focus on

Venture Capital

April, 2002

Legal Primer for Emerging Businesses

Some easy steps you can take to keep the legal side of your business in shape

In the hectic, sometimes overwhelming environment in which most emerging companies function, entrepreneurs often put off attending to the legal side of the business. This is an unfortunate fact, because, with a few simple steps, carried out consistently over time, business owners can assure that the value of the hard work and creativity which went into building the business is not lost to them and their shareholders through avoidable legal missteps. Following are some easy-to-implement ways that you, with the help of either your internal or external lawyer, can help protect your company's value, without a lot of hassle or expense.

Although this guide is geared to a company in early stages of development, many of the fundamental points also apply to more mature companies. Many companies follow the appropriate procedures at the outset, but do not build the constant implementation of these principles into their ongoing management, and lose the benefit of their earlier planning and work.

Behave as if your key assets are as valuable as you say they are

Many emerging companies today have, as their primary asset, intellectual property. A few simple steps can assure that your company truly owns that intellectual property.

1. Run standard checks to make sure your technology does not infringe a third party's intellectual property rights and you have necessary licenses.

The initial steps are easy — run a trademark search on domain names, company or product names or logos you are considering using before you use them, and if you are satisfied with the search results, file a trademark application. Conduct a patent infringement review to determine if there are any existing patents that cover an element of your business. If there are, see if you can license the patented technology. If there are no existing patents, consider filing a patent application for your technology. If you have a website, have a website audit performed to ensure you own or have a license to every element shown on the website. Every time you change trademarks, develop new technology or change your web site, repeat.

Many companies never have a lawyer do the initial review. Others have the lawyers search like crazy to clear the first trademark or piece of technology, and then never do it again. Some waste a great deal of money on numerous searches when the company has not yet decided what to do. Many problems can be avoided by handling this appropriately.

2. Use employee assignment agreements to make sure the company, not the employees or contractors, owns the intellectual property.

Since the technology is in the company's possession, it is counter-intuitive to think that the company might not have good title to it. However, problems often arise when the company does not take steps to acquire the intellectual property rights from the employees or independent contractors that work on the technology.

Many companies assume that they automatically own whatever their employees produce. This may be a good assumption if the employees are assembling goods at the employer's plant, but the rules for intellectual property are different.

Under a variety of laws, employees may have ownership rights in the technology unless specifically assigned to the employer in writing in accordance with applicable legal principles. Independent contractors nearly always own any technology they create for the company, even if they have been paid for it, unless the contractor's ownership rights have been specifically assigned to the company in writing. For these reasons, technology companies should have intellectual property assignment and confidentiality agreements from every employee, especially those working on the technology, and especially from every independent contractor.

Often companies will have the first round of employees sign agreements, and then stop. However, trouble appears when an employee who never signed an agreement leaves the company, and a possible cloud on the company's title to its intellectual property appears.

3. Protect your competitive secrets with a trade secret protection program.

Much of a company's proprietary information, technology and internal processes can be protected by a trade secret program. Ask officers of any company what advantages it has over the competition, and they will give you a long list. Ask what steps they have taken to make sure competitors do not copy these advantages, and many officers are suddenly at a loss for words. Applicable laws offer companies a fair amount of protection if, but only if, they take reasonable efforts to maintain the trade secret status of the information.

The key to a successful program is in the implementation.
Some tips: First, a lawyer can offer you a standard program, but if you want employees to follow it, let the lawyer tailor it to fit your company. A trade secret program that gets in the

way of employees doing their jobs will quickly be abandoned. Clever employees can easily find a way around those "iron-clad" procedures. Second, management and employees must be educated on how to follow the program, and the lawyer can help. Training should be early and often — poorly trained employees are a recipe for serious problems in attempting to protect your trade secrets. Finally, have an outsider check the program periodically for effectiveness. Lawyers and others perform audits of trade secret protection programs to help ensure that they are sufficient. If you already have a trade secret protection program, you need to check to see if it is working.

4. Have your lawyer help you avoid giving away your technology for nothing.

Many companies spend countless hours and precious dollars developing technology, but then leave the front door open for competitors to steal it. Any time your intellectual property comes into contact with the public, you have created a door through which your assets can be carried off. Since you may not know where the intellectual property "door locks" are, you should have your lawyer educate key employees or managers on where these locks are and how to keep them bolted.

You may have obtained trademark protection or patent protection, or you may be relying on copyright protection. However, if you do not use the appropriate notices when the name, slogan or description of the technology appears in written form (on your marketing materials, in advertisements or press releases, etc.), you have not locked in your intellectual property. Also, when you sign agreements with customers to whom your technology will be revealed (for the right price, of course), an unaware sales or contracts person can inadvertently give away rights to a lot more technology than the customer is paying for. Unless you want to hire a legal bouncer to check every piece of paper going out the door (not really do-able, and certainly not cost-effective), have the lawyer teach you where the doors and locks are, then check every so often to make sure your company is protecting these interests.

More experienced companies have learned the basics, but over time have modified their approach to fit more easily with business planning or sales, and no one has gone back to see if the modified approach actually works. If the company has not consulted a lawyer in a while (six months to a year, depending on the level of activity), it is high time for another legal review.

Set up a simple and effective structure for stock ownership, maintaining stock records and complying with stockholder agreements

1. Call your lawyer every time you want to issue stock.

Practicing lawyers know that a very high percentage of emerging companies have to clean up equity ownership matters at some point in the pre-IPO phase of the company's development. Many of these problems result from simple mistakes or not being vigilant. Think about the valuation you are seeking from an investor. Could the company really be worth that much if management is not sufficiently motivated to keep track of the ownership?

Issuing stock is more complicated than it first appears. First, every issuance of stock has to be approved by your board of directors. This is a tough concept for many CEOs to accept — the board trusts them with the company's money, but applicable rules do not let the CEO issue the stock.

Second, stock issuances are also subject to arcane securities laws. The rules divide investors into two groups: rich people ("accredited") and everyone else. The rules assume rich people can take care of themselves, so they do not need to be given large disclosure documents or be advised by sophisticated purchaser representatives. Everyone else needs special care and handling, and may not be acceptable investors unless you jump through a lot of time-consuming and expensive hoops.

Third, stock issuances may have tax consequences for the buyer, especially if the buyer is an employee. A classic case occurs when the founders issue stock to friends and early supporters for pennies per share, and then are fortunate enough to close a venture capital investment at $1.00 per share or more. Any early investor who is an employee of the company may be exposed to a large tax, since the IRS takes the view that the early round was undervalued and the difference between the value and the sale price constitutes taxable compensation.

To save yourself much aggravation, have a brief chat with your lawyer before each and every stock issuance. Also, avoid the common error of first committing to issue the stock and then calling the lawyer. The rules in this area are fairly rigid, and many times the business commitment cannot be honored.

Many companies have the lawyer physically keep the stock records as a failsafe mechanism, so that no issuance can occur that is not brought to the lawyer's attention first. Hiring lawyers to keep stock records is not especially efficient, but this works well for some companies. In any event, the important point is to call the lawyer early in the process, not after commitments or promises to issue the stock have already been made.

Experienced companies generally have worked through these issues, and have pretty good approaches. Nevertheless, problems still occur, most frequently when management makes commitments before consulting the lawyer. Many executives learn the rules pretty well, but some of these requirements are fairly complex. Do the safe thing — check with the lawyer.

2. Keep the stockholder agreement simple.

A stockholder agreement can be a useful part of a governance structure, and venture capital investors each have their own favorite basket of provisions. However, the company still needs to be able to function, and rather than wallowing in the complexity, management should resist provisions that can be problematic later. Put rights can upset new investors and preemptive rights are often very difficult to administer. First refusal rights, while fairly common, can be drafted by someone who has never had to administer the procedure. Consult regularly with the lawyer when the provisions are being considered, and build in a mechanism to get rid of the provisions when they have ceased to be useful.

Motivate your employees to work toward your business goals with a stock incentive plan

Ideas and technology are powered by enthusiastic people. Stock compensation still fuels employee enthusiasm with the promise of a share in the company's success. Many executives casually "borrow" a stock option plan from another company. Later, when the employees are awash with tax problems, securities law issues and accounting charges, they discover that the key to an effective stock incentive plan is in the implementation.

Example - Executive hears from your friends who have been at public companies that employees "pay" for options through "cashless" exercises where employees never have to put up cash when they exercise their options. The friend supplies a plan with a cashless exercise feature, and the employees are very happy with it. However, Executive learns later that this can result in the company having to take an accounting charge for the appreciation in all cashless exercise options granted under the plan. If the company does an IPO with 20% of its outstanding shares granted as options, and the employees cash in, a massive accounting charge can result. If Executive is lucky, a sharp-eyed lawyer or accountant will find the problem, which may or may not be reversible for options already granted.

Example - Entrepreneur knows that selling the company can be an attractive means for entrepreneurs to slingshot the business into the public company arena, and for employees to cash in on their hard work. So, the company adopts a plan where all option vesting accelerates on a change in control. However, many of buyers do not want option vesting to accelerate, after being burned by this in the past. After the employees cash in, many of them leave, and the purchased company is a hollow shell. As a result, Entrepreneur has made a sale of the company more difficult, and a possible exit strategy has backfired. A savvy buyer may pass on a company where option acceleration is unavoidable, and a savvy venture capital investor will perceive a problem with one potential exit strategy.

Example - CEO borrows from a friend a plan which provides for sales of restricted stock, where the employees get to own the shares and the company still holds a right to repurchase unvested shares as an incentive feature. The friend mentions that there is some tax form to be filed, a "Section 83(b) election," so that employees will not have to pay income taxes on the shares when they vest. But, CEO figures it is some IRS form employees can get next April, and goes merrily along selling shares to employees. Unfortunately, one of the employees tells his accountant about the arrangement, and CEO learns that this program can bankrupt the employees with huge tax payments unless the company goes public before the shares vest and the employees can sell the stock. The goal of an enthusiastic workforce is turned on its head, as the "incentive" plan only fuels employee resentment.

Result - With an ill-considered or poorly understood option plan, at best you have undermined the benefits to early employees and impressed future investors with your lack of sophistication. At worst you have built in a host of expensive problems that will crop up later.

Lesson - Get the tools to understand stock incentive compensation and take the time to learn how it is supposed to work.

How:

Learn to understand and implement the plan before you adopt it.

Some law firms now have packages that provide the building blocks for a successful stock incentive program, together with extensive explanatory materials, all at a reasonable, fixed price. In addition to the legal documents, you get advice that identifies key tax, securities law and accounting issues, as well as an administrative guide that gets the administrative staff up to speed on critical features and issues. Spending a few dollars and a few hours at the beginning can save you loads later.

If your company already has a plan, was it adopted after visiting with a lawyer about the complex issues? Do your people fully understand it? If you answered yes, then you are way ahead of many companies. Have the lawyer review the existing plan, and revisit the key issues. It is still possible to benefit new employees, and perhaps fix old problems you didn't know you had.

Treat employees as valuable assets

Every company says they do this, but many typical executives know they will be judged on the company's technology and the company's products and services, so they refer the employee management process to human resources (HR). Most emerging companies spend so much time with their products or services that they have little time left to consider their employees, even though the employment relationship is even more important than in most established companies.

Result - The haphazard and ill-conceived employment policies adopted without any management guidance provide little protection or cause more problems than they prevent; to the venture capital investor, management once again comes across as inexperienced.

Lesson - Make human resources a priority from the outset, and revise human resource policies as the company grows.

How:

1. Have the lawyer work with HR to put an employee program in place that starts with hiring.

You should have procedures in place to deal with HR issues as employees are brought on board. Your lawyer can suggest ways of handling the interviewing and hiring process that will avoid many possible employee claims. Ask your lawyer to train HR on the "dos" and "don'ts" of hiring, particularly the rules prohibiting discrimination based on age, race, sex, and disability, and what steps to follow when hiring employees from abroad. The lawyer can also help with offer letters, which may be construed as contracts, and particularly, how to deal with stock options in offer letters (a tricky area).

Your lawyer can help you establish payroll practices that minimize the risk of liability and clarify your commission plan. Poorly written commission plans can cost big bucks when the large contract everyone has been working on finally comes in, and eight different salespeople each put in for their 10%.

All employees should be required to sign well-crafted confidentiality agreements, which also help in establishing intellectual property ownership. A common mistake that emerging companies make is to borrow an agreement from a friend at another company. Failure to tailor the agreement to your company and specific circumstances may hinder your ability to enforce it. Most lawyers have form agreements, so you save little if anything by borrowing one — most of the legal work, and risk, is in the implementation.

You may also want to consider using non-compete or non-solicitation covenants with your employees, particularly key employees. Different states have different laws, so often the same company must use differently worded agreements for employees working in different states.

Your employee hiring process should also deal with any "baggage" the new employee might bring along. Be on the lookout for new employees, particularly employees who formerly worked for competitors, bringing along confidential information from the prior employer or failing to mention the non-compete they signed at the last job. Never hire an employee with a non-compete or other restrictive agreement without talking to your lawyer first.

It is never too late to institute good practices in this area. Growing companies have a lot of hiring ahead of them. Unless you recently (within the last year) put in place a program with the active participation of a lawyer, it is probably time for a new review.

2. Conduct periodic human resources audits and reviews.

As your company grows, your HR policies need to grow too. A periodic review of HR policies and practices can be one of your best money-saving ideas, and most of the work can be done in-house with some general guidance from the lawyer. Does your personnel handbook inadvertently establish a contract of employment, or have you done a good job of maintaining the "at will" employment relationship? Have employees actually signed the agreements you had the lawyer prepare at the outset of their employment? (Unsigned agreements or agreements signed later without appropriate contractual prerequisites do not protect your company.)

Your lawyer can help with the implementation of your employee performance evaluation process, and help avoid claims if non-performing employees are terminated. Your lawyer can also provide guidance and training on prevention of discrimination and harassment in the workplace. The emerging company workplace is often casual, which can be a good thing, but policies prohibiting discrimination and harassment — particularly sexual harassment — are essential. Discrimination and harassment can be very costly matters, not to mention very embarrassing for the company and management.

These issues are most relevant for companies that have already done some growing, to the point where the informal approach to HR no longer works. If your company has not been through a legal review in a while, there is no time like the present for a refresher.

3. Have your lawyer work with HR on employee termination procedures.

Your HR policies and trade secret protection program are really put to the test when the employment relationship is ending. Terminated employees are not likely to give you the benefit of the doubt as you walk them out the door. Your lawyer can guide you through the complicated considerations of employee terminations. Should you offer severance payments? How much? Does the separation agreement meet requirements for enforceability? Does the performance history support termination for poor performance?

Your lawyer can also assist with formal termination procedures and exit interviews in which steps can be taken that minimize employee dissatisfaction and claims later.

Regularly review your website

Have your lawyer perform a website "audit".

Many law firms have the wide variety of legal knowledge necessary to understand all the legal pitfalls. Your lawyer can assist you in identifying the legal and business risks associated with your intended use of the website. He or she can help you understand the risks and develop applicable privacy policies, terms of use, and disclaimers to help protect your rights and limit your potential liability in operating your website. Calling your lawyer before you go live with your website, and when you make material changes to your website, can help you avoid bigger issues down the road.

Companies that have numerous departments responsible for portions of the website can be most at risk in this area. As companies grow, they become less able to do an effective job of policing the website without political infighting. The website review is a good job for the experienced lawyer who appreciates the contribution from marketing, but knows where the company can get into trouble.

Understand and observe corporate mechanics

Corporate records represent a new area that must be mastered. Poor corporate records telegraph quickly to potential investors that management lacks experience or (even worse) the company lacks internal controls. The investor knows, having done this more times than you, that in every significant financing you do (including the venture capital investment) the lawyers will have to "audit" and render opinions on certain aspects of your corporate records, just like accountants review and opine on your financial results. If the lawyers cannot render clear opinions, future fund raising will be more difficult.

How:

Get some coaching from your lawyer.

The person on your team who has the most experience in this area is often your lawyer, who also has worked with numerous companies. Get a brief tutorial from the lawyer on how everything usually works and check in for a review or update periodically. New ideas and creativity in this area usually are not popular — doing it the tried and true way is.

Use your lawyer as a resource who has been through the process many times

As you proceed with the key decisions for your company, opportunities will arise to get useful information from your lawyer. Examples include negotiating your lease, reviewing investment term sheets and getting HR and benefits set up. These matters, which involve many potential legal risks, usually are not presented with a red neon light that says, "Call your lawyer." Many business people fail to make that 30-minute call to the lawyer to get helpful advice unless the other side insists on legal review as part of the process.

Before you make this mistake, remember that you grilled your lawyer mercilessly about his or her experience with similar companies before you hired him or her. You presumably were doing this to find someone who has gone through the process many more times than you have. That someone is now on your team, and you need to avail yourself of his or her experience.

Business people often need a process to get advice from the lawyer at the right time. They do not want to call a lawyer until the company strategy is developed (not a bad strategy). However, if they wait too long they become reluctant to call, since advice from the lawyer may require reconsideration of decisions that have already been made.

How to solve this problem? Have a short conversation with the lawyer at the beginning of the process, not to discuss details which are changing, but to be educated on the important legal matters to be achieved and legal pitfalls to be avoided. Then, before the matter goes to the board or to signature, but when things are fairly far along, call the lawyer again for a review. If you have applied the advice you received early in the process, the later call should not result in any embarrassing overhaul of the project, but should identify additional final benefits.

Result - the legal advice has been obtained in a timely fashion, without a lot of expense or mess.

As a general matter, it is useful to consult the lawyer when developing the agenda for board meetings. About fifty percent of the time, if an issue is important enough to bring to the board's attention, it is also worth obtaining legal advice. This is not only a useful check on when to get advice, it can avoid those unanswerable questions from the board about why legal review was not obtained.

You now have a modestly entertaining and helpful primer to effective use of lawyers by emerging companies. Reading this may have been more fun than actually talking to a lawyer (no jokes about how unexciting lawyers are, please), but asking your lawyer for help and advice from time to time will be more profitable in the long run. So, help us and help yourself — give us a call.

Hogan & Hartson, which put together these materials, has a track record of helping entrepreneurs translate ideas into thriving companies. We offer the emerging business a comprehensive array of services in areas from corporate organization and finance to intellectual property, employment and government regulation. Our lawyers bring with them the experience gained from closing literally hundreds of large and small corporate transactions over the past few years. We also bring the insight and innovation necessary to start up a business and compete in a changing marketplace.

Our mission at Hogan & Hartson is to help you navigate the complex process of building your business by providing timely and effective legal services at all points in your company's growth cycle.

Hogan & Hartson can help you make your emerging company more attractive. We can:

- conduct patent and trademark searches and perform a technology and intellectual property "audit"
- file patent and trademark applications
- provide intellectual property ownership and confidentiality agreements for use with employees and independent contractors
- provide a trade secret program that is tailored to your company and perform follow-up reviews
- help you develop a licensing program
- assist you with stock issuances and stock ownership records
- assist you with preparing or negotiating stockholder agreements
- provide a fixed-price, comprehensive stock incentive program with explanations of issues and guides to implementation
- help HR develop and implement employee hiring, retention and termination procedures
- perform website audits
- help you understand corporate mechanics and recordkeeping
- be your counselor and resource/problem solver.

For more information, please contact the following Hogan & Hartson attorneys:

Lawrence R. Seidman *Baltimore, MD*
email: lrseidman@hhlaw.com
410/659-2781

Steven M. Kaufman *Washington, DC*
email: smkaufman@hhlaw.com
202/637-5736

Richard K. Becker *McLean, VA*
email: rkbecker@hhlaw.com
703/610-6123