

## The Startup Lawyer

By Eric Koester, J.D. C.P.A.  
Heller Ehrman LLP  
Seattle, Washington

### PRE-COMPANY PERIOD: WORKING WITH FOUNDERS AND PROMOTERS

“Capital, talent and intellectual property are the steam, steel and barbed wire of the modern age. The most important job of lawyers for early-stage technology companies is preparing their clients so that they can attract, retain and protect those three essential assets of the new economy.”

-- James J. Greenberger (Business Law Today, January/February 2001)

Short of forming your own startup company, providing legal counsel to a startup company could be the closest thing many business attorneys will get to being an entrepreneur. Emerging companies face unique and often intricate legal and business issues – some of which can come back to haunt a startup company if not addressed prudently and properly in the early stages of the new company. Oftentimes entrepreneurs turn to their advisors and lawyers to guide them through these early days. Admittedly, for a startup counsel, there are a multitude of issues that can and will arise while assisting startup companies. But well considered advice can put your client on the path towards building a successful business.

In this article, we will discuss (i) the unique dynamic of representing a startup company – identifying typical points where the diverging interests of the startup and entrepreneur may arise, (ii) use of a founders term sheet to assist the entrepreneur to address key issues early on in the representation, and (iii) how a startup lawyer can assist his startup clients to avoid conflicts between the founders and their former employers.

### WHO IS THE CLIENT? THE ENTREPRENEUR AND THE AS-YET-FORMED COMPANY

Imagine this typical startup engagement scenario: *An entrepreneur walks into your office with a business plan and asks you to represent her. She’s developed a unique technology, is ready to file a provisional patent, and has some investors interested in putting in seed money to fund her idea. Now she’s come to you for your astute legal advice. There’s no company... yet. But the plan is to form one and help her grow. So who will you be representing – the entrepreneur or her soon-to-be company?*

The short answer is you represent the soon-to-be company. But, practically speaking, your advice about the company and how best to structure the company for the stockholders and management (which right now could just be the entrepreneur) will directly impact the entrepreneur. The lawyer is ultimately responsible to the best interests of the company, who is the client.

And while this seems fairly straightforward and clean to the startup lawyer, it isn’t always quite as clear to the entrepreneur or the founders. To the entrepreneur, they may believe that they are the company or at least the company is “theirs.” And you can see why an entrepreneur may believe that – the entrepreneur or founder is the only one you’re meeting with and you are advising her how to start her business. So, in her eyes, you are representing her *and*

her business, right? The end result may be that, to a new entrepreneur, the company-founder line is somewhat blurred as the founder truly is fully engulfed in the business-building process.

Yet as a startup lawyer, you do represent the company and should be clear to make such a distinction at the first signs of any potential misunderstanding. You can be certain that in the course of this representation, points do arise where what's good for the founders may not always be good for the company. The lawyer should be aware of this dynamic and diligently be on the lookout for conflicts on the horizon. Below are a couple of frequent examples of these diverging interests to watch for:

- Founders Stock. Should founders' stock be subject to restrictions such as vesting, transfer limitations, or other restrictions on the equity? On one hand, the founders would prefer to own their stock free and clear of any restrictions, but in some cases, it is in the company's interest to impose restrictions to ensure the stock is closely held or as a retention and incentive tool.
- Former Employers. The transition from outside employment into the startup is often times a gradual process, with the entrepreneur sometimes maintaining his or her role at another company during the early days of developing their business idea or forming the company. These "fluid" employment situations by some founders can cause issues to arise between the startup and the current/former employers of founders. In these cases, it is important for a startup lawyer to be careful about getting too entangled in these issues and be perceived as representing the founder. This is discussed further in this article.
- Equity Financings. In the context of an equity financing, one of the consequences for the founder is dilution of his or her interests. This means that the founders' and company's interests can diverge in this context – what may be the best investment or choice for the company, could dilute the entrepreneur's equity holdings. In addition, once investors are brought into the company, where differences exist between the founders and the investors, a lawyer could be asked to "take sides" in the dispute. Some diplomacy here can go a long way to recognize the benefits to both the company, the founders, and its investors.

Early on, be certain to draw proper boundaries in the representation and educate the client why this is important. In the event a dispute ever arise between a founder and the company, the attorney will be required to work for the company's interest only. In such a case, it can be in everyone's favor to have previously addressed this possibility and encouraged the founder to retain separate counsel to make certain that he or she has an attorney they are already comfortable with. Of course, this is usually clearly described in the engagement agreement, but the reality is that these details are often overlooked (and perhaps not understood), so be sure to speak with a new entrepreneur about the representation in advance.

#### **FOUNDERS TERM SHEET: HELPING THE ENTREPRENEUR WITH CHOICES AHEAD**

A new entrepreneur once said, "Wow, I didn't realize I'd have to decide so many things before I even really have a company." And the truth is, he was right. In the earliest days of

forming a company, the founders will face a myriad of choices and decision, many of which involve concepts that such founder has not comes across before and have implications down the road. Which state should we incorporate in? S-corporation or C-corporation or LLC? Founders contributions of cash or IP? Stock vesting? Salaries and benefits? Deferring compensation? Job titles? Stock or Options or both? For the lawyer, guiding a new entrepreneur through the process can be a challenge.

As a result, a startup lawyer should consider creating a “Founders Term Sheet” with the client. What often happens is a lawyer will ask a few questions, draft agreements, dump stacks of draft formation, employment and other agreements in front of a founder with brackets or blanks, and tell the entrepreneur to wade through them and give any questions. This can be quite overwhelming and you’ll be left with a founder cross-eyed on legal documents. Instead, consider beginning the process with an agreed to “term sheet.” This document is a way to get all of the issues and decision points on the table up-front, instead of tackling things in an ad hoc manner as they come up. This process saves time and frustration for both the lawyer and the client, and has the added benefit of saving money (smaller bills) for the client.

To help founders navigate these issues in a clear and time-efficient manner, the founders should discuss key items using checklist or questionnaire, and can finalize a “term sheet” before the attorney begins drafting corporate agreements. Exhibit A provides a sample of a founders term sheet.

#### **A CLEAN BREAK: ADVISING FOUNDERS DEPARTING FROM THEIR FORMER EMPLOYER**

A surefire way to make life difficult for a new startup is to draw the ire of the former employers of the founders. To see just what can go wrong, read the story of Torrent Technologies below and you’ll quickly recognize why helpful counsel for founders leaving a their prior employers can prevent heartache down the road.

#### **Torrent Technologies**

Travis Pine and his co-founder Theresa Johnston started Torrent Technologies after each left National Flood Services (NFS). Torrent was featured in the Seattle Post-Intelligencer because NFS, the former employer of over half of Torrent’s employees as well as Torrent’s largest competitor, filed suit against its former employees and their new company just two months after they’d incorporated. According to the P-I, NFS alleged that “the two former NFS vice presidents violated non-compete agreements, stole trade secrets, solicited NFS employees and interfered with customers” and the lawsuit “described the conduct of Pine and Johnston as “willful, extreme and egregious.”

Despite the mounting legal challenges, Torrent was still able to raise \$3.3 million in its Series A round with the lawsuit outstanding, but not without its share of headaches in assuring potential investors that the lawsuit would not affect the company. Torrent finally settled the lawsuit in late 2006.

For many new entrepreneurs, the process of hatching their new venture will begin while still working a “day job,” and oftentimes this business could be in a similar field as their current

employer or leverage the experience from that position. While this approach may allow the entrepreneur to keep a stream of income coming in and utilize their relevant background, it should also raise red flags in discussions with an entrepreneur.

In this case, the entrepreneur and the lawyer should become familiar with the employment-related agreements of all the founders of the new company. To mitigate these risks, the founders should take steps to (i) limit the risk of a claim by former employers that the founder misappropriated (or can't help but misappropriate) the technology, or confidential or proprietary information from their previous employers, and (ii) not breach any employment-related agreements with previous employers. Encourage the founders to be overly cautious, in particular if there is any potential overlap or future competition between the startup and the former employer.

The lawyer's role as company counsel in this context is to ensure that the founder can launch the new company without the undue threat of legal action by these previous employers. Again, this showcases the delicate balance, representing the company without taking on representation individually of the founders.

What are some steps you can take to limit potential problems:

- Avoid Overlaps. If at all possible, put a hold on all legal formation actions (including the incorporation of the new entity and issuance of founders' stock) until the founder has formally terminated employment with his current employer.
- Duty of Loyalty. Traditionally, an employee has a contractual 'duty of loyalty' to his or her employer. Therefore, while the founder is still employed, advise him not to breach the duty of loyalty to his employer by taking actions that could be deemed to conflict with loyalty to the employer. For example, the founder should not solicit other employees to leave, should continue to be diligent about work duties, and should not inappropriately take or gain access to any protected information.
- Employment-related Restrictions. Here, the devil truly is in the detail. As early as possible, have all founders provide their current (and recent) employment-related agreements (offer letters, employment agreements, confidentiality agreements, invention assignment, non-competition agreements, stock issuances, stock option agreements, etc.). The lawyer should assist the founders in identifying key restrictive covenants in the areas of non-competition, non-solicitation, confidentiality, etc. A startup counsel can offer helpful legal advise on areas such as:
  - scope of "confidential information"
  - scope of any non-competition provisions
  - customer and former employee non-solicitation clauses
  - limitations of invention assignment

Understanding each of these limitations can be crucial to laying out the formation plan for the business over the first months and years.

- Intellectual Property. For many startup companies, intellectual property is one of the most important assets in the company – and oftentimes that IP will have been developed prior to forming the company. As a result, issues surrounding intellectual property can quickly arise as an entrepreneur leaves a prior employer. The startup lawyer should understand the intellectual property (“IP”) each member of the founding team plans to contribute to the new company. For that technology, the lawyer should be certain that the founders understand the risks of IP misappropriation claims and the “work-made-for-hire” doctrine. Evaluate whether a previous employer could have an ownership claim to any technology being contributed to or developed for the new venture, whether under the “work-made-for-hire” doctrine or otherwise. If you suspect any “IP overlap,” get an IP specialist involved and perform a full risk analysis.

### CONCLUSION

The earliest days of representing a startup can be extremely rewarding for a business attorney. This time in a company’s lifecycle sets the stage for future events. However, there are numerous issues that may arise in these times. Awareness of conflicts and obstacles in the representation can keep the startup lawyer focused on providing value for the company and the entrepreneur.

## EXHIBIT A

### MEMORANDUM OF TERMS FOR FORMATION DOCUMENTS OF [COMPANY], INC.

<i>Founder/Key Employee Vesting</i>			
<b>Standard</b>	<table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top; padding: 5px;"> <b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Upfront vested shares: [25%]</li> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul> </td> <td style="width: 50%; vertical-align: top; padding: 5px;"> <b>Acceleration</b> <ul style="list-style-type: none"> <li>“Involuntary Termination”                             <ul style="list-style-type: none"> <li>Involuntary termination without Cause</li> <li>Voluntary termination for “Good Reason” (note 409A issues)</li> </ul> </li> <li>Change of Control                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul> </td> </tr> </table>	<b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Upfront vested shares: [25%]</li> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul>	<b>Acceleration</b> <ul style="list-style-type: none"> <li>“Involuntary Termination”                             <ul style="list-style-type: none"> <li>Involuntary termination without Cause</li> <li>Voluntary termination for “Good Reason” (note 409A issues)</li> </ul> </li> <li>Change of Control                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul>
<b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Upfront vested shares: [25%]</li> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul>	<b>Acceleration</b> <ul style="list-style-type: none"> <li>“Involuntary Termination”                             <ul style="list-style-type: none"> <li>Involuntary termination without Cause</li> <li>Voluntary termination for “Good Reason” (note 409A issues)</li> </ul> </li> <li>Change of Control                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul>		
<b>Customizations for [named founders]</b>	<table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top; padding: 5px;"> <b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Upfront vested shares: [25%]</li> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul> </td> <td style="width: 50%; vertical-align: top; padding: 5px;"> <b>Acceleration</b> <ul style="list-style-type: none"> <li>“Involuntary Termination”                             <ul style="list-style-type: none"> <li>Involuntary termination without Cause</li> <li>Voluntary termination for “Good Reason” (note 409A issues)</li> </ul> </li> <li>Change of Control                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul> </td> </tr> </table>	<b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Upfront vested shares: [25%]</li> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul>	<b>Acceleration</b> <ul style="list-style-type: none"> <li>“Involuntary Termination”                             <ul style="list-style-type: none"> <li>Involuntary termination without Cause</li> <li>Voluntary termination for “Good Reason” (note 409A issues)</li> </ul> </li> <li>Change of Control                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul>
<b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Upfront vested shares: [25%]</li> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul>	<b>Acceleration</b> <ul style="list-style-type: none"> <li>“Involuntary Termination”                             <ul style="list-style-type: none"> <li>Involuntary termination without Cause</li> <li>Voluntary termination for “Good Reason” (note 409A issues)</li> </ul> </li> <li>Change of Control                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul>		
<i>Employee Vesting (Stock Plan)</i>			
<b>Vesting Schedule</b> <ul style="list-style-type: none"> <li>Time Period? [3 or 4] years</li> <li>Cliff/No Cliff? [25]% vests after [12] months; or straight-line</li> <li>Periodic vesting? monthly or quarterly</li> </ul>	<b>Acceleration</b> <ul style="list-style-type: none"> <li>None, or</li> <li>Change of Control:                             <ul style="list-style-type: none"> <li>Single-trigger: [_%] upon COC; and/or</li> <li>Double-trigger: [_%] upon Involuntary Termination within _ months of COC</li> </ul> </li> </ul>		
<i>Capitalization</i>			
As set forth in capitalization table as provided			
<i>Officers &amp; Directors</i>			
Directors [LIST]	Officers [LIST]		
<i>Other Discussion Points</i>			
<u>Trademarks</u> <ul style="list-style-type: none"> <li>Do you need to trademark your logo or other tradenames?</li> </ul>			
<u>Employees</u> <ul style="list-style-type: none"> <li>Employees in California?</li> <li>Employees elsewhere?</li> </ul>			
<u>Qualification to do business</u> <ul style="list-style-type: none"> <li>Offices in any other states?</li> <li>Planning to do most of your business in another state besides Washington?</li> </ul>			