Legal Issues for Startup CXOs:

Mind the Bridge

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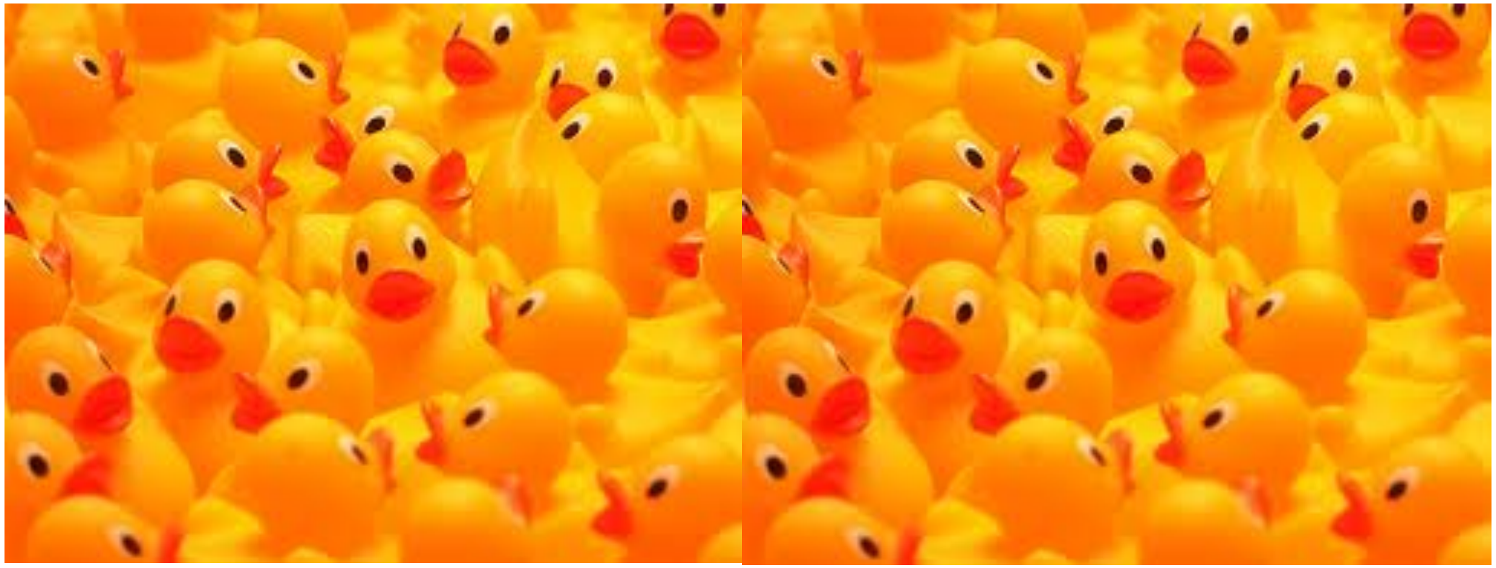
Presentation Overview

1. How to train your lawyer
2. Understanding & responding to legal issues
3. A few things you should read in an agreement

Remember: This is not Legal Advice.

"Your mileage may vary." Get a good lawyer to see how the points raised in this presentation show up in your own business.

Founder Illness:
Death by a Thousand Duckbites.



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A Thousand Duckbites.

Duckbites=the "important" but always brief things you have to do everyday—whether others ask you or you do them.

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Part 1 How To Train Your Lawyer

Lawyers are . . .

The Devil

Despicable

Expensive

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Lawyers Are . . .

Your time v. money

- How much is your time worth?

PLUS

Experience *and* expertise

PLUS

Important for contact/introduction

Important counselors/advisors

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Law Firm & Client Interests Often Diverge

- Lawyers (especially in big firms) make money by billing more hours

BUT

- Billing more hours costs the client more money.

Try to avoid using junior associates

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Use Expensive Counsel When It Matters

Expensive lawyers are good for "bet the farm" deals:

- Series A+ rounds
- Stock option plans
- Patents and patent litigation
- M&A

They are not worth it for "normal" projects

- Assignment, employment, TOU, distribution agreements

Pick the Lawyers Who Fit What You Need

- Talk to multiple lawyers. Talk to current & former clients (Get permission)
- Get an estimate
- Use lawyers who use short documents & know US VC documents
- Use expensive lawyers for expensive transactions and others for commercial transactions, etc.

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Discuss the Cost

- Discuss alternative fee arrangements
  - Flat, unit or capped fee
    - VC investment costs are always capped
- Consider "free" or "deferred" fees but *be careful!*
- Consider equity for legal services

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Limit How Your Lawyer Uses Your Money

All aspects of the work are subject to your advance approval:

1. Approve who will do the work
2. Only one lawyer at a meeting or on a call, or working on an agreement
3. Your approval on *all* tasks—with task-based estimate
4. No other charges/expenses—no phone, fax, photocopy, meals, taxis, staff overtime charges. No expensive hotels

“Free” or “Deferred” Legal Services

1. Not usually free, but an amount “deferred”
    - €15K-25K
2. How long will that last?
    - €At 400/hour, not long.
3. Require legal services through a certain milestone (e.g., Series A funding, etc.)
4. Control how many/which lawyers assigned

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Part 2:
Understanding & Responding to Legal Issues

What CXOs should know

&

what to do about them

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Part 2 Legal Issues:
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Part 2 Legal Issues:
What We Will Not Cover

- Incorporation issues
- Equity details (we will cover "big picture" & consequences)
- VC funding terms (e.g., term sheet)

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2.1 The Basic Messages

1. CXOs should know the essential issues to use law as a strategic asset (and control costs)
2. Equity allocation matters at first; Series A+ equity issues matter later
3. Pay attention to IP ownership & IP *control*
4. Metrics drive valuation; regulations drive metrics
5. Limit your indemnification obligations
6. Match your legal needs with the right lawyers

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2.2 Why Legal Issues Matter to CXOs

- Control your company's growth
- Impress your investors
- Lower costs
- Obtain the right deals with the rights partners

Why It Matters (cont’d)

1. Don’t cede control to your lawyers
2. Decide what you want to accomplish
3. Use law as a tool to do that

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2.3 The Basic Legal Issues

- Equity: *Clarify initial allocation v. fight later preferences*
- IP: *Maintain clear ownership & control in agreements*
- Contract Risks: *Limit the license grant and the indemnification provisions*
- Regulatory Risks: *Penetration metrics drive valuations; regulations shape your metrics*

2.3.1 Equity Issues

Promises, Promises—founders' stakes

External funding & your future

Clarify initial allocation v. fight later preferences

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Founders' Stakes

2 topics:

1. Allocation & Decision-making
2. How much is x% and for how long?

X% of What?

- X% *must* be of outstanding stock (a finite number)
- Shares *must* be subject to dilution
    - All future investment
- Shares *must* be subject to return/buyback
    - If a founder departs

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How Do Founders Decide?

Decisions generally made by 50% +1 share

- 1/3 each: 2 against 1
- 50/25/25: 2 against 1
- 51/24.5/24.5: 1 against 2

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Example:
33% Departing Founder

- CXO gets 1/3 of outstanding stock at departure?
  - *Founder left after 1 month, demanded 1/3 of stock*
- Or constant 1/3 (%) of all stock in the future?
  - *Founder left and demanded future stock issuance to maintain 33 1/3%* (No credible VC would invest in this situation)

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2nd Example: Sweat Equity to a Developer

You promise x% to a developer.

What does he/she get?

- X% of outstanding stock at departure? *(Negotiable)*
- Constant X% of all stock in the future? *(Never do it)*
- When does he/she get it? *(vesting schedule)*

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So What?

1. Allocate shares using specific and clear terms:
   - Percentage of *actual* number (outstanding at issuance).
   - Clarify that issuance is subject to dilution.
   - Clarify terms on departure (or vesting).
2. Decide who controls. Vote of majority or supermajority of shares?

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External Funding & Your Future

Investors will control your company and you

- Voting rights
- Corporate governance
- Additional capital issuance
- Your shares (reverse vesting)

The cost of outside investment

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US Structure—Seed/Angel

Seed/angel investors will (usually) seek a convertible note.

- Note is converted or repaid based on time or events
- Usually control the company through shareholder agreements

See Seriesseed.com for excellent documents

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US Structure—Series A+

In the US VCs will add a new class of stock and:

- Control the company (through preferred stock voting as a class)
- Protect their investments first (through "liquidation preferences")
- Control your employment and your shares

This is not necessarily a bad thing
(just the way it is)

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“Control Your Presence”

VCs will:

- Give founders between 50-80% of common stock “as if issued”
- Require “reverse vesting” over 4 years

This is not necessarily a bad thing
(just the way it is)

External Funding: So What?

1. Start vesting early. Insist on keeping percentage accrued since incorporation.
2. Find the right VC. Talk with other startups who have succeeded and failed to get investment from that investor.
3. Be prepared to walk away. If you do not like the deal, say so.
4. Find good counsel for what you need. Equity issues and VC funding require one of the top 10 firms in that space.

2.3.2 Intellectual Property Matters

IP: *Maintain clear ownership & control in agreements*

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The Basic Rule of IP

The person who *physically* creates it owns it . . .

. . . Logo, name, programming, data

The Basic Approach:
Obtain & Protect IP

1. Use *assignment agreements* with everyone
2. Control any data you generate
3. Register trademarks and copyrights
4. Use NDAs but use them carefully

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6 Initial IP Matters

1. The Company's Public Image: name, logo, site
2. What you build: programming—variations on code
3. What users see & use: content & functionality
4. What users generate: data, tables, other results
5. Data users give you: contact information (PII)
6. Data you generate: performance metrics, etc.

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6 Initial IP Matters:
The Legal Perspective

1. The Company’s public image: trademarks & copyrights
2. What you build: assignment agmnts, inbound licenses, copyright
3. What users/partners see & use: outbound licenses, TOU
4. What users generate: cross licenses (you & the user)
5. Data users give you: Privacy policy
6. Data you generate: outbound licenses

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6 Initial IP Matters: Why Should You Care?

1. Lack of Assignment: *Peanuts* & *Snoopy*. Facebook.
2. No Trademark registered: Budweiser
3. Lack of Assignment: Stanford University
4. Open Source Licenses: Lost the VC investment

IP in What You Build

Underlying platform

Programming

Design & Look-and-feel

Features & functionality

Basic Principle: The Company Should Own* all Rights to What You Build.

- Provides competitive advantage
- Prevents team members leaving & starting a competitor
- VCs demand it

**Own can also mean a license to it (e.g., Open Source)*

Acquire Your Core Technology.

At the beginning & in writing.

Everyone who makes anything must sign an assignment agreement

- Founders
- Designers
- Programmers
- Employees
- Independent contractors

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Assignment Agreements for (Almost) Everyone

- Each person owns what he/she creates until rights are assigned IN WRITING.
- Assignment must be "current." Developer *hereby* assigns . . .
- Work-for-Hire agreements=assignment.

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Expensive Assignment Errors.

- See *Stanford v. Roche*.
  - $10 Billion lost (invalid assignment)
- Snoopy & Peanuts:
  - Voiceover's voice was not assigned

Example of An Error in an Agreement

This is ***wrong***—from Docracy.com:

The Recipient ***agrees*** *to assign to the Company, or its designee, all right, title, and interest in and to any and all [Intellectual Property]*

Example:
Use the Present Tense

Developer ***hereby assigns*** *to the Company, for good and valuable consideration, all right, title, and interest, including any and all Intellectual Property Rights*

Open Source Software is *not* in the Public Domain & **It Is *not* Free**.

Make sure that your developers comply with the licenses

Example: Startup was not acquired by a large tech company due to Open Source issues

IP in What Users See & Use

Your website

mobile app

UX

Apps

Distribution partners will need a license agreement AKA "Distribution" agreement, Systems Integration Agreement

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IP in What Users Give You

If they give you copies of data, then they must give you a license—in the TOU.

If they give you contact information then it is PII—"Personally Identifiable Information"

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Create a TOU

Remember: It is a *license* not a sale.

Main points should be obvious and easy to read. Link to detailed agreement. Choose your jurisdiction.

TOU also covers use of User content (e.g., photos).

IP in Data You Generate

Your site will generate lots of data:

- Performance metrics
- Metadata
- Data about databases
- User usage patterns
- User preferences

Make sure you own it and then you can license it

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The Agreements You Will Need

1. Assignment Agreements: To transfer to the company whatever they make for you.
2. License Agreements:
   - "Inbound" To use what you need
   - "Outbound"
     - To let users use what they need (e.g., a TOU)
     - For partners or distribution/syndication
3. Privacy policy: To protect PII
4. NDAs: To protect what you have

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Use NDAs but Be Careful.
The Lesson from *Stanford v. Roche*

- Should be more specific than "business purpose"
- Should not have any assignment provisions
- Limit to 3 to 5 years
- Narrowly define "Confidential Information" (CI)
- Do not include trade secrets
- Include carve-out for M&A?

Example: M&A delayed by restrictive NDAs.

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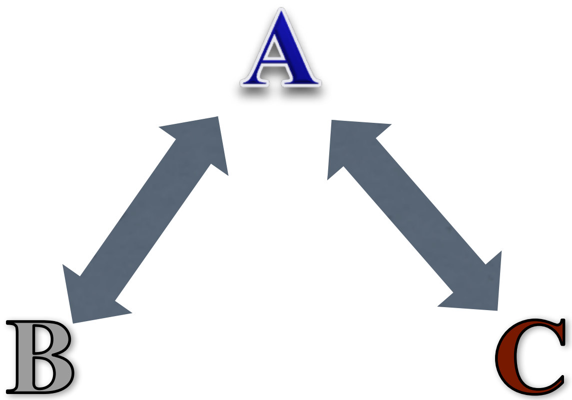
NDAs Are only for 2 Parties

Party A to Party B. Party A to Party C.

Party A “CI” cannot go from B to C.



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Part 3
How to Think about Legal Language

You can write your own or download them, but . . .

Pay attention

An Agreement Serves a Business Purpose

Think first about the business purpose and the relationship

- Start by thinking of what you want and you will provide
- Work with your counsel to establish "company policy" on standard legal issues:
  - *Every agreement includes many of the same terms: indemnification, representations, etc.*

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Write Down What You Want & Need

Create an *internal* Term Sheet

- Outline starts with your purpose, etc. (1st slide)
- Outline follows the agreement sections
- Specify what:
  - You want
  - You will give up ("wiggle room")

Paying Attention

- Who’s “We?” What’s “It?”
- What’s an agreement: Written, Oral and Course of Conduct
- What Matters in Agreements
- Examples of Important Elements

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We and It: Don't Use Those Words.

"We will license it to Verizon." Who's "we?"

- The European parent?
- The US sub?
- It=The technology?

Concentrate on creating solid defined terms

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Amending Agreements:
It Can Happen . . . When You Least Expect It.

- Written agreement does not prevent modification.
- You orally agree to a change.
- You continue to do something for a long time that differs from your written agreement.

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What Matters: Who Owns What & When?

- What is licensed? For what uses?
- Underlying technology? Implementation? Improvements? Derivative works?
- Upon termination?

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What Legal Issues Matter: The List

- License Grant
- Business Terms
- IP Ownership
- Termination
- Representations & warranties
- Choice of law & venue

Choose Your Negotiating Approach

- Pound on the table? Make threats?
- Be positive, calm, patient
- Closed v. transparent
- Term sheets>agreement drafts + schedules
- New versions & false deadlines
- “Good faith” and narrowing the issues

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Always Be Ready to Walk Away

Try to avoid being in a position where your company's life depends on you doing the deal

What is your walk-away point?

BATNA: Best Alternative to a Negotiated Agreement

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Remember: This is not Legal Advice.

"Your mileage may vary." Get a good lawyer to see how the points raised in this presentation show up in your own business.

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Thank you.

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