Counseling Start-Ups in the Aerospace Industry

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**Executive Summary**

Interest in the space industry is at an all-time high, thanks in part to billionaire backers, changes in technology, and political will. Working with a start-up client in any market is very different from counseling an established, mature enterprise. It requires a high degree of flexibility, willingness to make decisions with imperfect information, and business savvy. The challenges are even greater in the highly regulated space and defense industries. Legal issues and business considerations important to helping space start-up companies stay on the road to success include regulatory compliance, navigating legislation and government policy, IP protection, corporate governance, and financial management.

In the end, however, a space start-up is still a start-up, which is to say, it is a business, and businesses must make money. Legal counsel to these companies, whether external or in-house, need flexibility to prioritize and address a variety of issues, not all of which are purely within the realm of legal advice and none of which have all the available information an attorney generally wants to see before giving advice. Effective legal counsel to a start-up understands both the priorities of the business, which may change rapidly to react to market conditions, and the personalities and risk tolerances of the founders.

The following sections provide a high-level overview of some of the major considerations legal counsel will address when working with a start-up entity with regard to corporate law, intellectual property, and government regulation. Additional considerations may include employment law, risk management and insurance, real estate, and OSHA compliance.

**Corporate Considerations**

**Choice of Entity and Jurisdiction**

Deciding on the form of corporate entity depends on a number of factors including tax benefits, liability exposure, management structure, governance rules, and jurisdiction of formation.
Main entity choices include corporations, partnerships, and limited liability companies (LLC), each of which has its own set of requirements, benefits, and limitations.

The state of incorporation or organization selected will affect fiduciary duty requirements, stockholder rights, reporting requirements, taxes, M&A, and governance requirements. Delaware is most commonly selected as the jurisdiction of incorporation, regardless of where the company’s principal place of business will be located, due to its well developed body of law, business friendly regulatory structure, and lower taxation.

**Finance and Investment**

The initial capital input into the business from founders, friends, and family often does not last very long, particularly in the technology-intensive aerospace industry. The initial round of investment is referred to as the “seed round.” Seed funding most commonly comes from “angel investors,” generally high net-worth individuals, small family investment funds, or technology incubators. Investor sophistication, industry familiarity, personal contacts (that can lead to revenue), are just as important to start-ups as the money they bring in. Typical investments from these groups are in the $50,000 to $100,000 range and can take the form of straight-forward debt (notes), equity, convertible debt, or the newer “Simple Agreement for Future Equity” or “SAFE” which is comparable to a convertible note yet with an open-ended conversion date. Care must be taken in drafting the seed investment agreements with regard to investor rights, corporate rights, management and control, and exit of seed investors in future financing rounds with institutional investors and venture capital. Compliance with federal and state securities regulation, while the requirements may be minimal at this stage, must be met. Subsequent financing rounds generally are referred to as Series A, B, and C rounds (and may continue accordingly). Such financing generally is above $1M and involves more complex deal structures, agreements, and compliance obligations.

**Board of Directors and Company Management**

Corporations must have a board of directors to oversee management and governance of the company. LLCs’ and partnerships are more flexible in this regard. A board of directors is composed of inside directors, who are senior management and generally include at least the company president and/or CEO, and outside directors, who are not employed by the company and have expertise in the industry and a particular subject matter such as finance, business management, or government regulation. The primary role of the board of directors is to elect and supervise the officers and executive management of a corporation and to oversee major business decisions and compliance obligations. Members of the board have a “fiduciary duty” to company and its stockholders. Core elements of fiduciary duty include a duty of care to be fully informed when making decisions on behalf of the corporation, and a duty of loyalty to act in the best interests of the corporation. Courts have also ruled that directors have other duties to the corporation such as good faith, disclosure, and oversight.
Intellectual Property

In a technology-intensive industry such as aerospace, development, valuation, and management of intellectual property is a critical component of financial and market success. Intellectual property is an asset of the business which contributes to its value, financial model, and attractiveness to the investment community. Intellectual property can generate revenue through licensing agreements, assignment, or asset sales. IP due diligence should be a key component of any merger or acquisition transaction. Companies also need to take care to establish ownership rights and assignment of IP generated by employees, vendors, independent contractors, and consultants.

The four main areas of intellectual property are patents, trademarks, copyrights, and trade secrets, each of which is governed by its own set of statutes and body of case law. Patents and Trademarks are obtained by filing eligible applications with the US Patent and Trademark Office. Copyright in authored works automatically attaches when the work is created and can also be registered with the US Copyright Office. Trade secrets are the most amorphous category of intellectual property and consist of confidential information that is generally not known or ascertainable, derives an economic value or business advantage from its being secret, and is reasonably protected by the efforts of the secret-holder. There is no registration for protection of trade secrets or legal notice required, although it is good business practice to label trade secrets as “confidential” or “secret” when sharing with a third party, and then only under the terms of a binding, written confidentiality agreement.

Regarding technological innovation and inventions, whether to protect one’s intellectual property through the patent process or as a trade secret will depend on a variety of factors including product life-cycle, market volatility, value of the invention, and the likelihood of copycat products. Conversely, companies need to take care in their product development process to conduct “prior art” searches to avoid potential infringement of another’s intellectual property. Failure to do so can, and has, cost companies millions, if not billions.

Regulatory Compliance

No discussion of aerospace start-ups would be complete without a discussion of some of the major categories of regulatory compliance that may apply including: (1) export control; (2) national security; and (3) government contract rules. Additional oversight may include Federal Aviation Agency regulations for launch providers, Federal Communications Commission regulations for satellite communications, National Oceanic and Atmospheric Agency regulations for remote sensing, and of course the Foreign Corrupt Practices Act and corresponding international antibribery and corruption laws regarding the conduct of business overseas.
**Export Control**

Transactions considered exports by the United States Government include exports of hardware (physical goods), software (i.e. computer programs, et al.), or technology or “know-how” (intangible exports). Exports may occur when hardware, software, or know-how is transmitted overseas, including to APO and FPO locations (military bases and embassies). Exports may also occur if the hardware, software, or know-how is transferred to a non-US Person on US soil; these exports are considered “deemed exports.” Under applicable regulation, US Persons include US citizens and permanent residents. The main statutes governing export controls in the United States include:

- The Arms Export Control Act and International Traffic in Arms Regulations which control exports of military items and technology and are administered by the U.S. Department of State.
- The Export Administration Act and Export Administration Regulations which control exports of commercial or “dual use” items and technology and is administered by the U.S. Department of Commerce. “Dual use” means having both military and commercial applications yet not requiring regulation by the more restrictive AECA regime.
- The Trading with the Enemy Act (TWEA) and International Emergency Economic Powers Act (IEEPA) which govern trade sanctions and are administered by the U.S. Treasury Department.

**National Security**

Companies that wish to engage in classified work with the US Government will require security clearances for individuals and potentially for the facilities if the classified work is to be conducted in a corporate facility. This is an expensive and time consuming undertaking. The National Industry Security Program regulates industry’s access to classified information including security clearances, marking and handling of classified information, record keeping, auditing, and training, among other matters. The Program is administered by the Defense Security Service in the Department of Defense.

**Government Contracting**

Government contracting is likely to become a crucial element of revenue generation for any aerospace start-up, whether as a prime contractor or a subcontractor. The contracting process, from cradle to grave, and the terms and conditions of government contracts themselves are governed primarily by the Federal Acquisition Regulations (FAR), and agency-specific contracting regulations such as the Defense Federal Acquisition Regulations (DFAR) and the NASA FAR supplement. Other agencies may have their own FAR supplements or contracting rules that provide additions, deviations from, or exceptions to the FAR. FAR compliance must be managed throughout the contracting cycle, both from a legal and regulatory perspective and an accounting perspective. This too can be an expensive and time-consuming undertaking,
regulating not only commercial terms and conditions such as contract payment, milestones, liabilities, and intellectual property rights, but also supply chain sourcing, cybersecurity, and the human resources management.

Reference

1. Corporate Law

Delaware General Corporation Law (Delaware Code, Title 8; In particular: Subchapter IV – Directors and Officers; Subchapter VII – Meetings, Election and Notice; Subchapter IX – Merger, Consolidation or Conversion; and Subchapter XIV – Close Corporations, Special Provisions).

Securities Act of 1933 (15 USC §§ 77a, et seq.)

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). (Presumption that in making a business decision, the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action was taken in the best interests of the company.)


2. Intellectual Property


Copyright Act of 1976 (17 USC §§101-810; 44 USC §§ 505, 2113; 18 USC § 2318).


Defend Trade Secrets Act of 2016 (18 USC §§ 1836 et seq.)

3. Regulatory Compliance

Arms Export Control Act (22 USC ch. 39 §2751, et seq.) and International Traffic in Arms Regulations (“ITAR”) (22 CFR §§120-130).


Trading with the Enemy Act of 1917 (12 USC § 95; 50 USC App. §§ 1-44).


Federal Acquisition Regulations (Code of Federal Regulations, Ch. 48).