Lowndes Drosdick Doster Kantor & Reed, P.A.

ATTORNEYS AT LAW

LOCAL ROOTS. BROAD REACH.℠

Venturing Into The World Of Venture Capital

A Primer For Startups

Peter E. Reinert
Shareholder
Chair, Capital Markets & Technology Group
Peter.Reinert@lowndes-law.com
407-418-6291

Peter Simmons
Associate
Peter.Simmons@lowndes-law.com
407-418-6379

Lowndes, Drosdick, Doster, Kantor & Reed, P.A.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

TABLE OF CONTENTS

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

ABOUT THE FIRM

Lowndes, Drosdick, Doster, Kantor & Reed was formed in Orlando in 1969 by four partners who were engaged primarily in a burgeoning real estate practice. The firm's founders established a challenging mission: "to become Central Florida's best business law firm."

Today, we are truly a multi-practice law firm representing clients across a myriad of industries locally, nationally and beyond our borders. From our initial complement of just four lawyers and four staff members, Lowndes, Drosdick, Doster, Kantor & Reed has grown to become, according to the Orlando Business Journal, Central Florida's largest law firm.

We represent a variety of businesses, large and small, public and private, locally and nationally, across a wide spectrum of industries. We help clients in every stage of growth, including business formation, intellectual property transactions, strategic partnering, angel, venture capital and private equity financing, debt financing, IPOs and other public securities offerings and merger, acquisition and sale transactions. Depth and breadth of experience helps us anticipate and address the complex issues that arise in capital markets transactions, private equity and venture capital, M&A, public equity, debt financing, private securities offerings and intellectual property matters.

While we have grown and changed to meet the dynamic needs of our clients, the principles upon which we were founded have not changed.

- The firm has been recognized in The Legal 500 United States 2015 guide as a recommended leading law firm for the Real Estate and Construction - Land Use/Zoning category and the Mergers, Acquisitions and Buyouts - M&A - middle-market (sub-$500m) category. In addition, the following two lawyers have been recommended: Peter Reinert and Rebecca "Becky" Wilson.
- 44 firm attorneys have been recognized in the 2015 edition of *The Best Lawyers in America*, a leading peer-review survey of the legal profession. 25 firm attorneys were recognized in multiple practice categories, including 13 who were honored in three or more practice areas.
- Chambers USA 2015 recognized eleven partners as "Leaders in their Field" and ranked the firm in the areas of Corporate/M&A & Private Equity, Real Estate: Zoning/Land Use, Real Estate, Construction, and Litigation: General Commercial.

DISCLAIMER

This handbook is intended to be a general guide to key legal and business issues involved in starting a company. We recognize that each company and venture is unique, so there may be issues important to your company that are not addressed in this general guide. This handbook is not intended to be specific legal or business advice. We urge you to seek the counsel of an experienced business and licensing attorney before starting your business.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

GETTING STARTED

BUSINESS PLAN

Whether you are looking to start or grow your business, entrepreneurs are well advised to develop a business plan.

While a stellar business plan is no guarantee of success, your plan will provide the roadmap to achieve the success you desire. The question should not be *if* you create your plan, but *how* to formulate a plan that will take your company where you want to go.

We believe that the research and disciplined analysis involved in crafting a convincing business plan are integral steps in preparing to launch a venture.

Numerous decision points and unanticipated challenges will arise—your well-crafted business plan provides a framework for responding to these decisions and challenges.

The best plans will anticipate and provide convincing answers to the following questions:

PROPOSED PRODUCT/SERVICE

- Is the value proposition sound, articulated clearly and evaluated comprehensively?
- How original, innovative and thoughtful is the product/service?
- How will the business differentiate itself from the existing competition?
- How does the plan describe the user experience?
- How does the plan address relevant risks?

PREPARATION FOR LAUNCH

- Does the plan clearly identify a target market and customers?
- Does the team have a plan for developing relationships with key market participants?
- Do the financial projections reflect an understanding of the economics and potential growth opportunities or downside risks for the business? Are the financial projections comprehensive and realistic?
- How does the plan outline the business' core revenue model and ancillary revenue streams?
- Please evaluate the team's traction-to-date regarding product development.

EXECUTION PLAN

- Does the plan clearly outline future measurable, achievable milestones?
- Please rate the team's marketing strategy. How will they reach their target market segment?
- Please rate the team's sales strategy and progress. How will they sell to their first customers?
- How does the plan outline the plan to scale the business?
- Do the founding team members have sufficient expertise to launch the business? Does the plan address any needs for additional key people and strategies to attract these individuals?

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

GETTING STARTED

CHOICE OF ENTITY

Starting a new business involves prudent decision-making and thorough planning from the day the idea first enters one's mind, to implementing the concept and getting the business up and running, and finally, to ensuring that one's operation will remain a viable, burgeoning success.

One of the first steps in establishing a business is determining the appropriate structure, which will in turn, affect the business' taxation, legal and financial liability, and decision-making authority.

There is no magic business structure that will make all legal risks and problems disappear, and each person or group of people, must make the choice based on their specific goals and personal preferences. Beyond the actual decision of which structure to pursue, each option carries with it its own unique, concrete steps one needs to follow in order to start a business under that specific structure, as well as certain governance issues that may arise.

COMMON TYPES OF LEGAL ENTITIES

CORPORATION

A corporation is a very common form of legal entity for a for-profit business. It is created by filing a Certificate (or Articles) of Incorporation with the applicable state official (generally the Secretary of State) in the state where the corporation is formed. The Certificate of Incorporation encompasses the "constitution" of the company, establishing the basic economic and voting rights of the owners—referred to as stockholders or shareholders. These rights can be complex, but the fundamental powers include the right to elect a Board of Directors, the right to vote on fundamental changes to the corporation or its business, and the right to a share of proceeds after creditors have been paid in the event of a sale of the company. A corporation may be referred to as a "C" corporation or an "S" corporation. These designations evidence the applicable sections of the Internal Revenue Code that affect the respective tax status of the corporation. However, all corporations are treated as a "C" corporation for tax purposes unless a special "S election" is specifically made with the IRS. The C Corporation is the entity of choice for ventures seeking outside capital from angel investors, venture capitalists or other institutional investors, mainly because C Corporations allow for an unlimited number and type of shareholders and various classes of stock with differing rights. S Corporations, in contrast, can only have one class of sock, are limited to 100 stockholders, and can generally only have U.S. individuals as stockholders. It should be noted that one glaring disadvantage of the C Corporation is that it is subject to "double taxation"—the corporation itself must pay federal (and, where applicable, state) income tax on its profits and capital gains. Again, when these profits are distributed as dividends to the corporation's stockholders, each stockholder is typically taxed on his or her respective share of those dividends.

Continued on next page…

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

GETTING STARTED

COMMON TYPES OF LEGAL ENTITIES (CONT'D)

LIMITED LIABILITY COMPANY (LLC)

An LLC is created by filing a Certificate (or Articles) of Organization (or Formation) with the appropriate state agency. The owners of an LLC are usually deemed members rather than "shareholders" or "stockholders." Generally, the LLC members will elect "managers" who govern the LLC analogously to how a Board of Directors manage a corporation. While the Certificate of Formation tends to say little with respect to the ownership or governance of the LLC, the members instead enter into an "Operating Agreement" in order to prescribe the economic, voting, and other explicit rights of the members and managers. Indeed, in many ways an LLC can resemble a corporation, although different terminology is employed. However, LLCs differentiate themselves in at least one crucial respect—tax treatment. Akin to S Corporations, LLCs are ordinarily "pass-through" entities—normally treated as a partnership for federal and state income tax purposes. In this respect, the LLC itself does not owe tax on income that it earns, but instead, the owners are treated as the recipients of their respective share of the income and owe any corresponding taxes.

The chart on page 7 highlights the key differences between the five most common business forms, and the most important categories of issues one should consider in choosing an entity.

	SOLE PROPRIETORSHIP	PARTNERSHIP	LLC	CORPORATION	NONPROFIT ORGANIZATION
FORMATION	**EASIEST** • Springs into existence upon commencing business	**EASY** • No filing requirements to form • BUT partners should sign a partnership agreement	**MODERATE** • Articles of organization filed with state and pay filing fee • An operating agreement should be negotiated and executed. • Somewhat less burdensome than forming a corporation	**MODERATE** • Articles of incorporation filed with state and pay filing fee • Draft bylaws, hold an organizational meeting, and issue stock	**MODERATE TO DIFFICULT** • Articles of incorporation (containing specific information required by the IRS) filed with the state, and pay filing fee • Time-consuming application for 501(c)(3) exempt-status required unless you are under gross receipts threshold. • Additional requirements include recruiting directors, drafting bylaws, and holding an organizational meeting
OWNERSHIP	**1 OWNER** • Sole proprietor owns all the assets of the business and is entitled to all the profits.	**2+ PARTNERS** • Partnership owns its own assets • Partners are entitled to profits as set in partnership agreement or, absent a partnership agreement, state law (usually split equally per-capita or based on initial capital contribution)	**1+ MEMBERS** • LLC owns its own assets • Members entitled to share in profits, distributions, and other financial benefits • Allocation of profits among members generally set in the operating agreement or, absent a provision in the operating agreement, state law (usually split equally per-capita or based on initial capital contribution)	**1+ SHAREHOLDERS** • Corporation owns its own assets • Shareholders own stock that represents their percentage share of ownership in the business • Profits of the business may be distributed to shareholders in the form of dividends; distribution is based on share ownership	**NO OWNERS** • No personal benefit may accrue to anyone who controls or operates the organization
LIABILITY	Sole proprietor faces personal liability for the debts and obligations of the business, including for unlawful acts of employees	Partners face personal liability for the debts and obligations of the business, including for unlawful acts of other partners and employees	Members enjoy limited liability for the debts and obligations of the LLC, including for the unlawful acts of others involved in the business	Shareholders enjoy limited liability for the debts and obligations of the corporation, including for the unlawful acts of others involved in the business	Directors, officers, and employees ordinarily have no liability for the debts and obligations of the business, including for unlawful acts of others involved in the organization
OPERATION	**RELATIVELY EASY** • Few to no formalities required • BUT a sole proprietor must meet those tax and other regulatory obligations imposed on all small businesses.	**RELATIVELY EASY** • Few to no formalities required • BUT a partnership must meet those tax and other regulatory obligations imposed on all small businesses	**MODERATE** • Generally fewer formalities required than for corporations • Reporting and record-keeping requirements apply, as well as those tax and other regulatory obligations imposed on all small businesses	**MODERATELY DIFFICULT** • Numerous formalities required, including director and shareholder meetings • Reporting and record-keeping requirements apply, as well as those tax and other regulatory obligations imposed on all small businesses	**MODERATE TO DIFFICULT** • Numerous formalities required, including formal director meetings • Many record-keeping and reporting requirements apply, both to state offices and the IRS • This in addition to many of the tax (such as employment tax) and other regulatory obligations imposed on all small businesses
MANAGEMENT	Owner has full control	Partners have equal, full control unless otherwise arranged in a partnership agreement	Flexible structure like a partnership with rights and responsibilities outlined in an operating agreement	Managed by directors who are elected by shareholders. Directors appoint officers to run day-to-day operations. One person can fulfill all of these roles, but they are distinct roles	Managed by directors who appoint officers to run day-to-day operations
TAXES	**NOT TAXED AS AN ENTITY** • Owner reports business profits and/or losses on his or her personal tax return	**GENERALLY NOT TAXED AS AN ENTITY** • Partners report business profits and/or losses on their personal tax returns	**USUALLY NOT TAXED AS AN ENTITY** • Member(s) report business profits and/or losses on their personal tax returns, unless they choose to have the LLC taxed as a corporation	**SUBJECT TO CORPORATE TAX ON EARNINGS** • If earnings are paid out to shareholders as dividends, the individual shareholders also pay tax on the distribution	**SUBJECT TO CORPORATE TAX ON EARNINGS** *UNLESS ABLE TO ACHIEVE IRS AND STATE TAX-EXEMPT STATUS.* • Liable for tax on unrelated business income, and other taxes such as property and sales (unless local and state exemptions apply)

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

OWNERSHIP OF THE COMPANY

How do shares get allocated among founders, employees, investors, and others?

One of the most common challenges encountered by founding teams is how to allocate equity in their enterprise. Every time your company gets funding, you give up a piece of your company. The more funding you get the more of your company you give up. That "piece of company" is equity. Everyone you give a piece to becomes a co-owner of your company.
The basic idea underlying equity is the splitting of a pie. When you start your venture, your pie is likely rather small. You have 100% of a bite-sized pie. When you start taking outside investment and your company expands, your pie concurrently becomes larger. However, even though your pie becomes bigger, your proportionate share of the pie becomes smaller, or diluted. Thus, while dilution is bad in the sense that you are losing control of your company, it is often necessary to grow, as your pie gets bigger with each investment. The best way to balance this is to take investment only when it is necessary.

STAGE 1: FOUNDER'S STOCK

When the company is first formed, shares are issued to its founders. The total number of shares issued at this stage is determined arbitrarily but is often in the range of 2-10 million shares. Far more important than the total number of shares is each founder's relative percentage ownership of the company. Among the factors in making the determination as to the percentage of each founder's stock ownership, founders should consider:

- Development of the company's technology;
- Creation of the business idea and business plan;
- Leadership in promoting the company;
- Assumption of risk in launching the company; and
- Investment of time, effort and capital in the company.

STAGE 2: SEED ROUND

At this stage, your company may be in search of resources that come with more than just a dollar sign attached to them. Business "angels" are high net worth individual investors who seek high returns through private investments in start-up companies. Because of their business experience, many angels invest more than their money. They also seek active involvement in the business, such as consulting and mentoring the entrepreneur. Often an angel's contacts and advice can be more important than the money. Your company could consider applying for and accepting an invitation from an incubator or accelerator. These places provide the three things eager startups crave the most– cash, space, and advisors. While the cash is tight—offering between $25,000 and $100,000 in exchange for an equity stake of between five and seven percent—it is a lot more useful and sustaining to entrepreneurs than the money alone, as accelerators can have a thicket of connections just as useful as venture capitalists who come in for later funding rounds. This is illustrated by the fact that some of the biggest names in tech today, including Airbnb, Dropbox, and Reddit, have emerged from accelerators.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

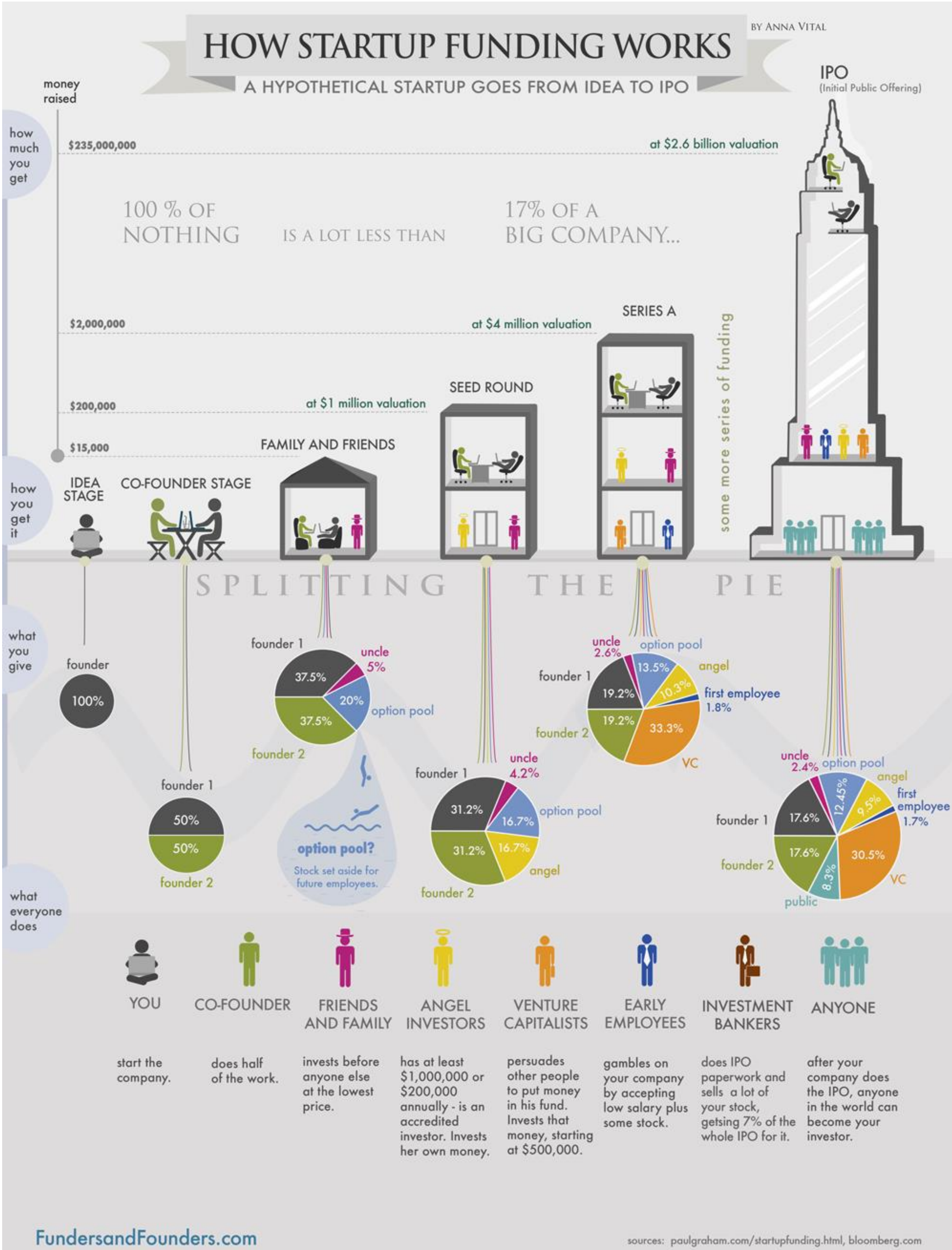
OWNERSHIP OF THE COMPANY

How do shares get allocated among founders, employees, investors, and others?

STAGE 3: VENTURE CAPITAL ROUND

Venture capital is a professionally managed pool of capital that is raised from public and private pension funds, endowments, foundations, banks, insurance companies, corporations, and wealthy families and individuals. VC investments average several million dollars but are harder to get and come with tougher terms than other sources of funding. VCs generally invest in companies which can, if successful, have a liquidity event—either a sale of the company or an IPO—within five to seven years and that will generate returns of five to ten times the amount invested. Because VCs invest large amounts, the money comes with more restrictions. Most only come into effect if the company gets into trouble. For example, VCs generally write it into the deal that in any sale, they get their investment back first. So if the company gets sold at a low price, the founders could get nothing. Ultimately, VCs invest with terms that are designed to provide them considerable control and to maximize the return for their investors.

The graphic on the next page illustrates a hypothetical startup getting about $15,000 from family and friends, about $200,000 from an angel investor three months later, and about $2 Million from a VC another six months later (created by Anna Vital of FundersandFounders.com):


HOW STARTUP FUNDING WORKS
BY ANNA VITAL
A HYPOTHETICAL STARTUP GOES FROM IDEA TO IPO
money raised
how much you get
$235,000,000
at $2.6 billion valuation
IPO
(Initial Public Offering)
100 % OF NOTHING
IS A LOT LESS THAN
17% OF A BIG COMPANY...
$2,000,000
at $4 million valuation
SERIES A
some more series of funding
$200,000
at $1 million valuation
SEED ROUND
$15,000
FAMILY AND FRIENDS
how you get it
IDEA STAGE
CO-FOUNDER STAGE
SPLITTING THE PIE
what you give
founder
100%
founder 1
50%
50%
founder 2
founder 1
37.5%
uncle 5%
20%
option pool
37.5%
founder 2
option pool?
Stock set aside for future employees.
founder 1
31.2%
uncle 4.2%
16.7%
option pool
31.2%
16.7%
angel
founder 2
uncle 2.6%
option pool
founder 1
19.2%
13.5%
angel
10.3%
first employee 1.8%
founder 2
19.2%
33.3%
VC
uncle 2.4%
option pool
angel
first employee 1.7%
founder 1
17.6%
12.45%
9.5%
17.6%
30.5%
founder 2
8.3%
VC
public
what everyone does
YOU
start the company.
CO-FOUNDER
does half of the work.
FRIENDS AND FAMILY
invests before anyone else at the lowest price.
ANGEL INVESTORS
has at least $1,000,000 or $200,000 annually - is an accredited investor. Invests her own money.
VENTURE CAPITALISTS
persuades other people to put money in his fund. Invests that money, starting at $500,000.
EARLY EMPLOYEES
gambles on your company by accepting low salary plus some stock.
INVESTMENT BANKERS
does IPO paperwork and sells a lot of your stock, getsing 7% of the whole IPO for it.
ANYONE
after your company does the IPO, anyone in the world can become your investor.
FundersandFounders.com
sources: paulgraham.com/startupfunding.html, bloomberg.com

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

VALUATION

What is the appropriate valuation of my business?

When it comes to valuation, do not let the word, its meaning, or its computation intimidate you. Ultimately, the question of valuation is a simple question of price. Just like assigning a price to any other good in the market, you are assigning a price to your business. Thus, when faced with the question of "what is the appropriate value of my business," the answer is quite simple: like any other pie, your business is worth what someone is willing to pay for it.

SUPPLY & DEMAND

Of course, the obvious takeaway from ECON101—the natural economic principles of supply and demand—apply to valuing your business. The more scarce a supply (*e.g.* your remaining slices of equity in a hot new pie of patented technology), the higher the demand (*e.g.* numerous impassioned investors competing for the deal, and driving up your valuation in the clamor). Yet another truism–that in courtship always appear as though you have multiple suitors—applies with equal force when valuing your business. Before you start soliciting investment, make sure your business will be perceived as new and unique to maximize your valuation, and conversely, allowing an investor to think they are the only investor pursuing your business will belittle your valuation.

THE INDUSTRY

Operating in conjunction with the simple tenets of supply and demand, is the industry in which your business operates. While a competitive commodity business will be less demanded and thus receive a lower valuation to close its financing, a next generation biotech business will be born into the world with a Brad Pritt-like veneer causing investors to lust after it with valuation upwards of ten times its revenues. In any event, before you approach investors with valuation expectations, make sure you have researched and digested the valuations achieved in recent financings or M&A transactions in your relevant industry.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

VALUATION

What is the appropriate valuation of my business?

STAGE OF DEVELOPMENT

Where you are in your stage of development is a crucial driver in calculating your valuation. Startup growth stages can be likened to the four years (stages) of high school education, and with each stage of maturation, comes a corresponding growth in your valuation:

- **Freshman**: anything from an idea on a piece of paper to a beta site—bootstrap financed, raising $50k-$500k.
- **Sophomore**: typically range from beta site to full production site with initial users—garnering seed stage angels, raising $500k-$1m.
- **Junior**: generally have achieved a full proof of concept around their business and have amassed rapid user or revenue growth, nearing $1m in revenues—backed by Series A venture capital, raising $1m-$5m.
- **Senior**: usually have progressed to multi-millions of revenue and are positioned to materially scale their businesses with a substantial capital raise—reaping Series B venture capital, raising $5m-50m.

When all is said and done, the investor will likely have a very good sense of what a business is worth, and what they are willing to pay for it. Ultimately, as you try to get investors excited about your startup and differentiate it from the hundreds of others they see each year, consider that investors are looking for that next 10x return opportunity—make sure your five year forecasted financials will swell large enough in that period to afford them a 10x return. The bottom line, as frustrating as it may be for any business searching for a definitive answer, valuation is far from an exact science, and should be approached as a relative science, as illustrated by the infographic available at **http://fundersandfounders.com/how-startup-valuation-works/.**

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

GETTING FUNDED

How does angel investing and venture capital work?

Common VC/angel investment terms can be broadly categorized into financial rights, governance rights, and exit rights.

FINANCIAL RIGHTS

The starting point in the discussion of financial terms for a VC investment is the **pre-money valuation** of the company. Specifically, investors will need to determine what percentage of the company they will receive in exchange for a specified investment amount. Typically, the original stakeholders in the company will contend for a higher pre-money valuation in hopes of minimizing the amount of dilution they will experience, and thus the amount of control in their company from which they secede. In contrast, investors will generally push for a lower pre-money valuation attempting to maximize the potential return on their investment. This valuation negotiation takes into account the risks that the company will not achieve its objectives, the risks that competition or market fluctuations will reduce the value of the company, and numerous other risks.

Valuation, including the per share price, is typically determined on a **fully-diluted basis**, meaning:

- The total number of issued shares of common stock owned by founders and others,
- Plus all shares of common stock which would be issued if all outstanding options and warrants were exercised,
- Plus all shares of common stock which would be issued if all convertible preferred stock were converted into common stock,
- Plus all shares of common stock which would be issued if all shares reserved for grants under a stock option or incentive plan were issued.

Most venture capital investments are structured as convertible preferred stock with a **liquidation preference**—a feature of the stock giving the holder entitlement to receive a stated amount per share in a liquidation or sale of the company prior to holder of common stock or other "junior" securities entitled to receive value for their stock. What is more, VCs often urge that the preferred stock be **participating preferred stock**, allowing the holders of the preferred stock to share on a pro rata basis with the holders of the common stock in any proceeds that remain after they receive payment of their liquidation preference. Less frequently, preferred stock will also carry a fixed rate **dividend**, which due to the cash constraints of startups, the dividend is not payable on a regular basis—the dividend instead accrues over time and may be added to the liquidation preference payable upon a sale or liquidation of the company. Essentially, these accruing dividends are best viewed as a return for the time value of money.

VCs further safeguard their ownership percentages in the company via preemptive rights, anti-dilution protection, and price protection. **Preemptive rights** furnish investors with the right to purchase a portion of the shares of stock sold by the company in future financing rounds, and thus empower them to preserve their existing percentage ownership in the company. **Anti-dilution protection** adjusts the investors' ownership percentages should the company effectuate a stock split, stock dividend, or recapitalization. **Price protection** effectively engenders a retroactive reduction in the effective price paid by VCs for its share of preferred stock in the event the company sells stock at a lower price than that originally paid by the VCs. Essentially, whenever the company sells shares in the future at a lower price, the company will have to issue additional shares to thee VCs to offset the price difference between the new price and that originally paid by the VCs.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

GETTING FUNDED

GOVERNANCE RIGHTS

As alluded to earlier, most investments provide VCs with appreciable ability to control the company. Indeed, most investment structures ensure that the VCs have the right to elect one or more members of the board of directors, assuring that VCs' chosen representatives have regular opportunities to consult with management and to review and vote upon budgets, material transactions, executive employment, and other strategic matters.

Additionally, preferred shares often contain **protective voting provisions**, or special voting rights stipulating that a company may not engage in certain activities or close certain transactions without first having received the affirmative vote of a designated selection of shareholders.

EXIT RIGHTS

Ultimately, VCs must successfully convert their shares in the companies in which they invest into cash or marketable securities in order to distribute such proceeds to investors in their VC funds—achieving a requisite level of liquidity in order to produce the necessary rate of return to their investors. The primary liquidity events for VCs occur upon the sale of the company for cash or marketable securities or the sale of company stock subsequent to an IPO by the company. While VCs do not contractually have the right to force the sale of the company, they do, nonetheless, have the practical ability to generally force a sale through their seats on the Board and concurrent special voting protections. To be sure, if VCs suspect that a sale of the company will furnish a greater return on investment than continuing to invest in development efforts, the VCs can effectively preclude the company from selling additional stock to raise capital, thus leaving the company with no alternative but pursuing a sale of the business.

VCs generally also secure registration rights, including **demand registration rights**—requiring the company to register shares with the SEC so VCs can sell their shares in public capital markets—and **piggyback registration rights** that provide VCs the right to include their stock in future registered offerings that the company may pursue. Alternately, VCs may require **redemption rights** to furnish them with a way to achieve liquidity if it is not a viable option through a sale or public offering. This provides investors the right to require the company to repurchase their stock after a specified time, usually four to seven years. The redemption price for VCs' stock may be based on the liquidation preference, the fair market value of the stock as specified by an appraiser, or the value of the stock based upon a multiple of the company's earnings. In practice, redemption rights provide VCs enormous leverage to make management struggle with their need for an exit, and ultimately coerce a forced sale of the company. In the same way, if the VCs trigger their redemption right and the company breaches its payment obligations, the VCs may be able to usurp control of the board of directors of the company and thus be situated to direct any future activities of the company.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

INTELLECTUAL PROPERTY

Why should a startup take steps to protect intellectual property?

From your business plan to your valuation, everything covered in this handbook has a single overarching message—how to convey your business' value to investors. Defensible intellectual property is often one of the top things venture capitalists want to see in a startup. IP rights secure to authors and inventors the exclusive right to make and use their writings and inventions for specified periods of time. These periods of exclusivity engender people to profit from their creativity—concurrently promoting creativity and fostering investment in new ideas and inventions.

PATENTS

A patent is a legal right granted by the government in exchange for which the inventor must fully disclose the invention to the public. A patent gives its owner the legally enforceable right to keep others from making, using, or selling the invention for the life of the patent, with the purpose of requiring public disclosure in order to encourage others to improve upon the invention and thus stimulate advancements in technology and economic growth. Patents can be secured for many types of inventions, including machines, processes, and composition of matter.

The common requirement is that the invention must be novel, useful, and non-obvious. A thorough discussion of these requirements is outside the scope of this handbook, but suffice it to say that the process of determining patentability and building a commercially meaningful patent portfolio is likely a lengthy, expensive, and complex process.

The critical questions you should be asking as you try to navigate this process for your startup include:

- Which inventions should I try to patent? (patent what is important to others, not just your business);
- In which countries should I try to get patent coverage?;
- How long will this process take?; and
- How much will this process cost?

COPYRIGHT

Copyright owners are granted the exclusive right to reproduce, distribute, publicly perform, publicly display, or prepare derivative works of their copyrighted work—an original work of authorship fixed in literary, audio-visual, or other media.

Unlike the costly and time-consuming process required for patent protection, copyright automatically accrues when a work is reduced to a tangible medium.

Of critical importance, if this reduction occurs during the course of employment, the copyright is generally deemed to be owned by the employer, while a work created or produced by an independent contractor will not be deemed to be owned by the company unless there is an explicit agreement otherwise or it satisfies the statutory definition of "work for hire."

While you are not required to register your copyright for such rights to exist, registering a copyright with the U.S. Copyright Office does convey certain benefits:

- It is necessary in order to file an infringement action;
- It allows the owner access to statutory damages and attorney's fees; and
- It provides evidence of ownership of the work at issue.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

INTELLECTUAL PROPERTY

Why should a startup take steps to protect intellectual property?

TRADE SECRETS

Trade secrets are confidential, secret information that provides the owner a competitive advantage including:

- manufacturing processes;
- customer lists;
- certain types of business information; and
- other "formulas, patterns, compilations, programs, devices, methods, techniques, or processes."

In order to qualify as a trade secret, the information must have economic value because of its secrecy, and the owner must take reasonable steps to safeguard its secrecy.

The owner of a trade secret has the right to prevent others from using or disclosing the trade secrets without permission and this protection can last, potentially, forever—so long as the trade secrets retain economic value, they remain secret, and reasonable steps are taken to preserve their secrecy.

Notably, absolute secrecy is not required so long as the trade secret cannot be discovered by legitimate means, *e.g.* reverse engineering. The prime example is the trade secret for the formula for Coca-Cola.

TRADEMARKS

A trademark is a word, symbol, or combination thereof used by a manufacturer or merchant to identify its goods or services and to distinguish them from those of its competitors.

Trademark and unfair competition law protects the trade identity and goodwill associated with the goods and services marketed and sold by businesses—providing owners the right to prevent others from using confusingly similar marks and reselling theirs goods without use of their marks.

While ownership of a trademark is generally established by actual "use" of the mark in connection with the sale of goods and services, registering the mark with the PTO provides certain benefits:

- It establishes a nationwide constructive date of first use; and
- It allows for recovery of attorney's fees and treble damages.

To ensure your trademark rights are not diminished or lost, make sure your business continuously uses the mark, actively enforces its rights against known infringers, and prevents it from losing its significance in the marketplace by becoming generic.

Lowndes Drosdick Doster Kantor & Reed, P.A.
ATTORNEYS AT LAW

ADDITIONAL RESOURCES

Small Business Administration
https://www.sba.gov/category/navigation-structure/starting-managing-business/starting-business

A Guide to Dividing Equity
https://canvas.upenn.edu/courses/216152/pages/allocating-equity-in-new-ventures

How to Write A Great Business Plan
https://hbr.org/1997/07/how-to-write-a-great-business-plan

The Strategic Secret of Private Equity
https://hbr.org/2007/09/the-strategic-secret-of-private-equity

How Venture Capital Works
https://hbr.org/1998/11/how-venture-capital-works

QUESTIONS/CONTACT

PETER E. REINERT

Shareholder
Chair, Capital Markets & Technology Group
Peter.Reinert@lowndes-law.com
407-418-6291

PETER SIMMONS

Associate
Peter.Simmons@lowndes-law.com
407-418-6379