

OSU-Cascades Innovation Co-Lab

Common Startup Mistakes

Presented by
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NOT MAKING FOUNDERS' STOCK SUBJECT TO VESTING

- What if one of your co-founders doesn't stick around?
- Subject the stock to vesting
 - Company has a repurchase right if the person leaves
 - Typical vesting period is 4 years (usually with acceleration if the employee is terminated without cause or leaves for good reason after a CIC)
- A VC may come in later and impose it

FAILURE TO MAKE AN 83(B) ELECTION

- Default rule is that stock subject to a substantial risk of forfeiture is taxed when the risk lapses (i.e. vests)
 - could result in a big tax bill with insufficient cash and illiquid stock
- 83(b) election accelerates tax to year of purchase (which is a good thing)
- Must be filed within 30 days

BE CAREFUL ABOUT PROMISING STOCK TO PEOPLE

- Choose your co-founders carefully (obviously).
- If it's your company and you are considering adding a co-founder, be clear with that person that you are considering him or her as a potential team member - but that you are making no promises of any equity - and, if that person is contributing at all to your idea, make sure you get a confidential information and invention assignment agreement from him or her and pay him or her some consideration for signing it.
- Form your entity, agree on how you are going to slice up the equity pie with your co-founders and make all co-founders' shares subject to vesting.

BE MINDFUL OF SECURITIES LAW COMPLIANCE ISSUES

- Don't commit fraud (obviously).
- Easiest way to comply with securities laws when fundraising is to only offer and sell securities to “accredited investors.”
 - The “rich”
 - Executive officers of your start-up
 - Directors of your start-up

BE MINDFUL OF SECURITIES LAW COMPLIANCE ISSUES (continued)

- Don't engage in "general solicitation" or "general advertising," e.g., don't say on your website that you are "looking for investors," unless pursuant to a SEC Rule 506(c) offering, i.e., "accredited investor crowdfunding"
 - If you want to do a Rule 506(c) offering, you first need a game plan for legal compliance - put the plan in place before you engage in any general solicitation or general advertising.

BE MINDFUL OF SECURITIES LAW COMPLIANCE ISSUES (continued)

- If you are raising money the traditional way, confine your offers to persons whom you already know and reasonably think are accredited investors.
 - Getting introduced to accredited investors through informal, personal networks of angels is generally fine.
 - Limit your public statements to what your company does and why people should buy your products, and avoid mentioning that your company needs money and that you'd like people to buy your stock.

REGULATION CROWDFUNDING

- Can raise up to \$1.07 million in a 12-month period pursuant to the exemption.
- The aggregate amount sold to any investor ***by all companies*** in reliance on the federal crowdfunding exemption in a 12-month period may not exceed the following: (1) if either the annual income or net worth of the investor is less than \$107K, then the greater of **\$2,200** or 5% of the lesser of the investor's annual income or net worth (5% of \$107K is **\$5,350**); and (2) if both the annual income and net worth of the investor are equal to or greater than \$107K, then 10% of the lesser of the investor's annual income or net worth (but in no event more than **\$107K**).
- must use an SEC-registered intermediary, either a broker-dealer or a funding portal, and only one such intermediary per offering.

REGULATION CROWDFUNDING (continued)

- Companies relying on the federal crowdfunding exemption must file certain information with the SEC and provide this information to the investors and the intermediary. That information includes, among other things, **financial statements** as follows:
 - **Offerings of \$107K or less** - GAAP financial statements and information from the company's tax returns
 - **Offerings of more than \$107K but not more than \$535K** - financial statements reviewed by an independent public accountant
 - **Offerings over \$535K** - financial statements audited by an independent auditor; provided that a company relying on the federal crowdfunding exemption for the first time could provide reviewed, rather than audited, financial statements.

REGULATION CROWDFUNDING (continued)

- Companies relying on the federal crowdfunding exemption would generally be required to file an annual report with the SEC and provide it to investors. The filing obligation terminates when one of the following events occurs:
 - you go public
 - you’ve filed at least one report and have fewer than 300 record holders
 - you’ve filed at least 3 reports and you have total assets of no more than \$10M
 - the company is sold or all of the Reg CF securities are repurchased
- Securities sold in federal crowdfunding transactions are “covered securities” with respect to which state securities laws’ registration requirements are preempted.

REGULATION CROWDFUNDING (continued)

- Companies with over \$10 million in assets must become reporting companies under the Securities Exchange Act of 1934 if their shares are held of record by 2,000 persons or 500 persons who are not accredited investors.
- Securities issued pursuant to Regulation Crowdfunding are exempted from this count if:
 - The issuer is current in its ongoing reporting obligations;
 - The issuer does not have assets of more than \$25 million; and
 - The issuer engages a transfer agent registered with the SEC to keep its books.

WATCH OUT FOR “FINDERS”

- Is the person/entity a registered broker-dealer?

GRANTING STOCK OPTIONS: BE MINDFUL OF SECTION 409A OF THE INTERNAL REVENUE CODE

- Generally, the strike price of stock options must at least equal the fair market value of the underlying common stock.
 - Avoid “in the money” stock options.
 - Consider getting at least a written valuation report prepared by a qualified individual (need not be a professional appraiser).

FAILURE TO COLLECT AND REMIT SALES TAX

- Nexus in a state may be merely economic rather than physical
- Can be a huge issue in a financing or sale

FAILURE TO DEVELOP TEMPLATE AGREEMENTS

- Base the agreement on industry examples
- Cover key terms, including payment and limiting liability

QUESTIONS?

- Feel free to contact mary.hull@stoel.com