

FOUNDER'S HANDBOOK



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Poyner Spruill^{LLP}

ATTORNEYS AT LAW

FOUNDER'S HANDBOOK

Overview of Poyner Spruill LLP

Poyner Spruill LLP is one of North Carolina's oldest and largest law firms, tracing its origin to 1883. The firm's attorneys bring to their clients' needs a wide range of experience, talents and knowledge. They have extensive involvement in the State's business, governmental, judicial, political and civic life and have provided and continue to provide leadership in professional and civic organizations across the state.

Poyner Spruill has offices in Charlotte, Raleigh, Rocky Mount, and Southern Pines, North Carolina, giving it a statewide presence. The firm's size enables it to foster individual attorney excellence in meeting the unique legal needs of emerging technology companies and also in such diverse practice areas as bankruptcy, workouts, creditors' rights, employment law, commercial real estate, employee benefits, nonprofit law, banking law, venture capital, public utilities, health care law, governmental relations, environmental law, intellectual property, securities law, municipal law, construction law, white collar criminal defense, as well as trials and appeals in all state, federal and administrative courts and tribunals and alternate dispute resolution. The firm brings to bear the resources, talent and experience of all four offices to serve the needs of its clients. In addition, its reputation, size, and client base enable Poyner Spruill to effectively represent the national and regional interests of its clients.

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Disclaimer

This Founder's Handbook is intended to be a general guide to 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 Founder's Handbook is not intended to be specific legal or business advice. We urge you to seek the counsel of an experienced business attorney before starting a business.

P.S. POYNER SPRUILL prepares this booklet as an educational resource to meet the ongoing needs of our corporate clients.



Introduction

This Founder's Handbook provides a general guide to the various issues that are faced by entrepreneurs when starting a company. This Founder's Handbook is organized by the following topics:

Choice of Entity

Initial Capital Structure

Venture Capital Basics

Intellectual Property Basics

Choice of Entity

One of the first decisions that you will make after you decide to start a company is the type of entity for your business. 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 incentivize employees with equity compensation, a Delaware 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 attached chart provides a detailed summary of the characteristics of these entities.

For companies that are planning to grow quickly and raise outside capital, incorporating in Delaware is the most common practice. This is due to the fact that Delaware's corporate laws widely are considered to be the most sophisticated, comprehensive, and well-defined. In addition, Delaware has well-established and company-friendly laws dealing with director fiduciary duties and other corporate governance matters.

Corporations

A corporation is created by filing a Certificate of Incorporation with the Secretary of State of the state of incorporation. 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.

If the corporation is properly organized and maintained, the stockholders of the corporation will not be personally responsible for the corporation's liabilities. However, if the statutory formalities are not followed, then a court may "pierce the corporate veil" and impose personal liability on the 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 of stock (or the rights and preferences of those classes of stock) of C corporations. There are several limitations that are applicable to S corporations, including: (i) they cannot have 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) they can have only one class of stock outstanding.

A C corporation is treated as a separate entity for federal and state income tax purposes. Thus, a C corporation is subject to double taxation. That is, the income of a C corporation is taxed at the corporate level, and if the income is distributed to the stockholders as dividends, it is taxed again at the stockholder level. An S corporation is a pass-through entity for federal and state income tax purposes. As such, the income of an S corporation generally is not taxed at the corporate level, but is passed through to the stockholders and 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 to offset income from other sources.

Corporations may issue incentive stock options which may have certain tax benefits to employees and may be useful in attracting and retaining employees. In addition, the sale of a corporation may be structured to qualify as a "tax-free reorganization" under the Internal Revenue Code. The foregoing applies to both C corporations and S corporations.

Shares of stock in C corporations may be "qualified small business stock" under Section 1202 of the Internal Revenue Code if the company's assets do not exceed \$50 million and certain other requirements are met. As a result, if all requirements are satisfied, an individual may: (i) exclude up to 50% of the gain on the sale of qualified small business stock held for more than five years or (ii) roll the gain on the sale of qualified small business stock held for more than six months into another qualified small business. Stock issued while the corporation is an S corporation would not be qualified small business stock even if the corporation later converted to a C corporation.

If the corporation is not successful and fails, then under Section 1244 of the Internal Revenue Code, the losses of the initial investments of up to \$1 million in total, under certain circumstances, may be used by the stockholders to offset a corresponding amount of ordinary income. An individual may deduct up to \$50,000 in any one year (up to \$100,000 on a joint return) on Section 1244 stock. This deduction applies to both C corporations and S corporations.

Limited Liability Companies

An LLC is created by filing Articles of Organization with the Secretary of State of the state of formation. 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.

LLCs provide members with the same limited liability that corporations provide to stockholders. Similar to S corporations, LLCs are pass-through entities that generally are treated as partnerships for federal and state income tax purposes. However, LLCs are not subject to the restrictions that are applicable to S corporations.

LLCs may not issue incentive stock options. The sale of an LLC may not be structured to qualify as a "tax-free reorganization" under the Internal Revenue Code.

Subject to certain exceptions, LLCs may distribute appreciated assets without triggering gain. Thus, assets may pass in and out of LLCs more easily than S corporations. In addition, if an LLC is converted to a C corporation, the shares of stock issued to the owners upon such conversion are not precluded from being qualified small business stock. For these reasons, an LLC is the type of entity that is most readily converted into a C corporation if the circumstances change.

Conclusion

Founders should consider establishing their business as a C corporation if they intend to grow the business for a sale or public offering by: (i) raising venture capital financing or (ii) using equity compensation to motivate employees. The major risk in 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 want to initially use 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 upon the quotient of the number of shares issued to that stockholder divided by the total number of issued and outstanding shares.

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 contribution 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 founder's shares be subject to stock restriction agreements. A stock restriction agreement subjects the shares to "vesting," meaning that the shares are earned, or become vested, over time. If the 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).

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 fairly common for founders to have 10% to 25% of their stock vested 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 or 50% vesting is quite common.

Subjecting stock to vesting can have significant tax consequences for the 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, the founder is then subject to ordinary income tax as the shares are vested on the amount by which the fair market value of the vested shares at the time they are 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 two basic types of equity compensation – stock options and restricted stock. There are two types of stock options – incentive stock options and non-qualified stock options – which differ primarily in the tax consequences for the

recipient, or the optionee.

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 is vested 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.

Only employees of the company are eligible to receive incentive stock options (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 stockholder with 10% or more stock). 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, then upon the sale of the stock, the amount by which the sales price of the shares exceeds the exercise price of the shares is taxed as long-term capital gain. 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.

Non-qualified stock options (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. The optionee's basis in the shares is stepped up to fair market value on the exercise date. In addition, upon selling the stock, the optionee has capital gains (either long-term or short-term, depending upon the holding period) in the amount by which the sale price exceeds his or her stepped-up basis in the stock.

As explained above, restricted stock is stock that the company issues outright but is subject to the company's buy-back right. 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. Also, 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.

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.

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. Experienced legal advisors can provide invaluable assistance to founders in making these critical decisions.



Venture Capital Basics

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.

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 is generally 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 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 sold successfully.

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 which 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 VCs expect the management team to operate the business without undue interference. However, most investment structures provide that VCs participate in management through board of directors representation, 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.

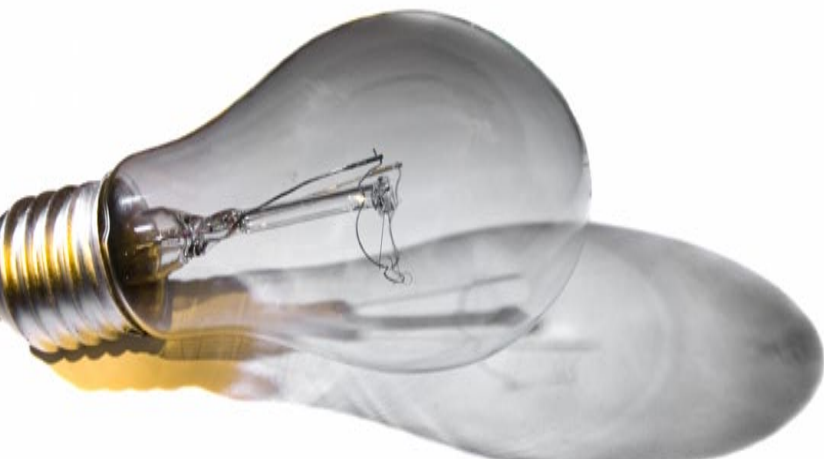
Generally, VCs do not have a contractual right to force the company to be sold. However, the sale of the company will be subject to approval of the VCs, and, depending upon the composition of the board of directors, the VCs may be in a position to direct the sale efforts. VCs typically also have demand 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 right may not be a practical way to gain liquidity. However, this right gives 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 right and the company breaches its payment obligations, they may be able to take control of the board of directors.

Other exit rights that VCs typically 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

VC investment terms may seem onerous and complex to entrepreneurs. However, by understanding the goals of VCs, entrepreneurs, with the assistance of experienced legal counsel, will be in a better position to negotiate an investment structure that meets the goals of both VCs and management.



Intellectual Property Basics

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.

Patents

A patent is a right granted by a government in exchange for the inventor’s fully disclosing the invention to the public. A patent gives the patent owner the right to keep others from making, using, or selling the invention for some period of time. Patent rights create a profit motive and encourage the invention of new products. When an invention is publicly disclosed, others will improve upon it and thus continue to advance the technology which promotes economic growth.

A patent is a powerful form of intellectual property that covers many categories of inventions, including machines, processes, details of manufacture, and compositions of matter. In order to be patentable in the United States, an invention, among other things, must be novel, useful, and non-obvious. Whether an invention is anticipated or obvious is judged from the perspective of a person of ordinary skill in the relevant art.

Applications for patents are filed with the United States Patent and Trademark Office (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 and typically will engage in a written dialogue with the patent agent or the attorney prosecuting the patent application regarding the scope of the application and other issues. The process of obtaining a patent may take several years and can be very expensive.

The scope of the patent is defined by the claims found at the end of the patent. The patent owner has the exclusive right to manufacture, use, practice, and sell his or her invention, and there is no exception for those who may independently develop the claimed invention. However, a patent does not give the owner freedom to operate, since it may be dependent on patents owned by others.

A patent application should be filed before the invention is first sold, offered for sale, publicly used, or disclosed in a printed publication. However, in the United States there is a one-year grace period, which means an inventor may still obtain a patent as long as he or she files a patent application within one year after disclosing, using, or selling the invention. For patent applications filed on or after June 8, 1995, the term of the patent is for 20 years from the first filed non-provisional application. For patents filed but not issued by that date, the term is either 17 years from the date the patent issues or 20 years from the date of the application, at the election of the patent owner.

The above discussion applies to utility patents. Design patents also are available for new and ornamental designs to protect a product’s look, the term of which is 14 years. Plant patents are available for asexually produced plants, the term of which is 20 years.

Since patents are issued by governments, the scope of the patent protection does not extend beyond the issuing country’s borders. Many countries are parties to the Patent Cooperation Treaty (the PCT), which allows applicants to file an International Application at the applicant’s home country patent office. An international PCT application preserves an applicant’s ability to later file separate patent applications in each PCT member country designated in the application. The filing party must file applications in each individual country within a specific time (depending on the country) to enter the National or Regional Stage and complete the applications at each of the designated offices.

The PCT Procedure may include an International Search and Examination, which is available for review before a decision is made whether to enter the National Stage. The PCT Application and the International Search Report are published 18 months from the priority date (if claimed) or the international filing date (if no priority is claimed).

Copyrights

Copyright protection is available for original works of authorship fixed in literary, audio-visual, and other media. The owner of the copyrighted work has the exclusive right to reproduce, distribute, publicly perform, publicly display, or prepare derivative works of the copyrighted material. A copyright will not protect ideas, procedures, processes, systems, methods of operation, concepts, principles, facts, or discoveries. However, it may protect the original and creative way that such unprotectable items are expressed.

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.

Unlike patent protection, copyright automatically arises when a work is reduced to a tangible medium. If this occurs during the course of employment, then the copyright is deemed to be owned by the employer. However, a work that is created or produced by a person other than an employee of the company (such as an independent contractor) will not be deemed to be owned by the company unless it meets the statutory definition of “work for hire.”

There is no required registration or application process for copyright to exist. However, a copyright may be registered with the United States Copyright Office, which is part of the Library of Congress. Such registration provides the following benefits: (i) it is necessary in order to file an infringement action; (ii) if it occurs prior to the infringement, then the copyright owner is entitled to statutory damages and attorney’s fees; and (iii) 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.

Trade Secrets

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. Trade secret law is similar in essence but may vary in particulars from state to state, as well as internationally. However, 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. 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.

Trademarks

Trademark and unfair competition law protects the trade identity and goodwill associated with the goods and services marketed and sold by commercial entities. Ownership of a mark, at least with respect to the geographic area of use, generally is established in the United States by actual “use” of the mark in connection with the sale of goods and services. However, registering the mark 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.

Trademarks (referred to as “service marks” when used in connection with services, but legally equivalent to trademarks) can include names for products and services, logos, slogans, and trade names. Trademarks can be “arbitrary,” “fanciful,” “suggestive,” or “descriptive.” Generally, arbitrary, 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, marks that merely describe in some fashion goods or services 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.

Trademark owners have the right to prevent others from using confusingly similar marks and from reselling their goods without use of their marks.

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.

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. Domain names are not a separate form of intellectual property; however, 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, copyrights, trade secrets, 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	Minimum of one; no maximum.	Maximum of 100.	Minimum of two in order to be taxed as a partnership; no maximum. However, almost all states permit formation of one-member LLCs that are treated as non-entities for federal purposes unless they elect to be taxed as a corporation. No limit.
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 may have voting and non-voting stock).	No limit.
Limited Liability	Generally, stockholders of a C corporation are not personally liable for the debts of the corporation, regardless of whether they participate in management. The only exception is when the corporate veil is pierced or if the liability arises from a stockholder's own actions.	Generally, stockholders of an S corporation are not personally liable for the debts of the corporation, regardless of whether they participate in management. The only exception is when the corporate veil is pierced or if the liability arises from a stockholder's own actions.	In an LLC, absent an agreement to the contrary, no members are liable for entity debt, regardless of whether they participate in management.
State Filing Requirements	Must file Certificate of Incorporation with filing officer of a state.	Must file Certificate of Incorporation with filing officer of a state.	Must file Articles of Organization with filing officer of a state.
Period of Duration	A C corporation continues in perpetuity unless the Certificate of Incorporation specifies otherwise.	An S corporation continues in perpetuity unless the Certificate of Incorporation specifies otherwise.	An LLC need not specify a term. It may be organized as an at-will LLC or as an LLC for a defined term or a specific purpose.
Formation	Generally tax-free.	Generally tax-free.	Generally tax-free.
Choice of Taxable Year	With the exception of personal service corporations, a corporation may choose any taxable year.	An S corporation (and a personal service corporation) must use a calendar year unless the corporation can establish a business purpose for use of a fiscal year. If a fiscal year is used, the corporation must make an annual payment to the IRS that approximates tax deferral received by stockholders.	An LLC generally has the same taxable year as a majority of the members. If a majority of members do not have the same taxable year, the LLC uses the taxable year of the principal members. If the principal members do not have the same taxable year, the LLC uses the calendar year.

	C Corporation	S Corporation	Limited Liability Company (LLC)
Method of Accounting	Must use accrual method if over \$5 million per year in average gross receipts.	May generally use cash method unless it sells goods out of inventory.	An LLC may only use cash method if it does not sell goods out of inventory and: (i) it is not treated as an association taxable as a corporation; (ii) its interests are not sold in a registered offering; and (iii) it is not formed for the principal purpose of avoiding or evading federal income tax.
Federal Tax Filings	No filing necessary upon formation (except for an EIN request); must file Form 1120 annually.	Must file Form 2553 to make S election; must file Form 1120S annually and distribute Form K-1 to stockholders.	No filing necessary upon formation (except request for an EIN); must file form 1065 annually and distribute Form K-1 to partners.
Self-Employment Taxes	Not applicable to corporate dividends; stockholder-employees are subject to employment taxes on wages.	Not applicable to S corporation pass-through income.	Uncertain.
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.
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).
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.