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When Should a Startup Company Engage a Law Firm?

I asked a friend, the CEO of an emerging, venture-backed company, the question posed in the title: "When should a startup company engage a law firm?" His immediate and emphatic response: "Never. Ever." Not very helpful…

The reason for my friend's tongue-in-cheek (I think) response is the time and money many entrepreneurs associate with engaging a law firm to assist with initial organizational matters. All too often, entrepreneurs accustomed to operating on tight timelines and even tighter budgets are reluctant to commit resources to legal assistance at the outset, opting instead to use services like LegalZoom to file necessary paperwork to form a business entity, or drafting and filing the paperwork themselves.

While simply forming a business entity is a straightforward task, experienced entrepreneurs understand that properly forming a company and issuing equity interests therein can be an involved and demanding undertaking. It requires much more than just filing a few forms. My entrepreneur friend quickly – though likely reluctantly – acknowledged that entrepreneurs are almost always better off engaging counsel early on. Selecting the appropriate type of entity, establishing proper corporate governance procedures, issuing stock, making timely 83(b) elections and entering into stock option agreements, among many other issues, are all nuanced exercises that require professional assistance. Failing to address appropriate issues or ask the right questions can lead to omissions or mistakes that can be extremely expensive later in a company's life cycle, particularly if the company is performing well.

Below are just a few examples of issues to think about, and questions to ask, when forming a company:

- ***Which type of entity should I choose?*** C-corporations, S-corporations, professional corporations, limited liability companies, limited partnerships, limited liability partnerships…selecting the appropriate legal entity can be confusing. The type of entity you choose will have important tax, liability and other business implications as the company matures, so it is critical to learn about the advantages and disadvantages of each entity type and make an informed decision that will set the company up for success and ensure that the founders remain shielded from personal liability to the extent possible. There is no "one size fits all" entity type. Depending on the nature of the business and its owners, certain entity types may be unadvisable or unavailable.

- ***How should the company be organized and capitalized at outset to facilitate financing?*** If you plan to raise capital in the near future, consider whether your target investors prefer one form of entity over another. While most institutional investors are comfortable investing in either corporations or limited liability companies, some institutional investors (and many angel or individual investors) have a preferred entity type. Knowing their preference at the outset will help you avoid the legal costs and paperwork involved in later having to convert from one entity type to another.

- ***What form of equity will founders receive? What about employees?*** You'll want to consider the number of shares or other equity interests to authorize, and whether to reserve a portion of those authorized shares for planned issuances to employees, directors and other important contributors to the company. Founders must be careful not to authorize an unnecessarily large number of shares, which could result in higher franchise taxes. Often, founders receive "restricted stock," which means that the stock is subject to a vesting schedule or is otherwise subject to forfeiture (for example, if the founder leaves the company). Vesting schedules are useful tools to keep founders and key employees incentivized to remain with the company over time, and institutional investors often insist on including them for key players. For founders, the trickiest part of a vesting schedule is deciding how long the schedule should be, whether the same schedule should apply to all recipients, and whether certain founders – those that have truly been involved with the company since inception – should be exempt from a vesting schedule and receive all of their equity up front.

- ***Should I file an 83(b) election? What are the consequences of not doing so?*** Under basic tax rules, a recipient of restricted stock does not recognize "income" attributable to such restricted stock until it vests, at which point the recipient would incur tax liability for the difference between the fair market value of the restricted stock at the time of vesting and the purchase price paid for the restricted stock. If, as is always the hope, a company performs well and increases its value over time, then the recipient could be stuck with an unpleasantly large tax bill. For example, if a founder pays $1.00 per share of restricted stock that is subject to a four-year vesting schedule, and after four years each share of stock is worth $100.00 due to the company's growth, then the $99.00 difference will be treated as income of the founder, payable at the applicable income tax rates. An "83(b) election," however, allows the recipient to recognize income on the date such restricted stock is purchased by treating the restricted stock as though it is fully vested on the date of purchase. By doing so, the recipient gets the benefit of the company's low valuation. Since the purchase price and the fair market value of restricted stock purchased by a founder are often the same (i.e., de minimis), the founder may not have any income tax liability at all. Failing to timely file an 83(b) election (it must be filed within 30 days after a founder purchases the restricted stock) can be a very expensive mistake.

- ***How do I make sure the company – not the founders or employees – owns important intellectual property and any future developments?*** Any investor will want to be sure that the company, and not the founders or any employee, owns critical intellectual property. Accordingly, all companies, and particularly technology, medical device or software companies with robust intellectual property, should require each founder and employee to execute agreements that assign to the company all rights in any intellectual property relating to the company's business, whether existing at the time of the agreement or developed thereafter.

- ***Should the founders sign nondisclosure agreements? What about noncompete agreements?*** Investors will similarly want to ensure that founders do not disclose the "secret sauce" or other sensitive information to outsiders, or leave the company to form or work for a competitor. Even just among founders, before considering what a future investor might ask for, these issues should be addressed to help galvanize the team and determine whether any founder's commitment to the venture is wavering. A founder's resistance to sign a nondisclosure or noncompete agreement, assuming the agreements contain reasonable terms, can be a potential red flag.

How can an entrepreneur make sure all of these issues, and many others, are adequately addressed? As my entrepreneur friend said, “Find startup-friendly counsel (at startup-friendly prices) that have done this many times over, and interview other clients of the firm as references to find out if they did a good job.” Even if an entrepreneur’s “business” remains just an idea, engaging a law firm early in the process will help ensure that the entrepreneur, and the eventual company, are protected if and when the company succeeds.

Many law firms, including ours, offer discounted rates to emerging companies, as well as deferred and/or flat fees for routine startup services. Alternative fee arrangements can make the prospect of engaging legal counsel much more palatable, so be sure to ask about such arrangements before signing an engagement letter.

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