

10 Big Legal Mistakes Made by Start-Ups

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As lawyers and venture capitalists involved with start-ups, we have seen plenty of legal mistakes made by entrepreneurs and start-up companies. The following are some of the more common and problematic legal mistakes we have seen.

1. Not making the deal clear with co-founders

You absolutely have to agree with your co-founders early on what the deal is among you. Not doing so can cause enormous problems later (see, for example, the Zuckerberg/Winklevoss Facebook litigation). In a way, think of the founder agreement as a form of “pre-nuptial agreement.” Here are the key deal terms you need to address in some kind of written founder agreement:

- Who gets what percentage of the company?
- Is the percentage ownership subject to vesting based on continued participation in the business?
- What are the roles and responsibilities of the founders?
- If one founder leaves, does the company or the other founder have the right to buy back that founder’s shares? At what price?
- How much time commitment to the business is expected of each founder?
- What salaries (if any), are the founders entitled to? How can that be changed?
- How are key decisions and day-to-day decisions of the business to be made? (majority vote, unanimous vote, or certain decisions solely in the hands of the CEO?)
- Under what circumstances can a founder be removed as an employee of the business (usually, this would be a Board decision)?
- What assets or cash into the business does each founder contribute or invest?
- How will a sale of the business be decided?
- What happens if one founder isn’t living up to expectations under the founder agreement? How is it resolved?
- What is the overall goal and vision for the business?

2. Not starting the business as a corporation or LLC

One of the very first decisions that founders must make is in what legal form to operate the business, but founders often start a business without consulting a lawyer and, as a result, often incur higher taxes and become subject to significant liabilities that could have been avoided if the business was started as a corporation or as a limited liability company (“LLC”).

The types of business forms that are available to a start up business are as follows:

- **Sole Proprietorships.** Generally speaking, a sole proprietorship requires no legal documentation, fees and filings other than state and local business permits. On the other hand, there are disadvantages to operating in the form of a sole proprietorship: (1) it only has one owner and if additional capital is required from another investor, the form is not available and a partnership or other entity form is required and (2) a sole proprietorship provides no protection for the founder against creditors of the business (in other words, creditors can directly sue the founder) in contrast to corporations, LLC's where, generally speaking, the creditors of the business cannot successfully sue the founders and other investors. We don't recommend sole proprietorships.
- **General Partnerships.** If there is more than one founder, a general partnership is often chosen as the legal form of business entity. Preferably, the founders will agree on a partnership agreement to "set the rules" among the founders; however, if the founders do not agree on a partnership agreement, most (if not all) state laws will supply the rules in the absence of an agreement. The income of a partnership is taxed directly to the partners generally on a pro rata basis. Finally, each partner of a partnership is generally liable for the debts of the business and thus exposes the personal assets of each partner to the business' creditors. We don't recommend forming a general partnership.
- **C corporations.** These are formed under state law (usually of the state where the business will be first operated or in a state such as Delaware that is known for its well developed corporate law). Most venture capital backed companies are C corporations.
- **S corporations.** These are formed under state law like C corporations but have favorable tax treatment for closely held (not more than 100 shareholders) corporations under federal and state tax laws.
- **LLC's.** These are formed under state law and are a hybrid form of corporation and limited partnership and have certain tax advantages over C corporations.
- **Limited partnerships.** These are formed under state law and are often formed to hold investment real estate and also are often the "investment vehicle of choice" for private equity firms and hedge funds.

Corporations, LLC's and limited partnerships are formed by filing documents with appropriate state authorities. The costs for forming and operating these entities are often greater than for partnerships and sole proprietorships due to legal, tax and accounting issues. However, all of the entities generally offer significant advantages for founders (and subsequent investors) including, significant liability protection from business creditors, tax savings through deductions and other treatment only available to corporations and LLC's, and ease in raising capital in contrast to sole proprietorships and partnerships.

Sole proprietorships and partnerships can later convert to a C or S corporation, LLC, or other legal entity but keep in mind that the conversion costs can be significant.

3. Not coming up with a great standard form contract in favor of your company

Almost every company should have a standard form contract when dealing with customers or clients. But, there really isn't a "standard form contract," as every contract can be tailored to be more favorable to one side or the other. The key is to start with your form of contract, and hope the other side doesn't negotiate it much. Here are some key items to come up with your form of contract:

- Get sample contracts of what other people do in the industry. There is no need to re-invent a contract.
- Make sure you have an experienced business lawyer doing the drafting, one that already has good forms to start with.
- Make sure you make it look like a standard form pre-printed contract with typeface and font size.
- Don't make it so ridiculously long that the other side will throw up their hands when they see it.
- Make sure you have clearly spelled out pricing, when payment is due, and what penalties or interest is owed if payment isn't made.
- Try and minimize or negate any representations and warranties about the product or service.
- Include limitations on your liability if the product or service doesn't meet expectations.
- Include a "force majeure" clause relieving you from breach if unforeseen events occur.
- Include a clause on how disputes will be resolved. Our preference is for confidential binding arbitration in front of one arbitrator.

4. Not complying with securities laws when issuing stock to angels/family/friends

If the founders form a corporation, limited partnership or LLC, the sale of stock, limited partnership interests or LLC interests to the founders and later investors will be subject to federal and state securities laws. Most securities laws require that the sale of shares must comply with certain disclosure, filing and form requirements unless such sales are exempt. Failure to comply with such requirements can result in significant financial penalties for the founders and the start up company including requiring the start up company to repurchase all the shares at the original issuance price even if the company has lost most, if not all, of its money. Consequently, in order to avoid such fines, penalties, and repurchase requirements, founders must hire knowledgeable lawyers to document the sales of shares in compliance with such laws.

5. Lack of employment documentation

Business start-ups often encounter problems when they do not maintain adequate employment documentation. Consequently, start-ups should have prepared a core group of employment documents to be signed by most, if not all, employees. A starting list of employment documents for a new company would typically include the following:

- Stock Option documents (if a corporation has been formed), including a Stock Incentive Plan, Notice of Stock Option Grant and Option Agreement

- "At-Will" employment offer letters (signed by the company and the employee, acknowledging that the employee or employer could terminate employment "at-will")
- Confidential Information and Inventions Assignment Agreement (discussed below)
- Employee Handbook (setting forth company policies on vacation, conflicts of interest, internet usage, etc)
- USCIS Form I-9 (to document verification of the identity and employment authorization of each new employee)
- IRS Form W-4 (the employee's withholding allowance certificate)
- Benefit forms, for benefits available to employees and family members (e.g., health insurance, dental insurance, 401(k), etc.)

6. Not carefully considering intellectual property protection

If you have developed a unique product, technology, or service, you need to consider the appropriate steps to protect the intellectual property you have developed. Both the company's founders and its investors have a stake in ensuring that the company protects its intellectual property and avoids infringing the intellectual property rights of third parties. Here are some of the common protective measures undertaken by start-ups:

- **Patents.** Patents are the best protection you can get for a new product. A patent gives its inventor the right to prevent others from making, using or selling the patented subject matter described in words in the patent's claims. The key issues in determining whether you can get a patent are: (1) Only the concrete embodiment of an idea, formula and so on is patentable, (2) the invention must be new or novel, (3) the invention must not have been patented or described in a printed publication previously, and (4) the invention must have some useful purpose. You obtain a patent from the U.S. Patent and Trademark Office, and this process can take several years and be complicated. You typically need a patent lawyer to draw up the patent application for you.
- **Copyrights.** Copyrights cover original works of authorship, such as art, advertising copy, books, articles, music, movies, software, etc. A copyright gives the owner the exclusive right to make copies of the work and to prepare derivative works (such as sequels or revisions) based on the work.
- **Trademarks.** A trademark right protects the symbolic value of a word, name, symbol or device that the trademark owner used to identify or distinguish its good from those of others. Some well known trademarks include the Coca-Cola trademark, the American Express trademark, and the IBM trademark. You obtain rights to a trademark by actually using the mark in commerce. You don't need to register the mark to get rights to it, but federal registration does offer some advantages. You register a mark with the U.S. Patent and Trademark Office.
- **Service marks.** Service marks resemble trademarks, and are used to identify services.
- **Trade Secrets.** A trade secret right allows the owner of the right to take action against anyone who breaches an agreement or confidential relationship or who steals or uses other

improper means to obtain secret information. Trade secrets can range from computer programs to customer lists to the formula for Coca-Cola.

- **Confidentiality Agreements.** These are also referred to as Non-Disclosure Agreements or NDAs. The purpose of the agreement is to allow the holder of confidential information (such as a product or business idea) to share it with a third party. But then the third party is obligated to keep the information confidential and not use it whatsoever, unless allowed by the holder of the information. There are usually standard exceptions to the confidentiality obligations (such as if the information is already in the public domain).
- **Confidentiality and Assignment Agreement for Employees.** Every employee should be required to sign such an agreement. It accomplishes several purposes. First, it obligates the employee to keep confidential the proprietary information of the business, both during employment and after employment. Second, it ensures any inventions, ideas, products or services developed by the employee during the term of employment and related to the business belong to the company and not the employee.

7. Not taking into account important tax issues

When starting a business, there are some key tax issues to consider. Here are some of the most common issues:

- **Choice of legal entity.** There may be valid reasons to choose a flow through tax entity, such as an LLC or S corporation. Flow-through entities allow business losses to flow through to the shareholders to use on their individual tax return. But most venture capitalists and institutional investors prefer C corporations instead of flow-through entities
- **Sales tax.** The company needs to collect sales tax on sales of its products, because failure to do so can have disastrous consequences. This issue is compounded if the company is selling in multiple states.
- **Payroll tax.** Many cities and counties impose a payroll tax.
- **Section 83(b).** Founders and employees need to consider whether they can mitigate potential tax issues by an IRC Section 83(b) election. A Section 83(b) election relates to when someone receives stock or options subject to vesting and can minimize deemed taxable income to the recipient.
- **Stock option issues.** Companies often grant stock options to employees. If not done in compliance with IRS guidelines, such grants can result in adverse tax consequences to the company and/ or the employee.
- **Qualified Stock Business Stock.** Holders of stock in qualified small business corporations may be entitled to a reduced rate of tax on gain from the sale of “qualified small business stock” under IRC § 1202.

- **Tax Incentives.** Depending on the nature of the business, various tax incentives may be available, such as renewable energy tax credits and investment tax credits.

A good accountant or tax lawyer familiar with these issues can be a valuable partner.

8. Coming up with a name for the company that has trademark issues, domain name problems or other issues

When picking a company name, it's important to do some research to help you avoid trademark infringement or domain name problems. You may be infringing someone's trademark if your use of a mark is likely to cause confusion among customers as to the source of the goods or services. Here are some of the steps to that can avoid naming issues:

- Do a Google search on the name to see what other companies may be using the name.
- Do a search at the U.S. Patent and Trademark Office site (www.uspto.gov) for federal trademark registrations on your proposed name.
- Do a search of Secretary of State corporate or LLC records in the states where the company will do business to see if anyone is using a similar name.
- Do a search on GoDaddy.com or other name registrars to see if the domain name you want is available. If the ".com" domain name is taken, this is very problematic and a red flag.
- Make sure the name is distinctive and memorable.
- You might want to have your intellectual property lawyer do a professional trademark search.
- Don't make the name so limiting that you will have to change it later on as the business changes or expands.
- Come up with five names you like, and test market it with prospective employees, partners, investors and customers.
- Think about international implications of the name (you don't want to have a name that turns out to be embarrassing or negative in another language).
- Avoid unusual spellings of the name. This is likely to cause problems or confusion down the road (though some companies like Google or Yahoo have been successful with unusual names, such success is often the exception rather than the rule).

Think about a hiring naming expert, such as hiring Alexandra Watkins at www.eatmywords.com

9. Not having a good Terms of Use Agreement and Privacy Policy for your web site

A Terms of Use Agreement sets forth the terms and conditions for people using your Web site. Your Privacy Policy is a legal statement on your Web site setting forth what you will do with the personal data collected from users and customers of the site, and how such data may be used, sold or released to third parties

A good Terms of Use Agreement will cover the following:

- How the site can be used and limits on uses;

- Disclaimers on warranties;
- Limits on liability of the site owner and its employees, officers, affiliates and directors
- How disputes will be resolved (e.g., through confidential binding arbitration precluding class actions);
- Representations and warranties of the site user, and indemnification to the site owner;
- Rights to refunds and returns if products are sold; and
- Intellectual property rights (e.g., copyrights).

A good Privacy Policy will cover the following:

- What information the site collects;
- How the site uses the information collected;
- How the information may be shared or sold to third parties;
- How the site deals with children under 13;
- How the site may allow the user to access the site through third party services such as Facebook and Twitter;
- A description of the use of cookies and other technologies on the site;
- The steps taken by the site owner to protect confidentiality and security of the information collected; and
- How changes to the privacy policy may be effected.

Privacy policies shouldn't blindly be copied from other sites. There may be legitimate reasons to narrow the privacy granted and to lessen the potential liability of the site owner.

10. Not having the right legal counsel

In a misguided effort to save on expenses, start-up businesses often hire inexperienced legal counsel. Rather than spending the money necessary to hire competent legal counsel, founders will often hire lawyers who are friends, relatives or others who offer steep fee discounts. In doing so, the founders deny themselves the advice of experienced legal counsel who can help the founders avoid many legal problems. Founders should consider interviewing several lawyers or law firms and determine if the lawyers or the law firms have expertise in some, if not all, of the following legal areas:

- Corporation, commercial and securities law
- Contract law
- Employment law
- Intellectual property laws
- Real estate laws
- Tax laws
- Franchise laws

Although it is not necessary that the lawyer or law firm retained by the founder have experience in all of the foregoing areas because certain problems can be "farmed out" to different lawyers or firms, it is often best that the founders retain a firm that can handle some, if not many, of the

areas of expertise listed above so as to provide continuity between the founders and their lawyers.

There are a number of ways for a founder or start up business to locate competent legal counsel:

- Friends and business acquaintances
- State bar referral services
- Internet legal Web sites (e.g., Lawyers.com)