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Legal Foundations for Founders

Target:

1. Session 1 — Business & Legal Foundations (aligned with Module 1: Business Foundations & Growth Direction): entity selection, operating agreements, equity structuring, and founder protections.

Session Notes — Entity Structure, Equity, IP, and Employment Risk

Slide Section 2: Entity Selection — The LLC vs. C-Corp Dilemma

- **Legal Structure Matters:**
  How a business is legally formed, whether as a corporation or an LLC, shapes its ability to raise capital, not just its day-to-day operations.
- **Why founders start as LLCs?**
  Cheap to set up, flexible governance, pass-through taxation (profits/losses flow to personal returns) — advantageous when cash flow is tight or the business is taking losses.

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Slide Section 2: Entity Selection — The LLC vs. C-Corp Dilemma

- **The inflection point.**
  As a business moves from 'small business' to 'high-growth startup' seeking institutional capital, the LLC structure becomes a liability.
  - VC funds, PE firms, and many accelerators are often structurally barred from investing in pass-through entities because their limited partners (pensions, endowments) can't absorb the associated tax liabilities.
  - Market standard for institutional capital: a Delaware C-Corporation.
  - Why Delaware: over a century of established Court of Chancery case law gives investors predictable outcomes in founder/board disputes — investors won't risk capital on untested home-state corporate law.
  - C-Corps unlock QSBS (Qualified Small Business Stock, IRC Section 1202): hold for 5 years, potentially exclude up to $10M (or 10x basis) of capital gains from federal taxes on sale. LLCs don't qualify.

- **Diagnostic question for founders:**
  Planning to raise institutional capital in the next 12–18 months?
  - If yes: budget for and map out an LLC-to-Delaware-C-Corp conversion before starting to pitch.

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Slide Section 3: Founder Equity and The 50/50 Trap

- **The cap table matters as much as the entity choice.**
  The most common and most dangerous early-stage mistake is the 'handshake 50/50 split.
    - Two founders splitting equity evenly and walking away with **no further agreement is a red flag**.
- **Include provisions to resolve deadlocks.**
  Never split equity 50/50 without an operating agreement that specifies how to break a tie — deadlocks (disagreements on loans, hiring a CEO, selling the business) can paralyze a 50/50-owned company.
- **Do not give the business away on Day 1.**
  Never issue stock to founders or anyone else without a vesting schedule.
    - Illustrative scenario: two co-founders split 50/50 on day one; on day 90, one leaves for another job. Without vesting, they walk away owning half the company while the remaining founder does 100% of the work for 50% of the upside.
    - Investor impact: seeing significant equity held by someone not actively working in the business ('dead weight') is a dealbreaker — investors will walk, and the company becomes effectively un-fundable.

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Slide Section 4: Vesting Mechanics and the 83(b) Election

- **Protection against the 50/50 trap:**
  A Restricted Stock Purchase Agreement — founders earn shares over time rather than receiving them outright.
  - Industry-standard schedule: 4 years total, with a 1-year 'cliff.'
  - For the first 11 months, a founder technically owns zero shares if they leave; on the exact 1-year anniversary, 25% vests at once (the 'cliff'); the remaining 75% vests monthly over the next 3 years.
  - If a founder leaves early, the company has the legal right to repurchase unvested shares, typically for fractions of a penny.
  - Acceleration clauses should be drafted upfront — e.g., a 'Change of Control' provision to accelerate unvested shares on acquisition, and negotiated terms for termination without cause — settled before there's cash flow or conflict, not during it.

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Slide Section 4: Vesting Mechanics and the 83(b) Election

- **The 83(b) Election (emphasized as critical):**
    - Stock subject to vesting is treated by the IRS as property; as it vests, if company value has risen, the founder owes income tax on the increase that year — even with no cash from a sale ('phantom income').
    - An 83(b) election is a simple letter mailed to the IRS within exactly 30 days of receiving restricted stock, electing to be taxed on today's value (usually zero for a new startup).
    - The 30-day window is strict and unfixable if missed — founders have faced large, unexpected tax bills simply from missing this filing.

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Slide Section 5: Intellectual Property (IP) Ownership

- **For a CPG-heavy cohort, IP –**Brand name, logo, unique product formulations — is the core engine of company valuation.
- **Always be prepared for due diligence.** In legal due diligence, investor counsel or M&A counsel for an acquirer will check the chain of title for every piece of IP.
- **Fatal mistake:** Assuming the company owns IP simply because the founder created it or paid for it.
    - Under US copyright law, the creator of a work owns it by default, unless a specific legal agreement assigns it otherwise.
    - For the first 11 months, a founder technically owns zero shares if they leave; on the exact 1-year anniversary, 25% vests at once (the 'cliff'); the remaining 75% vests monthly over the next 3 years.
    - The rule is absolute: every founder, employee, contractor, and agency must sign a Proprietary Information and Inventions Assignment Agreement (PIIAA), irrevocably assigning anything they create for the business to the corporate entity.
- Goal: the company owns the IP — not individuals.

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Slide Section 6: The Moonlighting Constraint

- **Do not mix your business with your day job.**
  Warning for founders 'moonlighting' — building a CPG brand nights/weekends while holding a W-2 day job.
  - Standard employment agreements/offer letters often include broad IP assignment clauses many state the employer owns any IP created during employment--full stop.
- **Operational hygiene to protect yourself:**
  - Never work on the startup during day-job business hours.
  - Never use employer equipment (laptop, phone, server, Wi-Fi) for startup work — emails, packaging design, etc.
  - Check state law — e.g., in California, employers generally can't claim ownership of IP created on personal time with personal equipment, unless it relates directly to the employer's business.
- **Highest risk scenario.**
  Working in a role related to the startup's industry (e.g., marketing at a food conglomerate while launching a packaged food brand) — employer has a strong legal argument to claim ownership of the startup.
  - If in this situation: get the specific employment agreement reviewed by counsel immediately.

Meet The Team

Jephte Lanthia advises on corporate and securities, fintech, and compliance, assisting fund managers with investments, securities offerings, broker-dealer regulation, and industry compliance matters.

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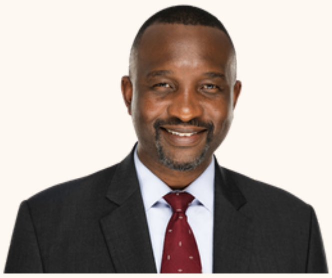

Hazvinei approaches deal-making and transactions like soccer, valuing teamwork and achieving success when every participant brings their best effort to deliver optimal outcomes on and off the field.

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