

FAQ for Entrepreneurs

When to talk to a lawyer and what questions to ask

You're an entrepreneur and you have a great idea for a new product. Or maybe you've already created a product, like an app, and have sold it to several customers. So, when should you talk to a lawyer and what should you ask?

Riaz Karamali, a partner in Pillsbury's Silicon Valley and San Francisco offices who represents emerging growth companies, answers some of the most common questions innovators face.

Q. At what point should I talk to a lawyer?

A. It's never too early to talk to me. I like to have a relationship with people and help them from falling into common traps at a very early stage. The same is true for all of your relationships with potential advisors. It's best to have those relationships intact before you start asking investors for money.

It's also much better to talk to us first than to try to incorporate online. That's because it's usually more expensive for an advisor to clean things up if you've already incorporated.

Q. When do I need to incorporate my new business?

A. It makes sense to consider incorporating when there is more than one person contributing intellectual property to the new venture. At the very latest, you need to do it before you launch a product publicly. For example, let's say you have an app and you've sold it to a few people. You could potentially be exposing yourself to personal liability if you don't incorporate.

Of course, it could also be too soon to incorporate. Maybe you go through ideas like water and you set a new company up every time. Then you might be incurring obligations for numerous companies and be required to file tax returns for each and every new one. That could cause a major headache.

Q. What do I need to consider when incorporating?

A. First, you need to choose the right form of entity and state of incorporation. The main options to consider are a C corporation, S corporation or LLC. It boils down

to whether you're a typical Silicon Valley emerging growth company with a very clear path—in which case a Delaware C corporation is usually the right option—or whether you are something else.

Q. When should I start looking for outside investors?

A. It really depends on the industry. In the Bay Area, we see a lot of software startups. Over the years, it's become much cheaper to launch those products, so investors expect you to spend more of your own money developing your product. And many people have already launched and have gotten feedback from customers before they even seek outside funding. Investors always like that.

Q. I'm collaborating with several people. How do I structure ownership?

A. This is something that the people involved need to figure out based on what they are putting on the table. The contributions of each founder need to be taken into account. For example, who brings in the intellectual property, the money—either directly or through relationships—and who puts in the time? The groups that are most successful are those that have already worked together and have confidence in the roles assigned to one another. And don't forget that shares issued to the founders at inception – we call that the “founders' round”—should be subject to vesting.

Q. How do I protect my ideas?

A. You need to start thinking about protecting your intellectual property very early on. In Silicon Valley, it helps to bounce ideas off of people. But if you want to protect a potential patent, you might need to keep your idea confidential (and share it under a Non-Disclosure Agreement only) until you at least file for a provisional patent. Then again, there aren't that many truly “original” ideas out there and patent protection may not be that meaningful for your product. It makes sense to talk through the costs and benefits of different approaches with your attorney early in the life of the startup.

Q. When do I need to start thinking about taxes?

A. In many cases, as soon as you finish your founders' round. As shares start vesting over time, each founder needs to file an 83(b) election with the IRS within 30 days of getting those shares. It can be very expensive for a founder to miss the 83(b) filing date—as time passes and the company arguably increases in value (whether or not there is a financing or liquidity event) the founder will owe taxes to the IRS as the stock vests.

Q. When should I start hiring employees?

A. It's always better if you are paying someone than not. If you have volunteers and they are not happy down the road, there might be wage claims with the state Labor Commissioner. You need to determine whether your team members would legally be classified as employees or contractors because there are mandatory employer contribution and withholding requirements that apply to employees.

Q. How do I make sure my employer doesn't claim that I've stolen their trade secrets?

A. Many entrepreneurs still have paying jobs and work on their startup at night and on weekends. Others have already left their old job. In both cases, we need to look at your employment agreements and make sure you are doing the right thing. If the product you are creating is not related to your employer's business, it may be OK as long as you work on it on your own time and with your own tools.

Q. What happens if someone says my product doesn't work and tries to sue me?

A. It's important to have the right disclaimers with respect to warranties and limitations of liability, and to present them in the right way. We can help you set those expectations correctly with your customers.

Q. I'm thinking about raising money through crowdfunding. Good idea?

A. There are three different types of crowdfunding. First, and with tools like Kickstarter, inventors are pre-selling their product and can get backers without selling stock, before the product is even launched. That's a good way to validate your idea, but it takes a lot of planning. The entrepreneurs who are most successful in crowdfunding already have a track record and social media followers, such as people who have already designed popular games. For someone who is designing their first game, it's going to be much harder.

The second kind of crowdfunding is done with the sale of securities to accredited angel investors through an online platform that satisfies applicable regulatory requirements.

This method of fundraising can be perfectly legitimate and, in many cases, can be a good option, but it is preferable to take funds from a small number of investors who you meet and get to know in person.

The third kind of crowdfunding, which is not yet legally permitted, is the sale of securities in small investment amounts to persons who are not accredited investors through a regulated online platform. In general, I am leery of this approach, because I think that having hundreds of small investors who don't know you and who may be very concerned about losing their investment could be a recipe for litigation. The SEC is working on final rules for this type of crowdfunding, but the proposed rules that have come out lead me to believe that this is not likely to be a viable option for most startups.

Q. How about Bitcoins? Can I accept those as investments?

A. Well, we could make that work if necessary, but there are a host of legal, tax and accounting issues to deal with that would not be trivial for a startup. So, I would stick to cash, unless there is a compelling reason to do otherwise. I note that in the 4th quarter of 2013, Coinbase—a leading Bitcoin exchange—raised \$25 million in venture capital and not a penny of that was in Bitcoins!

Q. What happens if my company doesn't make it?

A. The great thing about the California startup culture is that failure doesn't carry a stigma. It's almost a badge of honor. In fact, lots of investors don't want to invest in someone who hasn't failed at least once or even several times. Most start-ups fail and that's a reality. And that's why you want to bring in investors who have the same mindset and know that failure is a strong possibility.

Q. What about insurance?

A. It is probably premature for an unfunded startup to worry about insurance, but as soon as you close a reasonable-sized funding round, your investors will likely want the company to obtain directors' and officers' liability insurance as well as possibly key person insurance on the lives of the key founders.

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