Fellow

THE US FOUNDER EDITION

For US founders

# The 5 gaps diligence finds in US startups

Every one of these is cheap to fix today and expensive to fix under a term sheet. Here are the five that surface when investors, acquirers, or a serious hire finally look closely, plus the QSBS setup that can save you $10M or more at exit.

STEP 1 OF 5

# Choosing the wrong entity structure

**$5K to $15K to fix**

A founder came to us after incorporating as an LLC through an online platform. Saved about $1,000 upfront, then tried to raise a seed round. **US VCs invest in Delaware C-Corps.** LLCs create UBTI issues for tax-exempt investors like pension funds and endowments, S-Corps are restricted to US citizens and residents, and only C-Corps qualify for QSBS, which can exclude $10M or more in gains from federal tax at exit. The LLC-to-C-Corp conversion cost more than the original incorporation, delayed the round by weeks, and created tax complications that took months to unwind.

> **The fix:** If you are raising or plan to raise VC, start with a Delaware C-Corp. It is easier to be a C-Corp that never raises than an LLC that has to convert.

STEP 2 OF 5

# Skipping corporate formalities from day one

Personal liability

No board meetings, no minutes, personal and corporate finances mixed, operating as if the corporate distinction is just paperwork. **It surfaces at the worst possible moment: during investor due diligence,** where missing board consents and unsigned resolutions signal a company that is not well run, and deals slow down or fall apart. Worse, without proper formalities, courts can pierce the corporate veil and hold founders personally liable.

> **The fix:** Hold quarterly board meetings, keep minutes, use written consents for all major decisions, and maintain a corporate records binder from day one. This is the cheapest insurance you will ever buy.

STEP 3 OF 5

# No PIIAs before anyone writes code

Deals killed

Founders, early employees, or contractors start building without signing a Proprietary Information and Inventions Assignment Agreement (PIIA). **Under US copyright law, creators own their work by default,** so without a signed assignment the company may not own its core IP. It is one of the top due diligence flags that delays or kills deals. Retroactive assignments are expensive, and contributors who left on bad terms may refuse or demand payment.

> **The fix:** Get PIIAs signed before the first day of work. No exceptions, not even co-founders. If you already missed this, do confirmatory assignments immediately.

STEP 4 OF 5

# Granting equity without a 409A valuation

20% penalty per year

Companies grant options without a valid 409A valuation, or grant when the existing 409A is stale after a fundraise or material event. **For employees that means income tax plus a 20% penalty on the spread, every year.** For the company it means withholding obligations, reporting requirements, and a major red flag in any diligence. There is no easy fix for options granted at a discount.

> **The fix:** Get a 409A before your first option grant, and update after every material event. Budget $2K to $5K annually. This is not optional.

STEP 5 OF 5

# Informal equity promises and cap table chaos

**$15K to $50K cleanup**

Telling early contributors "you will get 2%" without board approval or documentation. Tracking equity in spreadsheets. Making changes without proper paperwork. **Oral promises may be legally enforceable,** the cap table diverges from the legal documents, and when it is time to close a round the cleanup can take months and cost $15K to $50K.

> **The fix:** Use a cap table platform like Carta or Pulley from day one. Never promise specific equity until the board approves, and document every transaction formally.

THE ONE THING THAT ACTUALLY MOVES THE NEEDLE

# The QSBS strategy that can save you $10M or more at exit

*Section 1202: the most valuable tax benefit most founders never set up correctly*

Qualified Small Business Stock (QSBS) under IRC Section 1202 lets founders and early investors exclude up to $10 million in capital gains (or 10x their basis) from federal tax at exit. On a $20M gain, that is $2M or more in tax savings. But the exclusion has requirements that must be set up from day one.

## The 5 requirements (all must be met)

1. **C-Corp only.** QSBS only applies to C-Corp stock. LLCs, S-Corps, and partnerships do not qualify. Choose wrong and you lose this forever.

2. **Original issuance.** Stock must be acquired directly from the company in exchange for money, property, or services. Buying shares from another founder permanently disqualifies those shares.

3. **$50M gross asset test.** The company's aggregate gross assets must not exceed $50M at the time of issuance and immediately after. Raise too much before issuing founder stock and you may fail this test.

4. **Active business test.** At least 80% of assets must be used in an active trade or business. Some industries are excluded (professional services, banking, farming, hospitality). Most tech startups qualify.

5. **5-year hold.** You must hold the stock for at least 5 years. The clock starts when you receive the stock, or when you file your 83(b). That is why the 83(b) matters: it starts your 5-year clock immediately.

**The mistake we see most often**

Founders restructure equity between themselves after incorporation: buying out a co-founder, rebalancing ownership, or transferring shares. Those shares permanently lose QSBS eligibility. Forever. Get the cap table right before you issue.

# Structure it right from day one.

> The best time to set this up is before your first grant. The second best time is now, before your next raise turns a quiet fix into an expensive one.

### MORE, EVERY MONTH

This guide is one piece of what we send founders. Once a month, our newsletter brings one costly mistake and its fix to your inbox. No filler, no pitch. We would love to keep them coming your way.

### TALK TO FELLOW

If your setup feels shaky on any of this, email **your@fellow.legal** and we will take a look, fix what needs fixing, and make sure everything ties to signed documents. Either way, if you have a raise coming and have not reviewed it lately, we are happy to do a quick audit first.

General information, not legal or tax advice.