2014 CALOBA IP Seminar: Start-up Legal Matters 101

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Starting a company demands a lot of hard work. Lots of surprises may be involved in this path; however, a lawsuit should not be one. To help entrepreneurs better prepared for their business adventures, on April 7th, 2014, CALOBA hosted a seminar entitled "Start-up Legal Matters 101." The event was held in the Mountain View office of Fenwick & West LLP, which jointly sponsored the event.

The panel examined how entrepreneurs understand key formation and management issues, minimize legal risks, collaborate and negotiate with investors, improve funding strategies, as well as protect their own business interests. The panel featured seasoned practitioners: Steven Levine (Partner at Fenwick and West LLP), Jessica Zhou (Former GC and VP Legal Affairs at Ubiquiti Networks, Inc.), Wei Zhou (CEO at Centrillion Biosciences, Inc.), Ruming (Catherine) Liu (Partner at MagStone Law LLP), and Derek Huoth (Associate at Fenwick and West LLP). Mr. Huoth also moderated the panel.

When should I incorporate?

Mr. Zhou advises that one should wait until the intention of financing is clear because you want to select the right format for the new company. The best practice would be to talk to a lawyer as soon as possible. This is especially true for someone that has co-founders in China. Ms. Liu emphasizes that one should try to avoid incorporating via online forms as a lot of issues are embedded in the incorporation process, which cannot be resolved by those online forms. For example, forming a company is not only a relationship between one and the government, but also a relationship between shareholders. How to identify the shareholders, how to define each relationship, and many other issues are crucial.

What are the different types of entities and which one should I choose?

Mr. Levine mentions that the most well-known forms are Corporations and Limited Liability Corporations (LLCs). Investors are familiar with Corporations, which include C Corporations and S Corporations. LLCs are tax efficient for owners but may not be ideal for setting up stock options. So, LLCs should be selected depending on the type of business. Ms. Zhou further adds

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that the employee pool needs to be identified for Corporations. Corporations are easy to attract funding from Venture Capital (VC) down the road, but one thing to keep in mind is that a double layer of tax structure is involved. Ms. Liu further adds that a lot of financing sources prefer using C Corporations. A lot of companies that went Initial Public Offerings (IPOs) are C Corporations, but LLCs have become popular in the U.S.

Where should I incorporate?

Within the U.S., Delaware is a well-known state for incorporating companies, as it is very business friendly and usually the incorporation turn-around is very quick. Another reason to choose Delaware is that the case law there is well established and provides good guidance. Delaware courts have a good and deep understanding of business issues. You do not save taxes by incorporating in Delaware. The reality is that if a company conducts business in another state outside Delaware, the company is subject to taxes and laws of both states. For example, California companies need common stock holder approval but Delaware only needs majority approval, then a company that conducts business in both California and Delaware needs to meet both requirements. In addition, Delaware Corporations cannot go IPO in China.

If there are a lot of cross-border transactions involved, you probably want to incorporate outside the U.S, but many corporations are still formed in the U.S. Lots of factors are combined, so you must think ahead.

Mr. Zhou stresses that some overseas investors are not keen on investing in U.S. companies. Those investors might only be interested in holding companies. The founders need to think carefully ahead because, if you start a U.S. company, it is very difficult and expensive to make the transition into a foreign company. Ms. Liu says that Cayman islands is popular among Chinese startups, mostly for the tax reasons. The companies often do that to avoid filing tax returns in the U.S..

Mr. Levine says that it may be expensive to set up an international tax structure and a lot of startups only prefer simple tax structures. Ms. Zhou stresses that one misconception is that you think you can avoid tax by incorporating in Cayman Islands. One common structure is to have a Delaware corporation that has holdings in an entity in Hong Kong, which has holdings in an entity in China. Mr. Zhou says that one cannot be all-around, so the best practice for an entrepreneur is to talk to a lawyer.

What is a good ownership structure?

Mr. Zhou says that one should keep the number of founders to a reasonable level, such as two or three. Each founder’s contribution can be different. When people fight internally, company is likely to fail, then it is longer is a legal issue. The percentage of shares in the beginning does not correlate that well with the percentage at the time of IPO. Ms. Zhou used Xiaomi as a different example. There are eight co-founders at Xiaomi. Things have not fallen apart since it was formed two and half years ago. Other companies might choose to use founding/founder team for some of the co-founders. Mr. Levine says that dividing all co-founders' shares evenly is often not a good idea. A company should be established with an honesty relative value such that everyone is incentivized. It is recommended that the equity be allocated prospectively not just retroactively.

How can founders be protected?

Founders should understand the goals behind financings, such as what would be acceptable to a VC. You want to avoid creating strange situations with VCs. Also, founders should hire their own lawyers. Investors' lawyers only represent investors' interests.

How much are legal costs?

It is rare for law firms to accept equity of companies as payments of legal fees. Ms. Liu says that initial consulting is usually free and incorporation is a separate charge. Incorporating in California costs a couple of thousand. Mr. Zhou says that law firms may accept deferred payments in return for a percentage in the company and uses Google as an example. Mr. Levine further adds that estimates of legal costs are usually based on the number of documents needed, the founder structures, or the stage of financing (e.g., series A, or seed financing).

How to transfer Intellectual Property (IP) rights?

Whether your IPs are protected in a jurisdiction would be one of your considerations, says Ms. Liu. Many tax and international law issues are implicated. For example, when you transfer your IP rights from the U.S. to China, import and export rules contracts need to be registered in the government. There is no compulsory license back to the U.S. Mr. Zhou mentions that when the IP rights held by a company are incorporated in Cayman Islands, then the California company needs to transfer IP rights via service agreements. When a California company creates IP rights, the Chinese company will be taxed. Fewer issues are involved when the transfer is from Cayman Islands to China. You should consult experts on these complicated issues.

What are IP considerations?

Ms. Zhou mentions that founders should keep a diary on the technology from day one. It is never too early to have dated written records on your technologies. Patents, trademarks, and domain names are usually the major IP considerations. It can become an annoyance for companies when threatened with IP infringement lawsuits. Many countries including the U.S. follow the first to file system. A company need to examine key markets or entry points. Provisional patent applications are good tools. Mr. Zhou comments that patent strategy is to prepare for a war as the disclosure in patent applications are public. In certain technology spaces, trade secrets may be a better alternative to protect your inventions. Non-Disclosure Agreements (NDAs) should be well crafted.

What are fund raising models?

Mr. Levine says that there are many different models, of which models based on convertible notes and notes are widely used. A company needs to understand its investor audiences. Is an investor an angel investor or VC? Outside the U.S., convertible notes may not be acceptable, so you need to understand your investors. At the seed stage, convertible notes that a holder can convert into common stocks or seed equities that allow investors to purchase preferred stocks are commonly used. The basic model in Silicon Valley is investors own preferred stocks whereas founders and employees own common stocks.