# What a Startup Should Know About Compliance & Risk Management, Part 1

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**You have a hot idea, the right team, and a bit of money.** Now it's time to change the world (in stealth mode of course). Where to start? Networking with prospective partners? In the lab building that first prototype? No, you have it! You'll log onto the IRS website and set up your Federal Employer Identification Number!

For most entrepreneurs, non-core activities like filing DE-1 forms and negotiating insurance rates are at best a necessary distraction to the value added tasks of creating product, finding customers, and building a team. At worst, they can be a confusing labyrinth of rules, regulations, and risks which if ignored or mismanaged can hurt your business. Unfortunately, a business does involve some non-core, administrative overhead that cannot be ignored. And what you don't know can bite you.

Compliance with regulatory requirements and contractual terms is a risk-mitigation matter that must be properly managed. While entrepreneurs are often comfortable managing technical and business development risk, they are often less adept at managing the legal, financial, and insurance risks.

Poor execution in these areas can hurt a startup's chance of success in several ways:

- Subject the startup to legal sanctions or other penalties
- Unnecessarily increase overhead cash burn, the lifeblood of a startup
- Jeopardize intellectual property rights
- Impair the startup's ability to obtain downstream funding
- Cut into an entrepreneur's most precious resource: TIME!

Large companies can afford the legal, accounting, and other risk management specialists to the degree required ($$$) to ensure compliance and minimize other risks. Unless you're a lawyer or CPA or you have an exceptional amount of startup capital, it is unlikely that you'll be able to do the same.

However with some upfront planning and an understanding of what to look for, it is possible to ensure regulatory compliance and mitigate the largest risks while minimizing cash burn and the impact on your time.

## Understanding the Risk/Cost Tradeoff

This is Part 1 of a two part paper series which describes the evolution of a prototypical technology-based startup in California with eventual plans to seek institutional funding, to show how compliance and risk management requirements escalate as the business grows.

For most startups, the burden of compliance and risk management increases when the business begins undertaking specific activities that trigger new levels of risk.

The main risk triggers are:

- Formal Organization, "Friends & Family" Funding, and Issuance of Founders' Shares
- Intellectual Property Creation
- Purchasing by the Business of Products and Services from Third Parties
- Hiring Employees
- Leasing Space
- Accepting Customer Purchase Orders

This paper will discuss the first risk two triggers. Part 2 discusses the last four.

## In the beginning…

Prior to the creation and registration of a formal business entity (e.g. limited liability company, S-Corporation, or C-Corporation) the founding team is informally affiliated, with each person contributing time and money on a voluntary basis and with each individual responsible for his or her own expenses. At some point, as the startup begins to gain momentum and both time and expenses mount, there is usually a desire for the founding team to organize formally so as to limit the founders' liability to third parties. The founders may also be raising seed capital from "friends and family," most of whom will be passive investors unfamiliar with the day-to-day activities of the startup.

## Formal Organization and Issuance of Founders' Shares

Corporations and limited liability companies are artificial constructs which serve to limit shareholder and employee liability to third parties. To achieve this, one must comply with the governing laws. In addition to limiting liability, formal organization as a corporation or an LLC defines the following:

- How the economic benefits and risks are to be shared amongst the founders and investors (i.e. shares, share classes)
- How those benefits will be taxed
- The rights and responsibilities of the parties involved
- The compliance requirements to keep the entity in good standing

For startups, the most common business entities chosen are:

- Limited Liability Company ("LLC")
- IRS Sub-chapter C Corporation ("C-Corp")
- IRS Sub-chapter S Corporation ("S-Corp")

The decision as to which business entity to select will have the following implications:

- Tax treatment
- Eligibility for financing from institutional investors
- Administrative burden (least for an LLC, greatest for a C-Corp)

A discussion of the tradeoffs is beyond the scope of this paper. While there are a number of "do-it-yourself" books available to help you select and register the proper entity, an attorney is usually the most cost effective way to ensure this is done correctly.

At this stage, **assuming there are no employees**, compliance requirements are low and involve just a few items:

- Filing Articles of Incorporation or Articles of Organization with Secretary of State
- Board adoption of Bylaws and organizational resolutions (in the case of a corporation) or execution of Operating Agreement (in the case of an LLC)

- Issuance of shares to founders in compliance with Federal and state securities laws
- Securing of a Federal Employer Identification Number ("FEIN") from the Internal Revenue Service
- Filing a fictitious name statement if the business will be conducted under a name different from the name stated in the Articles of Incorporation or Articles of Organization

Even if there are no employees, an FEIN is usually required by registering agencies and frequently needed for setting up supplier accounts.

Commensurately, ongoing administrative overhead is low, involving:

- Filing annual Statements of Information with the state
- Filing annual Federal and state tax returns
- Basic accounting and record keeping throughout the year adequate to support the tax filings
- Execution of annual written consents reflecting actions of the shareholders and Board, including election of Board members and appointment of officers
- Periodic updating of minute book share registry to reflect stock or option grants

It is advisable to keep the share registry updated, especially as the startup approaches the professional funding stage. There is nothing more frustrating than preparing to close a multimillion dollar funding deal and not being able to get cousin Bobby's signature because he's moved to Timbuktu, address unknown.

At some point, the startup may raise funds from "friends and family" or angel investors. As part of the financing process, it will have to make certain representations regarding financial and legal matters. So compliance with the matters discussed in this paper will greatly facilitate the financing process, while compliance gaps will complicate it.

**DID YOU KNOW?**

If your startup issues restricted stock to employees, those employees must file a Section 83(b) election with the IRS within 30 days of issuance in order to preserve their ability to get capital gains treatment on the eventual sale of the shares. If that 30 day window is missed, the employee will be taxed at ordinary income rates as the shares vest **even if the shares are not sold**. If the filing is made in a timely manner, and the shares are held for at least one year, the employee will not be taxed until the shares are sold, and will be taxed at capital gains rates.

## Intellectual Property Creation

The underpinning of most technology based startups is the creation of intellectual property ("IP") in the form of patents, trademarks, and trade secrets (including proprietary designs, software, process recipes, etc.). Yet surprisingly, many technology startups manage this poorly. Management must be diligent in avoiding IP risks, which include:

- Loss of IP rights through failure to obtain proper assignments
- Loss of IP rights through failure to adopt or enforce a lab notebook policy
- Disclosing too much proprietary information in provisional patent applications
- Loss of trade secret rights and foreign patent filing rights through disclosure of the startup's secrets without an effective non-disclosure agreement
- Breach of non-disclosure obligations through disclosure of a third party's trade secrets to outsiders
- Misappropriation of the trade secrets of others, especially prior employers

- Infringement of patents and trademarks owned by others
- Having to change the name of the company or its products after brand equity has been built up, due to trademark infringement

The administrative overhead required to manage these risks include:

- **Non-disclosure and invention assignment agreements** and the associated business processes for their execution and tracking
- Business process for the keeping of lab notebooks, mining of patentable inventions, review of invention disclosures, and filing and prosecution of patent applications
- Employee education regarding the creation and protection of intellectual property
- Patent "clearance" searches prior to significant investment in new products
- Trademark searches to ensure that company and product names do not infringe the trademarks of others

Because trade secret law requires that the owner protect the confidentiality of its trade secrets, it is particularly important to have non-disclosure agreements in place before discussions with key vendors, independent contractors, and employees.

In the case of vendors and contractors doing custom work, those vendors and contractors should execute, in advance, agreements assigning to the company any IP they create in connection with their engagement. **Don't assume that because you paid an engineering design firm to do contract work for you that you own it;** you'd be surprised what the fine print might say.

## In Summary…

This paper has discussed the compliance and risk management issues facing an entrepreneur in the early stages of his or her startup. In terms of summary practical guidelines, the startup should:

1) ***Organize formally early*** to put in place basic liability protection and establish the most favorable tax treatment for the business.
2) ***Define intellectual property strategy and processes early*** in order to maximize the value of the startup's intellectual property and minimize the risk of infringement.
3) ***Do the appropriate trademark searches, and register your domain names and trademarks early on***, to minimize the risk of having to change your name after brand equity has been built up.

At this stage of the startup's life, the compliance and risk management issues are relatively straightforward to manage. However, these escalate significantly in terms of complexity and downside risk as the business begins to issue contracts and hire people. Part 2 of this series discusses the issues associated with purchasing products and services, hiring employees, leasing space and accepting customer purchase orders.

**DID YOU KNOW?**

Signing a mutual non-disclosure agreement can potentially:

- Impair your ability to commercialize your own inventions?
- If used indiscriminately, impair your ability to claim trade secret status for your legitimate trade secrets?

To minimize this risk, be selective with whom you sign NDA's and use one-way non-disclosure agreements where possible.