

Pursuing Angel and VC Funding – Pitfalls to Avoid!

You've come up with a great idea, you've developed a prototype product, you've done customer discovery, you've assembled an awesome management team – Congratulations! Now you need angel or venture capital funding to continue your company's growth. Our firm often see early stage companies waste time and money because they aren't familiar with the capital raising process or the mindset of investors.

Two major concerns of investors for which start-up companies are often unprepared include (i) ownership of the company and its tangible and intangible assets and (ii) whether such ownership has been adequately documented.

Determining and documenting ownership sounds easy, right? In many cases, not so. Early stage companies are often cash-poor and grant equity (or options to acquire it, including convertible debt or preferred stock) in the company to service providers in exchange for services such product development, marketing assistance, etc. However, these agreements are often done on a handshake or by e-mail exchange rather than by formal signed documents. Even when there is a written agreement, it is often done without outside professionals, and the document invariably ends up being deficient from a legal point of view.

Disputes invariably occur as a result of these informal arrangements. One scenario is that the service provider believes that he has done his part and is entitled to his shares, but the company believes that the services were incomplete, poorly done, etc. and that the service provider is entitled only to part or none of the promised equity. The result is confusion as to exactly who are the company's owners and what their ownership percentages are. Quite possibly, a court battle may ensue. The movie *The Social Network* shows how a lack of mutual understanding in this area can cause years of expensive litigation. Confusion over ownership is a huge red flag for potential investors, who require certainty regarding who the shareholders are and what their respective ownership percentages. An old adage – “no one wants to buy a lawsuit” – is especially true here.

A second issue, especially relevant for technology companies but broadly applicable, relates to ownership of the company's intellectual property. A key element of the value of any technology company, regardless of its stage, is its intellectual property. However, many early stage companies have not locked down their IP. They may not realize it but there is uncertainty about who actually owns their IP. Many individuals and entities are typically involved in the development of the company's technology, as employees and as contractors. However, the company often overlooks formalizing these relationships. The company fails to document the relationship in a written contract or prepares a contract that omits key language required to give assurance that the company in fact owns, or where appropriate, has adequately licensed, all necessary rights in the intellectual property.

For an investor considering an early technology stage company, it is vital that the company have good documentation showing that its ownership or right to use of its technology and IP is fully buttoned-down. Our firm has seen numerous instances where the company did not have the necessary IP documentation and the result was long delays in funding, and in some cases where the deal fell apart and no investment was made based on this issue.

LAW FIRM 2.0[®]

FISHERBROYLES

A LIMITED LIABILITY PARTNERSHIP

A related problem is presented by death, divorce, disability or voluntary or involuntary departure of an IP owner. Even if there was a good relationship with the original owner, the same may not be true of executors, ex-spouses or disgruntled ex-employees.

The easy way to avoid ownership issues is only to grant equity in your company under agreements that have been properly reviewed by legal counsel experienced in this area. The IP ownership issue is easily avoided by having everyone involved in your company, whether employees or contractors, sign an agreement prepared by counsel that has appropriate assignment of IP language. Rather than trying to pick and choose and remember who should sign, the easiest approach is a blanket one – all employees and contractors need to sign an IP ownership agreement. In cases where a founder desires to retain ownership, appropriate licenses allowing major corporate transactions (such as mergers or sales of the company) should be in place.

When done at the outset, ownership documentation is a relatively simple matter to address. Later on, when funding is imminent, problems invariably arise. Typical problems include differences of opinions as to whether a service provider has done his part and earned his shares, compounded by problems of records being lost, people having moved and being difficult to contact, etc. Moreover, once the work is done or already well underway, or someone has died, gotten divorced, etc., it can be a tough sell to get anyone to sign the necessary documents when there is little or no motivation for them to do so. This is a classic case of “an ounce of prevention is worth a pound of cure.” Do it right at the outset at minimal cost, and in the long run you will save yourself a significant amount of time and money, and greatly increase your ability to successfully attract outside investment.

If you would like additional information, please contact any of the following FisherBroyles partners:

Atlanta

Carl Johnston
(404) 330-8179
carl.johnston@fisherbroyles.com

Chicago

Marty Robins
(847) 277-2580
martin.robins@fisherbroyles.com

Los Angeles

Steven Papkin
(310) 415-6254
steven.papkin@fisherbroyles.com

FisherBroyles, LLP - Cloud-based. Not Virtual™

Founded in 2002, FisherBroyles, LLP was the first in the U.S., and now the largest full-service, cloud-based law firm in the world. The Next Generation Law Firm[®] has grown to approximately 180 attorneys in 21 offices nationwide. The FisherBroyles' efficient and cost-effective Law Firm 2.0[®] model leverages talent and technology instead of unnecessary overhead that does not add value to our clients, all without sacrificing BigLaw quality. Visit our website at www.fisherbroyles.com to learn more about our firm's unique approach and how we can best meet your legal needs.

These materials have been prepared for informational purposes only, are not legal advice, and under rules applicable to the professional conduct of attorneys in various jurisdictions may be considered advertising materials. This information is not intended to create an attorney-client or similar relationship. Whether you need legal services and which lawyer you select are important decisions that should not be based on these materials alone.

© 2017 FisherBroyles LLP