

UNIVERSITY OF ILLINOIS  
AT URBANA-CHAMPAIGN

# Startups: Incorporation, Funding, Contracts, and Intellectual Property

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Class 5



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# Today

- Review Exam 1 today – or wait until next week when we will have grades?
- Reminder – Please e-mail me your peer evaluations if you have not already done so
- Class 5



# Venture Investment Data

- Top US cities for venture capital investing in 2014
  - San Francisco/Bay Area/Silicon Valley \$24.8B
  - NY \$5.3B
  - Boston \$4.1B
  - LA \$2.3B
  - Seattle \$1.2B
  - San Diego \$984M
  - Chicago \$862M (about 3.5% of SF)
- Total Regional Investment in Startups in 2014
  - US \$50B ~320M pop ~\$156.25/per (~30X others)
  - Asia \$22.5B ~4.3B pop ~\$5.25/per
  - EU \$4B ~743M pop ~\$5.40/per



# Part 2 - Contracts

- Entrepreneurs must deal extensively with contracts
  - Give a legally enforceable right
  - But! Contracts may be a legal tool, but their greatest business strength is their use to get something done, not their use as an exhibit in a courtroom
  - In a general sense, contracts really establish and structure/define relationships
    - Can be a simple or complex relationships
    - We really just want to have clear terms for our relationships and avoid disputes so that our company can grow



# What is a contract?

- What is a legally binding contract?
  - (1) An agreement, (2) Between at least two parties, (3) That is actually enforced by a court
- Not all agreements are enforceable
  - You never know for sure until the court rules
  - Many people think that they have a legally binding contract/agreement when they really just have an unenforceable agreement
- But! If you believe a contract binds you - it does
  - Elephant Metaphor



# Necessary For A Contract? - 1

- What is necessary to have an agreement that a court will enforce?
  - Does it need to say “Contract” at the top?
  - No - It’s just an agreement, typically don’t have to use “magic language”
  - Does it need to be written on paper?
  - No - Electronic transmission and storage is often considered more permanent than paper



# Necessary For A Contract? - 2

- What is necessary to have an agreement that a court will enforce?
  - What if one person is just kind of joking around?
  - Maybe - Objective reasonableness created in the mind of the perceiver?
  - What if I just write someone an e-mail that says “unless you tell me different by Oct 1, then X”?
  - Maybe - Objective reasonableness based on custom, practice, communications, etc.



# Contract Interpretation - 1

- Much of contract law is based on “reasonableness” – we want to enforce what the parties reasonably agreed to
  - Honor expectations of the parties
  - Honor practice in industry
- Typically, this is objective reasonableness, not subjective
  - What a reasonable observer would think, not what you thought you were doing
  - May vary based on environment



# Contract Interpretation - 2

- Lack of clarity in a contract is typically construed against the drafter
- Contracts try to cover all eventualities, but rarely do
  - Terms not specifically called out in a contract, yet seemingly required are interpreted using reasonableness
- We want to be as clear as possible in our contracts
  - Terms like “within a reasonable time” are not typically very clear



# Contract Interpretation - 3

- Contracts for ongoing relationships are often modified or depart from the original terms
  - Situations change
  - “Living Document” of an agreement reflecting the current understanding of the relationship
- Just having a contract with certain parties may be of great benefit to you
  - Signing a contract with Google may be a valuation/reputation/appearance of stability boost



# Enforcement - 1

- Contract disputes often arise due to lack of clarity in the contract
  - The parties often had different expectations when entering the contract and focused on “getting the contract signed” rather than creating a clear working relationship
  - Making your contracts clear and addressing issues pro-actively through the negotiation process is best
  - Focus on establishing the relationship, the contract is a clarification tool to make sure that everyone is on the exact same page



# Enforcement - 2

- Complex contracts are rarely “iron-clad”
- Typically allow the parties to withdraw
  - Not going to lock yourself up forever
  - Need to be able to adapt to changes
- Often lack of clarity in terms arises
  - Even if the terms were clear at the time of signing, circumstances may change that render them unclear
  - Tech advances - “Full-bandwidth connection”
  - Legal/Factual changes – “1<sup>st</sup> national bank of Yugoslavia”



# Enforcement - 3

- Contracts are enforced through the courts
  - Expensive, time consuming, uncertain
  - All potentially lethal for a startup
- Other party may attempt to weasel out due to business changes or seeking greater profitability
  - Personal honor matters
  - Even if they breach, it may be to your business benefit to just ignore it and move to someone else
  - Looking for relationships to help growth, not obsessive enforcement



# Enforcement - 4

- Think before entering agreement
  - If you think that the only way you will get the other party to perform their end of the contract is the court system, find someone else
  - You want to grow fast and a contract dispute will be a drag on growth
  - Don't make contracts with the Devil thinking that the contract will save you
  - Remember! If a dispute arises, you are first going to approach the other side to make it right before you go to the court system – if they are reasonable it can be worked out
  - Only going to court when it completely breaks down



# Get It In Writing - 1

- Sometimes people feel that getting something in writing indicates that you don't trust the other person – no!
- What it really helps with is clarity:
  - Tough to get really specific on the terms of the agreement in an oral exchange. Lots of opportunity for misunderstanding/lack of specificity
  - Separates “just talk” from “OK, this is really serious”
- And preventing “drift”
  - Recollections change over time
  - Situation may change – e.g., new person in company
  - Expectations change
  - Lack of clarity and drift are real factors that experienced entrepreneurs know are likely to arise and they want to minimize/address up front



# Get It In Writing - 2

- Of course, it does really help with enforcement, but you really don't want to have to go there
  - Focusing on establishing a clear relationship so that you can work together successfully
  - But! Some agreements **MUST** be in writing to be enforceable
- “Writing” means any non-transitory memorialization
  - E-mail, Text, etc.
- Prefer modalities that are self-authenticating
  - E-mail is trackable, no need to ask if they recognize their signature on the contract



# Origins of Contract Law

- Where does contract law come from?
  - Historic Case Law
  - Restatement of Contracts (“Restatement”)
  - Uniform Commercial Code (“UCC”)



# Contract Law- 1

- Historically, contract law was developed by the states in the state court system of each state as opposed to the federal court system
  - Lots of regional variation in interpretation of claims and provisions
  - Meaning of “Reasonably Promptly” that was enforced by a particular state court could vary
    - Maybe - Within 1 day in Massachusetts
    - Maybe - Within 30 days in Alabama
  - Interpretation arose from what local community found to be reasonable and repeatedly enforced



# Contract Law - 2

- General practice over decades created a fairly uniform sample set of decisions so that you could generally predict what a court would enforce
  - This is called “Case law”
- Sometimes state legislatures would intervene and codify contract principles
- End up with fairly specific, but fairly local:
  - Interpretation of terms
  - Some agreements/clauses not enforceable
  - Requirements for binding agreement



# Evolution of Contract Law - 1

- Locally varying contract law works well with local contracts
  - Example - Two Vermont Farmers – OK!
    - Both are socialized to have the same local community values
    - Both had the same expectation of those internalized values when they entered agreement
- But! - Now we have trains and roads and people of different communities making agreements
  - Example - New Yorker and Texan – Uh-oh
    - Very different values
    - Very different local laws and local case law
    - Very different expectations when entering the agreement



# Evolution of Contract Law - 2

- So which state's law gets used to interpret and enforce the contract?
- A race to the courthouse! -
  - Under the Constitution, states must give “full faith and credit” to court decisions by another state
  - Judgment from New York court must be enforced by Texas court
- State courts arguing about jurisdiction – especially elected judges, as many state judges are
- State legislatures expanding state jurisdiction to allow all possible cases to be filed there so that the state court can look after their citizens
  - “Long-arm” statutes allow suit in a state if you have



minimum contacts with the state

# Evolution of Contract Law - 3

- More recent unifying factors
  - Widely published national models for contracts
    - Restatement of Contracts
    - Uniform Commercial Code (UCC)
  - Choice of Law provisions in contracts
  - In general, the people with the money write the contracts and set the rules
    - Investors get what they want -and they use their local rules
  - Much, much, greater societal uniformity over different geographies with the advent of mass media – people nationwide trained to accept uniform standard
- Today – still some state variations, but substantial degree of uniformity on basics



# Restatement - 1

- Restatement (Second) of the Law of Contracts started in 1962, finished 1979
- Lawyers from many states got together to create a treatise with regard to how to interpret contracts
  - Tried to agree on what was “reasonable” nationwide
  - Non-binding, but very persuasive and implemented by many states
  - Sometimes only partially implemented by state legislatures or modified to reflect local case law



# Restatement - 2

- Restatement is high-level, definitional law – Exs.
- §24. OFFER DEFINED - An offer is the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it
- §30. FORM OF ACCEPTANCE INVITED
- (1) An offer may invite or require acceptance to be made by an affirmative answer in words, or by performing or refraining from performing a specified act, or may empower the offeree to make a selection of terms in his acceptance.
- (2) Unless otherwise indicated by the language or the circumstances, an offer invites acceptance in any manner and by any medium reasonable in the circumstances.



# Restatement vs. UCC

- Criticism - Restatement is too high-level, covers too many sensitive areas
  - Maybe we only need to support uniform system for sale of goods across state borders – not real estate or services, which states disagree about more extensively
  - Need specific enforcement of standard business terms
  - Need actual terms to be adopted as law by the states
- Enter UCC – Uniform Commercial Code
  - Deals with “personal property” (goods) rather than real estate or services – for those look to Restatement
  - Codified in all 50 states, so very uniform across the states – Restatement is much less uniform



# UCC – Really Technical

Article 2, § 2-310. Open Time for Payment or Running of Credit; Authority to Ship Under Reservation.

- Unless otherwise agreed
- (a) payment is due at the time and place at which the [buyer](#) is to receive the [goods](#) even though the place of shipment is the place of delivery;
- (b) if the [seller](#) is required or authorized to send the [goods](#), the seller may ship them under reservation, and may tender the documents of title, but the [buyer](#) may inspect the [goods](#) after their arrival before payment is due unless the inspection is inconsistent with the terms of the [contract](#) (Section [2-513](#));
- (c) if tender of delivery is agreed to be made by way of documents of title otherwise than by paragraph (b), then payment is due regardless of where the goods are to be received (i) at the time and place at which the [buyer](#) is to receive delivery of the tangible documents, or (ii) at the time the buyer is to receive delivery of the electronic documents and at the seller's place of business or if none, the seller's residence; and
- (d) if the [seller](#) is required or authorized to ship the [goods](#) on credit the credit period runs from the time of shipment but postdating the invoice or delaying its dispatch will correspondingly delay the starting of the credit period.



# UCC- 2

- Pretty much any “good” that you have ever purchased has been governed by the UCC
  - Any personal, portable thing
  - Eggs to clothes to iPads
- If your company is going to be selling goods, the sale will be governed by the UCC
- Have you ever read those “fine-print” forms? Their content is based on the UCC



# Restatement vs. UCC

- Some cases would be decided differently based on whether the Restatement or UCC is used to interpret the law
- How do I know which one is going to be used to interpret my contract?
  - Quick and Dirty – Are you a merchant selling goods? If yes, then UCC. Otherwise Restatement, especially if real estate or personal services are involved



# State or Federal Court? - 1

- Only get to Federal Court if the Federal Court has “jurisdiction”
  - Whether the Court is authorized to hear your dispute
- Two primary kinds for Federal Court
  - Federal Question Jurisdiction – a lawsuit with regard to federal laws or treaties (patents, contract with govt., etc.)
  - Diversity Jurisdiction – between “citizens” of different states and amount exceeds \$75,000
    - Corporation is a citizen of state of incorporation and state of principal place of business



Supplemental Jurisdiction in some cases

# State or Federal Court? - 2

- If no Federal jurisdiction, you are in state court
- Contract cases are typically not a Federal Question, but diversity jurisdiction may exist
- Thus, majority of contract cases heard in state court
- Many people want to be in Federal court
  - Judges are appointed, not elected
  - Belief that judges know the law better
  - State courts may employ “home cooking”
  - Perception of more fair procedure
  - If the company has strong ties with the state, they may want the state court



# State or Federal Court? - 3

- Even if the case is heard in federal court, the contract is still interpreted using the law of one of the states
  - “Choice of law” provision in contracts
  - “This Agreement shall be governed by the laws of the State of Illinois.”
  - The choice of law may produce a different outcome depending on which state’s law is used



Questions?

See you next week!

