WILLIAMS MULLEN
FOUNDER'S HANDBOOK

Your reference guide to starting a business

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Williams Mullen is a different kind of law firm. Our attorneys are entrepreneurial, uniquely blending the law, government relations and economic development to help grow the business of our clients in the U.S. and worldwide.

Yes, we are an AmLaw 200 firm founded in 1909 with over 220 attorneys in 11 offices across North Carolina, South Carolina, Virginia and Washington, D.C. However we also know that bigger isn't always better. Our geographic focus makes us a part of our region and helps us leverage connections in business, governments and courts for clients. Meanwhile our industry experience in both established and high growth sectors allows us to practice law on a global scale.

Achieving such an extraordinary level of value requires having the right team of lawyers with the right attitude towards client service and client relationships. We call this ***Finding Yes®***. At Williams Mullen, we push ourselves every day to better understand each client and its business – and to figure out creative ways of helping each client achieve its business objectives. Quite simply, we are committed to finding better ways to make good things happen for our clients.

INTRODUCTION

INSIDE

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At Williams Mullen, our goal is not to be just lawyers to our clients – we strive to be partners who constantly add value to your business, especially when you are building it from the ground up. Sometimes adding value can be as simple as explaining the basics without fear that the meter always is running.

This Founder’s Handbook is intended to be a general guide to some of the issues involved in starting a company. However, every company is unique, and the issues that are faced in each situation may vary significantly. Therefore, this Handbook is intended for informational purposes only and does not provide legal or business advice. We urge you to seek the counsel of an experienced business attorney and an accountant before starting a business.

We push ourselves every day to think of new ways of ***Finding Yes***® for our clients. When the time is right, we sincerely hope you will allow us to put that commitment to work for you.

One of the first decisions that you will make when starting a company is the type of entity for your business. This decision involves both the form of the entity and the state of its formation.

STATE OF FORMATION

A company's internal operations are governed by the laws of the state of its formation. Thus, choosing the state of formation is akin to choosing the default rules by which the internal operations of the company are governed. You may choose any state you wish in which to form your company. But for practical considerations, you generally should choose between the state in which your company's primary operations are based and Delaware.

If you expect the business to grow rapidly and to raise outside capital, forming your company as a Delaware entity generally will be your best choice.

Delaware has a sophisticated body of law governing business entities (particularly corporations). For this and other reasons many venture capitalists and other investors prefer to invest in Delaware entities since they consider Delaware law to be the national standard for corporate law. However, there may be advantages to incorporating in the state of your company's principal operations.

ENTITY TYPE

No single factor is controlling when determining the type of entity to select. However, if you expect the business to grow rapidly and to raise outside capital and you desire to provide incentives to employees with equity compensation, a C corporation generally will be the best alternative. Other types of entities that you may consider are S corporations and limited liability companies (LLCs). The characteristics of each of these forms of business organizations are described below. Also, the chart at the back of the Founder's Handbook provides a detailed summary of some of the characteristics of these entities.

One common theme to all of the entity types listed below is that, so long as the proper formalities are followed, the owners should not be held personally liable for the company's liabilities. If the statutory formalities are not followed; however, a court may "pierce the veil" and impose personal liability on the owners. These formalities include: properly documenting the formation and organization of the entity and not mingling personal assets and business with the Company's assets and business by maintaining separate assets, bank accounts, and records.

CORPORATIONS

A corporation is created by filing a formation document (generally entitled Certificate of Incorporation or Articles of Incorporation) with the state agency charged with overseeing corporations in the state (generally the Secretary of State). A corporation is owned by its stockholders, governed by a Board of Directors that is elected by the stockholders, and managed by officers who are appointed by the Board of Directors. A corporation may be a C corporation or an S corporation. These designations refer to subchapters of the Internal Revenue Code and affect the tax status of the corporation; they do not designate special types of corporations under state corporate law.

Generally, corporations are governed by the statutes of their state of incorporation, and the laws of different states vary as to how much they allow corporations to deviate from the default rules. This is one of the primary reasons that venture capitalists historically have preferred to invest in corporations (although this trend is changing as more companies are formed as LLCs). The relative certainty in the governance of corporations (particularly, Delaware corporations) reduces the amount of due diligence the venture capitalist must engage in to analyze the risk of an investment in the company.

Stockholders

There are no limitations on the number and type of stockholders of C corporations. Similarly, there are no limitations on the number of classes or series of stock that C corporations may issue. This means that C corporations can issue shares with different voting rights (e.g., a series of stock that gets ten votes for every one share, or no votes at all), dividend rights (e.g., a series of stock that is guaranteed a dividend payment over any other series of stock), or liquidation rights (e.g., a series of stock that has priority rights to any liquidation proceeds of a dissolving corporation). This gives the stockholders of a C corporation substantial flexibility in structuring their ownership interests.

Conversely, there are several limitations that apply to S corporations, including: (i) there cannot be more than 100 stockholders; (ii) all stockholders must be individuals, certain trusts or charitable organizations, or employee ownership or pension plans; (iii) no stockholder may be a nonresident alien; and (iv) there only can be one class of stock outstanding (although this class can be divided into voting and non-voting shares).

Equity Compensation

Corporations may use a wide variety of equity compensation plans to attract and retain management and other employees. The most common types of corporate equity compensation plans involve restricted stock, stock options, phantom stock, and stock appreciation rights. For more information on this topic, see the section entitled **Initial Capital Structure – Equity Compensation Plans**. LLCs may issue membership interest options or restricted membership interests to their members. However, LLCs cannot issue options to employees that qualify for the possible favorable tax treatment for employees that may be achieved with the issuance of incentive stock options in the corporate context. See the discussion

in the section entitled **Initial Capital Structure – Equity Compensation Plans**. An increasingly popular equity compensation structure for LLCs is to issue profits interests. Profits interests generally are ownership interests in an LLC that have no value when issued, but participate in the growth of the company from the point of issuance forward by allowing the employee to participate in the future profits of the business.

Taxation of Income

C corporations are treated as separate entities for federal and state income tax purposes. Thus, corporate profits are subject to double taxation. First, the C corporation itself is taxed on its income. Then, when the C corporation distributes income to its stockholders as dividends, the stockholders are taxed on the dividends received. In contrast, S corporations are pass-through entities for federal and state income tax purposes, and their income generally is taxed only once at the stockholder level. Similarly, the losses of an S corporation are passed through to the stockholders and, under certain circumstances, may be used by the stockholders to offset income from other sources.

Taxation Upon Sale of the Business

In some circumstances, the corporate form may allow for the reduction or deferral of taxation upon the sale of the business. For example, the stock of many C corporations (but not S corporations) with less than $50 million in assets is considered "qualified small business stock," and the sale of this stock may be subject to reduced tax rates if certain conditions are met. In addition, certain sales of corporations (whether C or S) may be structured as "tax-deferred reorganizations," which allows the stockholders to defer their tax liability to a later date. A taxable sale of a C corporation's assets, however, may be subject to double taxation.

LIMITED LIABILITY COMPANIES

LLCs are an increasingly popular entity choice for start-up companies. An LLC is created in a manner similar to the formation of a corporation: by filing formation documents (generally entitled Articles of Organization or Articles of Formation) with the appropriate state agency (generally the Secretary of State). The owners of an LLC are referred to as members. The members elect managers who govern the LLC. The managers then appoint officers who run the day-to-day operations of the LLC.

Unlike corporations, which are in many ways structurally inflexible, most state LLC statutes serve as a set of "default rules" that may be freely modified by the members of an LLC through their written operating agreement. This flexibility and pass-through the treatment (discussed below) are the primary reasons that an increasing number of company formations today take the form of limited liability companies.

Members

LLCs, like C corporations, are not restricted as to the number and type of their equity owners. Also like C corporations, LLCs may have different classes or groups of members that have whatever relative rights, powers, and duties are provided in the company's operating agreement.

Taxation of Income

While the ownership structure of LLCs generally is the same as that of a C corporation, the taxation of an LLCs income generally is the same as the taxation of an S corporation. LLCs are pass-through entities that typically are treated as partnerships for federal and state income tax purposes, meaning that the LLC's income is taxed only at the member level.

Taxation Upon Sale of the Business
While LLC membership interests themselves cannot constitute qualified small business stock, stock issued to an LLC's members upon the conversion of an LLC to a C corporation may so qualify. Unlike corporations, however, the sale of an LLC cannot be structured as a tax-deferred reorganization.

CONCLUSION

Founders should consider establishing their business as a C corporation if they intend to grow the business for a sale or an initial public offering by: (i) raising venture capital financing or (ii) using a wide variety of equity compensation to motivate employees. The major disadvantage to forming the business as a C corporation is the potential for double taxation if the business starts to generate significant cash or if a purchaser wants to buy the assets of the business in a taxable transaction, which would be subject to double taxation.

Founders should consider forming their business as an S corporation if they want a simple arrangement that will avoid double taxation while: (i) preserving their ability to sell the business for stock of the buyer in a tax-deferred manner; (ii) maintaining their ability to use equity compensation to motivate employees; and (iii) minimizing employment taxes.

Founders should consider an LLC if they want to avoid double taxation while preserving their ability to issue multiple classes of equity interests or to issue equity to owners who do not qualify as S corporation stockholders. In addition, an LLC may be the best choice when the founders initially want the potential tax benefits of a pass-through entity and later convert to a corporate entity without precluding their ownership interests from ultimately being treated as qualified small business stock.

INITIAL CAPITAL STRUCTURE

The initial capital structure of the company should be kept as simple as possible. When establishing a company's initial capital structure, it is important to limit the number of stockholders and to allocate the equity in a way that avoids the potential for voting deadlocks. However, allocating founders' stock is an art, not a science. There are several complex issues that must be considered in determining the company's initial capital structure and the division of the initial equity among the company's founders.

DEFINITIONS

"Authorized stock" is the total number of shares of capital stock (both common stock and preferred stock) that the company is authorized to issue.

"Issued and outstanding stock" is the total number of shares of capital stock that the company has actually issued to stockholders. Each stockholder's percentage ownership of the company is based on the percentage of the total number of issued and outstanding shares each stockholder owns.

ALLOCATION OF FOUNDERS' STOCK

The total number of authorized shares and issued and outstanding shares at the time the company is formed is arbitrary and generally has little importance. However, the relative percentage ownership of the company by the founders is critical. The percentage of each founder's stock ownership must be decided by the founders as a group and generally is based upon their relative contributions to the creation of the company. Among the factors that should be considered by the founders when making this determination are: (i) development of the company's technology; (ii) creation of the business idea; (iii) leadership in promoting the company; (iv) assumption of risk in launching the company; (v) writing of the company's business plan; and (vi) sweat equity. In addition, the relative anticipated ongoing contributions of each founder to the future success of the company should be considered.

VESTING OF FOUNDERS' STOCK

In order to ensure that each founder "earns" the initial stock that is issued to him or her, it is advisable that the founders' shares be subject to stock restriction agreements. Stock restriction agreements subject the shares to "vesting," meaning that the shares are earned, or become vested, over time. If a founder leaves the company during the vesting period, then the unvested shares are forfeited back to (that is, repurchased by) the company for a nominal amount (generally, the amount paid by the founder for the shares). This aligns the interests of all of the founders to work to maximize the Company's chances of success and, ultimately, its value. Also, it may minimize the dilution of the remaining founders' equity that results from the issuance of equity to the departing founder's replacement.

There are several factors that must be addressed with respect to stock vesting, including: (i) the length of the vesting period; (ii) up-front vesting; (iii) cliff vesting; (iv) acceleration upon termination of employment; and (v) acceleration upon a change of control. Generally, founders' stock vests over a three-to four-year period. It is common for 10% to 25% of founders' stock to vest up front. Cliff vesting means that a certain minimum period of time must pass before any additional shares become vested. A typical cliff vesting period is six to 12 months. If a founder voluntarily resigns or is terminated for cause, no additional stock should be vested. However if a founder is terminated without cause, resigns for good reason (meaning he or she is forced out), dies, or becomes permanently disabled, it is common for there to be an additional six to 12 months of accelerated vesting of that founder's stock. If the company is acquired, an additional one year of vesting, 50% vesting, or even full acceleration of vesting are quite common.

Subjecting stock to vesting can have significant tax consequences for a founder. In order to avoid these tax consequences, the founder must make an election under Section 83(b) of the Internal Revenue Code within 30 days of the issuance of the shares that are subject to vesting. If the founder does not make the Section 83(b) election on a timely basis, then the founder is subject to ordinary income tax as the shares become vested on the amount by which the fair market value of the vested shares at the time they become vested exceeds the amount that the founder paid for the shares. If the founder makes a timely Section 83(b) election, then the founder is taxed at the time the shares are issued based on the amount by which the fair market value of the shares exceeds the amount paid for the shares.

EQUITY COMPENSATION PLANS

In order to succeed, a company must attract and retain qualified employees, consultants, and advisors. Typically, early-stage companies cannot afford to pay market-based cash compensation. Thus, equity compensation is a critical element of the compensation packages of those companies. Start-up companies use four basic types of equity compensation — restricted stock, stock options, phantom stock, and stock appreciation rights (SARs). Most venture capitalists require that a company put in place an equity incentive plan that is equal to 15% to 25% of its capitalization. The more key hires that the company must make to round out its management team, the higher will be the equity compensation pool. The type of plans available to owners vary depending on whether the company is a corporation or an LLC.

CORPORATIONS

Restricted stock and stock options provide their holders with equity ownership of the company, and, therefore, both allow for the potential that gains related to their sale will be taxed at long-term capital gains rates. However, the company generally may not take a deduction based on its award of restricted stock or stock options to an employee.

Phantom stock and SARs, however, do not give their holders any equity ownership in the company, but instead tie a cash payment from the company to the employee to the company's performance. Employees generally are taxed on payments as a result of phantom stock and SAR plans at ordinary income tax rates. Accordingly, the company generally may take a deduction for these payments.

Restricted Stock

As explained above, restricted stock is stock that the company issues outright, subject to the company's buy-back rights. Also as discussed above, if the recipient makes a timely Section 83(b) election, any appreciation in the value of the stock is taxed as capital gains when the stock is sold, thus avoiding the tax issues associated with stock options. The recipient of restricted stock is entitled to full voting rights with respect to the shares, which can make a key employee feel more involved in the ownership of the company.

Stock Options

A stock option is a contract pursuant to which the company grants the optionee the right to purchase a certain number of shares of the company's common stock at a predetermined price. The right to "exercise" the option and purchase shares vests over time — generally, over three to four years, in equal monthly or quarterly installments. Often, there is an initial period of cliff vesting of six months to a year. There are two types of stock options — incentive stock options (ISOs) and non-qualified stock options (NQSOs) — which differ primarily in the tax consequences for the recipient, or the optionee.

Only employees of the company are eligible to receive ISOs. Among other things, an ISO must have an exercise price that is at least equal to the fair market value of the stock on the grant date (or 110% of the fair market value if the optionee is a 10% or more stockholder). In addition, the value of the shares (determined on the grant date) for which an ISO may first become exercisable in any year is limited to $100,000. The advantage of an ISO is that the optionee is not taxed until he or she sells the shares of stock that are purchased upon the exercise of the option. In most cases, if the requisite holding periods have been met, the amount by which the sales price of the shares exceeds the exercise price of the shares is taxed as long-term capital gain when the shares are sold. In order to receive this favorable tax treatment, the employee must hold the stock that is received upon exercising an ISO for at least a year after exercising the ISO and for at least two years after the grant date.

NQSOs may be issued to employees and non-employees, such as advisors, consultants, and directors. Upon the exercise of an NQSO, the grantee has ordinary income in the amount by which the fair market value of the shares received upon the exercise (valued at the time of the exercise) exceeds the exercise price. In addition, upon selling the stock, the optionee has capital gains (long-term or short-term, depending upon the holding period) in the amount by which the sale price exceeds the fair market value of the shares at the time of exercise.

Phantom Stock

The recipients do not actually receive stock (or, therefore, an equity position) in the company. Instead, phantom stock gives its holder the right to receive a cash payment from the company that is tied to the market price of the company's stock. By instituting a phantom stock plan, owners can give their employees a means by which they may participate in the growth of the company without actually giving those employees an ownership position in the company. As with stock, the employees will receive a large payment if the price of the stock increases and a smaller payment if the price of the stock declines.

Stock Appreciation Rights

Like phantom stock, stock appreciation rights (SARs) do not actually give their holders equity ownership in the company. As their name suggests, payments to holders of SARs generally are based on the appreciation in the value of the company's stock in excess of the price of the stock on the day of the grant. Like phantom stock, SARs give the owners a tool to allow employees to participate in a company's upside without diluting their own ownership position.

LLCS

LLCs can institute equity compensation plans similar to those described above for corporations, but the tax consequences of analogous plans (e.g., a restricted stock award versus a restricted membership interest award) can be drastically different. As an example, the recipient of restricted stock who makes a Section 83(b) election generally will be taxed on the award twice: once upon making the election, for which the recipient will be taxed at ordinary incomes rates for any amount by which the value of the stock on the grant date exceeds the amount the recipient pays for it, and once upon the sale of the stock, generally at long-term capital gains rates based on the appreciation of the stock. The recipient of a restricted membership interest in an LLC, however, will be considered a member of the LLC upon the making of a Section 83(b) election. Accordingly, the recipient will be taxed on his or her share of the annual profits of the company, regardless of whether the company makes a cash distribution to its members. Also, LLCs cannot grant ISOs to employees since ISOs were created under the provisions of the Internal Revenue Code that apply to corporations.

CONCLUSION

The structure and allocation of the initial founders' equity are very important decisions that can have a lasting impact on the company. Also, in order to attract and retain members of management and other key employees, it is imperative to establish the right type and amount of equity compensation.

Venture capital is a professionally managed pool of capital that is raised from public and private pension funds, endowments, foundations, banks, insurance companies, corporations, and wealthy families and individuals.

Venture capitalists (VCs) generally invest in companies that offer a high growth potential and a realistic exit scenario within five to seven years. Typically, VC investment structures include rights and protections that are designed to allow the VCs to gain liquidity and maximize the return for their investors. Broadly, these rights and protections include liquidation rights, management participation and control, and exit rights.

LIQUIDATION RIGHTS

Most venture capital investments are structured as convertible preferred stock with dividend and liquidation preferences. The preferred stock often will bear a fixed-rate dividend that, due to the cash constraints of early-stage companies, is not payable currently but is cumulative and becomes part of the liquidation preference upon the sale or liquidation of the company. The payment of dividends on the preferred stock will have priority over common stock dividends. These cumulative dividend rights provide a priority minimum rate of return to the VCs.

The preferred stock will have a liquidation preference that generally is equal to the purchase price (or a multiple thereof), plus accrued and unpaid dividends, to ensure that the VCs get their money back before the holders of the common stock (e.g., founders, management, and employees) if the company is sold or liquidated. Most VCs also insist on participation rights so that they share on an equal basis with the holders of the common stock in any proceeds that remain after the payment of their liquidation preference. These liquidation rights and the right to convert the preferred stock into common stock allow the VCs to share in the upside if the company is successfully sold.

OWNERSHIP PROTECTION

An important consideration to VCs is the percentage of the company that they own on a fully-diluted basis. Fully-diluted means the total number of issued shares of common stock, plus all shares of common stock that would be issued if all outstanding options, warrants, convertible preferred stock, and convertible debt were exercised or converted. This percentage is a function of the pre-money valuation of the company, upon which the VCs and the company agree. In determining the pre-money valuation, VCs analyze the projected value of the company and the percentage of this value that will provide their required rate of return. This analysis takes into account the risks to the company and the future dilution to the initial investors from anticipated follow-on investments.

VCs protect their ownership percentages through preemptive rights, anti-dilution protection, and price protection. Preemptive rights enable the investors to maintain their percentage ownership in the company by purchasing a pro rata share of stock sold in future financing rounds. Anti-dilution protection adjusts the investors' ownership percentages if the company effects a stock split, stock dividend, or recapitalization. Price protection adjusts the conversion price at which the preferred stock can be converted into common stock if the company issues common stock or stock that can be converted into common stock at a price below the current conversion price of the preferred stock (i.e., the VCs will be issued more shares of common stock upon the conversion of the preferred stock). This protects the VCs from the risk of having overpaid for their stock if the pre-money valuation turns out to be too high.

There are two common types of price protection: full ratchet and weighted average ratchet. A full ratchet adjusts the conversion price to the lowest price at which the company subsequently sells its common stock regardless of the number of shares of common stock the company issues at that price. A weighted average ratchet adjusts the conversion price according to a formula that takes into account the lower issue price and the number of shares the company issues at that price.

MANAGEMENT PARTICIPATION AND CONTROL

Many VCs state that they invest in management, not technology, and the management team expects to operate the business without undue interference. However, most investment structures provide that VCs participate in management through representation on the Board of Directors, affirmative and negative covenants or protective provisions, and stock transfer restrictions. Typical protective provisions give VCs the right to approve amendments to the company's Certificate of Incorporation and Bylaws, future issuances of stock, the declaration and payment of dividends, increases in the company's stock option pool, expenditures in excess of approved budgets, the incurrence of debt, and the sale of the company. In addition, VCs generally require that management's stock be subject to vesting and buy-back rights.

As long as the company is achieving its business goals and not violating any of the protective provisions, most VCs permit management to operate the business without substantial investor participation except at the board level. However, VCs may negotiate the right to take control of the Board of Directors if the company materially fails to achieve its business plan or meet certain milestones or if it violates any of the protective provisions.

EXIT RIGHTS

VCs must achieve liquidity in order to provide the requisite rate of return to their investors. Most VC funds have a limited life of 10 years, and most investments from a fund are made in the first four years. Therefore, investments are structured to provide liquidity within five to seven years so that investments that are made in a fund's third and fourth years are liquidated as the fund winds up and its assets are distributed to the fund's investors. The primary liquidity events for VCs are the sale of the company, the initial public offering of the company's stock, and the redemption or repurchase of their stock by the company.

Generally, VCs do not have a contractual right to force the company to be sold. However, the sale of the company will be subject to approval by the VCs, and, depending upon the composition of the Board of Directors, the VCs may be in a position to direct the sale efforts. VCs typically also have demand registration rights that theoretically give them the right to force the company to go public and register their shares. Also, VCs generally have piggyback registration rights that give them the right to include their stock in future company registrations.

VCs also insist on put or redemption rights to achieve liquidity if these are not available through a sale or public offering. This gives the investors the right to require the company to repurchase their stock after a period of generally four to seven years. The purchase price for the VCs' stock may be based upon the liquidation preference (i.e., the purchase price plus accrued and unpaid dividends), the fair market value of the stock as determined by an appraiser, or the value of the stock based upon a multiple of the company's earnings. An early-stage company (particularly one that is struggling) may not be able to finance the buyout of an investor, and the redemption rights may not be a practical way to gain liquidity. However, these rights give VCs tremendous leverage to force management to deal with their need for an exit and can result in a forced sale of the company. Also, if the VCs trigger their redemption rights and the company breaches its payment obligations, they may be able to take control of the board of directors.

Other exit rights that VCs typical require are "tag along" and "drag along" rights. Tag-along rights give the investors the right to include their stock in any sale of stock by management. Drag-along rights give the investors the right to force management to sell their stock in any sale of stock by the investors.

CONCLUSION

We offer a Venture Capital Guide as a companion to this Founder's Handbook, which discusses these investment structures in detail. If seeking venture capital is in your company's future, the Venture Capital Guide should prove an invaluable resource to you. By understanding the goals of VCs, entrepreneurs will be in a better position to negotiate an investment structure that balances the goals and interests of both the VCs and the entrepreneurs.

Intellectual property is a form of intangible property created through human creativity, imagination, ingenuity, and intellect.

The value of intellectual property is recognized by the United States Constitution, which gives Congress the authority to pass laws "to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries." This period of exclusivity allows people to profit from their creativity. This profit motive promotes creativity and encourages investment in new ideas and inventions. Intellectual property protection has become increasingly important as our economy has become more knowledge and technology-based. There are four general types of intellectual property — patents, copyrights, trade secrets, and trademarks — each of which is discussed briefly below.

PROTECTING INVENTIONS (AND OTHER INFORMATION) – PATENTS AND TRADE SECRETS

There are two separate means to protect your company's information — patents and trade secrets. Each method has its advantages and disadvantages, which are summarized below.

PATENTS[1]

A patent is a time-limited right granted by a government to exclude others from making, using, or selling an invention in exchange for the inventor's full disclosure of the invention to the public. Most innovation is incremental, and therefore it is in the public interest for inventions to be fully disclosed to the public. Thus, part of the cost of seeking patent protection is disclosing the invention to the public. But without some form of protection, the inventor who disclosed the "how" of his or her invention to the public would quickly find that he or she was being undersold by copycats who had no need to recoup innovation costs. The patent system attempts to strike a balance between the public's need for information regarding inventions and an inventor's profit motivations.

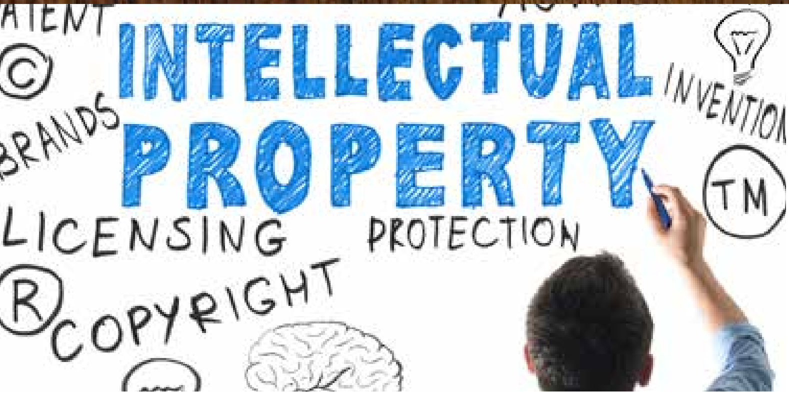
THE RIGHT TO EXCLUDE VERSUS FREEDOM TO OPERATE

The right to exclude others from practicing a patent claim should not be mistaken with the right to practice or perform the claimed invention. A patent gives its owner the right to prohibit others from practicing the patent claims, but the patent itself does not give its owner the freedom to practice the invention. It is possible for other patents to cover parts of a claimed invention. For example, Patent 1 may claim A+B+C, giving its owner the ability to exclude others in the United States from practicing A+B+C. But, Patent 2 may claim A+B, which would prohibit Patent 1's owner from freely practicing the invention.

For this reason, the owner should consider not only protecting intellectual property from infringement by others, but also studying the risk of infringing another party's intellectual property rights. A competent "freedom to operate" search can be an essential part of bringing a product to market. Typically, a freedom to operate search focuses on whether any patent claims may cover a proposed product or service. A freedom to operate search is different from a patentability search, which considers whether any aspects of an invention are already known, and thus, not patentable. Early consideration of patent issues may allow the opportunity to combine freedom to operate and patentability searches, leading to a more efficient analysis.

PATENT ELIGIBILITY IN THE UNITED STATES

In the United States, five requirements must be satisfied for an invention to be patentable: (i) the subject matter of the invention must be patent eligible; (ii) the invention must be useful; (iii) the invention must be novel; (iv) the invention must be nonobvious; and (iv) the invention must be adequately described or enabled in clear and definite terms. Whether an invention is anticipated or obvious is judged from the perspective of a person of ordinary skill in the relevant art.



The United States Patent and Trademark Office (PTO) lists the following categories of inventions that may be patented: processes, machines, articles of manufacture, compositions of matter, and improvements on any of the foregoing (in addition, ornamental designs of articles of manufacture and asexually reproduced plant varieties may also receive patent protection). At the time of writing this edition of the Founder's Handbook, the patentability of software-related inventions was in flux. The PTO and the United States court system have been scrutinizing claims related to software inventions, particularly with respect to whether the invention as claimed amounts to more than simply performing a known process using a computer.

PATENT PROSECUTION

Applications for patents are filed with the PTO, which evaluates the patentability of the invention set forth in the patent application. A Patent Examiner is assigned to each application by the PTO. Typically, the process of obtaining a patent involves numerous communications between the Patent Examiner and the inventor. The process of obtaining a patent may take several years and can be very expensive.

A patent application should be filed before the invention is first disclosed, either by sale, offer for sale, public use, or disclosure in a printed publication. However, the US patent system provides, in some instances, a one-year grace period for disclosures made by the inventor or third party (if the inventor can demonstrate that the third party obtained the subject matter of the disclosure from the inventor) prior to filing. There are exceptions to these grace period provisions, however, so the inventor is always best served by filing without reliance on the grace period provision in the first instance.

DURATION OF PATENT PROTECTION

The protection granted through patents is powerful. As noted above, the inventor is given the right to exclude others from making, using, or selling an invention as claimed. This is true even if a third party claims to have independently created the same invention without reference to the inventor's work. Patent protection for utility and plant patents lasts for 20 years from the first filed non-provisional application. Design patents provide protection for 14 years from the date of the grant of a patent.

GEOGRAPHICAL SCOPE OF PATENT PROTECTION

It is important for inventors who intend to market their products internationally that, as a government-granted right, patents issued by the PTO provide protection only in the United States. Other countries and regional patent authorities, such as the European Patent Office, have separate standards for patentability. For example, some countries require absolute novelty at the time of the patent application. This means that any form of public disclosure prior to the earliest patent application can defeat patent protection in some countries. Thus, the timing of patent application filings and public disclosures can be critical when patent protection outside of the United States may be commercially significant.

The Patent Cooperation Treaty (PCT), to which the United States is a party, offers a method for seeking protection in multiple countries simultaneously through the filing of a single application in a single patent office (although each country's office will make its own determination on patentability). The PCT provides an efficient method for reserving the ability to seek patent protection in numerous countries and can be a valuable part of an international patent strategy.

TRADE SECRETS

In contrast to patent protection, and as the name implies, trade secret protection is gained through the owners' efforts to keep their information secret. Trade secret law may be used to protect manufacturing processes, customer lists, certain types of business information, and other "formulas, patterns, compilations, programs, devices, methods, techniques, or processes." Computer software source code often is maintained as a trade secret. To qualify as a trade secret, the information must have economic value because of its secrecy, and the owner must take reasonable actions to maintain its secrecy.

While patent protection in the United States is a federal system, trade secret protection is generally a matter of state law. And while trade secret law is similar in essence across the country, it varies in particulars from state to state, as well as internationally. In fact, a number of developing countries provide little or no trade secret protection. The owner of trade secrets has the right to prevent others from using or transferring the trade secrets without permission. Unlike the time-limited duration of patents, trade secret protection can potentially last forever, so long as the trade secrets retain economic value, they remain secret, and reasonable steps are taken to preserve their secrecy. In addition, the owner of a trade secret has no claim against a third party who independently develops whatever information it is that the trade secret holder is protecting.

COPYRIGHTS

Copyright protection is available for original works of authorship fixed in any tangible medium of expression from which they can be perceived, reproduced, or otherwise communicated. The owner of a copyright is granted what is often referred to as a "bundle of rights," including the exclusive right to reproduce, distribute, publicly perform, publicly display, or prepare derivative works of the copyrighted material. This analogy is used because, generally, the owner of a copyright is free to assign or license any of the individual rights granted while reserving the others.

Copyright protects the expression of ideas, not the ideas themselves. Using the book, The Hunger Games, as an example, copyright protection extends to the book as a whole and to all of the characters in the book, but does not protect the idea of a science fiction story set in a dystopian, post-apocalyptic nation. But while it is usually easy to distinguish at the extremes between idea and expression, determining the line separating idea and expression in the middle of the continuum can be a tremendously difficult task.

Copyright protection is also unavailable for procedures, processes, systems, methods of operation, concepts, principles, facts, or discoveries.

Typically, copyright infringement occurs when a protected work is copied or used in some form without the consent of the copyright owner or in a way that is not permitted under fair use. Although copyright protections can be substantial, "fair use" of copyrighted material, such as for scholarship, research, teaching, news reporting, commentary, and criticism, does not constitute a copyright violation.

Copyright protection is automatic, and exists the moment a work is first reduced to a tangible medium. Once a work is fixed in this manner, copyright protection vests in the "author" of the work. If a novelist independently drafts a work, it is usually clear that the novelist is himself or herself the author. However, if the work qualifies as a work made for hire, than the employer or commissioner of the work is considered the author for the purposes of copyright law. A work is a work made for hire if it is either: (i) a work prepared by an employee within the scope of his or her employment or (ii) a specially ordered or commissioned work falling into one of several categories, but only if the parties expressly agree in writing that the work will be a work made for hire.

There is no required registration or application process for copyright to exist (although a work must be registered before a suit can be brought for infringement). However, a copyright may be registered with the United States Copyright Office.

Such registration provides the following benefits: (i) if it occurs prior to the infringement, then the copyright owner is entitled to statutory damages and attorney's fees and (ii) it provides evidence of ownership of the work at issue.

For works created after January 1, 1978, the term of a copyright for works created within the scope of the author's employment, or otherwise as work made for hire, is 95 years from the year of first publication or 120 years from the year of its creation, whichever occurs first. For works authored by an individual, the copyright term is the life of the author plus 70 years.

TRADEMARKS

Trademark and unfair competition law protects the trade identity and goodwill associated with the goods and services marketed and sold by commercial entities. Trademark law protects trademarks (marks associated with goods) and service marks (marks associated with services), including names, logos, slogans, and trade names.

In order to gain protection in a trademark or service mark, the mark must be distinctive. Marks are generally grouped into four categories: (i) arbitrary or fanciful; (ii) suggestive; (iii) descriptive; or (iv) generic. Generally, arbitrary or fanciful and suggestive marks are those that bear little or no relationship to the actual goods or services, and therefore are entitled to a relatively broad scope of protection. By comparison, descriptive marks, or those that merely describe the goods or services they are attached to, are entitled to protection only upon proof that relevant consumers already associate the mark with the goods or services provided by the owner of the mark. Generic marks (for example, the word "computer" when associated with computer equipment) receive no protection.

If a mark is protectable, protection can be achieved either through actual use of the mark in connection with the sale or goods and services or through registration with the PTO. Use, without registration, generally only provides protection within the geographical area of use, while registration with the PTO provides the following benefits: (i) it establishes a nationwide constructive date of first use; (ii) it allows for the recovery of attorneys' fees, treble damages, and other import restriction remedies; (iii) it provides prima facie evidence of the facts set forth in the PTO registration certificate; and (iv) it provides valuable documentation for obtaining and retaining Internet domain names

Trademark owners have the right to prevent others from using confusingly similar marks and from reselling their goods without use of their marks. However, as with patents, a trademark owner may potentially infringe the rights of another trademark owner. A "knock-out" search, particularly if performed before adoption of a trademark, can identify any risks of relying on a particular trademark. Typically, a knock out search is a preliminary search of registered marks, designed to identify clear risks of using a particular trademark. However, because trademark rights are established through use of a mark, another party may have superior but unregistered rights in a trademark. Thus, a more in-depth "clearance" search of trademarks in use can provide a more thorough assessment of any risks attached to using a particular trademark. Regardless of the depth of the search, the earlier the search is performed relative to adoption of a mark, the more useful its results.

As long as properly used, trademarks can provide protection for an unlimited length of time. However, trademark rights can be diminished, eroded, or lost if the owner does not continuously use the mark or does not actively enforce its rights against known infringers, or if the trademark loses its significance in the marketplace by becoming generic. For example, the phrase "Murphy bed," which was once a protectable trademark, became generic and lost its protection because customers began to associate the phrase with a wall bed developed by any manufacturer, and not just those developed by The Murphy Door Bed Company.

DOMAIN NAMES

It usually is important for a new company to obtain one or more Internet domain names from a domain name registrar in order to establish an appropriate web presence. While domain names are not a separate form of intellectual property, it is important to avoid selecting a domain name that might be confusingly similar to an established trademark. In order for a domain name to serve as a trademark, it must be used as a trademark in the body of the website or in some other manner so as to meet the normal requirements for trademark usage. Similarly, a company name is not necessarily a trademark unless it is used by the company in connection with the sale of goods or services in a manner that generates trademark rights.

CONCLUSION

In many cases, intellectual property is the most valuable asset of early-stage companies. Protecting that intellectual property generally is accomplished through a combination of patents, trade secrets, copyrights, and trademarks. In order to most efficiently and effectively protect their intellectual property, it is important for early-stage companies to develop an intellectual property strategy that reflects their business objectives as set forth in their business plans.

	C CORPORATION	S CORPORATION	LIMITED LIABILITY COMPANY (LLC)
Limit on Number of Owners	No limit.	Maximum of 100.	No limit (note: in most states and for federal tax purposes, a single-member LLC will be treated as a disregarded entity unless the owner specifically elects otherwise).
Limit on Types of Owners	No limit.	Owners limited to individuals, estates, and certain types of trusts.	No limit.
Limit on Type of Capital Structure	No limit.	Limited to one class of stock (although the one class may be divided into voting and non-voting stock).	No limit.
Limited Liability	Stockholders are only personally liable for the debts of the corporation when the corporate veil is pierced or if the liability arises from a stockholder's own actions.	Stockholders are only personally liable for the debts of the corporation when the corporate veil is pierced or if the liability arises from a stockholder's own actions.	In most states, members are only personally liable for the debts of the company when the corporate veil is pierced or if the liability arises from a member's own actions.

	C CORPORATION	S CORPORATION	LIMITED LIABILITY COMPANY (LLC)
Fringe Benefits	One of the major incentives to incorporation is that the corporation may deduct the costs of fringe benefits provided to stockholder-employees, and the recipients may exclude the value of the benefits from gross income.	Premiums paid by S corporation for health insurance, group term life insurance, and disability insurance for stockholders who own 2% or less of the value of the S stock are fully deductible and excludable; however, health insurance premiums for stockholders who own more than 2% are generally deductible but not excludable.	Health insurance premiums paid by LLC for health insurance for members are not excludable. Group-term life insurance and disability insurance premiums are not deductible.
Income Tax on Entity:			
Tax on Income from Operations	Yes.	No, with the exception of §1375 (tax on excess passive-investment income) and §1374 (tax on built-in gains on collection of certain accounts receivable).	No tax at entity level.
Tax Upon Sale of Asset	Yes.	No, with the exception of §1374 (built-in gains tax).	No.

	C CORPORATION	S CORPORATION	LIMITED LIABILITY COMPANY (LLC)
Recognized Gain Upon Distribution of Asset	Yes. Corporation recognizes gain on distribution of appreciated asset.	Yes.	Normally no gain or loss at LLC level, although if the distribution is not pro rata and the LLC owns hot assets, there may be ordinary income or capital gains recognized.
Recognized Loss Upon Distribution of Asset	No, unless liquidating distribution.	No, except liquidating distribution.	No.
Ability of Entity to Deduct Losses	Corporation can deduct losses, subject to rules regarding net operating losses and capital losses.	No entity deduction of loss.	No entity deduction of loss.
Ability of Equity Owner to Deduct Losses	No deduction is available to stockholders for corporation's operating losses.	Current deduction, limited by basis (which does not include share of entity debt), the amount-at-risk rules, and the passive-loss rules.	Current deduction, limited by basis (which does not include share of entity debt), the amount-at-risk rules, and the passive-loss rules.
Equity Owner Taxed on Undistributed Income	No.	Yes.	Yes.

	C CORPORATION	S CORPORATION	LIMITED LIABILITY COMPANY (LLC)
Effect of Nonliquidating Distribution of Cash on Equity Owner	Dividend (ordinary income) to extent of earnings and profits; then recovery of basis; then capital gain.	Generally treated as a recovery of basis and then capital gain.	Tax-free to the extent of basis; then generally taxed as capital gain, although if the LLC owns hot assets, some or all of the excess may be treated as ordinary income.
Effect of Nonliquidating Distribution of Property on Equity Owner	Same consequences as distribution of cash; basis of distributed property is its fair market value.	Generally recovery of basis and capital gain (with the exception of S corporations with accumulated earnings and profits accounts).	Non-recognition of gain and basis in distributed property equal to LLC's basis, although if the distribution is not pro rata and the LLC owns hot assets, the member may recognize ordinary income or capital gain.
Taxation of Sales of Equity Interests	Stockholder generally recognizes capital gain upon sale of stock, with limited exceptions.	Stockholder generally recognizes capital gain upon sale of stock, with limited exceptions.	Member generally recognizes capital gain, with the exception of §751 (ordinary income treatment to extent of hot assets).

	C CORPORATION	S CORPORATION	LIMITED LIABILITY COMPANY (LLC)
Effect of the Sale of an Equity Interest on the Entity	Shares may be freely exchanged without effectuating a dissolution of the corporation. However, if there is a transfer of more than 50% of the stock of a corporation over a three-year testing period, the corporation is considered as having an "ownership change," which will limit its use of net operating losses and other tax attributes.	Shares may be freely exchanged. However, if stock is transferred to an ineligible stockholder or a 101st stockholder, the corporation involuntarily terminates its status as an S corporation and immediately becomes a C corporation.	If, in any 12-month period, 50% or more of the total interest in LLC capital and profits is transferred, the LLC involuntarily terminates.

Endnote

1 On September 16, 2011, the Leahy-Smith America Invents Act was signed into law. Among other things, the law changed the US's patent system from a "first to invent" system to a "first inventor to file" (FITF) system for all patent applications with an effective filing date on or after March 16, 2013. The discussion in this section focuses on the FITF system.

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