In this very last section, we're going to talk about thing two of what every entrepreneur should know about legal issues.

Clint: When you're at the early stages of the company and you're raising that round of money, are there some investors that are better than others from a legal point of view?

Brad: There is a concept called an accredited investor. When you're starting out raising money, you want your investors to be under this definition of accredited investors. There are some exceptions to it as well but your fundamentally need to work with a lawyer to make sure that you do have most of your investors or all of them be accredited.

The dynamics are that accredited investors under the law are ones who have a certain net worth, have made a certain amount of investments or have a certain amount of income. It's the way that the SEC views as a way of protecting people from being essentially fleeced by investing and things that aren't valid.

This nothing of accredited investor is important to you as the entrepreneur because while you can raise money from non-accredited investors, they have certain types of rights that they can exercise if they don't like their investment.

The most significant one is a rescission right, or a right to say, "Hmm, I was just joking. I didn't mean to give you that money. I want it back now." In addition, in later rounds of financing or in acquisition, you can't have more than a certain number of non-accredited investors and in fact, some acquirers don't want you to have any because of the potential liabilities that track with them.

So make sure you understand the accredited investor rules and that you follow them.

Clint: Let's talk a little bit about 83B. What is it and when as an entrepreneur do I need to think about it.

Brad: So 83B election is a magical thing that you lawyer should do for you automatically but that you usually have do something too, sign or stick it in an envelope and lick the envelope and send it somewhere.

When you start a company, you get issued stock. As part of that issuance is stuck, you want to file what's called an 83B election. That 83B election locks in the basis for your stock or the cost of your stock. It means that you essentially only have to pay tax on the gain from that point.

Now the basis is often a very small number and the tax that you'll pay from that point forward is capital gains under the current tax law. In the absence of filing that 83B election, especially if your stock is vesting over a period of time, you run into situations where you have the value the stock at each vesting period and the amount of tax that you have to pay on the basis can vary significantly especially if the value of the stock has increased.

While it sounds like a relatively technically thing, it's very, very easy to solve. When you start your company and issue shares of stock, file an 83B election. Now, you only have 30 days to do this after you're issued your shares of stock.

A good attorney will do this but you'll be amazed at the number of times entrepreneurs don't file an 83B, either because they don't realize it's important or their attorneys don't realize it's important or make sure that they understand how important it is.

Clint: What's a 409A and when do I have to worry about it?

Brad: A 409A is effectively one of the many things that exist that are total employment guarantees for accountants. The notion of a 409A is that you have to do evaluation on your company in a certain way to value the common stock for purposes of issuing options.

If you go back to when we talked about options earlier, you grant options to your employees, to board members, to advisors, and these are options on shares of stock that could come out of your option pool for example, for all the employees that you're hiring after the financing.

Those options all have what's called a strike price. That strike price has to be either the fair market value of your common stock or a greater number. It used to be the case that your board could determine the fair market value of your common stock and they used their business judgment to determine that. About six or seven years ago, the SEC, FASB, the Financial Accounting Standards Board, decided, "We're going to do this a different way. We're going to have this thing called a 409A valuation" and there are a couple of different roles.

The safest way to do it is to have a third party (there are now scores of companies that exist to do 409A evaluations) come in, write a 50-80 page document, do a bunch of analyses and come up with a justification for your fair market value of those stock and stock options that you're issuing.

It's an annoying process. Fortunately, you have a one-year safe harbor. So as long as there aren't any crazy things that are going on in terms of transactions or additional financing, you only have to do this once a year. But every time that you have an additional financing or some kind of material change in the company, to be safe from an accounting perspective, you need to go through this 409A process.

In the context of acquisitions, this has become more important because of the reps and warrantees that is coming up more and more often is a rep around the 409A evaluation and the valuations for the fair market value of the common stock. So the buyers are basically saying, “It’s your responsibility to make sure you’re pricing your stock options correctly, not ours. Any liability that’s associated with that is yours.”

Clint: Let’s say I’m a startup company. I raised a modest amount of money. I’m not really crazy about paying someone else to do the 409A evaluation. Can I just do it myself?

Brad: You can but it’s a really bad idea for a variety of reasons. One is that you’ll probably get to a place, let’s assume success, where that early 409A evaluation will be deemed to be invalid. When it’s deemed to be invalid, you’ll have an accounting charge that rolls through the company and you might be in the position where you have to re-price those stock options that you’ve given off at that time.

The second reason it is a bad idea is that you’re really hurting the employee that you’re giving those stock options too because of the 409A is determined to be invalid or if it’s too low, the penalty is really a penalty that the employee pays, not the company pays.

It’s worthwhile spending a small amount of money and being diligent about this all the way through, notwithstanding that it’s a set of rules that are imposed on startups that don’t really add any value anywhere but good hygiene around it is valuable.