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From the Editor:

As we begin the new year, it is a good time to reflect on the emerging trends in technology that present opportunities to be explored by entrepreneurs who are considering starting new businesses and growing existing businesses.

Given the evolution of devices that people use to access applications and information (including mobile devices, wearables, and consumer and home electronic devices), connection models continue to expand and greater communications between devices is even more critical in a world where we are all connected, all of the time, in a seamless flow. This "device mesh" produces, uses and transmits information. As a result, emerging data classification and information analysis techniques are needed to organize this deluge of information, and strategies and technologies that link data from different data sources will be pivotal.

Some of the key themes that have been identified as likely to dominate the technology landscape in 2016 include the following:

1. Security. The presence of the "hacker industry" is forcing IT leaders to focus on detecting and responding to threats, as well as traditional blocking and other measures to prevent attacks. The trends include the form of encryption during both data transport and at rest, enterprise mobility management for mobile devices, containerization to isolate entire systems, and adoption of cloud solutions.
2. Data Mining. Predictive analytics, which is the ability to mine enormous amounts of internally generated data to determine future behavior patterns and trends, will permit technology users to store and access datasets online, driving greater use of cloud computing. This also encompasses algorithmic personality detection, through which the magazines and website subscriptions you purchase and photos you post to social media, etc., are used to harness your personal data to predict your future behavior and financial transactions.
3. Embedded Communications. Internet users are more than ever relying on their mobile devices to get online, thereby making click-to-call with call voice and video chat buttons embedded directly into apps popular with mobile users who can just press a button and connect instantly to a customer service representative.
4. Sensors and connected devices signaling real time updates. Sensors to collect and send real-time data that take advantage of devices that can report and communicate with each other will proliferate in medical uses (where small, cheap, and disposable is a preferred attribute), and in consumer uses (including wearables), so that users can interact with real-time data from connected devices throughout the day. This will expand to wifi earbuds, which can fit inside the ear allowing users to enjoy hands-free calling, music streaming, and other traditional audio applications, as well as providing audible notifications for activities such as monitoring heart rates.
5. Advanced Machine Learning. Machine learning, including robots, virtual personal assistants, smart advisors, as well as autonomous vehicles, are becoming autonomous intelligent agents who can deliver dynamic and contextual actions and interfaces (often through voice commands rather than menus and buttons on a smartphone).
6. Home Connectivity. Connected home products will proliferate as a result of lower prices, enabling a variety of opportunities for applications and devices to bring the benefits of a networked home to consumers, including home appliances and utilities that link up with smartphones, tablets, etc.

Entrepreneurs now, more than ever, need an integrated professional team approach to growing their business. We encourage you to reach out to our experts should you have any questions or desire further information on any of the topics covered in our Newsletter. We also welcome you to reach out to us in connection with any other legal questions or needs that you may have. We combine a client service team of talented professionals, with experience in all areas of the law which affect start-ups, emerging growth companies, and technology companies of all sizes. Our attorneys think like entrepreneurs, with a practical, solutions-oriented approach.

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Initial and Early Round Financing: Convertible Notes

Mark Bonenfant

Convertible debt (identified in market parlance as “convertible notes” or “bridge notes”) is a common strategy for initial and early stage financing for startup companies. Convertible notes are loans with the right of the holder to convert the debt into equity when the startup consummates a subsequent equity financing (a “qualified financing”).

Convertible notes are used for initial smaller funding rounds that that do not justify the costs of negotiating and documenting a preferred equity round. The financing may also defer the more detailed and complex discussions of valuation to the qualified financing. The more detailed provisions demanded from equity investors such as protective provisions on future corporate action, anti-dilution protections, board seats, information rights, or rights of first offer on future financings are typically not included in convertible note financings.

To compensate the investor for the risk of investing in the earlier round, convertible notes often include conversation discounts and/or valuation caps that permits the investor to participate in the later qualified financing on terms more favorable then the new investors in the qualified financing. The conversion discount permits the note holder to convert the principal amount of the note loan (plus any accrued interest) into shares of preferred stock at a discount to the per share purchase price paid by investors in the qualified financing. Discounts range from 0% to as high as 35% with 20% being common.

A valuation cap assures the investor that the note will convert based on a valuation which is the lower of the cap amount set forth in the note or the pre-money valuation upon which the qualified financing is priced. For notes that include both a valuation discount and a cap, the note will typically specify that the conversion price will be the lower of the price per share determined by the discount to the qualified financing price per share or the price per share determined by dividing the valuation cap by the company’s fully diluted capitalization immediately prior to the qualified financing. The investor receives the better of the two possibilities (lower conversion price per share means that the note converts into more shares in the qualifying financing). The valuation cap appropriately prices the equity value of the business at the time of the investment, although it often includes a projection of the valuation range of the qualified financing.

Convertible notes generally pay the holder interest at anywhere from 2% upwards to 5%, with the lower part of the range more typical. The investor, however, is not generally looking for a cash flow that the startup needs instead to build the business.

Unlike an equity security, a convertible note must be repaid on its maturity date with unpaid accrued interest if it has not been converted to equity. Notes generally have a maturity date of 12 to 18 months. Most investors, however, view convertible notes as an investment, and have only a limited expectation that the debt will be paid back. However, the maturity date and the debt-nature of the note are often responsible for exerting pressure on founders to find a qualified financing perhaps at the expense of losing focus on building value in the business. In practice, in most situations, investors will not call for a note to be repaid at the maturity date, and will instead amend the note to extend the note’s maturity date, typically for a period of another year. The investor is in a tough position. If the startup cannot complete a qualified financing (or another financing to allow repayment), it may have burned through the proceeds from the convertible notes and may be technically bankrupted. Even if there is excess cash to enforce payment, by providing the founders more time to find financing or an acquisition, the investor preserves its investment stake and upside option. One alternative for the startup is to permit the investor to convert the debt into equity at a predefined price (or valuation) if an equity financing has not been consummated by the maturity date.

A startup on an accelerated growth curve and/or with valuable intellectual property may be a target for an acquisition before consummating a qualified financing. Without protection the investors who took an initial risk in financing the startup could lose out on the appreciated value of the business. Convertible notes will delineate what is to occur on a “change of control” of the business (generally defined to include a merger, sale of substantially all the assets or a transfer in excess of 50% of the voting power). The most favorable outcome for the founders is to accelerate payment of the principal and accrued interest on the note and repay the investor. Investors may demand, however, that on or prior to a change of control the note convert into common shares at a pre-set price or the price per share as determined in the change in control transaction, or sometimes at the lower of the valuation cap or the change of control value per share. Another approach is for the note holders to be paid back their principal plus interest, plus a premium amount, generally 0.25-3x. Still other note terms give the note holder the option of choosing between such outcomes.

This is only a brief summary of some of the issues involved with convertible notes. There are some other methods to reduce the impact of note conversation discounts and valuation caps. Moreover, other strategies including seed preferred many offer more efficient means at reduced legal costs to achieve or exceed the objectives sought with a convertible debt financing. Therefore, consultation with an experienced advisor is highly recommended before embarking down the road of a convertible note structure.

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Protecting Confidential Information and Trade Secrets in a Tech Accelerator or Incubator

Dylan W. Wiseman

Tech accelerators or incubators enable start-ups to collaborate and share ideas, strategies, resources, and know-how. Uber, Spotify, and countless others have emerged from accelerators, incubators, or technology campuses. Amidst the open corridors, lounge spaces, and scattered pizza boxes, start-up businesses need to be mindful of the risks to their intellectual property. Tech incubators present unique risks because most members are extremely sophisticated regarding computers and electronic storage media. Likewise, in many tech incubators, start-up entrepreneurs may not appreciate California's laws around the ownership of intellectual property.

For many start-ups, the concepts for products or services are the life-blood of their operations and future. There are various junctures where a start-up's IP could potentially be disclosed—raising capital, recruiting employees, beta testing or testing a prototype, and in the day-to-day meetings which often occur in close proximity to other members of the incubator.

To put these risks into context, it is important the understand California's laws regarding competition. California workers are free to work anywhere, even for a direct competitor, provided the competition is fair and lawful. In California, most covenants not to compete are void and unenforceable. (Business & Professions Code section 16600.) As a result, start-ups should take both legal and technical measures to protect their IP.

While California will not enforce covenants not to compete, California's courts often enforce confidentiality agreements and intellectual property assignment provisions. The more specific the confidentiality terms, the more likely a court is to enforce the provision. Start-ups should make certain that they describe with specificity categories of information they seek to protect. We recommend prioritizing and identifying what information is highly valuable, or would cause the greatest injury if it were improperly used or disclosed, and build the confidentiality agreement around those categories. Confidentiality agreements should exist with employees, contractors, vendors and suppliers.

Confidentiality agreement should also encompass "trade secret" information. California follows the Uniform Trade Secrets Act (Civil Code sections 3426.1-11.). Trade secret information may include source code, CAD designs, research and development tests, business plans, customer, vendor, and supplier information, and other commercially sensitive information which gives the business a competitive advantage.

California's version of the UTSA has some unique features. First, it protects against the theft, use, or disclosure of information which can be in electronic, paper or memorized by an employee. Second, under California's definition of a "trade secret" it is immaterial that some aspects of the trade secret could be found in publicly available sources. Under California's UTSA, our Legislature likely anticipated that companies would compile information in their research and development efforts from public sources and modify or incorporate some elements into their products or services. Start-ups should make certain that their confidentiality agreements reference California's UTSA because of these unique features.

Likewise, California has specific Labor Code provisions which should be followed to ensure clear title to the start-up's IP. (Labor Code sections 2870-2872.) If the specific terms of the intellectual property assignment statute are not followed, a start-up can easily find itself in expensive litigation over the ownership of its technology. That type of battle will undoubtedly infuriate angel investors or venture capital firms.
Technical measures should also be used to protect confidential information and trade secrets. Particularly given the open, collaborative environment, start-ups should use firewalls, passwords, redundancies, two-step authentication, and should avoid having workers use BYOD devices for work projects. While popular, Bring Your Own Device work environments make it extremely difficult to retrieve data when employees leave.

Most data theft results from employees uploading files to the cloud, or to various storage devices. To help protect against employees taking information, start-ups should monitor computer usage, and also make certain to conduct thorough exit interviews and screenings of new hires.

Implementing legal and technical protections can certainly help start-ups thrive while protecting the company's IP.

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Using the Internet to Raise Money: Securities Laws and Crowdfunding Part 2

Philip Schroeder and Mark Bonenfant

In last quarter's Technology Industry Newsletter, we discussed various forms of equity and non-equity crowdfunding including proposed regulations implementing Title III of the JOBS Act, which establishes an equity crowdfunding model involving non-accredited investors. Since our last publication, the Securities and Exchange Commission (SEC), on October 30, 2015, released final rules for this form of crowdfunding, and these new rules will become effective May 16, 2016.

Under Title III of the JOBS Act and the SEC regulations implementing Title III, companies can raise money by selling securities to non-accredited investors and advertise this securities offering in limited ways without having to register the securities issued with the SEC, subject to compliance with many restrictions on both the investors and the companies issuing the securities. The following is a summary of the general framework of the Title III crowdfunding exemption but not a complete statement of the rules.

Limitations on Investment Amounts
To fit within the Title III crowdfunding exemption:

- The amount raised by the company may not exceed $1 million in any 12-month period (not including funds raised in offerings other than under the Title III crowdfunding exemption);
- Each investor may invest only up to the following maximum amounts in ALL Title III crowdfunding offerings across all issuers in any 12-month period:
    - if either the investor's annual income or net worth is less than $100,000, the greater of (a) $2,000, or (b) 5% of the lesser of annual income or net worth; and
    - if both the investor's annual income and net worth are equal to or exceed $100,000, the lesser of (a) $100,000, (b) 10% of annual income or (c) 10% of net worth;

Offering Must Be Conducted Through an Intermediary
To foster communication and information exchange between potential investors, each Title III crowdfunding offering must be conducted online through a single intermediary's online platform. A crowdfunding intermediary must register as either a broker under the Securities Exchange Act of 1934 or as a funding portal under Title III and the regulations implementing Title III.

Outside the intermediary's platform, the issuer may not advertise its Title III crowdfunding offering except by way of notices that contain limited information with the intent that potential investors be directed to the intermediary's platform for more information. Within the platform, issuers can communicate with investors regarding the offering terms as long as the issuer identifies itself as the issuer.

Disclosure Requirements
Prior to commencing a Title III crowdfunding offering, the issuer must complete a From C, file it with the SEC and make it available to the intermediary and the investors. Form C contains the following information, as well as other disclosures:

- Biographies of the directors and officers of the issuer covering their business experience during the past three years;
- A list of the issuers beneficially owning 20% or more of the issuer's outstanding voting equity securities;
- The issuer's business plan;
- A discussion of risk factors related to the investment;
- A reasonably detailed discussion of intended use of proceeds from the offering;
- A discussion of the issuer's financial condition, including, to the extent material, liquidity, capital resources and historical results of operations;
- Financial information as follows:
    - If the offering amount is $100,000 or less, (a) financial statements that have been reviewed or audited by an independent public accountant, if available, or (b) both (i) the amount of total income, taxable income and total tax, or the equivalent line items, as reported on the federal income tax returns filed by the issuer for the most recently completed year, and (ii) financial statements of the issuer certified by the principal executive officer of the issuer to be true and complete in all material respects;
    - If the offering amount is more than $100,000 but not more than $500,000, financial statements that have been audited by an independent public accountant, if available, or financial statements that have been reviewed by an independent public accountant;
    - If the offering amount is more than $500,000, financial statements that have been audited by an independent public accountant; however, for issuers that are selling securities under the Title III crowdfunding exemption for the first time, reviewed financial statements are sufficient if audited financial statements are not available; and
- Any material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

After the offering is complete, the issuer must file with the SEC and post on the issuer's web site an annual report that includes much of the same information requested in Form C except that the financial statements do not need to be reviewed or audited (unless such financial statements are available) and some of the offering-specific information does not need to be repeated. The annual reporting requirements terminate in a number of circumstances including after the filing of one annual report if the issuer has less than 300 stockholders of record.

In addition to the time required to prepare disclosures, the issuer's executive officers and director have exposure to liability for any information in the Form C that is materially false or misleading.

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Starting a New Business: Choosing the Right Entity for Your Business

Michael V. Lee and Julia T. Nguyen

As a startup founder, you cannot wait to change the world, but one of the most important issues you will need to address is choosing the type of entity to form to conduct your business. Angel investors and VCs usually like to fund founders who know what they are doing and forming a company can send them this signal.

In general, a new business owner may choose to conduct business through one of the following means:

- as a sole proprietorship;
- through a corporation;
- through a limited liability company; or
- if there are multiple business owners, through a general partnership or a limited partnership.

This article discusses the three most common ways new business owners conduct business as a start-up: (i) sole proprietorships; (ii) corporations, which are often further specified as C corporations or S corporations; and (iii) limited liability companies. While this article will briefly discuss sole proprietorships, most new businesses or start-ups are conducted through a separate legal entity, such as a corporation or a limited liability company.

Sole Proprietorships

A business owner may choose to conduct his or her business as a sole proprietorship. A sole proprietorship is a business owned and operated by one person. A sole proprietorship is not a separate legal entity. While a sole proprietorship may have some advantages (such as ease of conducting business and essentially zero organizational expenses (other than possibly obtaining and maintaining a fictitious business name or DBA)), it is significantly outweighed by a huge disadvantage – the sole owner has personal liability. In other words, the business owner is personally liable for all of the debts and liabilities of the business – meaning the business owner's personal assets are at risk and subject to the debts, liabilities and claims arising from the business. For this reason, most new business owners choose to form a separate legal entity to conduct business.

Corporations

A corporation is formed in California by the filing of articles of incorporation with the California Secretary of State's Office and in Delaware by filing of certificate of incorporation with the Delaware Secretary of State's Office. The corporation is owned by its shareholders who purchase or acquire stock of the corporation. Shareholders may also elect to enter into a shareholders agreement to set forth their rights and responsibilities.

A corporation is a legal entity that is separate and distinct from its owners or shareholders. As such, a corporation's debts and liabilities are also treated as separate and distinct from the debts and liabilities of its shareholders. In other words, unlike a sole proprietorship, the shareholders of a corporation are generally not personally liable for the debts or liabilities of the corporation – a corporation provides a shield or protection against personal liability of its shareholders.

Corporations must follow corporate formalities and requirements required by its articles of incorporation, bylaws and/or under applicable state laws. These formalities include having adequate capitalization, having a board of directors, having certain executive officers, having not less than annual meetings of its shareholders and directors, and maintaining separate books, records and bank accounts. The failure to follow corporate formalities may make the corporation more susceptible to claims of alter ego liability or piercing the corporate veil in which the corporation's shareholders can be held personally liable for the corporation's debts and liabilities.

There are two types of corporations – C corporations and S corporations. Both C and S corporations share the above characteristics of a corporation, but each have differing characteristics, advantages and disadvantages.

C Corporations

A C corporation is a more common type of corporation than an S corporation. One of the primary advantages of a C corporation is that a C corporation allows new business owners more flexibility in structuring the corporation's capital structure. Unlike an S corporation, a C corporation may have different classes of stock, with differing rights, preferences and privileges, and are not limited by the number or type of shareholders. Further, if you are planning on raising money with VCs and PE firms, those investors are generally most comfortable investing and dealing with a C corporation incorporated in Delaware.

A significant disadvantage of a C corporation is that it is subject to double taxation (whereas an S corporation is not subject to double taxation). Double taxation means that the corporation is taxed on its profits and when distributions are made to the corporation's shareholders, the shareholders are also taxed on such distributions.

S Corporations

An S corporation is formed in the same manner as forming a C corporation, but an S election must also be filed with the Internal Revenue Service in a timely manner. The primary advantage of an S corporation is that it is treated, for tax purposes, as a "pass-through" entity – i.e., the profits and losses of an S corporation are passed through to the shareholders and the S corporation is not subject to double taxation.

A significant disadvantage of an S corporation is that an S corporation is somewhat inflexible in terms of permissible capital structure. An S corporation may have only one class of stock. For example, an S corporation may not have both common stock and preferred stock. Further, the number of shareholders currently cannot exceed 100 shareholders and only certain types of shareholders may be shareholders in an S corporation. For example, another corporation cannot be a shareholder of an S corporation.

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Avoid Pitfalls in Your Terms of Use and Privacy Policy

Matthew Lubniewski

The terms of use and privacy policy on your website could be sources of unwanted liability to your business. The following is a list of some issues to consider when developing your terms of use or privacy policy.

Make Sure You Have a Privacy Policy

The California Online Privacy Protection Act ("CalOPPA") (Cal. Bus. & Prof. §22575) requires "[a]n operator of a commercial Web site or online service that collects personally identifiable information through the Internet about individual consumers residing in California who use or visit its commercial Web site or online service" to "conspicuously post its privacy policy…." Whether you know it or not, your website probably collects personally identifiable information about users. Make sure your website or app has a privacy policy.

Be Accurate

Your terms of use and privacy policy must accurately reflect your business and how you collect, store, and share users' personal information. Periodically review your terms of use and privacy policy (at least every six months) to make sure new services or features you have rolled out are covered. Periodically audit how user data is shared with third parties and how your company secures user data to ensure that your terms of use and privacy policy accurately describe your practices. Keep dated copies of every version of your terms of use and privacy policy so you can show what policies were in effect when a particular user visited your site or used your app.

CA's Automatic Renewal Law

If you sell automatically renewing subscriptions to consumers, California's Automatic Renewal Law ("ARL") (Cal. Bus. & Prof. §17600, et seq.) requires more than just a line or two in your terms of use notifying customers of the recurring charge. In short, the ARL requires that the company disclose the automatic renewal terms in a "clear and conspicuous manner" and provide the consumer with a written acknowledgment of the automatic renewal terms and cancellation policy "in a manner that is capable of being retained by the consumer." Failure to comply with the ARL makes the company subject to "all available civil remedies," which has given rise to numerous class action lawsuits against major companies. Even more onerous, if you send a customer products under an automatic renewal agreement without first complying with the ARL disclosure and acknowledgment requirements, those products are deemed to be "an unconditional gift to the consumer."

Do Not Track Signals

All major web browsers (mobile and desktop) now give users the ability to send a "do not track" signal to website operators that expresses a preference that their web browsing activity not be tracked. Unfortunately for users, there is no consensus on or legal standard for what an operator should do in response to receiving a "do not track" signal. The World Wide Web Consortium Tracking Protection Working Group is currently working towards a standard for what operators are expected to do upon receiving a "do not track" signal and a standard for how users can ensure compliance with their preferences.

In the meantime, the CalOPPA requires website operators to disclose how they respond to "do not track" signals "or other mechanisms that provide consumers the ability to exercise choice regarding the collection of personally identifiable information about an individual consumer's online activities." (Cal. Bus. & Prof. §22575). Make sure your privacy policy states how you respond to "do not track" signals.

CA's "Shine the Light" Law

California's "Shine the Light" law which is part of the California Consumer Records Act (Cal. Civ. Code §1798.83) requires most website operators that share certain types of customer data with third parties for "direct marketing purposes" to choose between two ways for allowing consumers to control whether their data is shared with third parties. The first option is to state in your privacy policy that you will either obtain customers' consent to opt-in to sharing their data with third parties for direct marketing purposes or provide a cost-free method for customers to opt-out of such sharing. The second option is to state in your privacy policy that, upon a customer's request, you will provide an accounting of the types of customer data shared with third parties and the identities of those third parties. The "Shine the Light" law involves numerous technicalities and exceptions. If your privacy policy does not include an on opt-in/opt-out scheme or an accounting scheme with respect to the sharing of customer data for direct marketing purposes, you may be unknowingly violating the law.

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Trademarks 101 for Start-ups: Basic Strategies

Farah Bhatti

Tech start-ups often have to balance how to protect their intellectual property without breaking the bank and without leaving rights open to infringement by other third parties. Strategies for protecting intellectual property, especially trademarks, will vary depending on the nature of the goods or services being provided, as well as the publicity/media coverage for the same, the manner in which and the places where the marks will be used, as well as a variety of other factors.

Trademarks are an intangible asset which can often be the most valuable asset of a company. While many technologies may be similar to one another, they are often copied or emulated by others. When an "original" product, idea or service is launched under a brand, consumers will often recognize such brand as the "original" and will be conscious that other similar products or services are either "knock-offs" or copies, and often view such other products or services as inferior to the original. The trademark itself is an indicator of source and quality. As such, it is a very important asset to be protected early on.
The most important trademark to be initially protected is one that is used not only as the name of the product or service, but also one that may be used as a name. However, before implementation of the brand or incorporation into a company name, it is highly recommended that a search of the mark be conducted. The worst thing is for a company to spend substantial time and money on branding and company formation efforts only to find that the chosen brand or name belongs to a third party and all branded and company materials must be changed before launch. For a company on a short timeline and for whom a launch date can be extremely crucial for fundraising and other timing purposes, having to change all of the materials would cause unnecessary delay, could harm the reputation of the company and could also cost the company a substantial amount of money.

Once a mark has been cleared, at a minimum, applications should be filed for the most dominant company trademarks in the United States. Most start-up companies will commence doing business in the U.S. and thus should initially focus on protecting its marks in the domestic market. However, given the global nature of the internet, and the potential for doing business outside of the United States, companies must be vigilant in tracking their online presence to determine where their popularity is growing. Because a U.S. trademark will only protect the mark in the United States, foreign protection must be viewed on a case by case basis. However, it is important to note that one application can be filed to cover the entire European Union. In this regard, if a company believes that it will be doing business or is becoming popular in one European country, it would be worthwhile to file an application to cover the entire European Union.

Where a company is producing, developing or manufacturing its products abroad, it should also seriously consider protecting its trademarks in such jurisdiction. Unlike the United States, which is a "first to use" country meaning that the first user of a trademark automatically obtains common law rights in the mark in the geographical area where the mark is used, the majority of countries in the world are "first to file" countries. In a "first to file" country, the first applicant of a trademark, even though they may not be the rightful owner of the trademark, can obtain rights in the mark to the exclusion of the rightful owner. In many instances, such third party registrant will then try to sell the trademark back to the rightful owner for a substantial sum. In such a scenario, even though the initial cost of the trademark filing may seem daunting, it is a substantial savings over having to buy back rights from a third party infringer, who can prevent you from using your mark in that jurisdiction.

Start-ups need to think about trademarks at the early stage in order to avoid infringing on the rights of third parties, and also to protect their interests in the U.S. and worldwide. If in doubt, discuss the strategies of filing with your trademark attorney who can help guide you through the different laws of particular jurisdictions and come up with a plan to protect and enforce your worldwide rights.

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Insurance: Why It Is Good For Your Company's Health

Manuel Fishman

Many techies have an aversion to insurance. Basically, you are paying a monthly premium to an insurance company for something that may not happen and when an incident occurs that is arguably covered by insurance, there is either an exception to coverage or there is a large deductible leading up to the actual loss not being covered. Worse, if an insurance company pays a claim to someone else, it may have the right to recover the loss from you. Understanding the gaps in customary policies is a key reason to get a good risk management consultant—more than just an insurance "agent".

The basic fact of life is that most companies will not enter contracts with your company without evidence of insurance—and the "industry standard" document that evidences insurance coverages is referred to as a "Certificate of Insurance" or a "COI". It is written on a standard form—referred to as an "ACORD" form. ACORD is an acronym for the insurance industry's nonprofit standards developer. Basic rule—an ACORD COI is not an insurance policy and does not provide insurance, it simply confirms that a party has the insurance covered by the form. Even more arcane, the COI is NOT issued by the insurance company, and is not binding on the insurance company. The COI is issued by an authorized broker or agent, and the insurance company is not bound to notify the person to whom the COI is issued of any changes in coverage. Notwithstanding these limitations, most contract counter-parties will insist on an ACORD COI as a condition to entering into a contract with your company.

The most common contract where a COI is needed is a service contract and a lease—and the most common coverages that a counter party to a contract or a landlord under a lease or sublease wants to see are: (i) insurance that protects you and the landlord/contract party against third party claims for injury to person or damage to a third party's property—this is known as commercial general liability insurance, and you purchase it with a per incident coverage amount and an annual aggregate coverage amount, often in the range of $1MM or $2MM per incident, and $3MM to $5MM, in the aggregate, or a combined single limit and aggregate coverage amount; (ii) insurance that protects your company against damage to the company's property (or "first party" loss) in the event of a casualty, like fire—this is known as property insurance, and you purchase it based on the "replacement value" of your property; and (iii) worker compensation insurance, which is pretty self-evident, and only applies to employees, not independent contractors. Many landlords have specific additional coverages that you may be required to carry—like insurance for fire sprinkler leakage in leased premises, insurance for business interruption, if you have to relocate during a casualty and cannot generate revenue from your space, and insurance for loss when an employee or agent gets injured or injures a third party in a company owned or non-owned vehicle.

As a tech company, you need to consider specific coverage for loss of data and data breaches, a property/casualty policy will generally not cover this, and most liability policies specifically exclude "data" as tangible property. You also need to know what coverages you are not carrying (for example, many tech companies do not carry business interruption insurance—although it is a commonly requested coverage, because everyone can work remotely in the event of a casualty and data is stored off site).

Most landlords and counter party's want to be named as an additional insured under the foregoing policies, so that the coverage provided runs to their benefit. While many insurance policies provide for an automatic addition of a contract as an insured contract, the better practice is to not rely on this, and to contact the insurance broker to make sure the proper endorsement is issued. For property insurance, there is no automatic additional insured concept, so an endorsement is generally issued. All of this needs to be shown on the COI.
The last concept you need to understand is "subrogation". This means that an insurance company gets to "stand in another's shoes" if it pays a claim. It applies to both commercial general liability and property insurance, and most contracts and leases require a waiver of this right, so that the insurance company that pays a claim does not turn around and sue your contract counter party or you based on the claim it honored! Most policies allow for a pre-loss waiver of the insurance company's right of subrogation. This needs to be shown on the COI.

Practical Advice: (i) insurance covers major losses, not every day losses, so pay for what you need, (ii) get the system down so you can issue COIs quickly and correctly, (iii) discuss your business with an experienced risk management person so that you can plug gaps in coverage and manage risk of loss and cost, (iv) figure out the relationship between deductibles, primary coverage and umbrella coverage—so you can better manage cost; (iv) understand which coverages you do not carry and why. Lastly, work with a risk management professional and a lawyer to understand the risks to be covered in basic contracts.

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Using the Internet to Raise Money: Securities Laws and Crowdfunding Part 2

Philip Schroeder and Mark Bonenfant

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Resales of Securities
The securities purchased in a crowdfunding transaction cannot be resold for a period of one year, unless they are sold (i) to the issuer, (ii) to an "accredited investor", (iii) as part of a SEC registered offering, (iv) to a family member (or trust for the benefit of a family member) of the investor, or (v) in connection with certain events like death or divorce.

Although Title III opens a new avenue for early stage companies to raise money, the restrictions on these types of offerings are extensive.

If you would like more information about crowdfunding offerings, please contact us.

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Starting a New Business: Choosing the Right Entity for Your Business

Michael V. Lee and Julia T. Nguyen

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Limited Liability Companies
A limited liability company (or LLC) is formed in California by the filing of articles of organization with the California Secretary of State's Office and in Delaware by the filing of certificate of formation with the Delaware Secretary of State's Office. The LLC is owned by its members who purchase or acquire membership interests in the LLC. The rights and responsibilities of the members are governed by an operating agreement entered into by the members. The LLC may be managed by the members or, if so designated, may be managed by one or more managers.

Like a corporation, an LLC is a legal entity that is separate and distinct from its owners or members. Like a corporation, an LLC's debts and liabilities are also treated as separate and distinct from the debts and liabilities of its members; i.e. the members of an LLC are generally not personally liable for the debts or liabilities of the LLC.

Like an S corporation, an LLC is treated, for tax purposes, as a "pass-through" entity – i.e., the profits and losses of an LLC are passed through to the members and the LLC is not subject to double taxation.

Unlike an S corporation, the members of an LLC have significant flexibility in structuring the LLC. For example, an LLC may have multiple classes of membership interests, each with differing rights and obligations; there is no limitation on the number of members; and there is no limitation on the type of members. Further, members have flexibility in determining distributions and allocations of profits and losses.

One of the disadvantages of an LLC (and also an S corporation) is that institutional investors, such as private equity or venture capital firms, in general do not like to invest in pass-through entities such as LLCs.

Which type of entity is the right one for your start-up?

The answer to this question is – it depends on a number of factors, including:

- the nature of your business
- whether there will be one or more than one owner
- whether pass-through tax treatment is of significant importance
- the nature of the proposed owners or investors
- whether there will be institutional investors

Choosing the right entity is an important step in starting your business. You should consult with your legal and tax advisors from the outset to avoid mistakes that could be costly to you and your start-up down the road.

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About Buchalter Nemer

Buchalter Nemer is a full-service business law firm that has been teaming with clients for over six decades, providing legal counsel at all stages of their growth and evolution, and helping them meet the many legal challenges and decisions they face.

The firm is consistently ranked among the leading law firms in California by Chambers and Partners, Best Lawyers, The Daily Journal and the Los Angeles Business Journal. It is also ranked among the leading firms nationally by American Legal Media and the National Law Journal.

Buchalter Nemer represents technology companies at all stages of development, from entrepreneurs to public corporations, as well as the industry's leading investors. We provide a full range of legal services, including: advanced technologies, intellectual property, mergers & acquisitions, corporate governance, start-ups, emerging companies and venture capital, private equity, labor & employment, domestic & international tax.

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