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## Common Questions Entrepreneurs Ask Us

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## **Invention Assignment Agreements**

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### **Q. What is an Invention Assignment Agreement?**

A. For entrepreneurs, many of which operate in innovation-driven marketplaces, intellectual property is often at the core of their business—as such, protection of intellectual property is high up the list of concerns for entrepreneurs. When one thinks of intellectual property, many immediately think of technology companies. But, a Company does not have to live in the world of inventions, algorithms or code to create intellectual property. As a start up grows, more and more people are asked to either work on, interact with or create intellectual property for the Company. No start-up wants to see the

fruits of their labor, the creations and the assets of the Company walk out the door. Enter the Invention Assignment Agreement. An invention assignment agreement is intended to guarantee that the company actually owns its intellectual property rather than the employees or contractors who worked on it. The invention assignment agreement is a contract between the company and a founder, employee or contractor, requiring that person to assign all intellectual property rights created over the course of that person's work at the company. This agreement is needed because, by default, intellectual property is not assigned automatically to the company.

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### Q. Why is an Invention Assignment important?

A. Sometimes, founders believe they can rely solely on the work-for-hire doctrine for protection; thinking that the employment relationship entitles them (or the Company) to all IP created during said employment relationship. Unfortunately, the work-for-hire doctrine is limited—covering copyright, but not patents or trade secrets. Additionally, if not coupled with a written agreement, the doctrine only applies to employees working within their defined scope of employment for the Company. Frequently, startups rely extensively on independent contractors and have very few or no employees often with many different job titles. Without an invention assignment agreement or CIIAA in place, founders are risking that Intellectual Property created by their employees walks out the door with the employee.

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### Q. How do you draft an Invention Assignment Agreement or (CIIAA)?

A. Invention Assignment provisions are most commonly seen in a Confidential Information and Invention Assignment Agreement (CIIAA). These agreements are typically delivered separately from an employee's offer letter or employment agreement. Independent contractors typically see these provisions in their independent contractor agreement. Founders typically see these provisions in both an initial intellectual property assignment agreement entered into at the time their company is formed as well as in a CIIAA or independent contractor agreement entered into in connection with their ongoing service relationship.

Entrepreneurs want to make sure these agreements are drafted to encompass as wide a range of intellectual property possible. In addition to inventions, conceptions, discoveries, improvements, and original works of authorship, the agreement often includes an assignment of "know-how" and "ideas" learned or created by the employee while employed. Further, these agreements typically require the employee or contractor to:

- Keep proprietary information confidential;
  - Assign all inventions to the Company (with key carve-outs for inventions and excluding IP created "off the job");
  - Return all confidential and proprietary information to the Company at the end of their contractual relationship with the Company;
  - Disclose all inventions made during the contractual relationship with the Company;
  - Name and carve-out all pre-existing inventions created prior to entering into the contractual relationship with the Company; and
  - Agree not to compete with or solicit from the Company during or after the contractual relationship terminates.
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## Q. What factors are important when creating an Invention Assignment Agreement?

A. To ensure a smooth ownership of Intellectual Property the Company should require that employees and independent contractors enter into an Invention Assignment Agreement or a CIIAA at the start of the employment relationship. Some key points to consider when choosing to implement an invention assignment agreement or CIIAA include:

- Who the parties to the agreement are and what happens to the agreement (and the IP) if the employer entity is bought, sold or effects a merger.
  - Consideration (or payment). The employee/independent contractor must receive something in exchange for performance of the obligations required by the CIIAA in order for the agreement to be enforceable.
  - What confidential and proprietary information is covered by the Agreement.
  - If Confidential Information will need to be shared with 3rd parties and the process for sharing with these 3rd parties.
  - Whether or not the employer intends to use an employee's name, likeness, or biographical information in connection with its business.
  - Deciding the state law that will govern interpretation of the agreement and understanding possible limits on enforceability of severability clauses under state law.
  - Deciding how to proceed if/when disputes occur—whether or not arbitration is to be used.
  - Making sure that the agreement does not contradict other agreements the employer (or another employer/entity) may have with the employee and to making sure the agreement supersedes those prior agreements.
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## Q. What can happen if you don't have an Invention Assignment Agreement in place?

A. When Intellectual Property is a large part of a start-up, the lack of an invention assignment agreement with a person that created important IP for the company could create additional hurdles for potential investors. If employees of the Company have not entered into an Invention Assignment Agreement or CIIAA, the investor is likely to demand that the Company obtain one. But if the person is no longer working with the company or, even worse, left on bad terms with the company, it might become expensive or impossible to obtain such an agreement. Additionally, if the person still owns the copyright to their work for the company, they could reuse it again in other situations, effectively competing with the Company.

## 83(b) Elections

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### Q. What are they and why should you file one?

A. The filing of an 83(b) election is both one of the most esoteric and one of the most concretely important steps that an entrepreneur must take when founding their company. Many entrepreneurs have heard of an 83(b) election and have been told that filing one is critical; however, what that filing is, and what problem they are solving by filing one.

Put succinctly, an 83(b) election is a notice to the IRS that you wish to be taxed on the value of your granted equity (i.e. shares of a corporation or units in an LLC) as of the date of grant rather than recognizing income on the value of that

equity as of the date that it vests. Making an election can allow you to defer a significant tax bill until the date that you sell your equity, and significantly lower your overall tax liability. But that description hides a lot of complexity, because an 83(b) election sits at the confluence of two critical areas of the law affecting entrepreneurs: taxation and vesting of equity grants. This FAQ will attempt to untangle them.

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### Q. What is vesting or reverse vesting?

A. Vesting (which is sometimes described in the startup context as “reverse vesting”), is an extremely common tool that companies and entrepreneurs use to promote retention. When you are granted equity subject to vesting, though you own that equity and control it (say for purposes of voting in a shareholder meeting), the company has an option to repurchase that equity at a nominal price if you ever leave the company. Over time shares “vest,” meaning that the company no longer has this repurchase right. A very common vesting schedule might last four years, with the first 25% of your shares vesting on the 12-month anniversary of your grant date, and the remaining 75% vesting in equal monthly amounts over the following 36 months.

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### Q. Why do taxes matter?

A. Because there are two different tax regimes: ordinary income, where the maximum rate is 37%, and capital gains, where the maximum rate is 20%. (This is an oversimplification because the U.S. has a progressive income tax, but almost always you will be taxed at a lower rate for capital gains than ordinary income.) In order to maximize your post-tax returns, the goal here is to ensure that any future gains in the value of your equity are taxed at the capital gains rate rather than ordinary income rate.

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### Q. How does vesting affect taxes?

A. When you receive compensation for your services in the form of equity, you are taxed, at ordinary income rates, on that “income” – the “fair market value” of the equity. However, absent an 83(b) election the IRS does not consider you to have “received” your equity until it has vested and your company has no right to repurchase it at below its fair market value. This means that for the IRS’s purposes, you would recognize income throughout the four-year vesting period described above.

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### Q. What is the significance of vesting and taxes?

A. As a successful entrepreneur, you are adding value to your business every day. As your business grows, so does the fair market value of the equity. Equity that might have been essentially worthless when you formed your company (i.e. most initial equity is granted to founders at hundredths or thousandths of a penny per share) might be worth \$0.25/share after one year. If you vest 1,000,000 shares after one year, those shares have increased in value from \$100 to \$250,000. One year into building a startup, only a very lucky few entrepreneurs are sufficiently liquid to pay the resulting tax bill. Wouldn't you rather pay taxes on just \$100 in additional income? You'll need to file an 83(b) election.

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## Q. What is an 83(b) election and what does it do?

A. An 83(b) election gives notice to the IRS that you would like to be taxed on the full value of all your shares, vested or unvested, at the time of grant. This accelerates your tax bill to the date of grant, but it also allows you to pay taxes on the initial, presumably very low, value of your stock.

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## Q. What other benefits are there to an 83(b) election?

A. An 83(b) election doesn't just prevent large, inconvenient tax bills; it also helps you to shift more of your future gains into the advantageous capital gains tax regime. This is because the appreciation in value of your equity is taxed at capital gains rates only after more than one year has passed from the date of grant (if an 83(b) election is filed), instead of from the date of vesting (if no 83(b) election is filed). An example:

- As in the example above, you are granted 4,000,000 shares at founding at a value of \$0.0001/share (a total value of \$400). You file an 83(b) election and pay  $400 \times 37\% = \$148$  of ordinary income tax. Each year thereafter, you vest 1,000,000 shares, at per share values of \$0.25, \$0.50, \$1.00 and \$2.00. After five years, you sell your shares for \$10,000,000. Congratulations! Because you filed an 83(b) election, you are taxed on \$9,999,996 of gain (giving you credit for the initial \$400 of value) at the 20% rate, or \$1,999,999.20, meaning a total tax bill of \$2,000,147.20.
- Same as the example above, except no 83(b) election is filed. Now, at each anniversary, you pay ordinary income tax on the 1,000,000 shares that vest. In year one, you pay \$92,500 in taxes; year two, \$185,000; year three, \$370,000; and year four, \$740,000. That's already \$1,387,500 in taxes! When you sell, you do receive credit for the taxes you've already paid, making the math not quite as simple as above, but you will pay \$1,250,000 in additional capital gains, or a total tax bill of \$2,637,500.00.

*Filing an 83(b) election has saved you \$637,352.80 in taxes.*

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## Q. You've got my attention. How do I file an 83(b) election?

A. Work with your legal counsel to get this right. Critically, an 83(b) election must be filed within 30 days of the grant of stock by the Company. If you miss this deadline, there is almost no way to fix the situation and receive this beneficial treatment. Additionally, the IRS requires that you provide copies of the election to the IRS (we recommend using certified mail, return receipt requested, to have a record of delivery), your company, and retain one for your personal tax records, and your state taxing authority may require that you file a copy of your 83(b) election with your state tax return. Experienced legal counsel can provide you with the appropriate forms and instructions to complete this filing.

Please note that in some situations, filing an 83(b) election is not required (e.g. when receiving a stock option, or for fully-vested equity), or, in a tiny minority, may not work to lower your tax bill. Again, working with legal and tax advisors will help you understand your particular situation and the value of the 83(b) election.

## Term Sheet/Letter of Intent

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## Q. Glossary

A. Accredited Investor refers to an investor meeting certain net worth and financial experience and sophistication standards, as set forth in Rule 501 of Regulation D of the Securities Act of 1933, as amended.

Equity Securities refers to ownership interests in an entity.

M&A refers to a transaction involving the merger of two entities, or the acquisition of one entity by another entity by means of a stock or asset purchase transaction.

Post-Money Valuation refers to the value of a company after completion of a new financing or equity investment transaction.

Pre-Money Valuation refers to the value of a company prior to the investment or infusion of new investment in the company.

Term Sheet (sometimes referred to as a "Letter of Intent" (LOI) or "Memorandum of Understanding" (MOU)) refers to a preliminary agreement outlining the basic terms of a proposed investment or M&A transaction.

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## Q. What is a Term Sheet?

A. A Term Sheet, sometimes referred to as a "letter of intent" (LOI) or "memorandum of understanding" (MOU) is a preliminary agreement for a potential transaction. It's preliminary in that the parties use the Term Sheet as a framework for the final definitive agreement that will set forth the detailed terms and conditions of the transaction. A Term Sheet precedes the final binding definitive agreement for the transaction – so it's pretty much an agreement to enter into another, longer agreement. In the context of an equity investment transaction, it sets forth the terms by which a company agrees to sell some of its equity interests to new investors. In the context of an M&A transaction, it sets forth the general terms of an agreement to buy or sell another company.

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## Q. Is a Term Sheet binding?

A. A Term Sheet is typically non-binding for the most part. An agreement or a part of an agreement is "binding" if it's enforceable by the other party to the agreement; in other words, if I don't do something that is a binding obligation, you can sue me for it. If an agreement or part of an agreement is non-binding, on the other hand, one party can't really do anything to enforce it against the other party. Because a Term Sheet is really just merely intended to evidence the parties' intent to enter into an agreement, it is generally non-binding (and typically includes all kind of qualifications and disclaimers to make sure it is not binding).

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## Q. What are the purposes of a Term Sheet or other preliminary agreement? How is this different from the two CEOs, or a company and potential investor, just talking about the deal and then shaking on it? You still need the final definitive agreement, so why bother with the Term Sheet?

A. A Term Sheet serves to focus the parties' attention on the deal and what they each expect the terms of the final deal to be. Putting the high-level, general terms in a written Term Sheet (or MOU or LOI – that is, actually putting something on paper) helps each party to feel like the other party is really committed to getting the deal done.

Creating a written Term Sheet can identify the big issues – so the parties can figure out if a deal is going to be possible before they put too much time and money into it. The Term Sheet establishes the really big, baseline terms and can identify what are called “deal-killers.” Say you’ve been talking to the president of a company about buying his business and he thinks you’ll be keeping his son-in-law on as the CEO, but you intend to immediately fire the son-in-law and put your brother in charge...deal killer for the seller if you don’t retain the son-in-law.

This can be true in the context of a bringing in new investors as well. You, as the founder of the company, may be intent on retaining management control. However, an investor infusing a significant amount of cash in the company is likely to want a say in how the company is operated. A key issue, particularly in investment in start-up or early stage companies, is the valuation of the company. A Term Sheet will set forth the percentage ownership of the company that will be sold to a new investor for an agreed-upon price.

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### Q. What is the typical format of a Term Sheet, LOI, or MOU?

A. A Term Sheet is usually fairly perfunctory – often just a bullet point list. An LOI or MOU is typically a little more involved and written in the format of a letter. But they’re all intended to do the same thing. And they’re all certainly less formal than the final contract will be.

For example, the Term Sheet may say something like “the purchase price will be \$1 million, subject to adjustment depending on inventory levels as of the date of closing.” Then the final agreement will have all kinds of detail as to how you count the inventory, how you value the inventory, how you calculate the adjustment, etc. In an equity investment transaction, a company may offer to sell non-voting equity interests, but the new investor may counter with a demand for voting or other management rights.

As you might expect, the length and format of a Term Sheet, MOU, or LOI will depend on the complexity of the transaction and the parties. Term Sheets, MOUs, and LOIs are used in all different kinds of circumstances in addition to M&A or investment transactions – for example, when a business is undertaking some kind of joint project with another company or maybe even between divisions in the same company, they might prepare a Term Sheet to set forth what resources will be contributed by each party and who’s responsible for which tasks.

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### Q. What is generally included in a Term Sheet?

A. *Basic deal terms.* As noted above, a Term Sheet will outline the key terms of the proposed transaction. In an equity investment transaction, a Term Sheet will generally set forth at least the following:

- The current capitalization of the company – who are the current owners of the company, and how much money or services have they contributed to the company?
- The amount of equity being sold to new investors, and at what price;
- The valuation of the company, on both a pre-money (before the new investment) and post-money (after the new investment funds have been contributed to the company) basis;
- Investor suitability – whether investors must qualify as “accredited investors,” which is basically a requirement that all investors must have certain net worth and investment experience and sophistication;
- The key terms of the equity securities that will be sold to the new investors, including:

- Will new investors be entitled to any preferred dividends or distributions?
  - Will new investors have any voting or management rights?
  - Will new investors have any rights to convert their securities into other securities of the company?
  - Will new investors be subject to restrictions on the transfer of their securities?
  - Will new investors be entitled to participate in any future equity offerings of the company?
  - In a M&A transaction, the Term Sheet will include the structure of the transaction (stock purchase, asset purchase, or merger), the purchase price, the manner of conducting due diligence, and conditions that must be satisfied before the deal will close.
  - *Confidentiality provisions.* A Term Sheet should always include confidentiality provisions. Before you and your new investors, or a buyer in an M&A transaction, sign a binding agreement, you are going to have to share confidential information about the company, such as the company's business plan, financial statements (including projections), tax returns, customer and vendor lists, profit margins on key product lines, and intellectual and other property owned. To protect this information, confidentiality provisions are crucial in a Term Sheet.
  - *Transaction timetable.* The Term Sheet should also set forth the expiration date of the offer to sell the equity interest in the company to new investors, and the expected timeframe to complete the transaction. In an M&A transaction, the Term Sheet will generally set forth how long the buyer will have to conduct its due diligence investigation, and when the transaction is expected to close.
  - *Risk factors.* A Term Sheet for an investment transaction should include a general precautionary statement that the investment involves certain risks. These risk factors may be described in more detail in a final offering document or investment agreement itself.
  - In an M&A transaction, a Term Sheet or LOI may include an "exclusivity" clause, which restricts a selling company from negotiating with other potential buyers.
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### Q. Are there any provisions of a Term Sheet that will be binding?

A. Although, as noted above, a Term Sheet is intended to be non-binding, there are generally binding provisions as well. In general, the deal terms – what you're selling/buying, the purchase price, everything about the actual deal – are intended to be non-binding. The process of negotiating the deal terms, however, are generally binding – how are the parties going to communicate, how much access does each party get to the other party's books and records, how long are you going to negotiate? What are you going to do if you get into a dispute? Confidentiality provisions (protecting the company's confidential and proprietary information) and exclusivity provisions (prohibiting negotiations with other parties for a similar transaction) should always be binding.

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### Q. Are there risks associated with entering into a Term Sheet?

A. Yes. A Term Sheet will take time, effort and expense to prepare. Depending on the size and complexity of the proposed transaction, as well as the relationship between the parties, a Term Sheet may not be necessary or efficient from a cost-benefit perspective.

Great care should also be taken to avoid creating binding obligations. A carelessly drafted Term Sheet might unintentionally include some terms that may be binding and enforceable against a party. You should avoid words like “will” and “shall,” and instead use words like “may,” “would,” “expect,” “intend,” and “propose.” Even if a well-drafted Term Sheet is careful to avoid looking like an actual binding contract, courts may consider a Term Sheet, LOI or MOU to at least create an obligation to negotiate a deal in good faith, based on the terms that set forth in the Term Sheet. If you diverge wildly from the terms in the Term Sheet, you could be accused of acting in bad faith.

## Private Offering

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### Q. What laws do I need to comply with when I sell securities?

A. Any sale of securities in the US must be done either through a registration of the securities (e.g. public offering) or through an exemption from registration at both the federal and state level (most commonly, Regulation D and related state “blue sky” exemptions).

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### Q. What are some other common mistakes people make when they are raising capital?

A. In addition to not engaging with competent securities counsel regarding exemptions for your offering, you shouldn’t (1) engage in any “general solicitation” (any publication about your offering, either advertisement, PR initiatives or via a publicly accessible web site), (2) retain or engage someone who isn’t a licensed broker dealer to help you sell securities, or (3) fail to keep your counsel informed as securities are sold so they can ensure that any required filings are timely made.

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### Q. What are the most common securities exemptions for entrepreneurial enterprises raising capital?

A. The most commonly used federal exemptions are found in Regulation D, and related state “blue sky” exemptions. Qualification for these exemptions, is based upon a number of factors, including the dollar amount to be raised in your offering, the wealth and sophistication of the investors, and the disclosure you plan to provide to investors.

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### Q. Are there filings and/or fees required in connection with these exemptions?

A. Filings are often (but not always) required for these exemptions. Most commonly, there are filing fees (typically a few hundred dollars) at the state level.

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### Q. When are the filings due?

A. Typically within 15 days after the first sale of securities in a state. For certain exemptions, filings can be required in advance of the first sale in a state.

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### Q. Are there other things I need to do to comply with these exemptions?

You will also need to confirm in writing that no officer, director, or affiliate has been involved in a “disqualifying event” (e.g. certain criminal convictions, certain court injunctions and restraining orders, orders of certain state and federal regulators, SEC disciplinary and similar orders, suspension or expulsion from FINRA).

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### Q. Are there any alternative exemptions I can rely upon?

A. While your Private Placement may qualify for other exemptions aside from those under Regulation D, such as the statutory exemption in Section 4(2) of the Securities Act, the requirements under these exemptions are vague and uncertain, and should be relied upon only in limited circumstances and with the advice and guidance of counsel.

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### Q. Who can buy my securities in an exempt offering?

A. Which exemptions are relied upon will dictate who can purchase the Securities during your offering. Depending on the specifics of your offering, the Securities may be sold to individual and/or entity purchasers classified as either “accredited” or “non-accredited” investors, although limiting the investors to “accredited” (as defined in 501 of Regulation D) investors only is the most common approach because it can streamline your disclosure obligations and exemption filing requirements.

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### Q. What makes someone an “Accredited Investor”?

A. For individuals, typically this means someone:

1. Whose net worth is >\$1,000,000. Positive equity in a primary residence is excluded from the calculation, along with certain mortgage obligations.
2. Who had an individual income in excess of \$200,000 (\$300,000 with their spouse) in each of the prior two years and reasonably expects an income of the same level in the current year.
3. A director or executive officer of the Company.

For entities, there are a variety of qualifications including:

1. An entity with equity owners that meet one of the tests set forth above.
  2. Banks, broker/dealers, insurance companies, investment companies, SBIC, certain employee benefit plans under ERISA, or private business development companies.
  3. Certain entities (corporations, trusts, LLCs, partnerships, certain trusts) with total assets in excess of \$5,000,000, which was not formed for the specific purpose of acquiring the Securities.
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#### Q. What do I need to do to determine whether the investor is accredited?

A. An investor must make a written representation to you that he/she/it qualifies as an accredited investor and best practice is to have them “check a box” indicating why they are accredited. Absent such a written representation, the investor is considered non-accredited. In addition, in connection with certain offerings (e.g. equity Crowdfunding or those involving “general solicitation”), you will have to take “reasonable steps” to verify the accredited status of all investors—these steps are outlined in SEC guidance but can include review of tax returns or financial statement or receipt of letters from licensed attorneys, accountants and/or broker-dealers.

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#### Q. Who can sell the securities?

A. Federal and state securities laws require persons who sell securities or help facilitate these transactions to be registered or licensed as broker-dealers or agents, unless an applicable exemption from registration applies. Note that this broker-dealer licensure exemption is different from the exemptions from federal and state registration for the Company discussed above. A federal exemption to the broker-dealer licensure requirement is available to officers, directors and employees affiliated with companies selling their own securities as long as they are not compensated based on sales of the Securities, and are not an associated person of a broker or dealer.

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#### Q. What if I use the services of an unlicensed person to assist with the fundraising?

A. If you utilize the services someone not licensed (but who should be licensed) under applicable law, it could invalidate the entire offering and have significant consequences. This is particularly true given recent aggressive regulatory positions taken on these matters by state and federal regulators. The potential consequences for utilizing an unlicensed third party can be significant, including: (a) voiding any federal or state registration exemptions, (b) creating a rescission right for the investor (i.e., the investor can demand their money back), (c) allegations of fraud if the arrangement is not adequately disclosed, (d) SEC or state enforcement concerns, and/or (e) negative impacts on future financings or a sale of the business.

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#### Q. Can I use a “finder” to help raise capital?

A. You may only retain an unlicensed “finder” under very limited circumstances and with significant limitations on what their interaction can be with potential investors. Note, however, that, even if the finder performs only such limited services, payment to the finder may never be based on whether or how much capital is successfully raised.

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#### Q. What type of disclosure do I need to provide to potential investors?

A. In addition to the exemption requirements referenced in other answers, you are also required to disclose all “material” facts about your offering and your business to prospective investors. Information is considered material if a reasonable investor would consider the information important in making an investment decision, or if disclosure of that fact might change a potential investor’s decision to invest. Failure to disclose material information could expose the Company to liability for securities fraud.

Balancing the Company's risk tolerance, the nature of the relationships with investors, and similar factors relating to possible future claims of securities fraud, you should prepare disclosure documents that you determine are sufficient to meet these disclosure obligations. The amount and type of information included in disclosure documents will depend on a number of factors including the sophistication of the investor, the dollar value of the securities being sold, how closely potential investors are connected to you, and your level of risk tolerance.

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#### **Q. Are there limits on tactics I can use to raise the capital?**

A. With certain limited exceptions (see below), most exemptions at both the federal and state levels prohibit you (or your affiliates/employees) from making a "general solicitation" of investors or engaging in general advertising of your offering. While this does not explicitly prohibit you from talking about its business in general terms, keep this prohibition in mind before making any outside communications so as to avoid publicly mentioning your offering or its terms.

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#### **Q. What is a general solicitation and how can I avoid it?**

A. General solicitation essentially involves activity designed to publicly promote the company's offering through mechanisms like advertisements (newspaper, social media, radio/tv), web content/postings, articles, communication with large groups with whom you have no pre-existing relationships.

*Some specific tips to avoid general solicitation:*

Don't communicate with potential investors unless you have some sort of preexisting relationship with them.

Don't commence making any public statements about the status of the business in general within a short time before your offering begins.

Don't offer to sell the securities or reference an offering in published articles, advertisements, public-facing websites, mass mailings, trade journals or notices.

Don't offer to sell the securities on the radio or on television, and do not make any cold calls to sell the securities.

Don't speak about your offer to sell securities at seminars or with large groups with which you have no pre-existing relationship, or post about the offering in online forums, comments sections, or discussion boards.

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#### **Q. Can I use Crowdfunding to raise capital for my business?**

A. In recent years, certain exemptions have been adopted that permit general solicitation/Crowdfunding in certain limited circumstances. These include equity crowdfunding, (including certain intra-state offerings), or offerings under Regulation 506(c). These types of offerings are relatively uncommon due to the administrative burdens involved in raising the capital and subsequent governance and administrative inconvenience involved with having large numbers of investors.

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### Q. What about Kickstarter or Indiegogo?

A. Conventional crowdfunding (e.g. Kickstarter and Indiegogo), where no interest in the business is being sold, does not involve the sale of a securities and is not subject to the registration and exemption requirements.

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### Q. What documentation do I need for someone to purchase securities?

A. The terms of each investment should be presented in a written agreement that includes information and representations from the investors and is signed by you and each investor. The representations should be confirmed by requiring the investor to execute a subscription/contribution agreement or purchase agreement, each of which would include a variety of investment representations which are required for securities law purposes.

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### Q. Why should I care about complying with securities laws?

A. Failure to comply with securities laws can have significant consequences, including (a) enforcement actions and related regulatory proceedings that can negatively affect your offering and even lead to potential civil and criminal liability, (b) a potential right of rescission for investors in the offering, and (c) potential allegations of securities fraud

As a practical matter, one of the biggest potential consequences for the failure to comply with applicable securities laws is the impact it may have on future financings or sale of your business. This is due to diligence, disclosure, and representation requirements, as well as your possible inability to obtain and deliver legal opinions regarding compliance when required by future investors or an acquirer.

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### Q. Anything else I need to be paying attention to while I raise capital?

A. Other than juggling all the balls required to actually get investors interested in making an investment, you should establish internal procedures to help ensure compliance with all rules governing the offering, and to maintain a record of the information sent to, and received from, prospective investors. The record should include the name of the person who will distribute the offering document, to whom they will be sent, and all records pertaining to each potential investor, including correspondence, meetings, phone calls, etc. Only specifically designated person(s) should distribute the offering document and answer investor questions for consistency purposes.

## Convertible Debt, Priced Equity and SAFEs

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### Q. Definitions

A. *Discount* refers to the amount by which the share price in the traditional priced equity financing is discounted for the convertible note or SAFE. The discount rate is sometimes referred to as the “bonus rate” since it can be viewed as a bonus to the investor in the convertible note or SAFE.

*Equity* is an ownership interest in the net value of a company. In a corporation, shares of stock generally represent equity in the corporation.



*Interest Rate* is the annual rate at which interest accrues on a note as long as the note is outstanding. Interest may be either compounding or simple. Compounding interest means the interest is turned into principal on a regular basis and accrues its own simple interest. Simple interest means the interest is not compounded interest. Generally, promissory notes issued by companies having a higher risk of default or that operate in a volatile sector have higher and more favorable (to the noteholder) interest rate terms that offer greater return to investors willing to bear the risk. However, interest rates on convertible notes issued by early stage companies are typically relatively low.

*Maturity Date* is the date on which the obligation to repay debt comes due.

*Most Favored Nation* refers to a clause that provides that, if subsequent convertible securities are issued to future investors at better terms, the better terms will automatically apply to the investor's SAFE.

*Principal Amount* is the face amount of an investor's note and will equal the amount of money invested by the investor.

*SAFE* is an acronym that stands for "simple agreement for future equity" and is a term used by Y Combinator that describes an "open source" document that has been drafted for use by early-stage private companies in financing deals.

*Series Financing* refers to the rounds of equity-based venture capital financing that startup companies use to secure required capital from investors. The stages (or rounds) of financing typically include Series Seed, Series A, Series B and so on. The Series Seed or Series A round is typically the first traditional equity financing round of venture financing.

*Valuation Cap* refers to cap on the ultimate valuation of the company as it pertains to convertible notes or SAFES.

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## Q. What is a SAFE?

A. A SAFE stands for a "simple agreement for future equity." The Silicon Valley accelerator Y Combinator authored this document in 2013. The SAFE was created as a simple replacement (less than five pages) for convertible notes, though a SAFE is not a debt instrument.

A SAFE is an agreement between a startup company and an investor. The investor invests money in the company using a SAFE. In exchange for the investor's money, the company grants the investor a right to purchase stock in a future equity round, subject to certain parameters set in advance in the SAFE.

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## Q. What is a convertible note?

A convertible note is a debt instrument. A convertible note is used by investors to loan money to the company in exchange for the future right to have the debt convert to shares of the company's stock. The proceeds of the loan are recorded as debt in the company's financial statements. The percentage and amount of shares that the debt will convert into is determined by the specific terms of the convertible notes. Generally, the debt will convert to new shares offered in the company's next equity financing.

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## Q. What is an equity financing?

In an equity financing, often called a "priced round," investors directly purchase stock from the company. In an equity financing, the company and the investors must first agree on a dollar figure amount for the value of the company. This is called the "pre-money valuation" or sometimes just the "pre-money." The company and the investors will then need

to agree on how much investment capital the company needs to achieve its next set of goals (called the “investment round” or the “round”). The investment represents a defined percentage ownership in the company and is based on the valuation of the company at the time of investment. Generally, investors will purchase preferred shares of stock, which provide holders of preferred stock with greater rights and privileges as compared to holders of common shares of stock.

In addition to agreeing on the pre-money valuation and the investment amount, the company and the investors will need to agree how the investors’ capital investment will be provided, including the universe of investors what investors contribute what amount. If there is an investor that contributes the majority of the capital (or even a larger stake than any other investor), they are usually called the “lead investor.” The lead investor will expect to negotiate many of the valuation variables and terms of the investment, including what sorts of decisions founders can’t make without board approval, who gets a board seat, and whether any investors get any special rights with respect to their return of capital.

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### Q. How does a SAFE compare to a convertible note?

A. A convertible note is debt. A SAFE is a convertible security that is not debt. A convertible note will include terms that a SAFE will not, specifically an interest rate and maturity date. Both SAFEs and convertible notes can have valuation caps, discounts and most-favored-nation provisions.

A SAFE is often simpler and shorter than most convertible notes, though, in practice, we often find that SAFE instruments that are heavily negotiated between the startup company and the investor can become complex instruments.

Both SAFEs and convertible notes convert into equity in a future priced equity round.

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### Q. What are some pros of convertible debt and SAFEs?

*A. Time and expense.* Convertible debt and SAFE instruments have the potential to be faster and cheaper to draft than series seed equity documents because the documents are often simpler, assuming all parties agree to use “form” versions (or versions close to the “form” versions). Also reducing time and expense is that parties may not do any legal or other due diligence in connection with convertible debt or SAFE financings.

*Fundraising flexibility.* Any amount of fundraising using convertible debt or SAFEs is fine. This can be very valuable to capital constrained early-stage startups.

*Control.* Debt or SAFE investors generally do not receive any board or management rights in connection with their investment. Further, because debt/SAFE investors are not stockholders of the company yet, they won’t even have a basic vote on any company matters. This will remain true until their investment instruments convert to equity.

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### Q. How does a convertible note compare to an equity financing?

A. In an equity financing, the company and the investors will need to agree on a dollar figure amount for the value of the company. This is called the “pre-money valuation” or sometimes just the “pre-money.” In contrast, fundraising through convertible notes postpones the need to agree on a pre-money valuation of the company prior to investment.

## Q. What are the key terms of convertible debt?

A. The primary features of convertible debt are the principal amount, interest rate, maturity date, conversion terms, repayment terms and amendment provisions.

*Principal Amount.* The principal amount is the face amount of an investor's note and will equal the amount of money invested by the investor.

*Interest Rate.* The interest rate of a convertible note represents the rate at which interest accrues on the note for so long as the note is outstanding. Interest may be either compounding or simple. Interest rates typically used to range from 6-10%. However, given the recent low interest rate environment, it is now increasingly common for the interest rate to be in the 1-2% range. The interest rate is one factor in an investor's return model and will be negotiated as part of the overall economics of the investment. A note without interest accrual may result in adverse accounting and tax consequences.

*Maturity Date.* The maturity date is the date on which the obligation to repay debt comes due. Setting the maturity date is a way to set expectations for investors as to the likely outside date for closing an equity round. In general, a later maturity date is better for the company.

*Conversion.* Conversion refers to the process by which the principal amount of the notes will automatically convert into shares of the issuer's capital stock in connection with the issuer's next financing. The conversion terms of convertible notes typically drive much of the negotiation of the debt instrument. The conversion process is further defined in three main ways.

- **Qualified Financing.** In most cases, an equity financing alone will not trigger an automatic conversion of the debt into equity unless a minimum amount of new cash is raised in the equity financing. The triggering amount is typically around 1x-2x the principal amount of the notes outstanding, but can vary. The purpose of the minimum triggering amount is largely to ensure the noteholders give up their debt instrument only when the company has demonstrated that it is in a healthy financial and capital position.

A conversion upon a qualified financing is considered "automatic" because it does not require the vote of either the company or the investors.

- **Conversion Discount.** Many convertible notes provide for a discounted conversion of the debt into the company's equity. This is in recognition of the idea that the noteholder should receive a benefit relative to subsequent equity investors due to the added risk taken by the noteholder by investing earlier in the company. A typical discount off of the price paid by the subsequent equity investors would be 15-25%. However, the higher the perceived risk of investing in the company (because of a long maturity date or other company-specific facts), the higher the conversion discount may be.
- **Conversion Cap.** The conversion cap is the maximum value at which the convertible debt would convert into the next financing, regardless of the value agreed to by the company and the new equity investors. Typically, the conversion cap and discount operate in the alternative, with the effective conversion price being determined either through the application of the cap or through the application of the discount based on which results in the lowest conversion price.

*Repayment Terms.* Traditionally, repayment of a convertible note would require repayment of the principal and accrued (but unpaid) interest by the issuer at the maturity date. In reality, however, if the convertible note hasn't converted automatically prior to the maturity date, the company likely does not have the money to cover the repayment obligations on the maturity date. Further, from the investor's perspective, the investor's intention in investing in the company via a convertible note was not simply to make its money back with interest, but to have the debt convert into equity under the terms of the note. Accordingly, the company and the noteholders frequently take a more flexible approach at the maturity date, specifically to allow noteholders to either elect repayment of the note or conversion into

equity. In case of conversion, the conversion price and the type of security (i.e., common stock or preferred stock) received upon conversion should be agreed to in advance. Alternatively, in cases where the maturity date is reached, the company and the investors may agree to extend maturity or to keep the notes outstanding and “due” but not otherwise take any action to collect or convert.

*Amendment Provisions.* Convertible notes usually require the holders of a majority of the principal amount of all outstanding notes to agree to amendments that would be binding on all noteholders. By not requiring unanimous approval for amendments, the company and the noteholders avoid administrative challenges (e.g., collecting signatures from minor noteholders) and “holdout” problems. In some cases, however, investors may require carveouts to the majority threshold for fundamental changes, such as changes to principal, conversion cap or interest rate, or for amendments that do not treat all noteholders similarly.

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## Q. What are the three key terms in a SAFE?

*A. Discount.* The discount refers to the amount by which the share price in the traditional priced equity financing is discounted for the convertible note or SAFE. The discount rate is sometimes referred to as the “bonus rate” since it can be viewed as a bonus to the investor in the convertible note or SAFE for assuming additional risk by investing in the company earlier than equity investors in a traditional priced equity financing.

The discount rate is typically heavily negotiated. A company may offer a higher a discount rate (e.g., 50 percent) if the company is desperate to get cash quickly, the company has limited access to potential investors or if the company has to compensate for a shaky operating history. On the flip side, a company may offer a lower discount rate (e.g., 10 percent) if the company is not immediately in need of a cash infusion, has one or more investors ready to invest a sufficient amount of money in the company or if the company’s operating history is viewed as at least satisfactory by the market. Twenty percent is a typical discount in the market.

Consider the following example of how the discount works: a SAFE investor gives the company \$1,000,000 in exchange for a SAFE with a discount rate of 50 percent. At the time of the traditional priced equity round, the SAFE will convert into shares of the company at a 50 percent discount from the price being paid by the investors participating in the traditional priced equity round. If the shares in the traditional priced equity round are being sold to the other investors at a price of \$2.00 per share, the SAFE investor’s \$1,000,000 would convert at a price of \$1.00 per share (a 50 percent discount). At a discount rate of 50 percent, the SAFE investor would receive 1,000,000 shares with the previous \$1,000,000 investment, while the other investors participating in the traditional priced equity round would receive 500,000 shares with a \$1,000,000 investment (or 1,000,000 shares with a \$2,000,000 investment).

*Valuation Cap.* The valuation cap is a cap on the ultimate valuation of the company as it pertains to convertible notes or SAFES. The valuation cap is a mechanism used to cap the risk early-stage investors will take when investing in an early-stage company. The valuation cap typically works hand-in-hand with the discount rate, such that, typically, the higher the valuation cap, the lower the discount and vice-versa.

Consider the following example of how the valuation cap works: continuing with the fact pattern above, which is that a SAFE investor gives the company \$1,000,000 in exchange for a SAFE with a valuation cap of \$4,000,000. At the time of the traditional equity financing, the company receives a valuation of \$10,000,000 and is to sell shares in the traditional equity financing at the same price used above, \$2.00 per share. The discount for the SAFE is calculated by dividing the valuation cap by the traditional equity financing valuation and then subtracting that valuation from 1, which equates to no discount. Mathematically, this is shown as follows:  $\$4,000,000 / \$10,000,000 = 0.4$  and  $1 - 0.4 = 0.6$ . The price per share for the conversion of the SAFE is then calculated by multiplying the discount by the traditional equity financing share price. In this example, this is shown mathematically as follows:  $0.6 * \$2.00 = \$1.20$  per share. With a valuation cap of \$10,000,000, the SAFE investor would receive 833,333 shares with the previous \$1,000,000 investment, while the other

investors participating in the traditional priced equity round would receive 500,000 shares with a \$1,000,000 investment (or 1,000,000 shares with a \$2,000,000 investment).

*Most Favored Nations Clause.* A most favored nation (MFN) clause provides that, if subsequent convertible securities are issued to future investors at better terms, the better terms will automatically apply to the investor's SAFE. The MFN clause falls away upon conversion of the SAFE into shares of the company's stock.

## Equity Compensation

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### Q. What is equity compensation?

A. Equity compensation is a common and effective tool for employee recruitment and retention for early stage and startup companies. Finding and retaining top talent is a problem all companies, especially start-ups, must deal with. Not only do start-ups have to compete with more established companies for top talent but also must realize that top employees often plan to venture off on their own and build their own thing. Enter equity compensation; the basic idea is to give an employee a part of the company—thus the employee is incentivized to care more about the success of the company as well as stay longer to see success.

There are many different ways to provide employees/others with equity compensation and these strategies are generally not that difficult to implement. However, it is incredibly important to follow the legal rules related to these grants as mistakes can be costly, resulting in a potential delay or death of a financing or M&A deal. This primer will focus on the basics of two specific ways to grant equity compensation—stock options and profits interest.

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### Q. What are stock options?

A. Stock options give employees the right to buy a number of shares at a fixed price for a defined number of years into the future.

*Understanding the basics of stock options require the understanding of the few terms below:*

Exercise: The purchase of stock pursuant to an option.

Exercise price: The price at which the stock can be purchased. This is also called the strike price or grant price. In most plans, the exercise price is the fair market value of the stock at the time the grant is made.

Spread: The difference between the exercise price and the market value of the stock at the time of exercise.

Option term: The length of time the employee can hold the option before it expires.

Vesting: The requirement that must be met in order to have the right to exercise the option—usually continuation of service for a specific period of time or the meeting of a performance goal.

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### Q. How do stock options work?

A. A company grants an employee options to buy a stated number of shares at a defined exercise price. The options vest over a period of time or once certain individual, group, or corporate goals are met. Some companies set time-based

vesting schedules, but allow options to vest sooner if performance goals are met. Once vested, the employee can exercise the option at the grant price at any time over the option term up to the expiration date. For instance, an employee might be granted the right to buy 1,000 shares at \$10 per share. The options vest 25% per year over four years and have a term of 10 years. If the stock goes up, the employee will pay \$10 per share to buy the stock. The difference between the \$10 grant price and the exercise price is the spread. If the stock goes to \$25 after seven years, and the employee exercises all options, the spread will be \$15 per share.

Options are either incentive stock options (ISOs) or nonqualified (sometimes referred to as nonstatutory) stock options (NSOs). When an employee/grantee exercises an NSO, the spread on exercise is taxable to the employee as ordinary income, even if the shares are not yet sold. A corresponding amount is deductible by the company. There is no legally required holding period for the shares after exercise, although the company may impose one. Any subsequent gain or loss on the shares after exercise is taxed as a capital gain or loss when the optionee sells the shares.

An ISO, provided the required conditions are met, enables an employee to (1) defer taxation on the option from the date of exercise until the date of sale of the underlying shares, and (2) pay taxes on his or her entire gain at capital gains rates, rather than ordinary income tax rates.

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## Q. What is profits interest?

A. A profits interest is an interest in the future profits and appreciation of the assets of a partnership (or an entity taxed as a partnership, e.g., a limited liability company, limited partnership, general partnership, etc.). A profits interest does not give the employee (or other service provider) an actual share in the value of the company at the time of grant. Instead, a profits interest is an interest that gives the employee the right to receive a percentage of future profits, but not any current capital. Contrary to most other equity compensation, the holder of a profits interest is the owner of that interest (subject to vesting restrictions). So, upon a grant of profits interest, the employee or service provider will become a full owner right away, but economically will share only in the future appreciation of the Company, not the current value.

All profits interests consist of two parts: an annual profit allocation and a liquidation value upon certain triggering events—meaning all profits interests consist of a right to receive Company profits yearly and upon a sale of the Company (or other company-changing event). Profits interests are flexible and the large degree of choice in the design of profits interest provides founders with a powerful yet flexible tool for attracting talent. Additionally, because a profits interest has no financial value when issued, it does not require an investment by the grantee.

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## Q. What is helpful to consider before granting profits interest to companies and/or employees?

A. *Threshold:* A participation threshold should be set—the “profit” in profits interest must be calculated based on a set value. A profits interest must be granted based on or above the then fair market value of the entity. A profits interest recipient is eligible for a percentage of any “profits” of the company greater than the participation threshold. So, while the participation threshold does not affect vesting, it will affect when a grantee will realize the benefit of the grant.

*Vesting:* Vesting must be considered. Profits interest can either be granted as vested or unvested. If unvested profits interest is granted, a vesting schedule, based on time, personal performance or business performance must be contemplated.

*Employee/Owner:* An individual who receives a profits interest grant cannot also be treated as an employee of the company. That is, when an employee receives a profits interest grant, the employee is now an owner of his/her employer and his/her salary is now self-employment income. As a result, the employee (now an owner) is obligated to

remit quarterly estimated income tax payments. In addition, the employee (owner) will become disqualified from participating in certain employee benefits programs.

*Rights:* Profits interest holders will have the rights and (in some cases) the obligations as an equity holder. Typically, the issues associated with providing an employee an equity stake in the company can be mitigated through the partnership or operating agreement or a second class of equity. But, certain entity forms (e.g., a general partnership) may create personal liability for the employee, despite the terms of the partnership or operating agreement.

*Taxes:* Profits interest recipients will be taxed on company income because a partnership is a “pass-through” entity for tax purposes—the company does not pay an entity level tax. Rather, the company’s profits and losses are allocated among the partners, whether or not the partner receives an actual distribution of cash. Meaning, a partner (including an employee holding a profits interest) must pay taxes on his or her share of the company’s profit even if the partnership does not distribute cash. In such a case, an employee will have to use his or her own cash from other sources to pay a tax bill currently in order to retain an interest in a company that may result in a cash payment at some unknown point down the road. To solve this issue, many partnership and operating agreements provide for mandatory tax distributions to address a situation where a partner (or employee) has to pay taxes but does not have an associated cash distribution to cover the cash expenditure.

## Single- vs. Double-Trigger Acceleration of Vesting

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### Q. Glossary

A. Acceleration refers to the occurrence of an event or events, after which certain stock that is subject to vesting schedules will become partially or fully vested.

Cliff refers to when a service provider becomes partially or fully vested in her stock on a specific date, rather than becoming partially vested in increasing amounts over an extended period of time.

Double-trigger acceleration refers to the partial or full acceleration of vesting of options or stock based on the occurrence of two distinct events. Each event constitutes a “trigger” and, if both events occur, that constitutes a “double trigger”.

Single-trigger acceleration refers to the partial or full acceleration of vesting of options or stock based on the occurrence of a single event. The single event constitutes the “trigger” for acceleration.

Restricted Period refers to the period during which restricted stock is unvested and subject to restrictions.

Restricted Stock refers to a compensatory award of company stock granted to a service provider that is subject to certain restrictions until it vests.

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### Q. What is restricted stock?

A. Restricted stock refers to a compensatory award of company stock granted to a service provider that is subject to certain restrictions until it vests. Most restricted stock is granted under a restricted stock plan and pursuant to an individual restricted stock award (or grant) agreement.

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### Q. What are the material terms of a restricted stock award agreement?

A. The following terms are the material terms of any restricted stock award agreement:

- Grant date
  - Number of restricted shares granted
  - Types of restrictions placed on the shares of restricted stock
  - The restricted period
  - Shareholder rights
- 

### Q. What are typical restrictions placed on restricted stock?

A. Restricted stock awards are typically restricted in the following ways: (i) the stock is forfeited if service requirements or other vesting conditions are not met or (ii) the participant's ability to assign, sell or otherwise transfer the shares of restricted stock is limited.

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### Q. How much does a recipient service provider pay for shares of restricted stock?

A. Typically, a service provider does not pay anything for the shares of restricted stock. The service provider providing future services often serves as sufficient consideration for the grant. However, some states may require employees to pay a nominal amount, such as par value, for the shares.

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### Q. When is restricted stock typically subject to vesting?

A. When a startup has multiple founders, it is often advisable for the founders to voluntarily subject their shares to vesting from the outset. This practice protects founders who continue working to build the company from a founder that departs early in the company's life, and prevents the departing founder from leaving with a meaningful chunk of the company's equity. When a startup has a single founder, the founder's shares are often not initially subject to vesting over time.

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### Q. When is the vesting schedule decided?

A. By setting the vesting schedule from the outset (i.e., before engaging an institutional venture capital investor (VCs)), founders have the benefit of setting the vesting schedule they think is most appropriate. When a startup raises outside capital from VC investors, the VCs generally require founders, as a condition of investment, to agree at the time of financing to subject all or a portion of their founder shares to a vesting schedule. VCs may be more likely to preserve existing vesting provisions if there is a significant amount of unvested shares at the time of venture financing, allowing the founders to benefit from their original vesting schedule.



#### Q. What does it mean to say vesting “accelerates?”

A. Acceleration of vesting refers to the occurrence of an event or events, after which certain stock that is subject to vesting schedules will become partially or fully vested.

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#### Q. What is a common vesting schedule?

A. In our experience, a standard vesting schedule typically requires a four-year total vesting period for all shares with a one-year cliff. Under this schedule, a quarter of the overall number of shares subject to vesting become vested one year after issuance, with the remaining three-quarters of the shares vesting in equal monthly installments over the next three years.

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#### Q. Is there anything else I need to know when considering purchasing restricted stock subject to vesting?

A. The value of restricted stock is generally not taxable as compensation to a service provider until the restricted stock vests. To ensure favorable tax treatment, it is critical that service providers who agree to purchase restricted stock subject to vesting file a Section 83(b) election with the Internal Revenue Service within 30 days of the issuance of the shares. [Insert link to 83(b) Election external resource.]

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#### Q. What is single-trigger acceleration?

A. Single-trigger acceleration refers to the partial or full acceleration of vesting of options or stock based on the occurrence of a single event. The single event constitutes the “trigger” for acceleration. The **“trigger”** in single-trigger acceleration is typically a sale of the company. This is designed to reward the employee for her contribution to the sale of the company. Single-trigger acceleration is the most employee-friendly version of acceleration discussed here and is usually only seen with founders and high-profile executives or service providers, if at all. A less common “trigger” in single-trigger acceleration is termination of the employee without cause or for good reason.

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#### Q. What are the potential benefits and drawbacks of single-trigger acceleration?

##### A. Benefits

Proponents of single-trigger vesting contend that this approach:

- Allows employees to share in the value created for shareholders by closing the transaction;
- Aids in the retention of employees through closing as the employees are incentivized to stay with the company until their shares vest; and

- Promotes fairness to high value employees because, unlike double-trigger acceleration, which rewards potentially less valuable employees who are terminated, single-trigger acceleration does not punish those employees who are assets to the company.

#### *Drawbacks*

Companies and investors may be hesitant to offer single-trigger acceleration as it could deter buyers from purchasing the company. A buyer typically wishes to secure the ongoing services of key employees so as to ensure smooth business continuity following the sale. Facing a single-trigger acceleration upon a sale of the company, a buyer may be forced to provide a more generous retention package for key employees, thereby making a purchase transaction more expensive.

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### **Q. What is double-trigger acceleration?**

A. Double-trigger acceleration refers to the partial or full acceleration of vesting of options or stock based on the occurrence of two distinct events. Each event constitutes a “trigger” and, if both events occur, that constitutes a “double trigger.” The **“triggers”** in double-trigger acceleration are typically a sale of the company and termination of the employee without cause or for good reason, usually within nine to 18 months after closing and sometimes prior to closing for a shorter period, such as three months.

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### **Q. What are the potential benefits and drawbacks of double-trigger acceleration?**

A. Double-trigger acceleration is increasingly popular with early stage companies that single-trigger acceleration. Double-trigger acceleration aims to align the interests of the employees, the investors and potential acquirers by (i) providing a safety net for employees who may be terminated as part of the integration and consolidation process post-closing, (ii) reducing the dilution of shareholders that occurs automatically when acceleration is triggered upon a sale of the company, and (iii) easing concerns held potential acquirers of a possible mass exodus of key employees post-closing that may be more likely to occur when acceleration is triggered upon a sale of the company.

#### *Benefits*

Proponents of double-trigger vesting contend that this approach:

- Aids in the retention of employees beyond the closing of the change in control transaction as the employees are incentivized to stay with the company until their shares vest;
- Protects employees if the buyer terminates them without cause or if the employees leave for good reason following the change in control; and
- Incentivizes employees to maximize long-term deal value.

#### *Drawbacks*

Double-trigger acceleration is a useful tool only if the option grant or equity award is assumed or continued by the buyer, which will not always be the case. An unvested option or equity award that terminates in connection with closing means there, technically, will be no unvested options or equity to accelerate if the second trigger occurs after the closing.

### Q. What is a non-compete agreement?

A. A non-compete agreement is a contract written to prevent one party from engaging in certain business activities that would be competitive with the other party or parties to the agreement. Non-competes are frequently found in a variety of contracts including employment agreements and business acquisition documents.

In the employment context, non-competes are rooted in the chance that an employer could train an employee with specialized business knowledge only to have the employee take that competitive edge and go work for another player in the market. Therefore, non-competes in the employment world are typically effective for the duration of employment and some following period. In a business acquisition scenario, buyers of a business want to be assured that when they complete the acquisition, the seller will not immediately set up shop and compete with the business they just bought. In addition to meeting the requirements of a contract, such as offer, acceptance, and consideration, the non-compete language in the agreement itself must be enforceable, which is what the following will focus on.

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### Q. How are non-compete agreements enforced?

A. Most states, with the exception of California, North Dakota, and Oklahoma will enforce non-competes as long as the non-compete is not overbroad. This means that there are reasonable limitations on the scope and time period of the agreement. For example, if an employer wanted an employee to agree to a non-compete completely prohibiting the employee from engaging in any kind of work similar to the work they are performing for the employer anywhere in the world for twenty years, a court would most likely find that to be an unreasonable non-compete. Employees need to be able to provide for themselves, so a non-compete that would effectively prohibit an employee from working if they left their current employer would likely be unenforceable. A non-compete should set forth what actions of an employee would constitute competition and be narrowly-tailored so as to increase the likelihood a court will find it enforceable. The following discussion will examine ways employers can limit non-competes from being overbroad, and thereby make them effective to protecting legitimate business concerns.

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### Q. What is an industry-focused non-compete?

A. There are several ways employers can tailor non-competes, so they are not overbroad and can be enforced. First, the noncompete can be limited to certain types of work. If the employer operates a niche software business that handles software development for a particular segment of the financial services industry, the employee could just be restricted from working in that specific area of software development. That way, if the employee wanted to seek other employment, there would still be other areas of software development the employee could work in. Limiting a non-compete to certain types of work is one way to make it as mutually agreeable as possible. Employers do not want to invest heavily into training their employees only to have them leave to go work for a direct competitor. At the same time, employees do not want to agree to a non-compete that is so onerous they would not be able to utilize their skills. So, crafting language about what type of industry an employee will be prohibited from working in is one way to accomplish this. It is important to remember that although an employer may limit the non-compete to a particular industry, the other aspects of the non-compete need to be reasonable as well.

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### Q. What is a geography-focused non-compete?

A. Another way to increase the likelihood a non-compete will be enforceable is to limit it to the geographic scope it applies to. For example, in the restaurant business, most customers typically come from the surrounding area. So, if a restaurant wanted to prohibit a key employee from duplicating the restaurant's concept across the street, they could agree to have the non-compete apply to some radius around the employer's restaurant. With the software example discussed above, the customer base could be scattered across the country, so limiting the non-compete to a fifty-mile radius may do very little to protect the software company from facing competition from an ex-employee. On the other hand, a fifty-mile radius for a restaurant employee would likely be more than sufficient as only the most loyal restaurant clientele would travel this far just to eat at a restaurant. Another way to limit the geographic scope to increase the likelihood of the non-compete being enforceable is to focus on the initial market of the company. Even if the company has customers across the country, if there is an initial market or concentration of customers, the non-compete could just apply to that particular market.

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### Q. What is a time-focused non-compete?

A. In addition to limits on type of industry and geography, non-competes can also be limited for the time period for which they are effective. While setting in place the proper industry or geographic restrictions is important, if those restrictions are only in place for a short period of time, such as one month, they will do very little. Courts typically find non-competes with terms of two years post termination of employment are enforceable. Although longer terms may also be enforceable, at some point it is likely that the non-compete will have already served its purpose. Due to the attrition of skillsets, industry contacts, and specific business know-how, if an employee is out of a particular field for two years, it is likely that employee could not be much of a threat after the two-year non-compete period has ended. There are certainly stories of individuals under non-competes setting up a competing business the day they are free from their non-compete, but for many typical non-competes, a two-year time period can be sufficient.

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### Q. Why are non-competes important?

A. While at first blush non-competes may seem to be rather onerous for employees to comply with, by utilizing the proper limitations discussed above, employers can craft a non-compete that should be palatable enough for employees that the employer will not scare away good talent, but at the same time will give the employer the protection they want. In business acquisition scenarios, non-competes are essential for buyers to provide assurance the buyer will get the full benefit of the business they acquire. By understanding the nature of the business trying to be protected business owners can focus on what aspects of a non-compete are important and how the non-compete can serve as a tool to safeguard the business they have built.

## IP Primer for Entrepreneurs

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### Q. What is company Intellectual Property (IP)?

A.

- Patents and Patent Applications
- Invention Disclosures

- Trademarks and Service Marks
  - Licenses and Agreements
  - Copyrights
    - Computer programs, formulae, and algorithms
    - Designs, blueprints, schematics
    - Instructional information
    - Web site information
  - Trade Secrets
    - Know-how
    - Customer information
    - Competitor information
- 

#### Q. How do you protect your IP?

A.

- Inventions (patents and trade secret policies)
  - Company names, logos, and tag lines (trademarks, service marks)
  - Computer programs, formulae, and algorithms (copyrights, trade secret policies)
  - Designs and blueprints (patents and copyrights)
  - Non-public methods and processes (trade secret policies)
  - Know-how (trade secret policies and NDAs)
  - Competitor information (trade secret policies)
  - Consumer information (trade secret policies)
- 

#### Q. How do you assess your IP with a due diligence evaluation?

A.

- Performed by a 3rd party, such as a potential investor, collaborator, buyer, licensor, licensee

- Identifies any risks and problems with Company IP before the 3rd party takes action
  - Performed by the Company – an internal IP audit undertaken before a 3rd party due diligence investigation
    - Identifies potential risks/problems in time to take remedial action
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## Q. What company IP may be scrutinized during due diligence evaluations?

A.

- Patents and Patent Applications
  - Trademarks and Service Marks
  - Licenses and Agreements
  - Copyrights
  - Trade Secrets
- 

## Q. What are the specific aspects of IP due diligence evaluations?

A.

- Patent Ownership / Inventorship
  - Declaration signed by all inventors?
  - Assignments by all inventors to company recorded?
  - Any inventorship disputes? (Is the inventorship correct?)
  - Any liens on assets of the company including patents/patent applications?
  - Is company exclusive owner of patents/patent applications or does it share ownership?
- Patent Claim Scope
  - Are the claims broad enough to protect against a design around?
  - Are the company's products/processes protected by owned or licensed patent filings?
- Patent Claim Validity
  - Are the claims free of the prior art?
  - Are claims supported by the specification? (Does it explain how to make and use?)

- Freedom-to-Operate
  - Any 3rd party patents/patent applications that would block commercialization of a company product/service?
  - Any 3rd party patents/patent applications that would block practice of any company patent/patent application?
- Licensing Obligations
  - Have all terms of all licenses been met?
  - Benchmarks met
  - Fees paid
  - Reports filed
- Trademarks
  - Was each application filed by the correct party?
  - Were re-assignments made by the correct party, at the right time and did they include the associated goodwill of the business associated with the mark?
  - Is the chain of title complete?
  - Are the goods and/or services up-to-date?
  - Do logo registrations match the current logo design?
- Copyrights
  - What is the registration status of Company publications, including print and digital materials?
  - Are there contracts with content developers, with work-for-hire provisions as applicable?
  - Any applicable licenses?
  - What copyright monitoring practices are maintained?
- Trade Secrets
  - Is a current trade secret policy in place?
  - Who in the company is responsible for policing the policy?
  - Are company and third party trade secrets tracked?
  - Is access to trade secret information restricted?