TRANSCRIPT

LegalMindsTV Exclusive Interview:

"Advising Entrepreneurs on Business Formation, Growth and Funding"

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To view the video of this interview, visit:
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Beforge we get started, please tell us about the focus of your practice.

The focus of my practice is working with venture capital funds and companies that are invested in by venture capital funds. That's principally where I am now. I've done about 20 IPOs in my time. Not that many IPOs anymore, it's just hard to make a practice based on that. But I've always represented technology companies and young companies, even the IPOs that I have done have been at NASDAQ, not New York Stock Exchange IPOs. So they are always on the smaller side. So I have a lot of experience representing young companies and I know how to help young companies grow. And I represent venture capital funds, because I've always done a lot of financing work. Even the IPOs that I did, some were representing the underwriters, so I've represented in investors all throughout my career.

At what point would you advise an entrepreneur to maintain the service of an attorney?

Generally, I recommend that entrepreneurs begin a relationship with an attorney as early as possible, because what I have found is that what an attorney can help an entrepreneur do is build a strong foundation for the entrepreneur's business.

What criteria should an entrepreneur use when they begin to consider engaging legal counsel?

First and foremost, your legal counsel is your partner, and the relationship is one that should be characterized by open communication, should be characterized by trust, should be characterized by rapport, because you're going to be working together a great deal. So, an entrepreneur should try to find someone that they feel they can work with, someone that they feel shares their vision for the business that they want to build.

There are a lot of smart lawyers out there. There’s not a dearth of smart lawyers in New York or any other place in this country, but the number of people that you will feel comfortable with is a subset of that. So, I think it's very important to find someone that you can work with, someone who shares your vision for the future of your business.

Generally the startups that I've spoken with have looked at engaging counsel when they started raising capital. What are some of the milestones at where you believe they should seriously look at engaging counsel?

I don't think an entrepreneur should wait until they’re at the fund-raising stage to engage counsel. I think they need to step back and build a strong foundation for their company, and part of that is building a legal foundation, because if you wait until you have a term sheet from a financial source to start to think about getting legal counsel, that can really upset your plans, because what will happen is the financial source is going to engage eminent counsel and that counsel is going to begin to ask a lot of questions and delve into the nature of the company that you have formed. If there are a lot of questions that get asked about how the entity was formed, how it was built, that’s going to number one, if the answers are not right, you're going to lose credibility as an entrepreneur with the financial source. And if the answers are not right, but the financial source is not turned off by the opportunity, it's then going to cause a big delay, because the financial source is going to ask you, as the entrepreneur, to step back and build up this enterprise in a way that they want to see it built. That takes a lot of time and you may, when you’re going out for financing, have not factored in that time into your business plan. You may have thought that you're going to get the financing that you need in three months, but if you have to go back at that point, and rebuild your organization, then your financing is going to take a lot longer and that may upset your plans. So it's best to have all your legal ducks in a row before you go out and look for the financial source that you need.

You referenced the entrepreneur's business plan. What do you think is the importance of having a business plan in terms of raising capital or for even broader goals?

The importance of a business plan is a question that I have posed when I've moderated panels on venture capital topics. It's something that I have learned over the last couple of years that my conception of the importance of the business plan was really not correct.

I always thought that the business plan was something that the venture capitalist or the angel was going to rely on, when they were making an investment in the entrepreneur's business. And after speaking with the VCs and with the angels and having them on my panels, it's absolutely not the case. They do not really find the business plan of any importance to them. They do their own research into the size of the market. They do their own research into who the competitors for the business are.

What they believe the business plan is important for is for the entrepreneur him or herself, that the entrepreneur in writing that business plan really learns more about their business than they knew before. By building a good business plan, they are now asking all the questions that they need to know to be able to present that business plan effectively when they do get a term sheet from a financial source, and it helps them while they're building that business plan find out more about the market and their competitors than they even really knew, that they thought they knew, because now they're very thoughtfully building that business plan, they're delving even deeper into their industry than they had previously.

The consensus of the venture capitalists that I know would tell you that the business plan is not for them, the business plan is for the entrepreneur.

Going back to the issue of raising capital, what doe you see the role of legal counsel and their firm in that process?

I believe the role of an attorney in helping an entrepreneur find capital is a multifaceted one. The way that I function with my clients is I will work with them on advising them on the structure of their business plan and their executive summary as they're building it. I'll give them advise on how I think these documents should be structured based on my experience with other clients as to what do the venture capitalists and the angels like to see in these kinds of documents and how they like to see them structured.

Then at the same time, I'm part of a large law firm, and we have a large private equity practice working with venture capital funds and working with technology companies that are seeking venture capital investment. And what we do as a firm is we share our information. We have many, many lists of venture capital funds either that we represent or that we have friends inside of, people that have invested in other clients of ours. Whether they're clients of ours or not, we have contacts at a lot of venture funds, and we do share those contacts. We have certain programs that we do at our firm to allow us as colleagues to know whose clients are looking for funding, the nature of those entrepreneur's businesses, and then we try to match them with venture capitalists and angels that we have relationships with. And we then do try to put our client's business plans, executive summaries in front of financial sources that we think are maybe interested in those particular businesses.

That's very important for the entrepreneur because I know that every venture capitalist out there will tell you, and I know they'll definitely try to review every business plan that is sent to them. I know they very honestly and in good faith do it. I think there is a difference in the way that they view and they'll even tell you this that a business plan that comes over the transom, so to speak, that is just sent in to their website by a potential entrepreneur who has gotten a hold of their website. When someone that the venture capitalist has done business with before sends them a business plan, that business plan gets a different kind of a hearing than a business plan that just gets sent in on the website unsolicited.

It's just a fact of life that when I send in a business plan to people that I know in the financial community, I will always get a call back. "Thank you, Peter. I'm going to look at that. I'll give you feedback." Now the feedback could be, "Thank you, Peter, it's not for us", or the feedback could be, "Thank you, Peter, it's not for us now, but we'd like to keep in touch with them. Can you set up a meeting or a conference call?", or it could be, "Thank you, Peter, it's not for us, but let me refer you to somebody else, because this might be up their ally." And that's a different kind of a hearing that that business plan is going to get than if it just went in unsolicited, they'll read it and then go, "thank you".

So far, you've talk mostly about venture capital. What are some of the other sources of financing entrepreneurs should consider?

In addition to venture capital financing, we advise our clients on other sources of financing for their businesses.

We do advise them on ways that they can bootstrap their business. Let's say, the client has a business that does not need as much money as a venture capitalist needs to deploy in an investment. So we advise them on friends and family rounds, we advise them on SBA loans, we might advise them on helping them to find a banker that might give them a good hearing. So that's one level.

Bootstrapping is not for everyone. There are lots of people that are not serial entrepreneurs and don't have the money they made on their last business that they can now invest in the current business, or they don't come from the kind of family where there is money that friends or family can supply. So, bootstrapping doesn't always work for everyone. And even with an SBA loan, there usually are personal guarantees that go along with the SBA loan. So again, if the entrepreneur doesn't have the personal resources to support a real guarantee for the amount of money that they need to get under the SBA loan, bootstrapping is not going to necessarily work.

So, then we will advise clients on angel financing or on venture capital financing. And they do run on different tracks only because angels will make investments at an earlier stage than venture capitalists typically will. There are some venture capital funds that do invest at the very early, at the seed stage. But that’s a smaller number. Angel investors, however, are willing to invest at seed stages, they're willing to invest before a prototype is built, they're willing to invest before there are any revenues generated by the business. We do have some connections with angels and we make the same kind of referrals to angel networks that we make to venture capitalists. And then, of course, if the company is at a stage at which it can qualify for venture capital financing, which is really the first institutional round of financing, then we can, of course, assist a client in that regard, as well.

What about debt as a source of financing?

There are times when we can advise an entrepreneur to take debt financing, but generally that's not going to be at a very early stage, because the company is pre-revenue at that stage, and there really isn't an ability to repay that indebtedness at this moment in time.

Now sometimes you can structure a debt instrument that all principal will accrue and will be paid along with the principal amount at a balloon period somewhere down the line two or three years, and if you can find a creditor who’s willing to do that, that's terrific. But, what we have found that is more successful with a young company that is willing to take in indebtedness and with creditors who are willing to give them a debt instrument, usually do that as a convertible debt. The way that we structure that usually is that the debt will be put in and the convertibility of that debt will be based upon certain milestones being hit. So that if the business is able to get an equity financing down the road at a particular level, we can then address the debt instrument as being convertible into that financing, at some discount to that financing usually, not too heavy of a discount, but at some discount.

What that allows the entrepreneur to do is it allows him or her to take in what is in essence an equity investment, but without dealing with the valuation discussion. When a company is at a very early stage, it's very difficult to place a value on that enterprise. And that's usually a pretty contentious discussion with the entrepreneur. But if you can structure something that allows the entrepreneur to take in a debt-like instrument without having the valuation discussion, you really benefited the entrepreneur and you've sped up the process of getting the money in that is necessary to allow the company to grow, so that they can get to the point in time which they can take in a more traditional equity investment. And many of the venture capitalists and the angels that I know are more than happy to look at companies that have been financed in that way.

How has the current state of the financial markets affected funding opportunities for entrepreneurs?

The current financial situation has had an impact on the venture capital world. Right now there's a dearth of exits, and exits are taking a longer period of time to obtain. What that means for the entrepreneur is that there is less money available right now to make in investments in entrepreneurial businesses and when there are investments that are being made in companies, what I found is that they're taking longer to make. Venture capitalists, even angels, are taking a longer period of time now to investigate the companies that they're investing in, because they want to make better bets, because the exits are not as readily available, and they don't necessarily have as much money to invest either. It's been the credit crunch.

As for the angel networks, the credit crunch has affected many angels in their own personal liquidity. There are some angels that are small funds, but typically the angel investor is an individual, while most individuals have had their liquidity affected. So, that's going to mean that there's going to be less money available and people are going to take a longer period of time to make their investments.

So the entrepreneur has to be able to bootstrap his company for a longer period of time now than in prior periods. That's what I'm seeing as a principle impact on young companies.

And another impact whoever is that because of the credit crunch that we've seen, a lot of venture capital funds that were going out for another fund to raise more money to deploy are having a harder time raising that money in this current environment.

Moving on from the topic of funding, perhaps you can talk a bit more about another legal area that's critical to many startups these days and that's the protection of their intellectual property.

The level of protection that an entrepreneur should apply to their intellectual property is dependent upon the value of that intellectual property to the enterprise. They're different because it's not inexpensive to protect your intellectual property. Then, there are also some types of intellectual property that are more difficult to protect. The typical form of intellectual property protection is patenting. It is not all types of intellectual property lend themselves to patents as the best source of protection. For example, software is particularly difficult to get a patent for. So if software and source code is the intellectual property that you want to protect, we will advise a client to go out and try to get a patent for their software. But typically we will advise entrepreneurs that have software as their intellectual property to try to protect it with confidentiality agreements, try to protect it as a trade secret, try to protect it by not making it available to the customer. And there are many ways that you can do that. But intellectual property, of course, is a building block of many entrepreneurial businesses.

But aside from the patenting, something that is very important, that all businesses can protect is the name and the identity of the company and the name and the identity of the products that that company has. Branding is very important, and we advise clients on branding routinely. We advise them about trademarking their names, trademarking their logos, and making certain that the name that they pick and the logo that they pick is something that is protectable. We always advise clients to do searches of the universe of company names and product names, so that they can be certain that before they invest a lot of capital and time into building up a brand that's based upon a particular name or particular logo that that name and logo are available to them and will also be a firm foundation again for growth of their business.

You mentioned earlier that building a strong foundation to the business in the early stage is critical to an entrepreneur's success. What are some of the legal business structures that start-ups should consider?

We do provide a lot of advice to entrepreneurs on the types of business structures that they should use. One thing that we do counsel entrepreneurs against is to operate their business as a sole proprietorship. Sole proprietorships are, I think, dangerous for entrepreneurs, because there is no entity that is between them and their customer, or them and the greater business world, so that if an entrepreneur is functioning through a sole proprietorship, then all the assets, the personal assets of that entrepreneur are on the line if something goes wrong with the business that the entrepreneur is operating.

So we typically advise entrepreneurs to set up an entity, a business organizational form through which they're going to operate their business, whether that's a limited liability company, or corporation, or an S corporation. The differences between those two forms are they're technical in nature, but all of them share a certain characteristics. The characteristics that they all share is a characteristic of limited liability, which means that when an entrepreneur functions through a corporation or through a limited liability company, the only thing that they have at risk is the amount of capital or the resources that they have invested in that entity and their own personal resources are not on the line at that time.

So, the protection of limited liability is very important, and that's one of the first things that we tell all entrepreneurs when they're starting a business.

The other thing that is different about corporations and limited liability companies is that typically a corporation, unless you elect the S corporation form -- and that has its own issues I don't think we'll go into that here -- but a corporation usually will be formed under statutes that have many, many restrictions on what you can do and how you can operate that business from a financial standpoint, from what you have to receive in order to issue additional equity interest in that company. For example, the kind of votes that you need to take internally in order to perform certain tasks or enter into certain transactions. So there are certain limits there whereas with a limited liability company, the sky is the limit. Those statutories were set up in such a way that they free the entrepreneur to create whatever structures they want within the framework of a limited liability company. So there is more leeway that the entrepreneur has in setting up the different kinds of things they want to see in the management of their entity, in the way that interests are transferred and who can become a participant in that entity. They're free in a limited liability company format.

And the one last thing that a corporation, unless it's an S corporation doesn't have for an entrepreneur that a limited liability company can have, is the aspect of pass through. A corporation is typically an entity that itself is taxed, so that the entity is going to pay a tax on its income and the only thing that could be passed down in the form of a distribution which for a corporation is a dividend that could be passed down to the equity owners of the corporation, is net of the amount of tax that has been levied against the net income or the income of the enterprise. With a limited liability company, you can elect to have a limited liability company function as a pass through vehicle, which means that the limited liability company itself is not taxed on its income. All the members, the equity owners of the limited liability company are going to get their allocation of that income to be taken into their own personal tax returns and they will pay their tax, but there won't be double taxation, there won't be tax on the income at the corporate level and then tax again on the income that is received by the members of the company. It's just going to be pass through, the income is passed through directly to the limited liability company members and they are only taxed one side on their own tax returns.

Obviously, tax issues are a signficant consideration when it comes to the company's legal structure. That said, what other kinds of professional advisors do you think are critical in the early stages of a company's growth?

In addition to seeking the best legal advise that they can find, we also advise entrepreneurs to seek the best professional advise that they can obtain in other areas as well. One of those areas is getting a very good accountant.

A good accountant can help the entrepreneur to structure the financial reporting that they provide to their financial sources. A good accountant can also help the entrepreneur anticipate liquidity crunches that might occur in their business as they operate it and they can help them anticipate when those liquidity crunches are going to develop and strategies, methods for dealing with those liquidity crunches. I think that's very important, and accountants provide a very important service to entrepreneurs. I always tell them to obtain an accountant at the very earlier stages.

I also advise entrepreneurs to get a good risk manager, which typically we'd refer to as an insurance broker, because every business has risks and the entrepreneur may not really know and be able to identify all the risks that that business may encounter as it grows. A good insurance broker understands and works with young companies as part of their practice, not just the same insurance broker that insures your car, gives you life insurance. It's going to be the person that you want to use to help you assess the risks and protect your company from risks. So a good risk manager is a very important advisor.

How important is it for entrepreneurs to set budgets for legal costs and how can they plan accordingly?

I know from my practice that in working with the young entrepreneurs that it's very important that you set expectations with entrepreneurs as to how much various things cost while you’re working for them providing legal service. Many times young entrepreneurs have never really dealt with a lawyer before. They don't know how the process of working with a lawyer works. They don't fully understand what the cost of good legal service is. So, you need to educate them, there needs to be full communication between the lawyer and the lawyer's client, and part of that communication does center around budgets.

Budgets are very important for the entrepreneur, because they have limited amounts of money and they need to factor in the legal services into the greater cost of the development of their business in accordance with their business plan. And if they are lucky enough to have angel financiers or venture capitalist, those guys are going to be very interested in setting budgets for the entrepreneurs. So the money that they invest in the enterprise is going to be spent in a way that they feel comfortable with and in a way that they’ve anticipated.

So the importance of setting budgets is to manage expectations with the entrepreneur. So they don't get ahead of themselves in terms of what they’re asking for and you can help them on what they really, really need. To find out what they really need and find out what they can afford and that's very important. At the same time, the lawyer can help in this regard, because the lawyer has a budget, he can set his own expectations as to how he staffs a matter, as to how much time he can actually spend or as to how he should be billing his client.

When you’re working with young, emerging businesses, you have to come up with some techniques that you might not be using with more established clients as to how you will be billing them, will you defer billing until certain times, will you give them discounted billing rates for certain periods of time, things like that. And counsel can work with companies to build a program that fits the needs and the resources of that particular company, so that everybody is satisfied.

I've seen many cases where entrepreneurs try to reduce legal costs by looking at templated documents, whether it's business formation forms, employment agreements, funding documents, or licensing agreements. Can those be an effective starting point that can help save costs down the road with their attorneys?

Sometimes I found in my practice that clients in trying to reduce their legal expenditures will try to go to online libraries and find documents in those libraries for business organization, for different license agreements, for different agreements that they might have with their employees and the like.

My advise to clients is to not go to those online libraries, because the law -- and what a good legal practitioner does for a client -- is not as much like a science as it is an art. There are lots of things that the client does not have experience with and they can pick up a form document and not understand what's best for their business, and what's best for the transaction that they’re trying to enter into. they might need something that is one off. Something that a good legal practitioner can craft for them that is special for their business, because that's what their transaction demands.

The things that you’re going to get from an online library are going to be middle of the road. It's not going to take cognizance of a lot of the nuances that may be part of the transaction that you want to enter into -- you don't have the background, you’re not a lawyer so you’re not going to understand what it is that you don't understand about the transaction and that can get you into trouble.

Then we get back into what we talked about earlier, which is there are things that would create a bad foundation for your business. If the contracts that you've used do not fully address the real needs of your business, that foundation is going to be shaky, and a shaky foundation will come back to haunt you later on.

Other than the example you just gave, what are some of the most common and avoidable mistakes entrepreneurs make?

Other than not using the best documents for the building of their businesses, I think one of the biggest mistakes that an entrepreneur can make is selecting the wrong partners. I'd like to say that you can't pick your relatives, but you can pick your business partners, and that is something that is a very, very important thing to do.

You need to pick someone to be your partner in your business that shares your vision for the company, again someone that you have rapport with and someone who is as committed to the business enterprise as you are.

Very frequently you'll see people come into a business and they'll all agree that's it's one for all and all for one and they're all going to take this business until the end. But that doesn't always happen. So one of the things that you should craft into the documents that you use around the organization of the business is what happens if one of the musketeers wants to leave before the building is built, before the business has gotten to the point at which that guy is not necessary anymore. And there are provisions that you can put into documents that you're not going to find in a lot of the form documents that will help you in that regard.

Something that I've used with some young entrepreneurial teams that I've represented is a vesting of the equity that the entrepreneurs get. So, once they've established what allocation of the total equity each one is going to get in the enterprise.

They then have to talk about what happens if somebody leaves, and what they don't always understand is that part of the way that they form their team is that they all do different things. One guy might be a code writer, one guy might be a much better business development person who is out there looking to make the deals that the company needs in order to grow, and one another guy is a great manager, and he can manage the entire entity. So, let's say there are three legs of a stool, and they got their relative equity percentages based upon the fact that they’re providing a leg of that stool, each one. If one of the legs of that stool falls out, well, they're going to need to replace that leg, and the way that a young company replaces that leg is not with cash, they don't have the cash, they can't pay a high salary to someone to come in and run that business. What they have is equity in that business. So, they’re going to have to give out a piece of the equity to the next person to pick up that leg of the stool. If they haven't made arrangements in the organizational documents to account for what happens if there’s an early departure, then someone who is early departing still will hold on to all the equity that they had. So let's say that person had a third of the equity, well, to bring in that same function, they may have to give away another third of the equity of that company, and that is going to be much more dilutive to the remaining partners, and the partner who left is going to keep a much greater piece of the entity than that person should have, and that's going to be something that is going to bite them later on if they haven't accounted for a vesting in of the equities. So if someone leaves early, they don't get to retain all the equity that they were originally granted.

And I think that’s something that is very important that entrepreneurs need to think about and that you’re not going to necessarily get out of a form document you get online.

On a final note, is there anything you think the entrepreneur needs to take away from

I think one very important things that every entrepreneur should know is to get the best professional advisors that you can at any time.

The other thing is when you have the professional advisor, communicate with that advisor. Tell them where you want your business to go, what's keeping you up at night. Because if you tell them those things, hopefully they can help you, and they can work with you to help you build a better business.

And the last thing is, be flexible and expect the unexpected. Really the entrepreneurial mission is something that does not have a set track to it. Things change. Things that you thought were going to happen tend not to happen or they don't happen as rapidly as you thought. It takes longer to get the financing that you need than you thought it would and your partners might not always be there with you and be as fully supportive as you thought they were going to be. So you have to be flexible and you have to expect the unexpected.