

# STRUCTURING A START-UP COMPANY FOR VENTURE CAPITAL FINANCING

BY

PETER B. FINN, ESQ.

*Peter B. Finn, Esq. is a Senior Partner with Rubin and Rudman LLP in Boston, MA. where he chairs the Firm's Biotechnology Practice.*

## **ABSTRACT**

*Venture capitalists are result oriented. They are not looking to finance the development of an idea but rather are seeking an appropriate return for their investors. Founders need to understand and appreciate that companies have to be structured to make money, not to research or perpetuate an idea. This natural tension must be recognized and the relationship balanced if a company is to receive a venture capital investment. This article identifies the key issues and outlines the legal structure that the venture capitalist will expect to see when reviewing an investment opportunity.*

## **INTRODUCTION**

In today's economy, venture capitalists will consider investing in a company that meets, among other items, the following criteria: 1) a platform technology; 2) a clear business and financial model; 3) an experienced management team; 4) a significant intellectual property position; 5) a large potential marketplace; and 6) an appropriate legal structure.

With the changing investing landscape, a reduction in the number of funding sources and a return to traditional valuations and business models, each criterion is important. Increasingly,

however, a company's legal structure is assuming greater significance. A legal structure that is biased towards the company's founders, fails to protect the core intellectual property, or creates an unworkable capitalization structure, is just as likely to cause the loss of a financing opportunity as a company that fails to satisfy any of the other essential criteria.

This article outlines the appropriate legal framework for an entity seeking venture capital from decisions relating to the state of incorporation to the essential agreements and inter-related documents that are needed to weave together the management team with the proprietary intellectual property.

Venture capitalists are often referred to as "financial investors" because their sole interest in making an investment is to create an appropriate return for their investors. They are not "strategic investors". While a venture capitalist is often defined as an institutional firm with several, on-going funds ranging from \$100 million to a billion dollars today, the definition properly includes sophisticated "angel" networks and even accredited, high net worth individuals who have operating experience and the financial staying power to make significant follow-on investments. Accordingly, the recommendations made in this article apply to all companies seeking outside investment financing.

### **CONSIDERATION #1: INCORPORATION**

Many companies start by incorporating in the state where the founders live or the company is doing business. "Local" states are preferred because counsel is more familiar with the corporation statute and incorporation process, and it is assumed that professional and filing fees can be saved. However, venture capitalists, almost without exception, favor Delaware as the state of incorporation. Thus, many investors will require a company to re-incorporate in Delaware or merge with a Delaware corporation and then qualify as a foreign corporation in the

state(s) in which business is going to be conducted before an investment is made. In addition to the delay and expense of reincorporation, there is the risk of having another entity reserve the proposed name.

There are a number of reasons that incorporation in Delaware is favored. Delaware's General Corporation Law (Title 8) is easy to comply with and offers management speed and ease of operation. This is true with respect to both procedural and substantive matters including, the notice period required before a stockholder or director action can be taken, the votes needed to approve a corporate activity; and that a consent action of stockholders for mergers and the like requires only a majority vote. Title 8 is supported by extensive case law and a business court that brings predictability and multiple precedents to almost every issue of corporate governance. Thus, in negotiating a term sheet or transactional document, the venture capitalist is guided by multiple precedents when drafting the language, and an appreciation of how a court would rule on many governance issues.

At the time of incorporation, tax issues should be addressed. For example, if a company is principally involved in research and development ("R&D") efforts, then it may be able to take advantage of the sales tax exemption afforded by many states. The sales tax exemption is a state level tax savings which occurs when an R&D company, meeting the research and development definition under state law, purchases certain consumables which are exempt from the state sales tax. An R&D company may also have potential tax savings on the federal level, pursuant to the research credit offered by the Internal Revenue Code, Sections 38 and 41, and a deduction pursuant to Internal Revenue Code, Section, 174. Unlike the federal credit and deduction where the savings are determined, in part, by the company's year end gross receipts, the state sales tax

exemption can have immediate and substantial tax savings generating outside gross receipts which are especially important for start-up companies.

To qualify for these tax credits, it may be necessary for the Company to establish a subsidiary which sells its research findings to the company (i.e. the parent), thereby generating the necessary gross receipts to qualify for the exemption. Each state statute must be analyzed as the sales tax exemption and the qualification criteria vary from state to state. The drawback is that the operational rules are complex and require the subsidiary to maintain separate books and records and operations in order to qualify. The potential sales tax savings have to be balanced against the cost of compliance and the management resources that will be directed to the effort. However, because of the potential tax savings, this issue should be included on a company's pre-incorporation checklist.

Those states that provide research and development credits are set forth on Exhibit 1.

Pursuant to Internal Revenue Code, Section 195, prior to the commencement of business operations, eligible start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses and deducted over a period of not less than sixty (60) months. Eligible start-up expenditures include: costs incurred reviewing a prospective business prior to reaching a final decision to acquire or enter a business; costs incurred subsequent to the decision to establish a particular business but prior to the time operations begin; and those costs expended for any activity engaged in for profit before the day on which active trade or business begins. Deferring the eligible start-up expenses enables the taxpayer to take advantage of the deductions after an income stream has been generated.

## **CONSIDERATION #2: ENTITY SELECTION**

The choice of an entity is generally between a regular business corporation and a limited liability company (“LLC”). The LLC is a hybrid form of organization, possessing certain attributes of a partnership and certain characteristics of a corporation. For example, the LLC combines the flow-through tax aspects of a partnership with the limited liability of the corporation. While LLC’s are appropriate in certain situations, in the context of a venture capital investment, a regular business corporation should always be utilized.

While the state statutes vary, all of the states and the District of Columbia have now enacted enabling legislation permitting the establishment of LLC’s. LLC’s are not favored by the venture capital community for a number of reasons. These reasons include:

1. Venture capital firms themselves are often organized as partnerships and thus, the LLC creates an exposure to the venture capitalist’s non-profit limited partners for an unrelated business income tax without providing the corresponding dollars to pay the tax;
2. The LLC is not eligible for a tax-free re-organization; (i.e. a “stock for stock” exchange). This eliminates one well established exit strategy by precluding the possibility of a tax-free merger with a public or private company;
3. While an LLC can issue options to employees if the LLC is taxed as a partnership (which the vast majority are), the LLC cannot issue Incentive Stock Options and cannot adopt an Incentive Stock Option Plan. This specific limitation will impact on the company’s ability to attract and retain qualified employees; and secondly, without the ability to offer incentive stock options, the cash component of the employee’s compensation will increase; and
4. It is not certain that the existing body of corporate case law will apply to LLC’s, thus eliminating a comfort level afforded by existing case law.

While LLC's offer significant flexibility and are favored by accountants because of the advantageous tax planning they offer, there are, as discussed above, significant negative features for companies seeking venture capital.

The argument is often advanced that an LLC should be used, (similar to the adoption of a Subchapter S status), and then "flipped" into a corporation when the venture capital investment is about to be made and/or the entity becomes profitable. While this approach may work in a limited number of situations, changing the corporate and tax status is time consuming, expensive, a distraction to management, and may result in adverse tax consequences. C corporations do not possess any of the negative factors noted above and the structure easily permits the creation of a series of preferred securities for investors.

Electing Subchapter S status is problematic. Subchapter S was introduced into the Internal Revenue Code in 1958, and subsequent revisions in 1982 and 1986 greatly enhanced the S Corporation's flexibility and simplified its use. As such, an S Corporation remains an appropriate entity consideration for a closely held business because the corporation is taxed as a partnership. Within this construct, shareholders deduct the losses on their individual returns and avoid corporate double taxation. However, state tax laws must be researched to determine whether an S corporation is a flow-through for state tax purposes.

Companies elect to be taxed as a Small Business Corporation (Section 1361 of the Internal Revenue Code), by filing Form 2553. While the election can be terminated (for example, by having a new shareholder decline to continue with the election or issuing a second class of stock to a venture capitalist), losses can only be deducted up to a shareholder's basis in the shares purchased. Since a founder's basis is often minimal, the benefits are often illusory. However, if the election is not properly terminated, the result will be the pass through of profits

to the shareholders including, the venture capitalist's limited partners, without the corresponding dollars to pay the tax (for example, if a grant is received late in the year there may not be enough time to incur losses that would offset the income).

While the issue of electing Subchapter S status should be a consideration on the pre-incorporation checklist, the better procedure is to establish the company as a C corporation from the outset.

### **CONSIDERATION #3: INTELLECTUAL PROPERTY**

Intellectual property is the core of every biotechnology company. It is essential that the nature and source of the intellectual property including, patents, know-how and, to a lesser extent, trade secrets, be understood and protected. Security will initially come from analyzing and determining the ownership rights to the intellectual property that the company starts with, and then protecting the same through appropriate documentation and agreements. Since founders bring their expertise and prior work experiences to a new organization, it is rare that a start-up organization will begin without significant intellectual property thus, the ownership of that intellectual property must be understood.

To address the intellectual property issues, the following questions must be answered:

- 1) Who are the Company's founders and are all of the inventors part of the Company? If not, the entity will require an assignment and/or license to acquire the rights and inventions from a holder who is not going to be part of the new entity.
- 2) What agreements have the founders, in any capacity, signed with prior companies that impact on the ownership of the intellectual property?

- 3) Has the intellectual property been developed or enhanced through university research and/or government sponsored research and, if so, what ownership claims can be made by those institutions to the intellectual property?

The due diligence required to understand the issues and possible conflicting contractual claims is significant. The best practice is to research and develop an intellectual property due diligence report.

The second level of intellectual property protection relates to the documentation and agreements that should be put in place at the time of incorporation including:

- 1) Founder's agreements that provide for the ownership of the intellectual property to be transferred to the company with the attendant filings made with the Patent and Trademark Office ("PTO");
- 2) Waivers or disclaimers of conflicting rights;
- 3) Invention assignment and non-disclosure agreements for each service provider including, consultants, independent contractors, scientific advisors, consultants and members of the Scientific Advisory Board. A form is included as Appendix A; and
- 4) Confidentiality and non-disclosure agreements that include provisions controlling publications.

All of this work and analysis is preliminary to a venture capital financing. Each investment transaction will include a Securities Purchase Agreement that will contain standard representations and warranties to be made by the company and occasionally the founders regarding the ownership, lack of infringement and control of the intellectual property. The company must anticipate these issues. The following are typical provisions:

- 1) "The Company owns or possesses sufficient legal rights, free and clear of any lien, encumbrance or other restriction, to its intellectual property necessary to conduct its business as it is currently being conducted and as proposed to be conducted without any conflict with, or infringement of, the rights of others. There are no outstanding options, licenses, or agreements of any kind relating to the foregoing..."

and

- 2) “The Company has done nothing to compromise the secrecy, confidentiality or value of any of its intellectual property required to conduct its business as it is currently being conducted or as proposed to be conducted. The Company is not aware that any of its employees, consultants or advisors are obligated under any contract (including licenses, covenants or commitments of any nature) or other agreement, or subject to any judgment, decree or order of any court or administrative agency, that would interfere with the use of his or her best efforts to promote the interests of the Company or that would conflict with the Company’s business as proposed to be conducted.”

To avoid ownership and control problems, a company should initiate an Intellectual Property Ownership Program that helps it build, maintain and protect the intellectual property portfolio. The components of an Intellectual Property Ownership Program would include:

- 1) A centralization of information that limits access to the company’s patents, know-how, confidential information and trade secrets;
- 2) The right to review, delay and possibly edit the publication of any article to provide the company an opportunity to file patent applications; and
- 3) The development of a checklist identifying each agreement that an employee, advisor, consultant and other service provider has to execute that would include the assignment of all of his or her rights to the intellectual property to the company. It is essential that these agreements be signed when the employment, consulting or other form of relationship commences to insure that there is adequate consideration for the assignment of the rights.

#### **CONSIDERATION #4: TRANSACTIONAL DOCUMENTS**

From inception, the founders and the company will need to consider a variety of agreements including, Founders’ Agreements, Employment Agreements, Stock Option Grants, Non-Disclosure and Confidentiality Agreements, and Scientific Advisory Board Agreements among others. Each of these agreements must be carefully drafted in order to balance the individual’s interests while appropriately protecting the company. Each agreement is important, and will be reviewed by the venture capitalist during the due diligence process.

The section will focus on the key components of these agreements and what the investors will be expecting.

**Founder's Agreement.** These contracts take many forms and are often referred to as a “Stock Restriction” or “Shareholders’ Agreement”. The document will focus on multiple issues including, restrictions on transferability, the commitment that each individual is making to the venture in terms of time and money and the assignment of intellectual property. Additional provisions will relate to rights of first or last refusal, co-sale rights, tag-along and drag-along rights. The purpose of this document is that it ensures that all of the founders are in agreement with each other, with their respective obligations to the company and with the focus and scientific direction of the Company.

Another area of concern relates to stock ownership and vesting. Many (if not all) founders will consider their shares vested when the entity is created. This issue (which also arises in the context of negotiating an employment agreement), creates significant concerns for the remaining founders and the venture capitalists. If a founder, for whatever reason, prematurely leaves, is terminated with cause, suffers a disability or dies, the company must have the right to “claw back” some or all of these shares, thus making them available for the founder’s successor. Generally, the venture capitalist will require the founder and other significant officers and employees to make a three to four year commitment to the company, with a small portion of their shares vesting up front and the balance thereafter vesting monthly or quarterly.

Tax planning also plays a role in the drafting of these documents. From a tax perspective, the best approach is not to use options but to issue restricted shares at a nominal price (i.e. before the intellectual property or rights or contracts are transferred to the company), with the company having the right to claw them back on a decreasing monthly, quarterly or other

negotiated basis. In this structure, the parties will articulate the exact circumstances under which there will be a divestiture of the shares and the purchase price to be paid by the company in the event of a repurchase. If the repurchase occurs at a time when the company has not made significant scientific progress, then a repurchase at the same purchase price paid by the founder or other grantee may be appropriate. However, if the termination occurs near the end of the vesting period and/or after scientific or other due diligence milestones have been achieved, then a formula approach to determining the purchase price that recognizes the founder's contribution is the better method. A form of a repurchase right that arises in an employment context is included at Appendix B.

Whenever there are restrictions on the shares being issued with a risk of forfeiture, the founder should file an "83(b) Election" with the Internal Revenue Service which allows the founder to disregard the forfeiture provisions on the shares and to take the value of the shares received into income when first received, rather than when the forfeiture restrictions are removed. The election is made within thirty (30) days after the issuance of the shares, and a copy of the election form must be attached to the stockholders income tax return for the year in which the election is made. The election by the founder entitles the issuing company to take a compensation deduction in the year such amount is included in the founder's income.

Finally, it is important to consider that most companies will require several rounds of financing. Founder's or Shareholder Agreements that include, for example, the granting of options, preemptive rights, anti-dilution protection and most favored nation clauses, will have to be negotiated with the venture capitalist, a time consuming and expensive process.

**Confidentiality and Non-Disclosure Agreements.** The confidentiality and non-disclosure agreement is central to a company's ability to protect its confidential information, trade secrets,

know-how and intellectual property rights. These agreements should be signed by everyone having access to the non-public information including, employees, founders, directors, advisors, collaborators and consultants to the company. As recommended, one individual should be responsible for coordinating this effort and ensuring that originals are maintained in a secure, central file. They will be examined by the venture capitalist during the due diligence process.

While there are many templates for confidentiality agreements depending upon whether they are one way or mutual and whether the companies are private or public, such agreements should contain the following:

- 1) A clear definition of what constitutes confidential information and whether oral information must be reduced to writing and submitted to the other party within a specified period of time;
- 2) A stated purpose for entering into the agreement;
- 3) The agreed upon exceptions to confidentiality;
- 4) The period of confidentiality; and
- 5) The right of a party to seek injunctive relief to prevent a breach of the agreement without the need to prove actual damages.

The form of a mutual confidentiality agreement is at Appendix C.

**Employment Agreements.** It is rare that a start-up entity takes the time to negotiate employment agreements; but they serve the same critical function in the employment area that Shareholder Agreements serve in the equity ownership area.

From the company's perspective, an employment agreement confirms the individuals' commitment to the company and covers important subjects including, duties and responsibilities, confidentiality, assignment of inventions, publication rights and non-competition. These issues

are interwoven with the protection of the intellectual property and work together to form a fence around the disclosure of the company's technology.

A well-drafted non-compete provision will prohibit the employee from competing, directly or indirectly, with the company for an agreed upon period of time after the employee leaves or is terminated. Critical to this document is the definition of the company's "business". If the language is too narrow it may miss key elements and not anticipate a change in the company's focus; and if the definition is overly broad (i.e. "the development of therapeutics for the treatment of autoimmune diseases"), it may not be reasonable in terms of time and space rendering it unenforceable. Each sentence must be thought through since a request to renegotiate the language is certain to be rejected. A form of a non-compete provision is at Appendix D.

In *EMC Corporation vs Kenneth Todd Greshem, et al.* (Suffolk Superior Court, NO. 01-2084 BLS), the Court permitted a former employee to consult with a competitor because the negotiated clause, while broad, did not actually prohibit consulting. The court stated, in part:

Here, where EMC, a sophisticated and knowledgeable entity, chose to embody its relationship with its key employees in a detailed and carefully written instrument...it is entitled to and should be held to the contractual language it chose. The Court should be careful not to impose its own views on the contacting parties or to let matters outside the four corners of the instrument (*emphasis added*) modify its expressed statements. Courts cannot [for example] use commercial context to override express provisions of a contract...While the situation may seem to be a glaring loophole in the restriction intended by the Agreement, the language chosen dictates the result. (*Id.* at pp. 6 and 7).

Accordingly, attention to detail is crucial when drafting these provisions. The agreement must contain a prohibition against the disclosure of confidential, proprietary information and be broad enough to capture what the employee learns either alone or in conjunction with others while being employed by the Company.

In the initial stages of development, a start-up company is likely to enter into a number of agreements with individuals such as consulting agreements, fee-for-service agreements, master service agreements and scientific advisory board agreements. These agreements must contain provisions relating to confidentiality, assignment of inventions, publication and non-competition. The form of a consulting agreement is at Appendix E and the form of a Scientific Advisory Board Agreement is at Appendix F.

**Stock Option Plan.** A well drafted stock option plan (“Plan”) is essential to attracting and retaining key employees, directors, consultants and scientific advisors. The Plan should provide the Board of Directors with as much latitude as the Internal Revenue Code allows and specifically, permit the Board to accelerate vesting in the event of a merger, consolidation or initial public offering. A cashless exercise provision is also essential. In addition, it is important that the qualified and non-qualified grant agreements contain the customary investment representations to insure that the exercise of the options and purchase of the shares does not constitute a distribution in violation of the Securities Act of 1933, as amended (the “Act”). 15 U.S.C. § 77a et seq. The form of a Plan is at Appendix G; an Incentive Stock Option Agreement is at Appendix H and a Non-Statutory Stock Option Agreement is at Appendix I.

The Plan should be adopted when the founder’s shares are granted. Generally, fifteen (15%) to twenty (20%) percent of the shares then issued and outstanding are allocated to the Plan. If the key executives are already incentivized, then the shares placed in the Plan will be at the lower percentage range and, if not, then the larger number of shares will be needed. Since the venture capitalist will not want the shares they receive to be diluted, they will require, as a condition to closing an investment, that the Plan be adopted by the stockholders with an appropriate allocation of shares. The parties will also need to agree on a number of key issues

including: 1) the length of the vesting period; 2) the strike price for the granting of non-qualified options; and 3) the approximate number of options that will be granted to employees at each level of employment.

It is also important that the company work closely with the firm's accountants to ensure that the accountants treat the options issued, for both tax and accounting purposes, in the manner expected by the company. The tax and accounting rules governing the treatment of options are complex and fact specific; as such, careful planning and coordination are essential.

**Compliance With Federal and State Securities Laws.** In any private offering, it is critical that the founders consider and comply with state and federal securities laws and regulations. Founders often believe – incorrectly – that an offering to “friends and family” is exempt from compliance with the securities laws and regulations. In fact, friends and family are still investors and must be evaluated and treated as such. Although several exemptions from registration exist under the Act, the law and regulations still require that the founders pay close attention to the status of their investors and how they are solicited.

The private offering exemption under section 4(2) of the Act exempts from registration “transactions by an issuer not involving any public offering.” 15 U.S.C. § 77d(2). To qualify for this exemption, the purchaser of the securities must:

- 1) Qualify as a sophisticated investor or be able to bear the investment's economic risk;
- 2) Have access to the type of information normally provided in a prospectus; and
- 3) Agree not to resell or distribute the securities to the public.

In addition, the company may not use any form of public solicitation or general advertising in connection with an offering under Section 4(2) of the Act. The larger the investor

pool, the more difficult it will be to show that the transaction is exempt. If one person does not meet the requirements, the exemption may be destroyed, potentially putting the entire offering in violation of the Act.

Regulation D of the Act provides important exemptions from registration for private offerings. A key feature of each exemption is the prohibition against general solicitation and advertising. Additionally, investors who purchase subject to a Regulation D exemption are buying “restricted” securities and may not resell them without registration or an applicable exemption. Two of the Regulation D exemptions are:

**Rule 505** which provides an exemption for offers and sales of securities totaling up to \$5 million in any twelve (12) month period. Under this exemption, a company may sell to an unlimited number of “accredited investors” and up to thirty five (35) other persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions. Purchasers must be purchasing for investment only and not for resale, and the issued securities must be “restricted.” Consequently, the company must inform investors that they may not sell for at least one (1) year without the shares being registered.

**Rule 506** is a “safe harbor” for the private offering exemption under Section 4(2) of the Act. If the company satisfies the following standards, the company will be assured of satisfying the Section 4(2) exemption:

- 1) An unlimited amount of capital may be raised;
- 2) No general solicitation or advertising to market the securities;
- 3) An unlimited number of accredited investors and up to thirty five (35) other purchasers; and
- 4) All non-accredited investors, either alone or with a purchaser representative, must be sophisticated - that is,

they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

The definition of an “accredited investor” is the same for each of the above exemptions.

Accredited investors include:

- 1) A director or executive officer of the company;
- 2) A person with a net worth, together with a spouse, of more than \$1.0 million; or
- 3) A person who has had income greater than \$200,000 for the past two years or joint income with a spouse greater than \$300,000 for the past two years.

When dealing with accredited investors, a company is not required to provide a Confidential Private Placement Memorandum (“PPM”). The company must, however, provide adequate financial statements prior to beginning the offering. What is essential is that there be full and fair disclosure of all relevant information regarding the company. This can be achieved through a PPM, a Business Plan, an executive summary or power point presentation. The more written information that the company provides the less chance there is for misunderstandings by the investors.

To ensure that the sale will only be to accredited high-net worth individuals, appropriate Subscription Agreements and Investor Questionnaires should be used. An investment should be accepted only after those documents have been completed, reviewed and accepted by the company. A form of a Subscription Agreement is at Appendix J and a form Investor Questionnaire is at Appendix K.

Finally, it is important to consider state securities laws or “Blue Sky” regulations. While exemptions vary from state to state, there is some degree of coordination. Typically, if the

offering is exempt from registration under federal securities laws, the offering will often require only a notice filing in the states where the offering is done – sometimes accompanied by payment of a fee. The company must evaluate the impact of the state securities laws in each state in which an investor resides.

Finally, when dealing with restricted securities, Rule 144 is important. Rule 144 provides for the public sale of restricted and control securities in limited quantities without the requirement that such securities become registered. As discussed above, restricted securities are securities acquired in unregistered, private sales from a company or from an affiliate of the company. Control securities are those held by an affiliate of the company. When an individual purchases securities from an affiliate there are resale restrictions even if the securities were not restricted in the affiliate's hands. As a general matter, under Rule 144, restricted securities may be sold to the public if the following conditions have been met:

- 1) The securities have been owned and fully paid for at least one year. The holding period only applies to restricted securities. Because securities acquired in the public market are not restricted, there is no holding period for an affiliate who purchases securities of the issuer in the marketplace. But an affiliate's resale is subject to the other conditions of the rule.
- 2) Current financial information is made available to the purchaser.
- 3) The seller files a Form 144, "Notice of Proposed Sale of Securities," with the SEC no later than the first day of the sale. If the sale involves more than 500 shares or the aggregate dollar amount is greater than \$10,000 in any three-month period. The sale must take place within three months of filing the Form and, if the securities have not been sold, the seller must file an amended notice.
- 4) If the securities were held for between one and two years, the volume of securities sold is limited to the greater of 1% of all outstanding shares, or the average weekly trading volume for the preceding four weeks. If the shares have been held for two years or more, no volume restrictions apply to non-insiders. Insiders must always abide by volume restrictions.

- 5) The sales must be handled in all respects as routine trading transactions, and brokers may not receive more than a normal commission. Neither the seller nor the broker can solicit orders to buy the securities.

The last step in selling restricted securities under the Rule 144 safe harbor is to be certain that the restricted legend is removed from the stock certificate(s). Only a transfer agent can remove the legend, but a transfer agent must first obtain approval from the company – usually in the form of an opinion letter from the company’s counsel.

### **CONSIDERATION #5: A SHORT LIST OF DON'TS**

Companies tend to repeat the same errors. In establishing a new entity, avoid the following:

- 1) Do not populate the Board with friends and family. Instead, secure the services of professionals and qualified outside directors who understand the business and market place, and who can provide objective advice;
- 2) Do not grant long-term employment agreements to a founder or inventor with a limited skill set and without the operating experience to manage and lead a start-up company;
- 3) Do not grant excessive stock options with rapid vesting schedules; and
- 4) Do not establish an unrealistic valuation for the company. Researching the competition will provide important valuation markers that should be followed. Venture capitalists are not interested in trying to convince founders that their company is not worth as much as they believe.

## **CONCLUSION**

The principle responsibility of the founder is to maximize the company's chances for success. This means understanding that the company's legal structure is as important a criterion to the venture capitalist as any other; and that the structure must be fair and balanced. For a start-up company, the early groundwork has to be done correctly. Venture capitalists are in the business of investing and doing deals. They are not in the business of fixing mistakes.

**EXHIBIT 1**

Alabama  
Arizona  
California  
Connecticut  
Delaware  
Georgia  
Illinois  
Indiana  
Iowa

Maine  
Maryland  
Massachusetts  
Minnesota  
Montana  
New Jersey  
North Carolina  
North Dakota  
Ohio

Oregon  
Pennsylvania  
Rhode Island  
South Carolina  
Utah