a newspaper – or both) and a schedule and method must be created for any creditor to make a claim against the business within a specified time. Each state has specific requirements as to how this must be handled.
7. If it is possible to settle all creditors' claims, then any remaining

⁶⁹ See, e.g., Shakir Ghosh, 'The Venture Capital Secret: 3 Out of Four Start-ups Fail' (*Harvard Business School News*, 19 September 2012) <https://www.hbs.edu/news/Pages/item.aspx?num=487> accessed 9 April 2019.

assets may be distributed to the owners of the business in proportion to their ownership interest. These distributions must also be reported to tax authorities as there are possible tax consequences from the distribution (see Section 7.7.5.2).

If it is not possible to satisfy all the claims of creditors, then a business can consider filing for bankruptcy. If owners of the business took on any personal liability for any of the operations or contractual relationships of the business, owners can also file for personal bankruptcy.

Bankruptcy, whatever state a business or individual is located in, is governed by federal law. All bankruptcy filings, cases, and procedures follow federal rules and take place in federal courthouses. However, each state has its own laws that govern wage garnishment and asset seizures and may provide more or higher exemptions for certain types of property (e.g., places of residence) than federal law does.

Businesses that are insolvent can file for bankruptcy under one of two regimes, either complete dissolution ('Chapter 7') or reorganization of the business ('Chapter 11'). Chapter 7 of the Bankruptcy Code governs the complete dissolution of a business. A trustee is appointed to make sure that all claims are paid pursuant to the law and the priorities of the creditors. A creditor with a 'secured claim' has a right in a specific asset such as real estate or machinery. That claim can only be satisfied from that asset, and that creditor has a prior claim on that asset before other creditors. A creditor can also have a claim against specific streams of revenue such as receivables. In that case all those proceeds must be dedicated to paying off that creditor before they can be used to satisfy other creditors' claims. If any funds or assets remain after paying all creditors, they can be distributed to owners. Certain owners may have priority claims against other owners. For example, many venture investment contracts provide for a preference for those shareholders to receive their capital back before other owners receive any assets. The bankruptcy trustee will oversee these distributions as well. A straightforward Chapter 7 dissolution can take as little as five months.

Chapter 11 of the Bankruptcy Code governs the reorganization of a business. Under this scenario, the business continues to exist and operate, and a plan is devised to pay creditors out over time. Creditors get a vote in the approval of the reorganization plan and, for that reason, often have a say in the specifics of the reorganization plan. As part of the plan, creditors

may take a continuing interest in the business. Many large US businesses have filed for bankruptcy, continued to operate, and exited bankruptcy as strong companies. Prime examples include General Motors and Delta, American, and United Airlines. Normally the existing managers continue to operate the business, but in the case of fraud or gross incompetence, a trustee may be appointed. Chapter 11 reorganizations generally take three to five years and tend to be complicated, lengthy, and expensive. A company considering this option should consult with an experienced bankruptcy attorney early in the process.

7.10.1 Individual bankruptcy filing: Chapter 7

Chapter 7 is available to individuals who are low-income and have little hope of paying off the debts they have incurred. While a bankruptcy filing can wipe out all debt at the time of filing, it also will negatively impact the individual's credit rating for up to 10 years and can make it difficult to get loans and credit cards during that period. Secured loans such as a car loan or mortgage are usually not wiped out by filing under Chapter 7 and may result in the loss of the asset.

If an individual's financial situation is straightforward, a Chapter 7 filing can take as little as four to six months. More complicated cases may take longer.

It is possible to file for a Chapter 7 bankruptcy using online forms and general discussions of bankruptcy law. An individual with a significant number of assets or a complicated financial situation may want to consult an experienced attorney.

7.10.2 Chapter 13

Chapter 13 is available to individuals who have a source of income but need more time to pay off all of their debts. A trustee will be appointed to administer an agreed upon plan to pay off creditors in line with the amount and nature of their claims. Most plans last from three to five years. Chapter 13 is complicated and will necessitate in most cases consultation with an experienced bankruptcy attorney.

7.10.3 Cost of bankruptcy

Filing fees for individuals filing for Chapter 7 or Chapter 13 bankruptcy proceedings under either chapter are slightly more than USD 300 at the time of this writing. Corporations also pay just over USD 300 to file a Chapter 7 bankruptcy. A Chapter 11 filing, however, costs USD 1,717. There may be additional fees if a trustee is appointed.

Attorney fees for a case may run as low as USD 500 for a simple, individual filing or be over USD 10,000 depending on the complexity of an individual's case and the location of the filing. Attorney fees for corporate filings will generally be much higher given the complexity of most corporate proceedings.

7.11 Start-up ecosystem in the US

Globally, the US is ranked first among start-up ecosystems as a result of a large pool of start-up-friendly investors and an extensive network of resources for entrepreneurs. Large cities such as San Francisco, New York, and Los Angeles are well known as the location of many successful start-ups, but even medium-sized cities in the US (for example, Austin, Texas; Salt Lake City, Utah; and Pittsburgh, Pennsylvania) are developing flourishing start-up ecosystems. In addition, there are now several government and non-profit initiatives to incentivize start-ups to locate in small cities or more rural areas.

Many start-ups locate in the US in order to have easy access to the many incubator and accelerator programmes located throughout the country. These programmes provide some combination of working space, educational programmes, networking events, and mentoring opportunities. Joining an incubator or accelerator can be very beneficial for first time entrepreneurs that are looking for help getting their company on its feet. Some well-known accelerators and incubators include Y-Combinator, 500 Startups, and Angel Pad.

Another compelling feature of the US is the number of colleges and universities producing engineers, business students, data scientists, bio scientists, and financial experts. Research discoveries made while working at a university often become the basis of a new company. In the US, it is

not uncommon for there to be an arrangement between a university and its employees (often including graduate students) such that the university owns the discoveries but supplies the employee(s) who made the discovery with an exclusive licensing agreement. These arrangements provide a benefit to both the university, who may get favourable publicity and monetary benefit, and the academic entrepreneur, who may have access to resources and support that would otherwise not be available.

A characteristic of US start-up ecosystems that is not often mentioned is the deep pool of beta testers and first users. In the beginning, a start-up needs early adopters who are willing, and in fact eager, to try out new products and provide feedback to the company. It is easier to find those people in a city with a well-educated, innovative, tech-savvy population. It has been said that Uber, Lyft, and Airbnb were all born in the San Francisco Bay Area because of the number of people willing to use the product before it was well known or fully tested.

The most sought-after characteristic of the US ecosystem is the number and deep pockets of potential investors. In 2018, VC firms invested USD 99 billion in US start-ups. 86 per cent of all US VC investments were limited to four US cities. Start-ups in San Francisco attracted 41 per cent of all VC funding, New York City 18 per cent, Los Angeles 14 per cent, and Boston 13 per cent (see Figure 7.2). Starting a company in one of these cities may increase a company's chances of obtaining VC funding because many VC offices are already located in these cities and focused on companies near them.⁷⁰

One phenomenon that has surfaced in recent years is investments in, or outright purchases of, start-ups by larger companies, many of whom were start-ups themselves not that long ago. Sometime, the larger company is eager to have a start-up's employees (often engineers) work for them. In what is known as a 'talent acquisition', a larger company may determine that the best way to obtain those engineers and other founders (the talent) for themselves is to acquire the entire start-up. Other times, a start-up may be pursuing a project that is quite risky. An established company may not want to associate its brand with that project until it is a proven success. In that case, the larger company will make a significant investment in the start-up so that they can have a first look at the start-up's technology as

⁷⁰ See <https://about.crunchbase.com/blog/venture-capital-dow-jones-q2-2018/> accessed 15 July 2020.

Figure 7.2 US ecosystem

it develops. Google has a venture arm (Google Ventures) that is focused on investing in new companies. Other companies like Salesforce and GE have their own venture arms as well.

Another often-overlooked aspect of a robust start-up ecosystem is the impact that it has on the business community (including lawyers, accountants, marketers, bankers, and investors) around it. The atmosphere of innovation and disruption that start-ups often bring with them spreads to the professionals and business people that work with them. The result is traditional businesses often begin to think about new ways of doing things. For example, lawyers in the San Francisco Bay Area are willing to work with early-stage start-ups on what is called a ‘deferred compensation’ basis, meaning that legal work will be accrued as completed, but not billed to a start-up unless it reaches a specified level of funding. In most of the US, legal work is billed to clients in the month it is completed, and often a retainer of several thousands of dollars is required before any work begins. San Francisco lawyers, however, realized the benefit of supporting many young companies as a way of finding and becoming the favoured

law firm for the next unicorn. This means that a certain amount of legal work will be written off, but the payout is huge if Google or Apple is one of the start-ups the firm helped when they were young. Attorneys in other regions in the US are less comfortable with this creative approach to customer relationship building.