

SILICON VALLEY LAW GROUP

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**THE
ENTREPRENEUR'S GUIDE
TO
FORMING A HIGH TECHNOLOGY COMPANY**

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TO THE READER

Silicon Valley Law Group is a business law firm located in San Jose, California, which specializes in representing semiconductor, networking, computer software, hardware and other companies in their legal matters. The attorneys of Silicon Valley Law Group have undertaken an effort to assist entrepreneurs by producing certain booklets to guide them through some of the difficult legal issues they may face. The Entrepreneur's Guide to Forming a High Technology Company is one in the series. Other publications include:

- * The Entrepreneur's Guide to Venture Capital
- * The Entrepreneur's Guide to Trade Secret Protection
- * The Entrepreneur's Guide to Selling A Privately Held Company
- * The Entrepreneur's Guide to Reverse Mergers and Reverse Takeovers
- * The Entrepreneur's Guide to Sexual Harassment in the Workplace: Employer Protection Against the Tidal Wave in Employment Litigation
- * The Entrepreneur's Guide to Selecting the Business Entity
- * The Entrepreneur's Guide to Employment Law in the Workplace – Strategies for Legal Compliance
- * The Entrepreneur's Guide to Public Companies – A Playbook for Coping with the Legal Rigors and Regulations Faced by Public Companies

If you have any questions regarding the contents of this Guide, or if you would like copies of other Guides, you are invited to contact Silicon Valley Law Group at the following address and telephone number:

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The content of this publication is not intended as legal advice but to assist the reader in understanding the legal issues involved in forming a high-technology start-up company. Readers should not act upon information contained in this publication without consulting legal and tax counsel.

I. INTRODUCTION

Forming a high technology company is a difficult yet rewarding task. Although high technology start-ups face many of the same issues confronting more mature and stable companies, there are numerous legal issues which are unique to the fact that these companies are in their infancy, may grow rapidly and often intend to develop and sell very complicated and state of the art technology.

This Guide identifies, analyzes and provides practical solutions to a number of legal issues faced by high technology start-up companies that wish to secure venture capital or other outside financing and one day conduct an initial public offering. The issues covered include avoiding claims of trade secret misappropriation, establishing a trade secret protection program, establishing and maintaining ownership of technology, choice of business entity, corporate formation basics, compliance with federal and state securities laws, correcting unlawful share issuances, financing the start-up company and ownership and transfer restrictions.

II. AVOIDING CLAIMS OF MISAPPROPRIATION OF TRADE SECRETS

A. CIRCUMSTANCES UNDER WHICH TRADE SECRET CLAIMS ARISE

Usually founders of a start-up company are leaving a prior employer to establish a new company. The ultimate nightmare for a start-up company is for it to be sued by the former employer(s) of the founders. In the rush to leave their former employer and establish a new company to pursue an innovative idea, entrepreneurs are often unaware that they may be walking through a minefield. A start-up company can rarely afford the economic cost and distraction of a major legal battle.

Trade secret litigation has become common in high technology industries. Trade secret lawsuits are not only used to protect legitimate business interests in intellectual property but also as a competitive weapon which an established company will use to crush an upstart competitor. As a result, the founders of a high technology company should consider what steps can be taken to avoid lawsuits for misappropriation of trade secrets and related

claims.

A common scenario for a high technology start-up is for the founders to have worked with at least one prior company. During their employment, the founders were exposed to the technology of the prior employer, its business practices, financial condition and customers. It is also common for the start-up to develop technology, that is competitive with or related to the technology developed and sold by the former employer(s) of the founders, and/or sell to the same customers of their prior employer(s). The prior employer views such competition as a significant threat to its business interests and files a lawsuit for misappropriation of trade secrets and related claims.

B. DUTIES OF FORMER EMPLOYEES AND CONSULTANTS

Individuals who were officers of the former employer not only have a duty to refrain from misappropriating trade secrets, but also may owe a fiduciary duty to the former employer¹. The fiduciary duty, owed by former employee-officers, prevents them from preparing to compete prior to their departure and from recruiting employees of the former employer to the new enterprise.

Although former employees who are not officers and consultants generally do not have a fiduciary duty to their former employer, they must refrain from unfairly competing by misappropriating trade secrets or taking any confidential information of the former employer, particularly if the former employees have signed any non-disclosure or non-competition agreements with the former employer. This is very important for although California courts generally do not enforce non-competition agreements, they do enforce non-disclosure agreements. Generally speaking, however, a former employee can take the general skills and knowledge acquired during his former employment.

C. PRACTICAL STEPS TO AVOID TRADE SECRET LITIGATION

Although it is not always possible to avoid claims of misappropriation of trade secrets, taking the actions set forth below can reduce the risk of such claims.

1. Steps to Be Taken Prior to the Termination of Employment

Individuals terminating their employment to start a company should not utilize any of the tools or instrumentalities of the former employer including telephones, computers, manufacturing equipment or other items for planning or starting the new company. Use of such items may give the employer a claim to ownership of the new business or its assets and generally appears unfair to the employer which will hurt the former employee if litigation results. Likewise, the planning for the venture should take place during non-work hours.

Employees preparing to leave should be honest with their employer. When employees are vague or evasive regarding their future plans, employers become suspicious. An element of mistrust is created, and the employer is unlikely to give the benefit of the doubt to the departing employee. The employer will closely scrutinize the employee's actions, especially his or her post termination business activities. However, the disadvantage to being honest is that the advance notice gives the employer time to strike first by filing a lawsuit or to immediately terminate the employee when the employee was counting on receiving additional compensation until the termination date.

On the date of the employee's departure, the employee should have an employer's representative present when the employee cleans out his or her office. In addition, the employee should prepare an inventory of the items left in the office, obtain the signature of the employer's representative and provide a copy to the employer's representative who is witnessing the packing of one's former office. If an inventory is prepared and signed by an employer's representative, the former employer will have difficulty making a trade secret misappropriation claim.

Often, former employees take with them such things as their rolodex, engineering notes, sales prospect list, and other items. These items are often taken innocently under the belief that they were created by the employee and thus belong to the employee. This can be a fatal mistake for a departing employee. NO MATTER HOW INNOCENT OR USELESS THE ITEMS APPEAR TO BE, THE DEPARTING EMPLOYEE SHOULD NOT TAKE ANY PROPERTY OF THE FORMER EMPLOYER.

With many employees working from home, the

temptation to keep files generated on the employee's home computer and other items developed at home is great. Nevertheless, all such items should be returned to the employer.

2. Steps to Be Taken Post-termination

If possible, a former employee should take a long vacation prior to establishing the new business. The longer the time between the departure date and the establishment of the new business, the less likely it is that a claim for misappropriation of trade secrets will prevail. In addition, if possible, the departing employee should work as a consultant or accept employment with another company for an interim period. Assuming that the consulting projects or new employment do not directly compete with the former employer, this supervening event may cut off liability for trade secret misappropriation. In addition, a departing employee should attempt, if possible, to avoid directly competing with the former employer.

III. ESTABLISHING A TRADE SECRET PROTECTION PROGRAM

The success of any business depends on its ability to obtain and maintain a competitive advantage in the marketplace. Often such advantages are provided by some formula, process, knowledge or product that a competitor does not possess. Although, trademark and patent protection have their uses, most often, a high technology start-up must rely on trade secret protection for its technology and business information.

California Law defines a trade secret as: Information, including a formula, pattern, compilation, program, device, method, technique or process that (i) derives independent economic value, whether actual or potential value, from not being generally known; and (ii) is subject of efforts that are reasonable under the circumstances to maintain its secrecy².

Accordingly, trade secret law focuses on two critical factors: (i) commercial value; and (ii) secrecy. Establishing the commercial value of a trade secret is relatively straightforward. However, structuring a trade secret protection program that

will be considered by a court to consist of "efforts that are reasonable under the circumstances to maintain secrecy" is more difficult.

A. LEGAL REQUIREMENTS

To meet the reasonable efforts test, the law requires that the trade secret owner undertake actual efforts that are rigorous enough to force another to use improper, unethical, or illegal means to discover the trade secret.

In structuring a trade secret protection program to meet this standard, the start-up company must consider³: (i) the efforts to maintain secrecy may not consist of all conceivable means to maintain secrecy, prevent improper means of discovery or be so extensive as to make discovery impossible; (ii) the efforts must be steps actually taken, as opposed to mere intent; (iii) the trade secret must be treated as secret by some combination of physical security measures, confidentiality procedures and employee education; and (iv) the efforts must be directed at a particular trade secret as opposed to general business security.

While there is an extensive list of efforts that can be undertaken by a trade secret owner, the primary concern is to select and implement those efforts which are reasonable under the circumstances yet not so extensive as to make discovery impossible. To make this selection, the start-up company should identify all of the efforts that may be used to protect the secrets. The start-up company must then balance the costs and benefits of each applicable effort in selecting the measures to include in its trade secret protection program.

In choosing the particular measures, the start-up company must consider three situational factors: (i) the nature of the trade secrets; (ii) the nature of the industry; and (iii) the nature of the company. In analyzing the nature of the trade secret, the high technology start-up must consider whether it is obviously something that should be kept secret or is non-intuitive in nature. The less obvious a secret, the greater the need to inform employees that it is a trade secret and must not be disclosed. Similarly, the value of the trade secret has an impact on what efforts are reasonable. The greater the value, the more extensive the efforts to protect it should be.

With respect to the nature of the industry, companies in industries that are extremely competitive and that have high levels of employee turnover require more extensive efforts to maintain secrecy. In analyzing the nature of the company,

one must evaluate the size and financial strength of the company. A small company with few employees need not undertake the extensive protective measures required by a Fortune 500 company.

The trade secret protection program should accomplish two major objectives: (i) it should prevent misappropriation of trade secrets, and (ii) be sufficient to convince a court to enforce a company's right in its trade secrets against misappropriation.

B. MONITORING, REVIEW AND ASSESSMENT

To have an effective trade secret protection program, an employee within the start-up company should be assigned to be responsible for the continuous monitoring, review and assessment of the program. Such person should have the ability to enforce the program and periodically evaluate its performance, adding or deleting features as required. Once the program is adopted, it must be followed. If litigation occurs, the company's position could be worse if it has not followed the program than if the program had never been established.

C. SECURITY MEASURES

The physical layout of a company's facility is usually the starting point in identifying the security measures for the protection program. Physical security measures include: locks on entrances, buzzer locks on doors to sensitive areas; visitor sign-in and screening and use of identification badges; exclusion of the general public; shredding of sensitive documents; physically separating work areas from the rest of the facility; locking files; and using computer access codes, screen savers, and other security for computer networks.

D. CONFIDENTIALITY PROCEDURES

Confidentiality procedures fall into four major categories: (1) document control; (2) procedures directed at computer use; (3) procedures directed at employees; and (4) procedures directed at third parties outside of the company.

1. Document Control

With the advent of photocopy machines, faxes and computers, document control has become a difficult task. Nevertheless, measures can be taken to reduce the risk of misappropriation of trade secrets embodied in documents. Classes of documents that are important must be identified and classified according to the level of security required.

For example, documents that may be shared with any company employee may be classified and marked "Proprietary - Internal Use Only". More sensitive documents may be classified and marked as "Proprietary - Need-To-Know". These documents would consist of proprietary information that should be disclosed only to employees or others needing this information in order to perform their jobs, such as departmental budget information, organizational charts, product performance reviews, market studies and market research. The most sensitive information may be classified and marked "Proprietary - Registered". This information would include information that has the greatest value to the company, such as business plans, unreleased financial results of operations, and information regarding new unreleased products. Information with this classification should be assigned a number for tracking purposes and not photocopied without the originator's consent. Finally, when not in use, the materials should be kept in locked cabinets.

Once documents are classified, they should be conspicuously marked with the appropriate notice. Access to such documents should also be appropriately restricted. Employees should be periodically warned against leaving sensitive documents on their desks or at the copy machine. When sensitive documents are no longer needed, they should be disposed of in receptacles designated specifically for such purpose.

2. Procedures Regarding Computer Use

Since computers are so common in the work place, procedures to protect the integrity and secrecy of the information stored therein have taken on an added importance. Physical access to computers should be limited. For example, computer screens should have lock functions, employees should be instructed to log off if they will be out of their office for any length of time and passwords and other data protection methods should be used as appropriate.

Special caution should be taken with electronic mail. Unauthorized users can access electronic mail systems, and it is easy to send electronic mail to the wrong address. Generally, more secure methods should be used when transmitting proprietary information.

3. Procedures Directed at Employees

Procedures should be developed to alert employees to the necessity of protecting trade secrets and deter inadvertent disclosure. Employees should be made aware of company policy regarding trade secret protection at the interview stage. Additionally, such policies should be made part of any company policy manual. Posters should be placed throughout the premises warning of the consequences to the company of trade secret disclosure.

All employees should be required to sign confidentiality and assignment of invention agreements. These agreements require employees (1) to avoid disclosure of any proprietary information without appropriate authorization, (2) to disclose to the company on an ongoing basis all research and technical activity and (3) to acknowledge any inventions, developments, modifications or enhancements during the course of employment belonging to the employer.

When an employee terminates his or her employment, the employee should be required to turnover all company property including research, reports, drawings, blueprints, schematics, and designs to his or her supervisor. The departing employee should also receive an exit interview. Exit interviews give the company the opportunity to impress upon the departing employee his or her continuing obligations to the company. In addition, information should be gained about the departing employee's new employer for monitoring or future reference.

4. Procedures Directed at Persons Outside of the Company

Almost every Company conducts business with suppliers, vendors, consultants, contractors, sub-contractors, investors and other parties outside of the Company. Often trade secrets must be disclosed in the conduct of such business. Non-disclosure agreements are critical to protect trade secrets in these cases. Additionally, if business is actually transacted, a non-disclosure provision should be part of every contract. The Company

should develop special non-disclosure and confidentiality agreements for visitors, bidders, contractors, consultants and employees.

IV. ESTABLISHING AND MAINTAINING THE OWNERSHIP OF TECHNOLOGY

As a result of budget constraints, the desire to avoid hiring employees and other reasons, it is common for high technology start-ups to use contractors and independent contractors in the development of technology. Often, these consultants are friends and former colleagues of the founders. They may actually be independent consultants or be moonlighting on the side. Start-up companies that have used such consultants must examine the role of those persons to determine if one or more of them have an ownership claim. Start-up companies contemplating the use of consultants must take care to avoid losing ownership rights.

A. WORKS MADE FOR HIRE

Many high technology products are based upon drawings, diagrams, reports, and other items reduced to a tangible medium of expression. In addition, many high technology products involve software ranging from microcode embedded on an integrated circuit to a stand-alone software product. As a result, copyright law is often used to determine ownership rights.

A copyright is usually owned by the author of the work and is generally the person who translates the idea into a fixed, tangible expression entitled to copyright protection. However, in cases of a "work made for hire", the employer or other person for whom the work is made is considered the author. The "work made for hire" doctrine sets the ground rules for ownership of the work created at the direction of someone who might not have expended any labor in its creation, except to direct or give instructions to the individual who performed the development. The determination of the proper author in a situation in which there is a work made for hire determines who will acquire and use the bundle of rights that are bound with the copyright ownership.

1. Section 101 of the Copyright Act of 1976

Section 101 of the Copyright Act of 1976 (the "Copyright Act") provides two definitions of a "work made for hire." A work made for hire is a work prepared by an employee within the scope of his or her employment. The Copyright Act fails to provide a definition of "employee." Second, a work is made for hire if it is specially ordered or commissioned and falls into one of the following categories: (1) for use as a contribution to a collective work; (2) as part of a motion picture or other audio-visual work; (3) as a sound recording; (4) as a translation; (5) as a supplementary work; (6) as a compilation; (7) as an instructional text; (8) as a test; (9) as answer material for a test; or (10) as an atlas.

In order for a work to be considered a work made for hire pursuant to the latter definition, it must fall within one of the ten categories, and there must be an express written agreement signed by both parties that the work shall be considered a work made for hire.

A work not falling into either of the definitions of Section 101 of the Copyright Act is not considered a work made for hire, and the person who does the hiring does not own the work. Instead, the owner of the work is the person who labored to create it, usually the consultant or independent contractor. The only way a hiring party can own the work in such a case is if the owner transfers or assigns the copyright of the work to the hiring party.

Since the management of start-up companies is often too busy or neglectful to obtain a written agreement, much of the litigation arising out of the work made for hire doctrine centers on the issue of when an employer/employee relationship arises under the Copyright Act. The courts have generally been divided in determining whether an employee within the scope of his employment has prepared the work.

2. Important Court Decisions

The Supreme Court's decision in Community for Creative Non-Violence v. Reid⁴, has clarified many of the questions that have surrounded the employer/employee issue in work for hire cases. In Community for Creative Non-Violence, the Court was called on to determine whether a statue commissioned by a non-profit organization and created by an individual artist was property of the

organization or the artist. The two parties did not enter into a written agreement, and nothing was said about copyright ownership. It is immediately apparent that the statue does not fall within the latter definition of the work for hire doctrine, since the statue does not fit within one of the ten categories, and there was no writing stating the work was to be considered a work for hire. Therefore, the only way to characterize the statue as a work for hire and permit ownership by the non-profit organization was to classify the artist as an employee rather than an independent contractor.

After a systematic examination of the independent contractor versus employee issue, the Court concluded Mr. Reid was in fact an independent contractor and sole owner of the copyright and the work.

The basic question in Community for Creative Non-Violence was: when does one step out of the realm of independent contractor status and become an employee. The Court applied common law agency principles as the test of whether the hired party can be considered an employee. The factors used in determining whether one is an employee within common law agency include:

- (1) who has control over the method and means of performing the work;
- (2) what kind of skill is required to perform the work;
- (3) what is the source of the instrumentalities or tools (an independent contractor often owns his own tools);
- (4) at what location is the work performed (independent contractors often work from their own studios or offices);
- (5) what is the duration of the relationship between the parties (independent contractors usually work on a per project basis with a definite term);
- (6) does the hiring party have the right to assign additional projects to the person hired (independent contractors negotiate their fees on a per project basis and do not accept additional projects unless additional fees are promised);
- (7) does the hired party have discretion over when and how long to work (independent contractors can often pick their own hours and times to work);
- (8) what is the method of payment (independent contractors usually work on a commission or fee basis whereas employees are usually paid a regular salary);
- (9) can the hired party hire and pay his own assistants (this would be indicative of an

independent contractor rather than an employee);

(10) whether the work is part of the regular business of hiring (a hiring for a project unrelated to the primary business of the hiring party would be more likely to be an independent contractor);

(11) does the hiring party provide employee benefits like pension or insurance (most companies that hire independent contractors do not include such persons in the company benefit plan); and

(12) the tax treatment of a hired party (a form 1099 would indicate independent contractor status).

The difficult task in analyzing the elements discussed in Community for Creative Non-Violence is weighing the relevance of each factor. At least five factors are certain to be significant in every hiring situation. These factors are: (1) the right to control the manner and means of the creation of the works; (2) the skill required; (3) whether or not employee benefits are available and given to the party creating the work; (4) the tax treatment of the hired party; and (5) whether the hiring party has the right to assign additional projects to the person creating the work.

3. Impact on High Technology Start-Up Companies

There are two key elements to this issue that affect high technology start-up companies. These include (a) determining whether the start-up company owns the present technology that it believes it owns; and (b) ensuring that the start-up company owns the technology that is developed in the future.

Where the start-up company is seeking advice after the creation of the work, one must determine (i) does the work fit into definition 1 or definition 2 of the Copyright Act; (ii) if definition 1 applies, one must determine whether the person is performing labor as an employee under traditional rules of agency law, i.e. that he or she receives a regular salary, works under the control of the company including the manner and means of performing the work and other factors.

Where the founders were involved in the development of similar technology with their former employer, the former employer may have a claim to the technology. Additionally, it is common for companies to have their employees sign broad agreements assigning to the employer products and ideas developed by an employee during his employment with the company. If one or more of the founders of the high technology start-up company entered into such an agreement, the

start-up company's ownership of the technology may be in jeopardy.

Start-up companies often jeopardize their rights by failing to obtain written agreements with consultants that assist in product development. In addition, start-up companies historically tend to use independent contractors as opposed to employees to save money. Consequently, many companies have lost rights in the technology developed. Where the start-up company is subcontracting the development of the technology to consultants or other persons who fit into the independent contractor mode, the start-up company should enter into development and/or consulting agreements that address the issue and make the ownership of the technology clear.

B. THE INTELLECTUAL PROPERTY AUDIT

As a result, one of the first steps to be taken by the entrepreneur in forming a high technology start-up is analyzing the ownership of the technology. The process used in evaluating the ownership of the technology is referred to as the intellectual property audit. The purpose of the intellectual property audit is to determine the origin of the intangible assets and the extent of the owner's interest in the technology and related intellectual property rights. In addition, the intellectual property audit will determine the scope of rights that third parties may have, by license, ownership or otherwise, in the company's assets. Intellectual property audits also provide information with respect to putting in place systematic procedures for protecting and perfecting intellectual property rights. In this regard, the intellectual property audit can detect defects in existing intellectual property assets and the mechanisms and procedures for protecting and perfecting such rights.

Finally, the intellectual property audit may allow the start-up company to avoid liability for third party claims and infringement resulting from the development of new products. As a result, not only does the intellectual property audit provide information regarding the ownership of technology that was created, but it also helps the start-up company put the procedures in place to ensure that it will own the technology that is created in the future.

1. Motivation for an Intellectual Property Audit

Although the intellectual property audit is important for all technology start-ups, it is crucial for start-ups that are seeking venture capital financing or contemplating licensing or joint venture arrangements. Venture capital firms, potentially interested in funding the high technology start-up, licensees or potential joint venture partners, will conduct their own audits. An intellectual property audit conducted by these entities may vary in scope, depending on the circumstances of each transaction. As a result, it is very important for the high technology start-up to perform its own audit prior to seeking those arrangements. By conducting the audit, the start-up company will be able to identify and potentially correct any problems prior to entering into negotiations. If problems are not detected until these entities conduct their own due diligence, the agreements will be significantly delayed or the defects in the chain of title will simply cause these parties to look at other opportunities.

2. The Scope of the Intellectual Property Audit

The appropriate scope of the intellectual property audit is based on the type of property involved and the value and nature of the property. If the start-up company is seeking venture capital, the audit should be broad in scope and cover all of the technology. If the high technology start-up is considering filing an action for trademark infringement against a competitor, it may simply want an investigation limited to the trademarks involved.

The broader the investigation, the more information obtained, and the higher the cost. However, the greater the investment in the transaction, the greater the value of knowing the status of the technology. An intellectual property audit can be designed to take on whatever form is appropriate under the circumstances. At one end of the spectrum, an audit can simply train company personnel on proper procedures for protecting intellectual property in the future. At the next level, a preliminary assessment may be performed to respond to a narrow set of issues.

After reviewing the preliminary assessment, the company can decide whether or not to expand the scope of the audit in a particular area. This type of assessment may be appropriate if the start-up

company's interest in the intellectual property is narrow, or if the company cannot afford a more comprehensive audit. On the other end of the spectrum, the highest level of review is a comprehensive intellectual property audit.

Depending upon the complexity of the audit, the process can take from several weeks to several months. Depending upon the company's desire, the final audit report may be in a letter-form or in a more detailed, comprehensive report. Because most high technology start-up companies are very cost conscious, company personnel should be used whenever possible to retrieve and organize information, provide historical background, and other information regarding the development of the company's technology and the company's intellectual property protection practices.

3. Conducting the Intellectual Property Audit

Like a financial audit, the attorneys and management for the high technology start-up company should develop an audit plan. An audit plan will define the areas of inquiry, establish time deadlines, set forth responsibilities, and initially define, what documents should be reviewed and the personnel to be interviewed.

Usually, an employee of the start-up company should be assigned to coordinate the document request and collect the relevant information requested by attorneys for the company. Such information is then collected and reviewed concerning the nature of the property.

The pertinent documentation includes:

- (1) registration and recordation documents, including trademark, copyright and patent registration certificates and/or applications;
- (2) pending applications filed (including all correspondence, filing and background documents related to the application at issue;
- (3) uniform commercial code filings;
- (4) license and maintenance agreements;
- (5) OEM and distribution agreements;
- (6) government contracts;
- (7) correspondence regarding any patents, copyrights, trademarks or proprietary information;
- (8) employee and consultant agreements;
- (9) source and object codes;
- (10) flowcharts, technical specifications, and other design documents;
- (11) clean-room affidavits and other documentation relating to clean-room development;
- (12) resumes;

(13) materials referred to during the development process;

(14) journal articles, published papers and textbooks;

(15) notes of design meetings;

(16) competitive analysis documents; and

(17) marketing files.⁵

A checklist of pertinent questions should be developed and management and engineering personnel should be interviewed. The following is a sample checklist of interview questions:

(1) What was the origin of the property/product/technology?

(2) When was it first conceived?

(3) When was the development completed?

(4) Who are the people who were involved in the development?

(5) Were they considered employees or consultants?

(6) What types of intellectual property might be available to protect the property?

(7) Did any person use any technical information or copyrighted, patented technology of others in the development, support, or enhancement of the technology?

(8) Does any third party have intellectual property rights that could be violated by past or future users of the property?

(9) Have any offers, licenses, or assertions of property rights been received?

(10) If consultants were used in the development of the technology, what measures were used to protect the interest of the hiring parties and to ensure that the hiring party owns the rights to the property developed by the consultant?

(11) If any part of the property was purchased or licensed from third parties, what rights were acquired and are the obligations, that have been or could be breached, cause a reversion of rights?

(12) Has the technology been licensed to, or derived under work with, a government agency requiring special procedures in order for rights to be retained by the developer?

(13) Have necessary federal and state registrations been made and transfers recorded with appropriate agencies?

(14) Have required affidavits of use or other post registration requirements such as payment of maintenance fees been complied with?

(15) Has the property been used to secure performance of any obligation?

(16) Do third parties own any license rights, joint ownership rights or other rights in the

property?

(17) Is the party substantially similar in function, appearance, or coding to the property of others?

(18) If any portions of the property are held in escrow, what are the conditions for release?

C. CURING DEFECTS IN THE OWNERSHIP OF TECHNOLOGY

The intellectual property audit may reveal unprotected technology, defects in the chain of title or that a third party has rights in the technology. Where there is a defect in the chain of title or a third party has rights to the technology, remedial action may include: (1) obtaining written assignments from parties that may have an interest; (2) licensing the rights of third parties; (3) reverse engineering the technology or part thereof; or (4) using clean-room procedures to independently develop the technology or part thereof.

1. Written Assignments

The most common way of curing defects in the chain of title of technology is for the high technology start-up to obtain releases of claims or interest in the technology from those who have been involved in its development. Written assignments of rights may also be obtained and recorded, if necessary. Obtaining assignments after the fact can be difficult. If the relationship of the parties is good, an assignment may be easy and inexpensive. For the high technology start-up company, it is much easier and less expensive to take remedial action prior to engaging in negotiations with venture capitalists, joint venture partners or potential licensees, or once another company has made an offer to purchase the technology. In these situations, obtaining rights from other co-owners or parties involved in the development process may be very expensive.

2. Licensing the Rights of Third Parties

Another alternative is for the start-up company to offer to license the rights of others in the technology and pay them future royalties. The benefit of this approach is that the licensor shares the risk of the commercial viability of the technology. However, on the negative side, the future profit margins of any sales or licenses of products incorporating the technology are reduced.

It is often the potential value of the technology including the potential for high profit margins that attract investors to a company or justify the cost of the original development.

3. Reverse Engineering

Where such alternatives are not feasible or too expensive, the high technology start-up should consider reverse engineering or independently creating the development. Reverse Engineering is a study and observation of a product to determine its makeup and character in order to construct a product that accomplishes a similar or same result. There can be no doubt that reverse engineering may require copying in one form or another to achieve the same result. Reverse Engineering of hardware is a well-known concept. Section 906 of the Semiconductor Protection Act speaks of allowing reverse engineering of semiconductor chips. Such reverse engineering involves peeling away the layers of the semiconductor chip.

Reverse engineering software is more problematical. Two circuit court cases have discussed the permissibility of copying a computer program where copying is a necessary step in reverse engineering.

In *Atari Games Corp. v. Nintendo of America, Inc.*⁶, the Federal Circuit Court held that reverse engineering of a computer program can be fair use under Section 107 of the Copyright Act. The fair use exception to copyright exclusivity permits any individual in rightful possession of a copy of a work to undertake necessary efforts to understand the work's ideas, processes, and methods of operation. Sometimes, the very nature of a work requires a certain amount of copying referred to as "intermediate copying" or copying prior to creating a final product so that it can be fully observed, analyzed, and understood. Thus, reverse engineering object code to discern the unprotectable ideas in a computer program is fair use.

The Court in *Atari Games Corp.* made clear that in order for the fair use exception to apply to reverse engineering, there must be a minimum amount of copying, and any reproduction of protectable expression must be strictly necessary to ascertain the bounds of protected information within the work. In addition, fair use copying for purposes of reverse engineering can only be copying that is done from a copy that the party lawfully obtained. It should be noted that the amount of copying allowed under this analysis does

not give a party more than the right to understand the particular computer program and to distinguish the protected from unprotected elements of the program. Any copying beyond these bounds is infringement. Therefore, one cannot use reverse engineering as an excuse to exploit commercially or otherwise misappropriate protected expression.

In *Sega Enterprises Limited v. Accolade, Inc.*⁷, the Court ruled on reverse engineering as a fair use.

This case, like the *Atari Games* case, involved attempts by a video game manufacturer to develop a security system so that only authorized computer games could be inserted into the manufacturer's game console. The Court held that where disassembly is the only way to gain access to the ideas and functional elements embodied in a copyrighted computer program, and where there is a legitimate reason for seeking such access, disassembly is fair use of the copyrighted work as a matter of law.

Having determined that reverse engineering of the Sega Enterprise security system was reverse engineering allowed under the Fair Use doctrine, the Court analyzed the four factors of the Fair Use Doctrine with regard to whether the copying could pass as fair use. These factors included:

- (1) the purpose and character of the use;
- (2) the nature of the copyrighted work;
- (3) the amount and substantiality of the copying; and
- (4) the effect on potential markets of the copyrighted work.

4. Independent Development

Another approach to the problem of a defect in the chain of title is for the start-up company to undertake independent development of the portion of the product or the product itself. A company can undertake such a project by relying on "clean-room" procedures. The concept of clean-room procedures was upheld in *Intel v. NEC Corp.*⁸. In utilizing the clean-room concept, the start-up company would attempt to prove that even if its work is substantially similar to a copyrighted work, it does not infringe because the start-up company had no access to the copyrighted work, and the work was independently developed.

In the case of computer software, for example, clean-room procedures could require the start-up company to create two groups of developers, a specifications group and the programming group. The specification group would be allowed to see the copyrighted computer

code and prepare the functional specifications from which a newly hired programming group would create new code. The programming group would not be allowed to see the actual code of the copyrighted program, but instead, only the functional specifications prepared by the specifications group.

The basis of this concept is a principle of copyright law that protects only the expression of ideas and not the ideas themselves. The functional specification attempts to capture only the ideas underlying the competing product. The programming group creates its own expression of those ideas by preparing the computer code that conforms to the functional specification.

Using "clean-room procedures" can help a company reduce the likelihood of losing a copyright infringement lawsuit. However, this method may be expensive and time consuming. In addition, a company utilizing this methodology still runs the risk of being involved in litigation. Finally, there is a risk that the specifications may be so detailed that it tracks the competing product's expression.

D. TRANSFERRING CURRENT AND FUTURE INVENTIONS TO THE COMPANY

The transfers of copyrights, patents and trademarks must be in writing and recorded. Remembering these basic rules will save the entrepreneur much time and money. For example, Sections 204 and 205 of the Copyright Act spell out the requirements for transfers of a copyright. Section 204 states:

(a) Transfer of copyright ownership, other than by operation of law, is not valid unless an instrument of conveyance, or a note or memorandum of the transfer is in writing and signed by the owner of the rights conveyed or such owner's duly authorized agent.

In order to transfer a trademark, the transferor must transfer the goodwill associated with the mark in the transfer. The failure to do so renders the transfer of the mark invalid.

V. CHOICE OF ENTITY

While most high technology start-ups utilize the corporate form, it does not follow that in all situations (or for all time), the start-up must, or should, utilize the corporate form. Other types of business entities may be appropriate for cost, tax or

control reasons, including the general partnership, limited partnership and a new hybrid form of business, the limited liability company ("LLC"). Moreover, corporations, for tax purposes, come in two variations - the C corporation and the S corporation.

A. CORPORATION

1. General

The corporation is probably the best known and most common of the business entities used to constitute a high tech start-up. The general familiarity of all persons involved in commerce, finance and banking creates a feeling of acceptance and comfort when dealing with a corporation. For the foreseeable future - absent massive changes in Federal and/or state tax laws - the corporation shall remain the start-up entity form of choice.

2. Benefits of Incorporation

Corporations are created under authority of state law and are regarded as separate legal entities or "persons" within the legal system. Corporations enjoy unlimited life, and an identity separate and apart from those who own ("shareholders") and manage it ("directors", "officers" and "employees").

As a general proposition (to which there are some exceptions), a corporation's shareholders have "limited liability." They are not personally liable for the debts of the corporation, but rather can only see their investment rendered worthless (or diminished) should creditors pursue the corporate debtor. However, in a start-up environment, where the new corporation may have few assets and no credit history, the reality is that the founders may well find themselves asked to personally guarantee such obligations, as a building lease, bank line of credit or supplier credit. With fiscal success of the business, such guarantees may be expected to fall away.

Corporations enjoy relative ease in raising capital. It is relatively easy to buy and sell shares of stock as compared with the sale of assets or partnership interests. However, as discussed below, the issuance and transfer of a corporation's shares have special rules, considerations, risks and traps for the unwary.

Corporations also offer ease of control at both the ownership level and in the management area. While California's cumulative voting feature,

California Corporations Code Section 708, assures that the minority can be represented on a Board of Directors, as compared to a state like Delaware where a majority can elect all directors, still the majority of shareholders can elect a majority of directors and thus assure themselves of control. In a high tech start-up, the founders will want control.

With the ability to elect a majority of the Board, the founders can assure the election of their management team. The shareholders, as a class, have no right to participate in the day-to-day management of a corporation, as for example, partners would in a general partnership. Moreover, in corporate form, outside investors can be issued non-voting preferred shares so that the founders, despite a much smaller cash investment, can retain voting control.

3. Director Liability

A unique facet to the corporate form is the ability to limit the personal liability of directors with respect to actions brought by or in the right of the corporation for breach of the director's duties to the corporation and its shareholders. Corporations Code Section 204(a)(10). This protection does not, however, extend to intentional misconduct, bad faith acts contrary to the corporation's best interests, transactions from which a director derives improper personal benefit, reckless disregard of a director's duties, or an unexcused pattern of inattention to one's duties as a director.

4. Disadvantages of Incorporation

Corporations may be more expensive to maintain than other business forms. Costs to incorporate, including professional fees, range from \$1,000 - \$3,000. Prudence dictates that records be kept of directors' and shareholders' meetings, as well as shares issued and transfer records. For a start-up company, it is rare that the founders will have these skills, so they must either be purchased or deferred, with the latter creating its own set of problems. Partnerships, on the other hand, require little documentation to maintain the entity.

5. S Corporations

For income tax purposes, most corporations are referred to as "C corporations" in the sense that the determination of their income for tax purposes is controlled by Subchapter C of the Internal Revenue Code of 1986. A C corporation's

maximum federal income tax rate is 34%. This compares with a maximum income tax rate for individuals of 39.5%.

C corporations suffer the so-called "double taxation" vice. The corporation's earnings are taxed at applicable corporate rates. Then, if the corporation elects to distribute any of its earnings to the shareholders (the declaration of a dividend), the dividends will be taxes as ordinary income to the shareholders, and the corporation is not entitled to a business expense deduction for the dividends paid out.

Where a corporation is eligible to elect so-called Chapter S status (an election made under Subchapter S of the Internal Revenue Code), the vice of double taxation can be avoided - some say to be replaced by a new vice. Income earned by a corporation electing to be taxed under Subchapter S will be taxed to the shareholders. The corporation pays no federal income tax. Conversely, if the corporation has a loss, that loss can be allocated to the shareholders and deducted against other shareholder income, but only to the extent of the shareholder's basis in his/her shares.

The S corporation's income is taxed to the shareholders regardless of whether the corporation distributes any income to the shareholders - the worst tax scenario: taxable income without offsetting cash with which to pay the tax. Also, California taxes the income of a Chapter S corporation to the extent of 1.5% of income, but not less than \$800.

B. GENERAL PARTNERSHIP

1. General

Although it is not commonly associated with a high tech start-up, the general partnership is one of the most common (sometimes by accident) forms of business entity. A partnership is an association of two or more persons to carry on, as co-owners, a business for profit⁹.

2. Benefits of Partnership

A general partnership may (but should not) be created by oral agreement. The creation of a partnership does not require the intervention of any public agency. The cost of creating a partnership with a formal agreement is usually comparable to or less than for a corporation. The expense of periodic maintenance is nominal.

A general partnership is a tax reporting, but not

a tax paying, entity. The partnership's income or loss is directly allocated to the partners in their respective ownership interests.

A general partnership could be appropriate for a high tech start-up during the very early planning and possibly development stages where a limited number of people are involved, and liabilities are modest.

3. Disadvantages of General Partnership

The owners ("partners") of a general partnership are jointly and severally liable for all of the partnership's debts. That liability extends not only to the value of the partner's investment in the partnership, but to all of his/her personal assets. While most catastrophic liabilities can be insured against by a partnership, the risks of partnership form can still be significant. This general liability feature of the partnership works to undermine the entrepreneurial spirit.

The creation of new ownership interests and the transfer of those interests within a partnership are sufficiently cumbersome (except for the absence of securities regulation), that they are not well suited to the high tech start-up environment. Moreover, in most partnerships, all partners must agree to admit new partners. Each partner, in a general partnership, normally enjoys the right to act on behalf of the partnership and to participate in the partnership's management.

C. LIMITED PARTNERSHIPS

1. General

A limited partnership differs from a general partnership in that there are two classes of partners: general and limited. As its name implies, it offers a form of limited liability to certain owners.

2. Advantages of Limited Partnership

The major advantage of a limited partnership is that the limited partners (but not the general partners) are not liable for the partnership's debts. Rather, they are treated as "investors", as their "risk" is limited to the loss of their investment.

Limited partnership profits and losses are allocated among the partners in accordance with their respective ownership interests. In addition, limited partners have virtually no voice in the

management of the partnership's affairs. That power rests with the general partner(s).

3. Disadvantages of Limited Partnership

The general partners remain fully liable for all partnership debts in the same fashion as a general partnership. This usually requires that the limited partnership have a corporate general partner. The use of a corporate general partner complicates the structure and adds to the cost of formation and maintenance.

Limited partnership interests are securities, and their sale must comply with the provisions of the Federal and California Corporate Securities Laws. California law requires that the agreement of the limited partners be in writing. Such agreements are complex and can be quite extensive. Their cost of preparation can be expected to exceed that of a corporation. In addition, unlike general partnerships, limited partnerships must register with the California Secretary of State.

D. LIMITED LIABILITY COMPANY

1. General

A limited liability company ("LLC") is an entity created under state statute that combines the corporate characteristic of limited liability for all of its owners with the tax classification and flexibility of a partnership. The owners or "members" of an LLC are offered limited liability protection in the same manner as shareholders of a corporation under existing corporate law¹⁰. If the LLC's organizational documents are properly drafted, the federal income tax applied at the entity level is eliminated and only the LLC's members are subject to federal income tax, like partners in a partnership or shareholders in an S Corporation.

Because of the organizational flexibility and tax advantages offered by LLCs, they are ideally suited for a wide range of business activities, including those presently conducted in the form of general and limited partnerships. LLCs are attractive vehicles for real estate ventures, joint ventures, venture capital funds and international investments.

2. Tax Considerations

The following are some of the factors that should be considered in evaluating the usefulness of

an LLC from a tax perspective. For purposes of this discussion it is assumed that the LLC is classified as a partnership for federal income tax purposes.

a. Advantages of LLC's Over C Corporations

Whereas the income earned by a C corporation is subject to the double taxation vice, a LLC is not subject to federal income tax. The members pay federal income tax on income earned by the LLC in proportion to their share of the LLC's income. Unlike a C corporation, a LLC may specially allocate income or loss to its members in accordance with Internal Revenue Code ("IRC") § 704(b). Additionally, a C corporation is subject to double tax on liquidation, unlike the LLC which does not generally recognize gain or loss upon liquidation. Only the members may be subject to tax on distributions received from the LLC's liquidation.

A C corporation may have a portion of the salary deduction for an officer-shareholder disallowed as unreasonable compensation. Any disallowed portion would typically be treated for tax purposes as a dividend rather than as salary. However, a LLC member's income is either taxed as a guaranteed payment under IRC § 707 or as the member's distributive share of LLC income under IRC § 701 et seq.

b. Advantages of LLCs Over S Corporations

S corporations are subject to certain restrictions on the number and type of shareholders they may have. S corporations may not have more than 35 shareholders. Corporations, partnerships, certain kinds of trusts, pensions plans and non-resident alien individuals may not be shareholders of an S corporation. LLCs are not subject to any of these restrictions. In addition, S corporations may not hold more than 80% of the total voting power and total value of another corporation's stock. LLCs are not subject to this restriction. Furthermore, unlike LLCs, S corporations are not permitted to specially allocate income, gain, deduction or loss among their shareholders or to make disproportionate distributions to their shareholders.

S corporations may not have more than one class of stock outstanding. LLCs may have any number or variety of classes or series membership

interests. S corporations are subject to certain penalty taxes for built-in gains and excessive passive income. These penalty taxes do not apply to LLCs. Finally, it is very easy for an S corporation to forfeit inadvertently its status as an S corporation (e.g., the acquisition by a non-eligible person or entity of stock in the S corporation).

c. Disadvantages of LLC's -- Tax Considerations

Members of a LLC will not enjoy all the advantages of the numerous fringe benefits available to shareholder-employees of a C corporation. For example, an LLC's members: (i) may not receive tax free life insurance and medical benefits; (ii) may not participate in an IRC § 125 cafeteria plan established for the LLC's employees; and (iii) will find significant restrictions with respect to qualified retirement plans (e.g., inability to borrow from the retirement plan).

The members of an LLC may be subject to higher marginal tax rates than corresponding corporate tax rates.

In addition, LLCs organized or doing business in California are subject to the minimum annual franchise tax, plus a graduated fee based upon the total income of the LLC from all sources. In some cases, the fees payable in California will be higher than the 1.5% corporation tax.

3. Piercing the Limited Liability Company Veil and Fiduciary Duties

Notwithstanding the general rules of limited liability, a member of an LLC shall be personally liable for any debt, obligation or liability of the LLC under the same or similar circumstances and to the same extent as a shareholder of a corporation may be personally liable for any debt, obligation, or liability of a corporation¹¹. Thus, the criteria used to determine whether to "pierce the LLC veil" are the same criteria used to determine whether to "pierce the corporate veil", with the important exception of failure to observe corporate formalities.

The fiduciary duties a manager owes to the LLC and its members are the same as those of a partner to a partnership and its partners¹². However, the members may modify these duties, in the written operating agreement with the informed consent of the members¹³. This may be a tremendous advantage in avoiding litigation and claims by other owners.

4. California Tax and Fees

California Revenue and Taxation Code § 23091 provides that every LLC organized, qualified or doing business in California that is classified as a partnership for federal income tax purposes shall pay an annual franchise tax of \$800¹⁴. Such LLC's also shall pay an annual fee based on total income (defined as gross income plus the cost of goods sold that are paid or incurred in connection with the trade or business of LLC).

For taxable years beginning on or after January 1, 1997, these fees are as follows:

Total Annual Income	Annual Fee
Less than \$250,000	\$ 0
\$250,000 or more, but less than \$500,000	\$ 500
\$500,000 or more, but less than \$1,000,000	\$ 1,500
\$1,000,000 or more, but less than \$5,000,000	\$ 3,000
\$5,000,000 or more	\$ 4,500 ¹⁵

Beginning in 1999, the fee is subject to adjustment up or down annually by the Franchise Tax Board to ensure the "revenue neutrality."¹⁶

VI. CALIFORNIA CORPORATE FORMATION BASICS

Since 1977, California corporations have been deceptively simple to "create". Articles of Incorporation seldom exceed 1 - 2 pages letter size, single space. The contents of Articles are mandated by law, and the Secretary of State publishes a booklet of approved forms entitled Corporations Check List.

A. BASIC STEPS AND DOCUMENTATION

1. Name Registration

The Secretary of State is prohibited from filing Articles of Incorporation "which set forth a name which is likely to mislead the public or which is the same as, or resembles so closely as to tend to deceive, the name of a domestic corporation, the name of a foreign corporation" which is qualified to transact business in California, or a name which is under reservation for another corporation¹⁷. The incorporation process should always begin with a

check for the availability of the desired name.

A high technology start-up company must be very cautious in selecting a name. If the founders perceive that a corporation's name is going to be a marketing delight, the company should run a trademark/tradename search to ensure that the desired name is not being used by someone somewhere other than California. More than one start-up company has "squandered" a meaningful portion of its capital having to change its name because of its failure to conduct a trademark search.

2. Articles of Incorporation, Bylaws, Incorporator Action, First Director Action

The package of papers necessary to manifest an incorporation consist of: (1) the Articles of Incorporation; (2) incorporator action adopting Bylaws and electing directors; (3) Bylaws; and, (4) organizational action of the directors.

Today, Articles are almost all boilerplate and contain little, if any, discretionary features: (1) name; (2) authorized capital included "blank check" preferred stock; (3) agent for service of process; and, (4) limited liability for directors. Articles can be more complex where there is common and preferred shares and the terms of the preferred shares are set forth in the Articles; however, this usually occurs later with arrival of venture capital investors.

Once Articles are filed, the incorporator adopts the Bylaws (which fix the number of directors), elects the first directors and resigns. Except for the incorporator's adoption of Bylaws and election of directors, the Minutes of the organizational (or first) meeting of the directors (or an action by unanimous written consent in lieu thereof) are crucial to a valid and viable start-up corporation. Such Minutes or action should cover (as applicable) and at a minimum:

- (1) location of principal office of the corporation;
- (2) adoption of corporate seal and form;
- (3) amortization of incorporation expenses;
- (4) election of officers;
- (5) establishment of bank account and designation of persons authorized to sign;
- (6) approval/ratification of facility lease;
- (7) acknowledgement of indebtedness to founders in connection with incorporation;
- (8) selection of fiscal year;
- (9) authorization to obtain/register with: (a) employer identification number; (b) Employment

Development Department; (c) State Board of Equalization;

- (10) authorize obtaining insurance including:
 - (a) workers compensation;
 - (b) comprehensive general liability;
 - (c) fire and casualty;
- (11) fix officers' compensation;
- (12) authorize issuance of shares;
- (13) authorize borrowing; and
- (14) consider election under Subchapter S of Internal Revenue Code.

3. Restricted Stock Purchase Agreements

It is a common practice for the founders of the start-up company to receive their ownership in the company by a means of a restricted stock purchase agreement. This agreement provides for the number of shares to be received by the founder, the price paid in cash or contribution of technology and other matters. The agreement also usually provides the company the right to repurchase all or part of the founder's shares at their original purchase price., if the founder leaves the company before a certain time. This concept is usually referred to as "reverse vesting". The company's repurchase right expires over time, often monthly or quarterly.

4. Other Documents

The new corporation will also need to file in the Office of the Secretary of State within 90 days after incorporation, a Statement of Domestic Stock Corporation which will set forth names and addresses of officers and directors, and the agent for service of process. Failure to file this form can result in penalties or even suspension of corporate status. The Secretary of State mails this form to the incorporator with the file-stamped articles of incorporation.

Assuming shares are issued under an exemption found in the California Corporations Securities Law, a Notice of Issuance must be filed with the California Department of Corporations within 10 days after the corporation accepts consideration for the shares. Stock Certificates should be prepared in a timely fashion and distributed to the shareholders.

B. TIME AND EXPENSE OF INCORPORATION

Once the corporate name has been checked for availability and the incorporator has executed

Articles, incorporation can be accomplished overnight - if not sooner. If time is not a factor, documents may be sent to the Secretary of State by mail. Documents will be filed as of the date of their receipt in that office. However, 3-4 weeks is the norm for getting documents returned.

A more reliable method is to send the Articles of Incorporation and checks to a filing service and pay the service fee to hand carry the articles to the Secretary of State counter where, for an extra \$15, the Secretary of State's office will file your documents (after review by the legal section) that day. Certification and return via the service can usually occur within one day.

The out-of-pocket costs of incorporation are significant:

- | | |
|--|-----------------|
| (1) Franchise Tax Board-
(for privilege of incorporation;
not a prepayment of first year
Franchise tax) | \$800 |
| (2) Secretary of State to file
Articles and certify two copies | \$100 |
| (3) Secretary of State counter
filing fee | \$15 (optional) |
| (4) Filing agent | \$26 (optional) |
| (5) Minute Book, seal,
stock certificates | \$70+/- |
| (6) Statement of Domestic
Stock Corporation | \$10 |
| (7) Name Reservation Certificate | \$14 (optional) |
| (8) Notice of Issuance to
Department of Corps. | \$25-\$100 |

Attorneys' fees for basic incorporation services can be modest. They depend on the services to be rendered.

VII. DEFECTS IN CORPORATION FORMATION

A. INCOMPLETE INCORPORATION

While the entrepreneur may reasonably conclude that the corporation exists once its Articles are filed in the Office of the Secretary of State, incorporation in a substantive legal sense is just beginning. Moreover, with the advent of corporation kits and software featuring form Bylaws and Minutes, etc., it is not difficult to miss things. While not intended to be exhaustive the following are some of the more common "omissions" encountered:

1. Bylaws and Directors

While the number of directors can be included in the Articles, the common practice is to provide for the number of directors in the Bylaws. Be sure that the number of directors appointed by the incorporator, or elected by the directors or shareholders, is consistent with the number of directors authorized in the Articles. It is quite common to see the number of persons serving as directors greater than the number authorized in the Bylaws. When this happens, one can have an issue as to whether the Board was lawfully constituted.

2. Officers

The election of officers, especially as people come and go, should be reflected in minutes of meeting of the Board. People should not be permitted to represent themselves as officers (vice president is a favorite), unless so designated by the Board of Directors and not the President.

3. Bank Accounts

All banks require corporate customers to adopt the bank's form of resolutions authorizing the opening of an account and designating those authorized to draw on the account. To open the account, the corporate secretary must certify the adoption of the bank resolutions. This is invariably done on the back of the account signature card. Care must be taken to see to it that these resolutions are included in (or incorporated by reference in) the corporation's Minutes. When corporate officers change, new bank resolutions need to be adopted. This becomes very important where the corporation seeks to recover from its bank on checks drawn by a former officer (usually to him/herself).

4. Chapter S Election

Where a corporation elects to be taxed under Subchapter S, that election must be made and filed with the Internal Revenue Service and State taxing authority no later than 2 1/2 months after incorporation to be effective for that taxable year. The election is made by the corporation and must be consented to by all shareholders in writing. This means that if a corporation desires to elect under Subchapter S in its first year, it must be sure to complete its capitalization (issuance of shares) within the first 2 1/2 months. This can prove to be a very tight schedule. It is not unusual to see start-up companies lost important tax advantages

because of the failure to file the relevant state and federal S election forms.

5. Workers' Compensation Insurance

Unless the corporation's only employees will all be shareholders from day one (in which case the corporation can defer this issue until the first non-shareholder employee comes along), the corporation must obtain workers' compensation insurance. Otherwise, the corporation's shareholders will be liable with the corporation for work related injuries to company employees. The liability will be to reimburse the State Compensation Insurance Fund for payment made to, or at least for, the benefit of an injured employee.

6. Debt Acknowledgement

The director Minutes should reflect the corporation's acknowledgement of indebtedness to founders for monies advanced in connection with the incorporation and should include a promise of repayment. It would be preferable to have the corporation execute and deliver promissory notes in connection with such indebtedness. Having a written record of such indebtedness is essential where such indebtedness will either: (a) be canceled in exchange for stock, or (b) repaid from the proceeds of the sale of stock to others. The failure to document loans can lead to disagreements among shareholders. Shareholders may, after significant time has passed and memories faded, come in conflict over whether money delivered to the corporation was loan or equity.

7. Asset Valuation

Where shares are to be issued in exchange for services already rendered or for tangible assets, or for intangible assets (technology), the Board must determine the "fair value to the corporation in monetary terms" of such services or assets¹⁸.

8. Documentation of Share Issuances

One of the most common oversights is the failure to issue shares, or the failure to complete the issuance of shares, and/or the failure to comply with state securities laws to establish otherwise available exemptions. Also seen in this area is a failure to observe limitations on share issuances created by

the Bylaws or separate investor agreements, such as rights of first refusal.

Because the goal of most high tech start-ups is to create wealth from a combination of modest personal investment, extraordinary hard work and someone else's money, share issuance records should be well documented from the beginning. The due diligence of the venture capitalist investor or an acquiring suitor will almost always start with a corporation's capitalization and share issue records.

The specifics of share issuances should be reflected in Board Minutes. The Minutes should reflect to whom shares are to be sold, the number of shares per purchaser, the price per share in dollars and, where the consideration for shares is other than cash, specify that consideration: such as cancellation of indebtedness, tangible property, intangible property, services rendered. Every sale of shares (and for that matter, every grant of an option) should be authorized by the directors and reflected in the Minutes of their proceedings. Documenting board approval of share issuances can avoid disputes among shareholders over whether a particular issuance was legal and approved by the board. In situations where shareholders are struggling for control of the corporation, the absence of formal board approval of a stock issuance and share certificates allows one faction to dispute the number of shares owned by another shareholder.

9. Action Inconsistent with Articles and Bylaws

Board of directors will, on occasion, take action inconsistent with the corporation's Articles or Bylaws, or may take action purporting to amend Articles or Bylaws, but which in fact and law do not. Examples include: (a) authorizing the selling of shares in excess of the total authorized capital; (b) electing directors in excess of the authorized number; (c) changing the corporate name or using a name different from the name reflected in the Articles; (d) stock splits or stock dividends without first amending the Articles; (e) adopting stock option plans where the number of shares under the plan, when added to already issued shares, exceeds the total number of shares authorized in the Articles.

B. CURING DEFECTS IN CORPORATE FORMATION

1. Generally

Defects and omissions in the formation of a high tech start-up may not turn up for months, even years, after formation given the circumstances leading to their discovery. It is a tribute to the law-abiding nature of our society that things work so well when the foundation may be flawed. As general propositions, it is safe to conclude that (1) for every problem, there is a solution; and, (2) it is never too late to find solutions.

2. Updating the Minute Book

a. Generally

The Minute Book, containing the Articles, Bylaws, proceedings of shareholders and directors, and stock issue and transfer records, is the heart of a corporation's history. A reasonably complete, up to date Minute Book can create an aura of confidence for outsiders interested in a corporation. In the long run, keeping a Minute Book updated is worth the investment.

b. Amending Articles and Bylaws

Since Articles are only amended when the Certificate of Amendment is filed in the Office of the Secretary of State (Corporations Code Section 908), no retroactive effect can be achieved. Where a corporation has acted (1) as if its Articles had been amended, or (2) in a manner lawful only if its Articles had been amended, there is little room within which to maneuver. First, evaluate whether the action can be undone either with the consent of all concerned or without economic harm to third persons. Second, determine if the action in question is needed for the future and what can be done to cure the unauthorized acts. Depending on the answers to these questions, proceed with amending of the Articles in the usual fashion.

Bylaw amendments, on the other hand, are more susceptible to retroactive correction since they do not involve the intervention of a public official. The failure to amend Bylaws to increase the authorized number of directors to reflect the actual number of directors elected can be repaired in retroactive effect by having the directors and/or shareholders (depending on who had the power to change the number of directors) taking

contemporaneous action which amends the Bylaws effective as of the prior date, and having the Board and shareholders take contemporaneous action ratifying all actions taken by the Board subsequent to the unauthorized increase in the number of directors.

Alternatively, if the directors and shareholders have remained the same throughout, there is no reason not to have them take the necessary action as of the prior date, using that date, since they were always authorized to do so.

c. Correcting/Supplementing Minutes

Minutes as actually prepared, can contain errors as well as have obvious (at least in hindsight) omissions. This can be equally true of both shareholder and director Minutes, but is seen more frequently with director Minutes. For shareholders, the problem is more frequently the absence of Minutes altogether.

Corrections and supplements should be made on a contemporaneous basis, ratifying and authorizing action effective as of the prior date. Actions by unanimous written consent are especially helpful here as the action can be taken in concise form. Under no circumstances should the original "offending" prior Minutes be removed from the Minute Book or destroyed.

The effective date of such corrective actions would be dictated by the circumstances, with the goal being to have the corrective action speak as of the date (or prior thereto) of creation of a corporate right or obligation.

d. Missing Minutes

Most commonly, one will find an absence in the Minute Book of Minutes covering the shareholders' annual election of directors and the annual election of officers by the directors. Where the shareholders and directors are the same persons, they may act indiscriminately as both without indicating in what capacity they are acting.

The Minute Book should reflect for every year of corporate existence, the election of directors by the shareholders (or by the Board, where replacing a departed director) and the election of officers by the directors. For missing years, shareholder actions by unanimous written consent and director actions by unanimous written consent electing officers, each dated as of the date called for in the Bylaws for the annual meeting, should be prepared,

executed and inserted in the appropriate chronological location in the Minute Book.

The foregoing solution may not always be practical where the number of shareholders is many, or there are problems as to who are the prior shareholders. In this case, the approach should be to have the current shareholders by resolution at the next shareholders meeting (or by action under Corporations Code Section 603(a)), ratify all action taken by all Boards as to which the records of their election are missing.

e. Missing Director Actions

Apart from share issuance matters, it is common for the board of directors to have failed to authorize or ratify material commercial rights or obligations. Of importance here is an action previously represented to third parties as having been taken. For example: (a) representations to banks of account opening and borrowing authorizations; (b) representations to lessors of real estate and personal property of lease authorizations; (c) representations to governmental agencies as to the authority of corporate officers.

Correction here is relatively simple as in most cases the Board probably believed that it was taking the requested action. If the then concerned directors are still in office (or available), an action by unanimous written consent dated as of the prior date will be appropriate. If the prior concerned Board is not available, then the current Board should take contemporaneous action ratifying and authorizing as of the prior date, the appropriate action.

3. Correcting Share Issuance Matters

a. General

Corrective action with respect to share issuance matters involves both corporate law and securities law, with the latter being the driving force. Here, the problems range from a failure to document a share issuance, through a failure to comply with the securities laws and failure to observe the terms of share issuance agreements, to the transfer to potentially innocent persons of shares sold in violation of applicable securities laws. This topic is one of the most often encountered with the high technology start-up.

b. Unkept and Unknown Promises

Any audit of a start-up's capitalization includes identifying anyone who believes he or she is a shareholder. Under the California Securities Law, a promise of a security, even an oral promise, is a security¹⁹. Few entrepreneurs form a high tech start-up without promises of an equity interest, whether of shares or options for shares. It is common for members of the founder team to work on product development or marketing plans, in exchange for shares when the corporation is formed. Consultants are promised shares in exchange for business plans. Finders are promised shares for "finding" investment capital. All of these promises must be identified and documented in writing.

c. Breach of Share Issuance Agreements

While non-compliance with the securities laws is the most common omission, failure to issue shares in accordance with the terms of agreements is also common. Here, the problem is "simply" one of breach of contract. Usually, the breach is technical in the sense that everyone intended to happen what did happen, but forgot to obtain a needed approval or waiver. The shares issued are valid shares. It is a question of securing the missing approval or waiver after the fact and moving on. Such omissions should be corrected at the earliest possible time before passing events give the omission significant economic value.

d. Failure to Issue Shares

It is also common for the founders to put their money and property in the corporation in exchange for an agreed number of shares (but without the shares being issued) with the founders being regarded as shareholders by all concerned. It is highly desirable to cause all such shares to be formally issued before new shares are sold to outside investors. The first step, if applicable, is to cause the Board Minutes to reflect the authorization of the sale and issuance of such shares.

The next step is to issue the shares; that is, prepare the appropriate stock certificates (and stock issue records), and deliver them to the shareholders. The certificates should be dated as of the date on which the corporation accepted/received the consideration for the shares. Depending on how long the corporation has existed and the absence of needed shareholder actions, cash and property

could be treated as loaned to the corporation, such that the date of shares issued becomes the date such indebtedness is canceled in exchange for shares. If interest or rent is paid on these "loans", shares could be issued also in cancellation of the obligations to pay interest/rent. However, the shareholder will recognize ordinary income for the canceled interest/rent.

VIII. COMPLIANCE WITH FEDERAL AND STATE SECURITIES LAWS

A. REGULATORY APPROACHES

The offer, sale and issuance of securities by a corporation is regulated at both the federal (Securities and Exchange Commission) and state level ("Blue Sky Laws" - Commissioner of Corporations in California), and the regulatory underpinning at both levels is quite different. While perhaps a bit of an over simplification, federal law is built on the concept of "full disclosure" - you can sell whatever you want, to whomever you wish, so long as you tell the truth - the whole truth - about what you are selling.

California and other states, on the other hand, have adopted a paternalistic approach to the sale of securities that actually seeks to protect the investor. For example, the California Commissioner of Corporations may prohibit share qualifications where he or she finds that the proposed plan of business of the issuer or the proposed issuance or sale of securities "is not fair, just or equitable"²⁰. The Commissioner uses this power to support rules prescribing various situations, such as employer stock purchase plans or incentive stock option plans, just what such plans may and may not provide.

B. REGISTRATION/QUALIFICATION REQUIREMENTS

Section 5 of the Securities Act of 1933, as amended (the "1933 Act") makes it unlawful absent an exemption for any person, directly or indirectly, to use interstate commerce or the mails to offer to sell a security, unless a registration statement has been filed with the Securities and Exchange Commission (the "SEC"). The 1933 Act is a comprehensive regulatory scheme designed to protect investors and to promote full disclosure of material information to prospective investors – the facts investors would find important in making an investment decision – by requiring the filing and

approval of a registration statement containing material facts of the investment merit of securities being offered publicly before the securities can be offered for sale.

Similarly, California law makes it unlawful for any person to offer or sell a security in California in an issuer transaction unless the offering has been qualified with the California Department of Corporations or is exempted. Qualification with the California Department of Corporations or other state securities administrators, while not as time-consuming or expensive, involves extra costs, and in some instances, prohibitions which the founders of a company will seek to avoid. The increased costs of a registered offering are a result of several factors, including the necessity of dealing with regulatory authorities, additional legal requirements for registration, and the higher legal, accounting, and printing costs associated with the disclosure materials.

Failure to comply with the registration requirements of the federal securities laws could lead to a variety of severe consequences, including but not limited to rescission of the purchase of the securities, damages, criminal prosecution, and injunctive actions by the regular authorities²¹. State securities laws provide similar civil, criminal and injunctive remedies²².

Since registration with the SEC is time-consuming and expensive, many companies seek to avoid the registration process by obtaining an exemption from registration. Additionally, if the company is in the very early stages of development, it may be better to seek loans from financial institutions or raise capital by selling securities in exempt transactions.

C. EXEMPTIONS FROM REGISTRATION AND QUALIFICATION

1. Federal Exemptions

The principal federal exemptions that may be available are the private placement exemption pursuant to Section 4(2) of the 1933 Act, Regulation D and the intrastate offering exemption under Section 3(a)(11) of the 1933 Act and Rule 147 thereunder.

a. Section 4(2) Private Placement Exemption

Section 4(2) of the 1933 Act exempts from registration "transactions by an issuer not involving

any public offering.” To qualify for this exemption, the SEC and the courts have interpreted non-public offerings to be available to sophisticated offerees and purchasers who have access to the same kind of information that a registered offering would provide, who are able to “fend for themselves” as knowledgeable investors and who agree not to resell or distribute securities to the public²³. If securities are offered to even one person who does not meet the required conditions, the entire offering may violate the 1933 Act. However, Rule 506, a safe harbor under Regulation D, provides the objective standards to be relied on in order to meet the requirements of this exemption and is discussed below.

b. Regulation D Exemptions

Regulation D, effective April 15, 1982, governs exemptions from registration for certain limited offerings of securities. Regulation D is a series of eight rules, numbered 501 through 508, and establishes three exemptions from the registration requirements of the 1933 Act. An issuer of securities, whether a partnership, corporation, or other entity, may have available to it one or more of these exemptions, depending on the (i) amount of the offering, (ii) accredited investors, (iii) manner of the offering, (iv) information disclosed, (v) resale, (vi) integration and (vii) notice of sale. Rules 501-503 prescribe terms and conditions generally applicable to the three exemptions contained in Rules 504-506.

(i) Amount of Offering

Rule 506 is a non-exclusive safe harbor for transactions exempt from registration under the private placement exemption of Section 4(2) of the 1933 Act. Under Rule 506, an unlimited amount of capital can be raised, and certain disclosures are required. The safe harbor is available to all issuers for offerings sold to no more than thirty-five sophisticated purchasers plus an unlimited number of “accredited investors”. The issuer is required to make a subjective determination that each purchaser, individually or by means of a purchaser representative, other than accredited investors, meets certain sophistication standards. Since Rule 506 is a non-exclusive safe harbor, an offering that does not satisfy all of its conditions may still be exempt under Section 4(2).

Rule 505 provides an exemption for medium-sized offerings and sales not exceeding \$5,000,000

in any twelve-month period where sales are made to not more than thirty-five purchasers and an unlimited number of accredited investors. Corporations, partnerships, and any other issuer that is not an investment company qualify for the exemption. Unlike Rule 506, Rule 505 does not impose sophistication requirements for purchasers; however, certain information must be disclosed, depending on whether or not the issuer is a reporting company under the Securities Exchange Act of 1934. (the "1934 Act"). Issuers must inform investors that they may not sell for at least one year without registering the transaction or qualifying for another exemption since securities under Rule 505 are restricted.

Rule 504 provides an exemption for small offerings subject to state Blue Sky laws. Rule 504 applies to non-public companies in situations where no more than \$1 million of securities is sold in a twelve-month period. The advantage of Rule 504 is that there is no ceiling on the number of investors and there are no restrictions on the manner of the offering.

(ii) Accredited Investors

The term "accredited investor" is used throughout the rules to refer to persons or entities that are not counted toward the limitations on the number of purchasers. If accredited investors are the only purchasers in offerings under Rules 505 and 506, Regulation D does not require delivery of specific disclosures as a condition of the exemption. Furthermore, the issuer's obligation to ensure the sophistication of purchasers applies only to investors that are not accredited. Specifically, under Rule 501, "accredited investor" means any person who comes within any of the eight categories set forth in the Rule at the time securities are sold to that person. These include certain institutional investors, certain entities with total assets in excess of five million dollars, directors and executive officers and high net worth individuals.

(iii) Limitation on the Manner of the Offering

Except as provided in Rule 504(b)(1) for certain Rule 504 offerings, the start-up company and any person acting on its behalf is prohibited from offering or selling the securities by any general solicitation or general advertising, including, but is not limited to, any advertisement,

article, notice or other communication published in a newspaper, magazine, or similar media or broadcast over television or radio. However, seminars or meetings are allowed to discuss the offering so long as attendees have not been invited by any general solicitation or general advertising. Realistically, this provision requires that the issuer control the number and kind of offerees so as to show that no general solicitation existed even though no offeree qualification per se is present.

(iv) Information Disclosure Requirement

There is no disclosure requirement in Rule 505 and 506 offerings made exclusively to accredited investors, although these offerings are still subject to the anti-fraud provisions of the 1934 Act. However, if securities are sold to any non-accredited investors, disclosure to all non-accredited investors becomes mandatory, although the disclosure varies with whether or not the issuer is a reporting company under the 1934 Act and the amount of the offering involved. If the issuer is a reporting company, it must furnish its most recent annual report, any subsequent Exchange filings and a brief description of the particular offering. Otherwise, for the non-reporting companies, the disclosure requirements vary with the amount of the offering. Generally, the disclosure requirements for non-accredited investors are extensive and may be expensive as well. The issue of the proper disclosures has long been a difficult issue for high technology start-up companies. The form that these disclosures take, which is the subject of fierce debate among business people and the legal profession, shall be dealt with below.

(v) Limitations on Resale

Except for Rule 504 offerings, securities sold in Rule 505 or 506 offerings are restricted and cannot be resold without registration under the 1933 Act or further exemption therefrom. The issuer must exercise reasonable care to assure that purchasers of the securities are not statutory underwriters because of their intent to redistribute the securities acquired, within the meaning of Section (2)(11) of the 1933 Act. Therefore, the issuer should have the purchasers sign letters of intent, disclose the securities' restricted nature and legend the securities as restricted.

(vi) Integration

Regulation D does not define an "offering". As a result, an issuer must be careful to avoid having several offerings integrated as one. Under the integration principle, an issuer cannot slice and dice an offering so that different parts fit separate exemptions. For example, if two offerings purportedly relying on the Rule 506 exemption were integrated and if each had eighteen non-accredited purchasers, the exemption would be lost for both because there would be more than thirty-five purchasers. In addition, the issuance would not qualify for the exemption set forth in California Corporations Code §25102(f) to be discussed below.

The relative importance of the integration factors varies depending upon the circumstances. However, the fact that the offerings are part of a single plan of financing will weigh heavily in the direction of integration. These factors include whether the multiple transactions (i) are part of a single plan of financing, (ii) involve the same class of security, (iii) took place at about the same time, (iv) involved the same consideration and (v) were made for the same general purpose. Rule 502(a) provides a timing safe harbor against the integration problem for offers and sales of securities six months before and after a particular Regulation D offering.

(vii) Filing of Notice of Sale

The issuer must file with the SEC five copies of a notice on Form D no later than fifteen days after the first sale of securities in a Regulation D offering.

Table of Regulation D Offerings:

	Rule 504:	Rule 505:	Rule 506:
Amount of offering:	\$1 million ceiling	\$5 million ceiling	Unlimited amount
Period of offering:	Within 12 months	Within 12 months	Unlimited time
Investors:	Unlimited number and kind of investor	Limited to 35 non-accredited investors + any accredited investors	Limited to 35 investors, but not required to be accredited, just sophisticated
Manner of offering:	Unlimited ads and solicitation	No general ads and solicitation	No general ads and solicitation
Resale:	Restricted	Restricted; security must be registered before resale	Restricted; security must be registered before resale

c. Intrastate Offering Exemption - Section 3(a)(11)

Another valuable exemption used by high technology start-up companies is the intrastate offering exemption, which has the advantage of allowing certain general advertising, no investment sophistication requirement for purchasers, and no limitations on the number of purchasers or the size of the offering. To qualify for the Section 3(a)(11) exemption, the issuer must be incorporated in the state where it is offering the securities, carry out a significant amount of its business in that state and make offers and sales only to residents of that state.

This exemption is designed to permit interstate, local financing that can be consummated in its entirety in the state where the issuer is both organized and doing business. This exemption is predicated on the assumption that state securities laws are adequate in regulation that type of transaction. However, if any purchaser resells any of the securities to a person who resides outside the state within a short time after the company's offering is complete, the entire transaction, including the original sales, might violate the 1933 Act.

In order to provide greater objectivity and certainty in determining whether the Section 3(a)(11) exemption was available, the SEC in 1974 adopted Rule 147, a non-exclusive safe harbor, providing that if all the conditions of that rule are met, the exemption in Section 3(a)(11) will be deemed to be available. It is possible, however, that transaction not meeting all of the requirements of Rule 147 may still qualify for the intrastate offering exemption.

2. California Exemptions

If a company is selling securities, it must comply with federal and state securities laws, and it is important to emphasize that if a particular offering is exempt under the federal securities laws, that does not necessarily mean that it is exempt from any of the state laws. In California, the most popular exemption is found under California Corporations Code Section 25102(f). It exempts from the qualification requirement any offer or sale of any security which meets each of the following criteria:

- a. Sales (not offers) that are made to no more than 35 persons, including persons not in this state.
- b. All purchasers who either: (1) have a pre-existing personal or business relationship with the offeror or any of its officers, directors or controlling persons or managers, if the offeror is a limited liability company, or (2) by reason of their business or financial experience or the business or financial experience of their professional advisors who are unaffiliated with and who are not compensated by the issuer, could be reasonably assumed to have the capacity to protect their own interests in connection with the transactions.
- c. Each purchaser represents that the purchaser is purchasing for the purchaser's own account and not with a view to or for sale in connection with any distribution of the security.
- d. The offer and sale of the security is not accomplished by the publication of any advertisement. As noted earlier, the Commissioner is authorized to (and has) required the filing of a Notice of Issuance where the exemption of Section 25102(f) is asserted. However, failure to timely file the Notice of Sale does not defeat the exemption.

Another California exemption found at California Corporations Code Section 25102(n) became effective in September 1994. It exempts from qualification any offer or sale of a security in a transaction, other than a roll-up, that satisfies all of the following criteria:

(i) The issuer is a California corporation or a foreign corporation which, at the time of the filing of a Notice of Transaction, is subject to Corporations Code Section 2115.

(ii) Sales of securities may be made only to qualified purchasers or other persons the issuer reasonably believes, after reasonable inquiry to be qualified purchasers. The term "qualified purchaser" is defined in a number of ways. For example, the amount to be invested must not exceed 10% of the person's net worth, the person's net worth (exclusive of home, home furnishings and automobile) is at least \$250,000, and the person's gross income during the prior year exceeded \$100,000, and can reasonably be expected in the current year to exceed \$100,000. Each natural person investing must also be sophisticated or be represented by a sophisticated person.

(iii) Each purchaser must represent that they are purchasing for their own account and not with a view to distribution.

(iv) Each natural person purchaser (with certain exceptions) must receive at least five business days before the sale, a written offering disclosure statement that meets the requirements of Regulation D. However, the exemption is not lost if the disclosure statement fails to meet the disclosure requirements of Regulation D.

(v) A general announcement of the proposed offering may be published by written document only, provided the announcement sets forth the information called for under Section 25102(n)(5).

(vi) No telephone solicitation is permitted until the issuer has determined that the person to be solicited is a "qualified purchaser".

(vii) The issuer files a Notice of Transaction both concurrent with the publication of a general announcement or at the time of the initial offer of a security, whichever is first and within 10 business days following the close or abandonment of the offering, but no later than 210 days after the date of the filing of the first notice.

Please note: unlike Section 25102(f), the exemption accorded by Section 25102(n) "is unavailable if an issuer fails to file the first Notice required under subparagraph (a) or fails to pay the filing fee". The Commissioner may impose an administrative penalty of up to \$1,000 for failure to

deliver the required disclosure statement within 5 days prior to the sale to a qualified purchaser.

D. ANTI-FRAUD PROTECTION

A difficult area for entrepreneurs to appreciate is the application of the anti-fraud provisions of the state and federal securities laws. Exemptions under the 1933 Act only exempt transactions from the registration provisions of Section 5 of the 1933 Act. The issuer and its principals still may be liable under the anti-fraud provisions of Sections 12(2) and 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Generally, Rule 10b-5, a source of significant litigation, provides that it is unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The focus of much of the litigation is the failure to disclose material facts. Many entrepreneurs believe that since Regulation D, Rule 504 does not require any particular disclosure. However, notwithstanding Rule 504 or Section 3(11) (intrastate exemption), full and fair disclosure must be made. Disclosure in exempt offerings are made in four general ways, including: (1) a private offering memorandum, (2) a business plan, (3) assembling miscellaneous documents and records into a package, and (4) allowing potential investors access to the premises, files and management of the issuer. The costs and benefits of each method are straight-forward. The private offering memorandum is the most expensive, takes the most time, and provides the highest level of protection to the start-up company from claims based upon Rule 10b-5. Allowing potential investors to access the premises, records and management is the easiest, least time consuming, least expensive and most risky.

IX. CORRECTING UNLAWFUL SHARE ISSUANCES

A. THE UNLAWFUL SHARE

1. Status

A share issued without compliance with the Federal and State securities laws is an "unlawful" share. However, as noted earlier, it is an issued share (as between the corporation and the

purchaser), and its holder is a shareholder with all applicable rights. The unlawful share creates contingent liabilities against the corporation and certain of its officers and directors in favor of the purchaser. It also may be a violation of state and federal criminal laws²⁴.

For purposes of this discussion, it will be assumed that the only civil law violation is the failure to qualify shares under state law. Under Section 25503, any person who violates Section 25110 (the qualification requirement) shall be liable to any person acquiring from him the security sold in violation of such section, "who may sue to recover the consideration he paid for such security with interest thereon at the legal rate, less the amount of any income received therefrom".

California law currently has no provision where an issuer can "cure" an unlawful issuance. Rather, all that the issuer can do is take steps which cut off the right of the purchaser to sue to recover the amount of his/her investment, plus interest; or if the purchaser has sold his unlawful shares, to recover the difference between his purchase price, plus interest, at the legal rate and the value of the security at the time it was disposed of, plus any income received thereon by the purchaser. There are four potential solutions:

(1) A private offer by the corporation to repurchase the shares at cost, plus the legal rate of interest, in exchange for a release of all claims. This will usually work where the investor wants out or the stock value has fallen or is virtually worthless.

(2) After making full disclosure, another shareholder (usually a key employee-officer) could purchase the shares at the negotiated price in exchange for a release of all claims and then contribute the shares to the corporation, which restores them to the status of authorized but unissued.

(3) Wait out the running of the statute of limitations under Section 25507, which is the earlier of two years after the violation or one year after the purchaser discovers the violation.

(4) Extend to the purchaser (and here it usually is a group of purchasers), an offer of repurchase under Corporations Code Section 25507(b). Here, an application is filed with the Commissioner of Corporations and a fee paid (almost as if the shares were being qualified in the first place). The Commissioner approves the form of repurchase offer and to the extent the purchasers reject the offer of repurchase, the causes of action for violation of Section 25110 are wiped out. This

approach is used where the value of the shares exceeds the repurchase price, plus interest, or all concerned want to stay on for the ride.

B. THE UNLAWFUL OPTION

A variation here is the option that is granted without qualification or an available exemption. Clean up is more difficult because there usually is no consideration to return because the option was granted to an employee. A corrective program could include:

(1) Qualifying the option plan with the Department of Corporations. In other words, get a permit so that future options and their exercise will be lawful.

(2) With the optionee's agreement, cancel the unlawful option in exchange for a new lawful option. Here, the problem will be the option exercise price and exercise term. Usually, those problems can be solved by giving the employee credit for the time lapsed under his/her unlawful option on the time of exercise, and increasing the number of shares covered by the option to "make-up for" the price increase.

(3) If (b) above does not work, consider a repurchase of the option or a repurchase offer.

(4) If any unlawful options have been exercised, then follow the steps outlined under No. 2 above with respect to the shares.

X. FINANCING THE START-UP COMPANY

A. SOURCES

1. Bootstrap Financing

A common financing technique is for the founders of the start-up company to make initial capital contributions and loans necessary to start the company. The remaining financing is provided internally from the revenue generated from the company. The benefit of this method is that the founders remain in control and benefit from the success of the company. On the other hand, unless the start-up company has sufficient capital, it will suffer from constant shortages of working capital and its growth will be limited.

2. Relatives, Friends and Business Associates

Probably the largest source of capital, in number if not dollars, is relatives, friends, customers, and suppliers. This type of potential investor usually is familiar with the operating history of the business and knows its need for capital, is well acquainted with the company's principals and can therefore be relatively easily interested in providing venture capital. This familiarity with the enterprise without other business sophistication may, however, create difficulties in complying with federal and state securities laws. Since it is often easier to obtain capital from this source than other sources of funding, this source of funding is useful. However, because family members or close friends may have provided the financing, the stress for the founders may be greater.

3. Venture Capital Companies

Venture Capital firms include those investing private funds exclusively and those that utilize both government and private funds. Venture capital firms are a primary source of equity-type financing for small and medium sized businesses. They are receptive to proposals from companies in many different situations and will arrange varied financing plans. Some companies prefer straight equity interests in high technology companies, while others prefer to minimize risk through convertible debt instruments. Often venture firms are helpful in providing business contacts, management advice, and members for the management team. However, their representatives may be difficult to work with and usually focus on the interests of the venture firm as opposed to the company.

4. Angel Investors

Another large source of investment capital is private individuals or investment groups. These investors are often referred to as "Angel Investors". They are typically individuals with a net worth ranging from one million to ten million dollars. Many of them are self-made and have started or owned a company. They often look for investments in their area of expertise and provide not only capital but advice and management assistance. For the high technology start-up, Angel Investors are usually one of the best sources for seed capital.

Since the size of venture capital funds has grown dramatically, most venture capitalists have moved away from seed financing.

5. Institutional Lenders

Banks, commercial finance companies, insurance companies, pension funds and other institutional lenders are a major source of private financing. Transactions with these lenders ordinarily are structured as direct loans, but significant terms such as interest rates, maturity, and prepayment may be favorably negotiated with many institutions when the loan is coupled with warrants or other equity features. Institutions vary with regard to the minimum and maximum sizes of loans they will make. Debt financing provided by these institutions can be helpful in growing the business and meeting working capital needs. However, most lenders insist on fully secured loans. Most high technology start-ups have little or no assets. The value in these companies is in their technology (which may or may not be developed) and talent of their employees. Most banks and similar financial institutions have little ability and even less interest in understanding the technology, its market potential and other factors which give the start-up company value.

6. The Small Business Administration

The most prominent governmental source of financing is the Federal Small Business Administration (SBA). This agency makes direct loans and guarantees loans to eligible businesses.

a. Business Loans

The SBA may grant a qualifying small business a loan for (a) business construction, expansion, or conversion (b) the purchase of machinery, equipment or facilities, or (c) working capital. For this purpose, a small business must be independently owned and operated, not dominant in its field, and must meet the following general maximum size standards²⁵:

(i) Wholesale: annual receipts from \$9.5 million to \$22 million, depending on the industry.

(ii) Retail: annual receipts from \$2 million to \$8.5 million, depending on the industry.

(iii) Service: annual receipts from \$1.5 million, to \$8.5 million, depending on the industry.

(iv) Construction: annual receipts of not more

than \$9.5 million, averaged over a three-year period.

(v) Manufacturing: from 250 to 1500 employees, depending on the industry.

As a matter of policy, the SBA will not make loans if the proceeds will be used to (a) pay off existing loans to creditors in a jeopardy situation, (b) make a distribution or payment to the borrower's principals, (c) free funds for speculation, or (d) acquire, construct, improve, or operate real property held primarily for sale or investment. The SBA also will consider the company's past earnings and history, future prospects, and other business factors to determine its ability to repay the loan.

The SBA can make a direct loan to an eligible business of up to \$100,000 with a maximum maturity of five to ten years (except for construction loans, which may have a maturity of up to 15 years) at current SBA interest rates. If the loan is made in participation with a private lending institution, the SBA may participate up to \$35,000 in the over-all loan. Personal guarantees or endorsements by the principals are required, as well as security for the loan. The collateral may consist of machinery and equipment, accounts receivable, or real property.

b. Loan Guarantees

If the SBA does not desire to make a direct loan, or if an eligible business requires more money than the SBA can lend directly, it will consider guaranteeing a loan made by a bank or other qualified lender.

B. USE OF FINDERS

Finders are small organizations or individuals who raise small amounts of money for start-up and early stage development companies. Finders usually do not identify themselves as such; most finders hold themselves out as venture capitalists, consultants, business advisers or investment bankers. Some finders will write the business plan, recruit a management team, and put together a board of directors, in addition to finding money. If a start-up company elects to use the services of a finder, references should be checked and prior deals studied.

Finder's fees are negotiable. Small deals are more expensive, often costing five to ten percent of the first million dollars raised. In some deals, the finder who does everything such as putting together a management group, writing a business plan and

establishing a board of directors, may charge thirty percent of the funds raised.

C. STRUCTURING THE INVESTMENT

1. Convertible Preferred Stock

Over the years, sophisticated investors have come to favor a certain kind of investment vehicle, namely, convertible preferred stock with a liquidation preference, redemption rights, and anti-dilution protection. No two such securities are the same, but general industry standards have developed. The complex terms of preferred stock have been developed primarily to provide, at a minimum, a return of the investment should the start-company fail, and an exit mechanism should the company neither succeed nor fail, but go "sideways."

A liquidation preference ensures that in a liquidation the investor will at least receive its money back before the common shareholders receive anything. Preferred stock with a mandatory redemption feature gives the investor the right to require the start-up company to redeem the investment at a specified time and price if that investment has not already been liquidated. In the past, liquidation preferences and redemption prices contained in the terms of preferred stock were fixed at a relatively modest premium above the original purchase price. The investor based his expectation for high returns on his participation as an equity holder in the overall growth of the portfolio company.

Today, investors, especially venture capitalists, are negotiating tougher deals with companies, and adopting some of the techniques of the merger and buyout industry in order to increase venture capital returns and reduce their risk. They are adding new features to their standard convertible preferred stock.

2. Debt with Simple Interest

At times, transactions can be structured as true loans. This structure contemplates a promissory note, usually secured by the technology providing for interest only payments after a certain period and principal and interest payments at a later date. One immediate legal obstacle to this approach is that the interest rate must comply with usury laws.

As high as a stated interest rate may be, the upper range of returns on a debt investment will be

higher if the investor also participates as an equity holder in the overall growth of the start-up company. Thus, when investors make debt investments, they generally seek either an equity conversion feature or a detachable warrant as an equity "kicker" or "sweetener".

3. Convertible Debt

As stated above, any pure debt investment has the disadvantage that no matter how high its interest rate is set, it still does not have the upside potential of an equity investment. Consequently, investors generally seek some sort of equity "sweetener" or "kicker" to improve their returns on a debt investment, such as an equity conversion feature, detachable warrants, or a parallel direct stock purchase.

In the past, some investors have avoided investments in convertible debt securities because when securities are repaid, the equity conversion feature disappears. A convertible debt investment does have some advantages over, for example, a straight debt investment with detachable warrants. Unlike debt with warrants, the holder of a convertible debt security is not required to assign a separate value to the conversion feature. Convertible debt investments offer another advantage in that the time period during which the purchaser holds the debt security before conversion can be tacked with the holding periods for the stock issued upon conversion of such debt security: (i) to obtain capital gains treatment under tax law, and (ii) for Rule 144 purposes.

4. Debt with Warrants

An investor can avoid having to pay up front for an equity "kicker" on a debt investment by using detachable warrants. Warrants can be separately transferred, and generally survive repayment of any debt securities with which they are issued. For tax purposes, however, if the warrants are purchased as a unit with debt securities for the face value of such debt securities, the warrants must be assigned some value. If that value exceeds a de minimis amount, as determined in accordance with tax regulations, then the purchaser must recognize original issue discount on the debt securities in the amount of the fair market value of the warrants.

Investors seeking to increase overall return on an investment in debt securities plus warrants can use a redemption or "put" agreement covering warrants (and/or the stock issued upon

exercise of the warrants) to ensure a cash return on the warrants of a certain amount on a specified date.

XI. OWNERSHIP AND TRANSFER RESTRICTIONS

A. THE BUY-SELL OR SHAREHOLDER'S AGREEMENT

Assuring control of a high tech start-up is an essential aspect of the incorporation process, but often is overlooked, or deferred for reasons of expense. Most start-up founders want to be assured that outsiders will not gain ownership of the usually low cost founders shares associated with a high tech start-up. Other times, they would like some assurance that if anything tragic should happen to them, their family will get something for their entrepreneurial effort. The solution is the so-called "Buy-Sell Agreement", "Shareholders Agreement" or "Founders Agreement".

Such agreements, which need to be in writing, will be between the corporation, all then current shareholders, and will require all future shareholders to become signatures. These agreements will prohibit the transfer by any means or under any circumstances of the corporation's shares, except as permitted under the agreement. The agreement will then cover some or all of the following topics:

1. Right of First Refusal

Before any shares may be transferred, the shareholder must first offer the shares to the corporation and/or the remaining shareholders at the terms of the proposed transfer. The corporation and/or the remaining shareholders then have an absolute right (but not the duty) to purchase such shares on the offered terms for a fixed period of time.

2. Death or Disability

In the case of a shareholder's death or total disability, the corporation (and/or the remaining shareholders) will enjoy the right to purchase all of the deceased/disabled shareholder's shares at an agreed of formula value. The corporation may in these situation, have a duty of repurchase; although in such situations, that duty is backstopped by key person life insurance or other insurance.

3. Termination of Employment

Termination of employment for causes other than death or disability will give rise to a right of first refusal (or a duty of repurchase) to purchase the terminated employee's shares at an agreed or formula value. Where termination is for cause, the formula value can produce a lesser purchase price.

4. Bankruptcy

Bankruptcy and other financial disasters can trigger a right or duty of repurchase in the corporation and/or shareholders at an agreed or formula value.

5. Divorce

In marital dissolutions, the non-employee spouse can agree to sell his/her community interest in the corporation's shares to the employee spouse at an agreed value, formula value or the value determined by the Family Court.

6. Share Legends/Escrows

The corporation's stock certificates will carry a legend notifying that the shares are subject to transfer restrictions and rights of purchase. Alternatively, all share certificates could be held in an escrow under conditions designed to ensure compliance with the terms of the buy-sell agreement.

7. Stock Options

Any stock options granted by the corporation would include a provision that all shares issued on the exercise of the option are to be held in accordance with the terms of the buy-sell agreement.

XII. SUMMARY

Entrepreneurs form companies for the purpose of achieving financial and other personal goals. The achievement of these goals is often frustrated by the failure of the entrepreneur to understand the legal pitfalls and traps existing in the present business-legal climate. Whether the entrepreneur is faced with a problem of ownership of technology, avoiding litigation or correcting problems in the incorporation and share issuance process, proper attention to these issues is critical to success of the

venture. The old adage "an ounce of prevention is worth a pound of cure" applies to start-up companies. It is the intent of this publication to help the entrepreneur to avoid the pitfalls and to contribute to the success of high technology companies.

FOOTNOTES

- 1 Bancroft Whitney v. Glenn 64 Cal. 2d 327 (1966).
- 2 Cal. Civ. Code 3426 et. seq.
- 3 Electro-Craft v. Controlled Motion, Inc. 332 N.W.2d 890, 901 (Minn. 1983); Clark v. Bunker, 453 F.2d 1006, 1009 (9th Cir. 1972); Henry Hope X-Ray Products, Inc. v. Marron Carrel, Inc., 674 F.2d 1336, 1340 (9th Cir. 1982).
- 4 490 U.S. 730 (1989)
- 5 This list of documentation and the following checklist of pertinent questions are taken from John R. Halvey and Barbara M. Melby, Checklist for Performing Intellectual Property Audits, The Intellectual Property Law Strategist, Jan. 1995.
- 6 975 F.2d. 832 (Fed. Cir. 1992).
- 7 977 F. 2d. 1510 (9th Circuit 1992).
- 8 10 U.S.P.Q.2d 177 (N.D. Cal. 1989).
- 9 Cal. Corp. Code § 15006.
- 10 Cal. Corp. Code § 1710(a).
- 11 Cal. Corp. Code § 1710(b).
- 12 Cal. Corp. Code § 17153.
- 13 Cal. Corp. Code § 17005(d).
- 14 Revenue and Taxation Code § 23153.
- 15 Cal. R&T Code § 17942(a).
- 16 Cal. R&T Code § 17943.
- 17 Under Corporations Code § 201.
- 18 Under Corporations Code § 409(e).
- 19 See Cal. Corp. Code §§ 25017 and 25019.

- 20 Under California Corporations Code § 25140.
- 21 1933 Act § 12; 15 U.S.C. § 77l. 1933 Act § 24; 15 U.S.C. § 77x. 1933 Act § 20; 15 U.S.C. § 77t.
- 22 Cal. Corp. Code §§ 25503,25530, and 25540.
- 23 SEC v Ralston Purina Co., 346 U.S. 119, 73 S.Ct. 981, 97 L.Ed. 1494 (1953). SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980).
- 24 The civil liability provisions of the California Corporate Securities Law are found at Corporations Code §§ 25500-25510, while the criminal law aspects are found at §§ 25540-25542.
- 25 (13 CFR §§ 121.3-1-121.3-10).