A counselor's dose of preventive medicine

When it comes to dealing with legal issues, prevention is better than cure, say David Redlick and Virginia Kapner.

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So you want to turn your research discovery or invention into a business: what should you do first? Write a business plan? Assemble the management team? Raise money? You know that there is a lot of "legal stuff" involved in starting a business, but you can do that later, right? Wrong. Unless you correctly address some of the legal issues at the start, you risk losing your idea, having your senior management defect, and not being able to raise capital. Fortunately, all of these issues can be addressed cost effectively in the early stages of a startup's life by using proper documentation and implementing the following four policies:

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- Ensure that you are the legal owner of the idea
- Select an appropriate corporate structure
- Protect all forms of intellectual property generated in house
- Make sure that your relationship with your employees gets off to a healthy start.

Start with a clean bill of health

If you have an idea that you want to commercialize, first make sure that you own it—other people involved in developing the idea might also feel that they have legal rights to it. Even if the idea came entirely through your own efforts, your former or current employer may legally own the idea and be able to bar others from commercializing it.

Employers often try to ensure ownership of their employees' ideas if they were conceived during business hours, were generated using company funds or equipment, or are related to the employer's business. If you have, or had, an agreement with your former or current employer that addresses the concept of an invention, or that includes confidentiality, nondisclosure, or noncompetition provisions, you should have a lawyer review it to ascertain whether the employer has any rights to the idea or can prevent you from pursuing it. Even without a specific agreement assigning all inventions to the employer, if an idea was conceived either during the course of employment or using the company's confidential information or other assets, the company may have certain rights to that idea.

However, should another person or entity have rights to the idea, do not abandon the venture before you have even begun. Often the other party will either (i) agree that they do not have any rights to the idea, (ii) assign their rights to you or the new company, or (iii) license their rights to the company. Academic institutions and medical centers generally have specific guidelines about the terms on which they will assign or license technology to organizations affiliated with staff or that arise out of the research that they have funded. If you identify issues surrounding ownership of the idea, these should be addressed promptly, because they will only become more expensive to resolve as your company brings value to the idea.

Building strong bones

One of the first decisions a scientist–entrepreneur needs to make when starting a new business is to decide on its legal status. Several different forms of entities are available, including partnerships, limited liability companies, and corporations, each with different tax (and other) advantages and disadvantages.

Choosing between the various options depends to a large extent on the nature of the business and its strategic plan. However, if

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you intend to build a business that will attract institutional investors, there is just one option—incorporation.

A corporation is a legal entity through which all business is conducted, and which is separate from its owners and shareholders. It is essential to conduct business through a corporation if you wish to obtain "limited liability"—this is when the corporation, rather than the shareholders, becomes liable for all the company's debts and obligations. However, be warned that if you do not strictly observe corporate formalities, the corporate "shield" may be pierced and you and other shareholders will become personally liable.

In the United States, a corporation is created under state law, and the laws within the specific state of incorporation govern the corporation's structure. For a local business operating in one state only, there may be advantages to incorporating in that state. However, many companies incorporate in the state of Delaware: Delaware has the largest body of corporate case law and, from the standpoint of management, has one of the United States' most sophisticated and flexible corporation statutes.

A business entity is incorporated under a corporate name. Before selecting a company name, you should look into the availability of that name and identify potential conflicts by searching state and federal trademark databases. At the state level, you should check with the secretary of state's office—both in the state of incorporation and in all other states where the company may have a physical presence—to see if the corporate name is available. States will generally allow a name to be reserved upon written request to the secretary of state. Conducting a trademark search will give you a preliminary indication of whether you could obtain a trademark on the name and will help ensure that the name will not infringe on other trademarks. Although it is not required, many companies also check the availability of the Internet domain name before selecting a name, because a company's web address is often an important asset for promoting and operating a business.

To incorporate, usually a founder is named sole incorporator and files the corporate charter with the secretary of state. Once a company is incorporated, corporate formalities must be observed. The corporation should keep comprehensive corporate and shareholder records and hold regular board meetings. The board must approve all equity issuances—typically issuances of stock and also stock options, which are rights to acquire stock in the future at a fixed price—and approve all major contracts. This is not just for good form: a clear record of the ownership of the company's equity is a prerequisite for a venture financing or public offering.

The founder then appoints a board of directors, which will thereafter be elected by the stockholders. Corporations are required to have a board of directors, which is responsible for overseeing the operations of the corporation on behalf of the stockholders. At the first board meeting, the directors authorize the company to begin conducting business by approving the election of officers, approving by-laws, and opening a company bank account.

The board elects the officers of the corporation, who are then responsible for the day-to-day management of the corporation. Although some states have specific guidelines on the number of directors, Delaware merely requires that a corporation have at least one director. Typically, the company's founders become the first board members, and the board is expanded when outside investors, such as a venture capitalist, insist on having a board seat (see page BE57). Founders may consider expanding the board earlier to bring in directors with relevant industry backgrounds, business experience, strategic contacts, or other attributes that complement the strength of the founders.

A company should choose its directors with care: the board exercises ultimate power over, and has ultimate responsibility for, the company. Life science companies often establish scientific or medical "advisory boards" to involve people with relevant industry expertise without giving them any direct control over the running of the corporation.

Taking stock

As part of the incorporation process, a founder must decide how many shares of stock to authorize. Shares of stock are units of the equity in a corporation, and are a measure of "ownership." The number of authorized shares in a company's corporate charter is the maximum number of shares that the company is permitted to issue. States charge a filing fee, and often franchise taxes, on the basis of the number of authorized shares. Although it is possible to change the number of authorized shares at a later date, it will require the payment of an additional filing fee to the state. Accordingly, a founder should establish the initial capital structure of the corporation that maximizes the flexibility of the company's future financing requirements, while minimizing filing fees and franchise taxes.

In general, a corporation authorizes the maximum number of shares available for the minimum filing fee, ensuring that the corporation has sufficient shares to cover initial issuances to the founders, key employees, and the first round of investors.

The board and shareholders can vote to change the number of authorized shares after incorporation. Because stock must be issued at a price at least equal to its par value (which is the stated value of the stock, not the market value), it is preferable to have a nominal par value, such as one cent. Startups should pay particular attention to complying with the applicable securities laws relating to the issue of stock, because failure to do so will create problems later.

Start-up companies may want to authorize a class of preferred stock in addition to common stock. Preferred stock is a unit of equity ownership in a company that entitles the holder to preferential treatment over the holders of common stock. Holders of preferred stock get paid before holders of common stock during either the liquidation or sale of the company. As a result, common stock is often valued at 10–85% of the value of the preferred stock.

A company's charter can authorize the board to designate the rights and preferences of that preferred stock in the future. This offers the company the flexibility to issue preferred stock to investors at a later date without the need for a stockholder vote. Investors often insist on investing in convertible preferred stock because it can get priority treatment during liquidation and have other governance and economic rights that are superior to those of the common stock.

Early-stage companies often wish to issue preferred stock to investors because, under US federal income tax law, the corporation can treat the price paid for preferred stock differently than the fair market price of the common stock. As a result, the company can grant stock options and issue shares of common stock to employees at a price that is lower than that of preferred stock without adverse accounting consequences. If a company issues stock to employees for a purchase price that is less than the fair market value, or stock options with an exercise price at less than the fair market value, the company will generally be required to make a compensation charge to its earnings that is equal to the difference between the purchase price or exercise price and the fair value on the date of grant. As the company matures, the value of the common stock and preferred stock become more comparable. For example, a very early-stage company with untested technology may sell shares of preferred stock to investors at $1.00 per share and grant stock options to employees for common stock at $0.10 per share. When the company has a product that is progressing well through clinical trials, the startup may

sell preferred stock at $5.00 per share and grant common stock options at $4.00.

The critical prescription

Developing and implementing an intellectual property strategy is one of the most important aspects of establishing a successful biotechnology company. Depending on the nature of the technology and the ideas, a company may protect its intellectual property through patents, trademarks, copyrights, or trade secrets.

However, bioentrepreneurs are often surprised to learn that under the patent law of "doctrine of employee invention," the patent rights to an invention belong to the employee and not the employer, even if the invention was conceived and developed by the employee during the course of his or her work with company materials. Similarly, under copyright law, the title to a work initially belongs to the individual author, not to the company employing the author, although the "work-for-hire" doctrine may deem the employer to be the author of a work under certain circumstances. A startup company should require that all employees and consultants sign an "assignment of inventions" agreement, obligating them to assign all rights to inventions developed during the course of their work or using company resources to the company.

An ounce of prevention is the cure when it comes to trade secrets. When deciding whether to enforce the protection of a company's information as a trade secret, a court will look at what precautions the company took to maintain the secrecy of that information. All employees, consultants, and other third parties who come into contact with the information should be made to sign a confidentiality agreement. The company should impose physical and electronic barriers preventing unauthorized access to the information: these may be as simple as locking the doors to a laboratory at night or password-protecting access to certain electronic databases. Startups should be particularly careful about disseminating business plans, especially to a potential investor or strategic partner who might later become a competitor.

How you deal with legal issues in the early stage of your company's development may have a significant influence on your ability to achieve your goals.

The corporation's lifeblood

Attracting and retaining key employees is often as critical to a startup's success as protecting its intellectual property. In their enthusiasm to assemble a talented management and scientific team, founders may unwittingly commit the company to more than it can deliver. By engaging in due diligence during the hiring process—using well-crafted offer letters and being judicious in the use of equity incentives—you can avoid many costly hiring mistakes.

Although there is no legal requirement to set out the terms of employment in writing, a carefully worded offer letter is a cost-effective document in which all companies should invest. An offer letter should set out the basic terms of employment, and state that the post is "at will" and can be terminated at any time, without notice or cause. The offer letter should notify the employee of agreements that must be signed as a condition of employment, such as confidentiality, assignment of inventions, non-solicitation, and non-competition agreements. US employers must complete and return an employment eligibility verification form for all employees, even US citizens. The offer letter should state that the prospective employee must provide acceptable proof of eligibility for work in the United States before they can begin work. Offer letters should require that the prospective employee confirm that his or her employment by the company will not violate any agreements with former employers or other parties. Under the principal of "tortious interference with contract," you could be sued by your employee's former employer if you caused your new employee to breach his or her non-competition agreement with a former employer.

Offer letters should avoid promises and predictions, in particular concerning continued future employment and equity compensation. An employer should never promise the employee a percentage interest in the company, because this could be misconstrued later. Rather, if compensation is to be part of the package offered, the letter should speak in absolute numbers about shares based on the company's capitalization at the time of offering. For example, a letter that states a person will receive the right to acquire 5,000 shares of common stock at a particular price and time subject to board approval is less likely to be misconstrued than a reference to receiving 5% of the stock in the company, which is unclear about when and how the 5% is measured (e.g., is it at the time the offer letter is written, or forever?).

Legal health checkup

- Do you have legal rights to your idea?
- Could others claim to have rights too?
- Have you incorporated your company and decided on a name?
- Have you checked for clashes of this name with others registered as company names, trademarks. and internet domains?
- Are you holding regular board meetings and keeping minutes, records of share issuances, and contracts?
- Have you decided on how many shares to authorize?
- Have you implemented an intellectual property strategy?
- Is the company making an effort to protect trade secrets?
- Do you provide a well-crafted offer letter to potential employees clearly managing expectations?
- Have you ensured that new employees have signed over rights to inventions to your company?
- Have all new employees signed confidentiality, non-solicitation, and non-competition agreements?

Preparing for growth

To succeed, a biotechnology company must be able to commercialize its intellectual property, attract and motivate management talent, and raise capital. How you deal with legal issues in the early stage of your company's development may have a significant influence on your ability to achieve these goals. The simple steps discussed above (and see, "Legal health checkup") will help establish an efficient and effective corporate structure, protect your company's intellectual property, and position the company to be attractive to outside investors. In doing so, you can prepare your company for its next stage of growth.

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