JOHN J. McDONALD
Kelley Drye & Warren LLP

John McDonald is a senior associate in the Tyson's Corner, VA, office of Kelley Drye & Warren LLP. Kelley Drye is an international law firm based in New York with more than 325 attorneys. Go online at www.kelleydrye.com

John is a member of the firm's Corporate and Venture Capital group, advising clients on a full range of corporate transactional matters, with a particular focus upon representing early-stage growth companies as well as investors in such companies. He also represents private equity investment firms and their portfolio companies in leveraged buyouts, mergers and acquisitions, divestitures and recapitalizations.

John can be reached at 703-918-2396 or by e-mail at jmcdonald@kelleydrye.com.

Tips for Managing Legal Issues Confronting Emerging Growth Companies

In the rush to develop technology into marketable products and services, emerging growth companies can easily miss implementing some important legal protections, with potentially serious consequences. Entrepreneurs should take pro-active steps to ensure that the value of their hard work and creativity is not lost through avoidable legal missteps.

Implementing IP Protections

The legal rules for intellectual property can sometimes be non-intuitive, so it is important to follow proper legal procedures to be sure that the company, and not third parties or its employees and contractors, have clear ownership of this key asset.

• Check that your company name and core technology don't infringe on another company's IP rights.

Start with the name of your company, website address and names of your key products and services. If your lawyer finds no conflicts in the trademark databases, consider having those names trademarked. If a completely different type of business has trademarked a name similar to that of your company or your key products and services, it may be possible to obtain a cost-effective license from the trademark holder for use of the name.

Next, consider your core technology. Have you had it patented? If so, your lawyer has most likely already made sure that it doesn't infringe on any already patented technology. Even so, if, like most emerging growth companies, you've continued to develop your technology, you need to ensure that any new significant developments aren't infringing.

Filing a provisional patent application for your company's core technology — essentially marking your company's stake in the ground — can be a cost-effective means of obtaining IP protection for a one year period, before starting the more time-consuming (and expensive) process of filing a definitive patent application. If another company has patented a portion of your company's technology, consider licensing that technology for the limited purpose required by your business.

• Make sure all employees and contractors sign confidentiality and invention assignment agreements.

As surprising as it may seem, title to patentable inventions created on company time often belongs to employees and contractors (personally) unless they specifically assign such title to the company. For this reason, many venture capital firms require, as a condition to funding, that their portfolio companies have obtained confidentiality and invention assignment agreements from all current and former employees and contractors. It is often easiest to have employees sign these agreements as soon as they're hired, as part of their HR-related paperwork, and to obtain agreements from contractors as part of their engagement documentation. A situation that you want to avoid is having venture capital funding or an acquisition transaction delayed while you try to obtain an IP assignment agreement from an estranged former employee or contractor, who will use that leverage to extract payment from the company.

Keeping Your Company's Capitalization Clean

If you've ever taken a company public or obtained venture capital financing, you know how important it is for your company to have clean capitalization — every issuance by the company of stock or securities convertible into stock (e.g., warrants, options and convertible notes) needs to have been approved by the company's board of directors and comply with applicable federal and state securities laws, and the company needs to have appropriate documentation. Outside investors, whether they are public stockholders or VC firms, need to have comfort that the piece of your company they are paying so much to obtain really is as represented.

Board approval of stock and convertible securities issuances is relatively straightforward — either your board can hold a meeting (with the minutes serving as evidence of approval) or each of your directors can sign a "written consent."

Securities law rules applicable to issuances of stock and convertible securities are more complex — each issuance either must be registered with the Securities and Exchange Commission or be exempt from such registration. As a practical matter, what this means for most emerging growth companies is that every issuance must comply with the private placement exemption rules. Under the most widely used private placement exemption rule ("Rule 506"), for each stock or convertible securities issuance, either the recipient must satisfy the "accredited investor" test or >>

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>> the company must supply a comprehensive disclosure document to the recipient. For cost reasons, most companies choose to require each investor to satisfy the "accredited investor" test.

To be an "accredited investor," the recipient must be an executive officer or director of the company issuing the stock or convertible securities, or satisfy one or more prongs of a financial test — the recipient (together with his or her spouse) must have a net worth of $1 million or more, or must have had annual income of $200,000 or more ($300,000 or more with the recipient's spouse) for each of the past two years and a reasonable expectation of having such level of income in the present year. Recipients that are "entities" (corporations, LLCs, partnerships, etc.) must have at least $5 million in assets or each equity holder of the entity must be an "accredited investor."

Emerging growth companies commonly encounter securities law problems when they try to compensate outside consultants, vendors and others who aren't "accredited investors" with company stock or convertible securities, rather than using their precious cash. Another typical problem area for emerging growth companies is allowing friends, family members and others who don't satisfy the "accredited investor" test to purchase company stock or convertible securities.

Making Your "Backoffice" Compliant

Some emerging growth company executives believe that employment and employee benefit rules are things they'll have the luxury of worrying about when their companies are much larger entities, with their own human resources departments. More seasoned executives know that having a basic understanding of the rules early on and applying continued vigilance is the best way to avoid employment law, tax and ERISA problems.

Understanding the fundamental rules for hiring and firing is essential. The overarching rule is that all such decisions must be made in a non-discriminatory manner. Some executives believe that "at will" employees can be terminated for any reason. Though technically true, terminating an employee who is a member of one of the "protected classes" (i.e., women, racial minorities, disabled persons, and older people) without having evidence of a non-discriminatory reason for the termination could potentially expose the company to liability. For this reason, performance problems that may lead to employee termination should be well documented over a reasonable period. Instituting an exit procedure for terminated employees that includes obtaining a release from claims can also help protect the company. Some companies determine that payment of severance in connection with obtaining a release of claims from a terminated employee is money well spent, but those release agreements need to be crafted carefully to ensure enforceability.

In addition to these general concerns, there are a number of practical considerations particular to emerging growth companies:

- Hiring non-US citizens with particular technical skills could raise H-1B visa and related immigration law issues.
- Potential employees may have "baggage" in the form of non-competition, non-solicitation and confidentiality obligations to former employers.
- Offer letters that include discussions of bonuses need to be carefully crafted since they could be interpreted as binding contracts — the last thing an emerging growth company needs, after working hard for months to land that all-important first contract, is eight employees each putting in for 15% of the contract proceeds as a result of poorly drafted bonus provisions.
- Some emerging growth companies choose to "outsource" their payroll function to third-party service providers, and some VC firms require such outsourcing to help focus their portfolio companies' management on growing the business.
- Obtaining non-competition and/or non-solicitation agreements from employees can help protect your company, but the enforceability of such provisions varies depending on state law.

Avoiding common legal mistakes made by emerging growth company executives can improve your bottom line. Remember to use your lawyer not only for technical advice about how to comply with the rules, but also to offer insights into "market" practices for companies like yours. ■

The comments in this article do not constitute legal advice from the author or Kelley Drye & Warren LLP. Readers with particular questions about the matters discussed in this article should seek the advice of counsel.

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