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Emerging Companies and Venture Capital Newsletter

Emerging Companies / Venture Capital Newsletter and Legal Updates from Haynes and Boone, LLP

SEPTEMBER 2020

Developments in California Law for the Gig Economy

Roger Royse

Alexis Maguina

With many employees being furloughed or laid off as a result of COVID-19, many employees are looking to opportunities in the gig economy to supplement (or replace) their income. Any such persons should be aware of recent changes in the law that affect displaced workers.

On January 1, 2020, California's Assembly Bill 5 (AB5) took effect, recharacterizing many independent contractors as employees for many purposes. The new law is aimed at gig economy platforms such as ride share platforms that have not provided employee protections and benefits to their drivers. Although the law affects ride share platforms, its application is much broader and effectively classifies every service provider as an employee if they meet an ABC test, which treats a worker as an employee unless the worker performs work that is outside the ordinary course of the hiring entity's business.

The law is now being tested in the courts and a proposition is on the November ballot asking voters to give ride-sharing companies an exemption to AB5. Companies like Uber Technologies, Inc. ("Uber") and Postmates, Inc., as well as the California Trucking Association, are challenging the constitutionality of AB5 in federal court. While the federal case is pending, the Attorney General of California, joined by several municipalities, filed a lawsuit in a California state district court seeking to force Uber and Lyft, Inc. ("Lyft") to reclassify their ride-sharing drivers as employees rather than independent contractors. The California state district court ruled in favor of the Attorney General but a last-minute ruling by a state's appeal's court delayed the enforcement of the district court's ruling while further litigation is pursued.

At the same time as the app based drivers are challenging the law, the California Employment Development Department (EDD) has increased its enforcement efforts against misclassification of employees.

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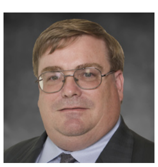
However the court case or the vote turn out, many companies will find that they are operating under new rules and increased scrutiny when it comes to worker classification. This new emphasis on classification probably could not come at a worse time, as individuals seek other sources of income in the gig economy. Even new and startup companies (especially new companies) must be vigilant to ensure that they comply with the labor laws.

As an example, a legal mistake that startups make which is closely related to misclassification is the failure to comply with minimum wage laws. Startup companies often attempt to pay employees in equity instead of cash, contrary to federal and state labor laws. The costs to the employer of an erroneous position on the issue can include taxes, penalties, unpaid wages, overtime, waiting time penalties and more. The careful gig worker will be cognizant of their treatment under current federal and state law before wither hiring workers, establishing a platform business or participating in the gig economy.

For more information on recent changes in California law. See our articles posted [here](#).

Protecting Your Inventions on Autonomous Vehicles



Gary Edwards

Autonomous vehicles involve an integrated convolution of sensor technology, navigational technology, computing (Artificial Intelligence), power systems, hydraulics, and mechanical manipulators to provide for a vehicle that operates to perform specific tasks substantially without operator intervention. As an example, a farm implement may include specialized sensors, task specific navigation, and task specific machinery. Many technological advancements involving this convolution can be protected either with trade secrets or with patent protection. Inventions directed to vehicles can be directed to individual sensors, individual specialized systems, power management, and to the integration of the components to form the automated final product.

Protecting an invention as a trade secret can be valuable for inventions that cannot be determined from a third party by an inspection of the final product (e.g., inventions that cannot be reverse engineered). Trade secret protection is valid for the time that the invention is actually kept a secret. If the invention is acquired by a third part through valid means (e.g., not through intentional theft of the trade secret), it is not protected. Further, sufficient steps must be taken to protect the secret to guard against theft.

One area where protection by trade secret can be used is with data. An AI used in operating the vehicle is trained with a data set so that data that is input to the AI results in expected control parameters to the vehicle. This data set is often painstakingly acquired over time as sensor inputs result in appropriate control system outputs. The AI is then expected to operate efficiently and safely to sensor inputs. Protection of these data sets can be difficult as they do not lend themselves easily to patent protection. Often, data sets that are acquired to train the AI are protected by contractual arrangements or by trade secret protection.

Patent protection for inventions is preferred to protect most technological advancements. Patent protection provides for a right to exclude others from practicing the invention specifically claimed in the patent for the term of the patent. To obtain a patent in a particular jurisdiction, the invention being claimed must be fully disclosed in a document, directed to patentable subject matter, and be novel and non-obvious over publicly available disclosures. A granted patent, which often results from correspondence with the patent office to amend the claims, is presumed valid and can be challenged at any time. Based on US patent filings, patent protection can be sought in over 140 countries

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around the world. It is worth noting that patent protection is only provided in countries where a patent has been granted. Consequently, care should be taken with regard to where to file for patent protection.

Inventions resulting from the technological advances made in autonomous vehicles can and should be protected. Consult your Intellectual Property professional to determine the best way of protecting these advances.

Venture Capital Investment Vehicles

Maria V. Hopper

Rob Atras

Although many approaches to raising capital exist, companies must consider the most appropriate method given its current position. This article summarizes common tools and discusses the stage at which companies should consider using each in its fundraising.

Convertible Notes

Convertibles notes are most commonly used as initial fundraising. They automatically convert into equity at an agreed upon milestone, often when the valuation is set for a later fundraising round.

Convertible notes are ideal for startups because preparation and negotiation is usually quick and inexpensive. Additionally, they allow companies to delay establishing an equity valuation until a later date or round of funding. This is advantageous for early-stage companies with little data to use for valuation. Most convertible notes are amendable and rarely contain restrictive terms. However, to compensate for early investing risks, convertible notes sometimes contain a conversion discount, warrant, or valuation cap.

Warrants

Warrants are typically issued in early fundraising stages and have long-term expiration dates, incentivizing long-term investor involvement. They attract investors by offering greater potential upside in the company through an investment opportunity without an initial capital commitment. Warrants are sometimes issued in conjunction with convertible notes to entice investment in an earlier round of financing.

SAFEs

Unlike debt instruments, the price of a SAFE is not determined at issuance, and SAFEs do not carry interest nor have a determined maturity date. Instead, when a holder ultimately receives equity, the price is set at its then-current value. The triggering event, typically a subsequent funding round or liquidation event, is determined during initial negotiations, so companies and investors should consider future equity dilution.

Simple and straightforward, SAFEs are best used by startups and early-stage companies. Typically negotiated quickly, they are inexpensive to draft. SAFEs are considered founder-friendly because they generally lack investor protections and restrictive terms.

KISSes

A KISS (“Keep It Simple Security”) gives its holder a right to purchase equity in a future fundraising round in exchange for an initial investment. Ideal for startups, KISSes typically involve simple documents, avoiding lengthy and expensive negotiations. KISSes were developed to counter the lack of investor protections in SAFEs, and operate as a hybrid between a SAFE and convertible note. KISSes are more investor-friendly because they often include Most Favored Nations clauses (promising the best value as compared to future investors) and contain identical terms for all KISSes issued in the fundraising series.

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Series Seed Financing

Series seed financing is a company's first official capital raise and are used by a company already operating to support its business plan by funding product development, market research, hiring key team members, and the pursuit of a viable product. Seed financing rounds are made up of smaller investments from third-parties who provide the funding for operations until a future financing round. This provides companies the time to fine-tune business models and develop product prototypes. While larger investors may require protective terms and restrictions, seed investment documents typically don't include extensive investor protections often negotiated in later financing rounds.

Series A Financing

Series A financing follows a seed round. The lettered financing rounds indicate that a company is ready for growth and capitalization of its business.

Series A financing can be a lengthy process, often requiring significant diligence and negotiations. This makes it well -suited for a company that is scaling up its business, rather than an early stage startup. Because it involves larger investment amounts than in seed financings, investors obtain greater company ownership.

Further, Series A holders typically receive preferential voting rights, rights to preempt dilution and the ability to participate pro rata in future fundraising rounds, and the right to elect Series A director(s). Consequently, the Series A financing documents require extensive negotiations and are more investor-friendly.

For questions regarding this content, please contact the authors of this article or visit Haynes and Boone's [Emerging Companies and Venture Capital Practice Group] page.

Startup Financing Strategy During COVID-19

Angela Kwok

In the VC community, especially for early stage investments, the valuation of a startup is strongly influenced by subjective factors, mainly how the investors view the business, market and management team of the startup. While there are no objective benchmarks for valuing early startups, the valuations of these companies are especially vulnerable to an uncertain economy.

Valuation is a very important issue for startups. If the valuation of the company is too high, then there will likely be a down-round[1] in the next equity financing of the startups. If the valuation is too low, then the startups will give away too much of their company for the amount of capital they raise. The uncertainty surrounding the future impact of COVID-19 on our economy is making it much more difficult for both investors and startups to assess the valuation of early stage companies.

What can a startup do to obtain funds and reduce the risk of a next down-round equity financing during such uncertain market circumstances? The Simple Agreement for Future Equity ("SAFE") approach could be a good choice to cope with the uncertainty in the market.

The SAFE structure was created by Y-Combinator as an easy-and-quick standard agreement for startups to raise money at an early stage. The SAFE forms have evolved over time, but the guiding principles behind SAFEs have remained intact: SAFEs provide investors and founders a means of allowing a startup to raise equity capital without setting a valuation during a period of uncertainty while at the same time giving investors and founders a high degree of certainty around the level of ownership associated with a SAFE investment. The SAFE approach to financing has many advantages, but investors and founders need to fully understand the SAFE structure and its potential disadvantages before taking this route.

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Advantages

SAFEs would be a good strategy to raise money in the current uncertain economic climate due to the following advantages:

1. SAFEs avoid the immediate need to set the valuation of the company because the startups and the investors only need to fix a valuation cap[2] in the SAFE instrument and allow the valuation to be determined in a later round that would typically be led by a VC fund. This could help to avoid a down-round in the next equity financing.

2. SAFEs, in their simplest form, are standard agreements. The standardization and simplicity help startups save legal fees and negotiation time, thus lower the costs and increases the speed with which startups will receive financing.

3. SAFEs are easy to understand and their standardized format may help startups to attract smaller investors.

4. As compared to convertible notes, SAFEs have no interest rate and no maturity dates, which saves startups money and reduces the time pressure on them to raise an equity round.

Disadvantages

However, SAFEs also have some disadvantages.

1. SAFE financing rounds usually raise relatively smaller amounts of capital than a formal equity round.

2. If a startup uses multiple SAFE rounds in a row, the result can be a more complex cap table. This is especially the case when a startup issues numerous SAFEs in very small amounts, which will create a very complex cap table and can potentially create significant and unexpected dilution for an unsophisticated founder.

3. SAFEs attract smaller, non-institutional investors. Hence, unless the startup is being advised by experienced angel investors or part of a well-developed incubator, a startup raising money using a SAFE may not be able to get the expert business guidance they would have received from institutional VC investors.

Conclusion

SAFEs are an easy, quick and relatively low cost way to raise money when the market is uncertain. They allow a startup and investors to focus on financing the company without focusing excessively on the risks associated with setting a valuation that is too high or too low in a volatile market environment. Overall, SAFEs are a good fund-raising strategy which can allow a startup to quickly receive financing are and help it survive this challenging economy.

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[1] "Down round" equity financing means the company values less than the previous round of equity financing, i.e. the price of the shares of the company in the current financing is lower than the price of the shares sold previously.

[2] "Valuation cap" means a ceiling, or cap, on the pre-money valuation at which the SAFE swill convert in a next equity financing. If the startup's valuation in the next financing is greater than the valuation cap, the SAFE investor's money will convert at the valuation cap.

Life Sciences Considerations Regarding Compulsory Licensing, March-In Rights, and the Defense Production Act during COVID-19

Roger Kuan

Joan Wang, Ph.D.

Under pressure to overcome the ongoing global pandemic, the U.S. government faces political pressure and is motivated to take any and all measures to facilitate the dissemination and use of innovation related to the diagnosis, treatment and prevention of COVID-19. There are various paths by which the federal government might seek to accomplish such goals, including via: (1) Compulsory Licensing, (2) March-in Rights under the Bayh-Dole Act of 1980, or (3) the Defense Production Act. As discussed in this alert, the conditions under which the government can pursue one of these paths and the likelihood that it will pursue it may vary.

Read full article here.

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Initial Observations Regarding the USPTO's Patents 4 Partnerships Pilot Program


Jason Novak


Daniel Kennedy

On May 1, 2020, the United States Patent and Trademark Office (USPTO) announced the Patents 4 Partnerships (P4P) platform, a pilot program that aims to connect companies who wish to acquire or license patents assets (including issued patents and pending patent applications) with the owners of those assets. The P4P program consists of a searchable database of patent assets that are voluntarily submitted by their owners, with that database provided to connect potential buyers and licensees with potential sellers and licensors.

Read the full article **here**.

Qualifying for the USPTO's COVID-19 Prioritized Examination Pilot Program


Jason Novak

When the USPTO launched its COVID-19 Prioritized Examination Pilot Program on May 14, 2020, a key focus was to shorten the timeline to patent protection of COVID-19 related innovations for small businesses and independent inventors, who already face the difficult task of getting important products to market with limited resources. By implementing this pilot program, the USPTO is striving to minimize its impact on a product's barrier to entry and allow important and potentially life-saving products to get to market faster.

Read the full article **here**.

Special thanks to summer associate Lyric Stephenson for contributing to this article.

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COMING SOON

How to Prepare Your Startup for Venture Capital Investment - Part 1
October 6, 2020

Visa Update: U.S. Government Actions Impacting Business and Tech Visas
October 8, 2020

How to Prep for Venture Capital Funding Part 2: Venture Capital Terms
October 20, 2020

F50 Global Capital Summit Fall 2020
October 27, 2020

PREVIOUS EVENTS

Startups in a Down Economy: Legal, Business, and Financing Strategies
September 22, 2020

Commercial UAV Expo Americas Virtual Event
September 15-17, 2020

Venture Capital Panel: Funding for Startups in the COVID-19 Era
September 15, 2020

Venture Capital Panel: Investment and Latest Innovations in IoT
September 8, 2020

How International Startups Can Move to Silicon Valley
September 1, 2020

Venture Capital Panel: Investment and Latest Innovations in Insurtech
August 25, 2020

How to Negotiate with Venture Capitalists
August 18, 2020

Funding 101 for Tech Entrepreneurs
August 11, 2020

Venture Capital Panel: Investment and Latest Innovations in AgTech
August 4, 2020

Pitch Global Silicon Valley Global Investing Summit-Lifesciences
July 28, 2020

Venture Capital Panel: Investment and Innovations in Autonomous Vehicles
July 28, 2020

Visa Options for International Tech Professionals, Entrepreneurs, and Investors
July 22, 2020

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PREVIOUS EVENTS (CONTINUED)

Top Ten Legal Mistakes that Could Kill Your Startup

July 14, 2020

Venture Capital Panel: Investment and Innovations in Energy and Climate Tech

July 7, 2020

How to Protect Your Intellectual Property

June 30, 2020

Venture Capital Panel: Investment and Latest Innovations in Fintech

June 23, 2020

F50 Global Capital Summit

June 15-17, 2020

Startups in a Down Economy: Legal, Business, and Financing Strategies

June 9, 2020

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We'd like to hear your feedback and suggestions for future newsletters. Please contact:

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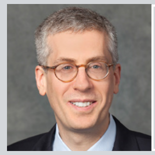

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