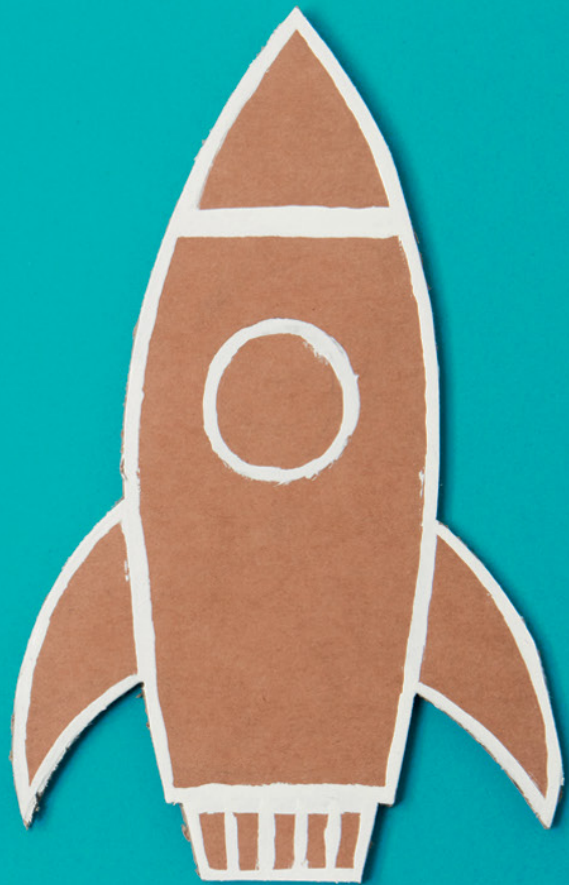


# 10 Legal Mistakes That Your Start-up Should Not Make







Start-ups have a lot to think about as they journey toward success. Legal issues are often low on the list of priorities, but a little bit of legal foresight can help prevent costly problems down the road. Following are some of the legal mistakes that can limit or jeopardize the ultimate success of a start-up.

By Tamara Fraizer and Leah Brownlee

## #1 Postponing Proper Legal Action and Advice

Many entrepreneurs are focused on their technology, product and/or service, and the business of selling it, and they postpone getting good legal help. They avoid speaking with a knowledgeable lawyer, assuming that they cannot afford to do that. They may instead take advantage of do-it-yourself legal products, including templates and exemplary forms, or copy documents they find on the internet. This bootstrapping approach may save money in the short term but can create insurmountable problems down the road.

Avoiding lawyers and using standard forms increases the chance that you will not address critical legal issues in a timely fashion. Do-it-yourself legal products address common situations, but may or may not work for a particular start-up's situation. An entrepreneur needs to first identify the legal issues that need to be addressed, and this will typically require an assessment by a knowledgeable lawyer. This should be done in a timely fashion because fixing mistakes is almost always more costly than avoiding them in the first place. Indeed, some mistakes – such as the failure to file for intellectual property (IP) rights in a timely fashion – cannot be fixed.

A smart entrepreneur will seek legal advice early, and then work collaboratively with knowledgeable lawyers to address potential issues. Most lawyers will provide an initial consultation for free and many will make special accommodations for start-ups, including doing work on a fixed fee basis or deferring all or part of the payment, usually in exchange for equity. By finding the right lawyer, negotiating payment and then working closely with that lawyer, an entrepreneur ensures a sound legal foundation for the venture.



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## #2 Making Legal Solutions Too Complicated

Legal solutions, even those that address hard problems, need not be complicated. Indeed, the more complicated the legal solution, the more problems may be created. For example, more complicated solutions may be harder to understand and implement, and, therefore, may be viewed by investors with skepticism. They may also be harder for a court to understand, and, therefore, run the risk of being construed contrary to intentions.

Instead of developing complicated legal documents, a smart entrepreneur will work to identify the critical legal issues and make good, informed decisions about legal options. “Issue-spotting” is the challenge and decision-making is what the smart entrepreneur must do. Ideally, the identified critical legal issues will be addressed wisely with timely execution of clear, simple and easy-to-understand legal documents.

## #3 Failing to Identify IP and Get Protection

Most entrepreneurs know that it is good to get a patent, if only to attract investors. But waiting to file a patent application can mean not getting a patent. This is because our patent laws have changed and, as of March 16, 2013, it is the first inventor to file for a patent that gets the patent – not the first person to make the invention, as it used to be. This, of course, only matters if more than one person has invented the same thing, but that often does happen and the chance that it will happen is greater the longer one waits. The smart entrepreneur will, therefore, file a patent application as early as possible.

More generally, the smart entrepreneur will consider all of the options for protecting IP and develop an overall IP strategy as early as possible. This is particularly important where a start-up is built around abstract ideas or naturally occurring processes, which may not be eligible for patenting. But for all entrepreneurs, developing a strategy for the complementary use of trademark, trade secret, copyright and patent protection can help ensure a competitive advantage in the marketplace. Doing so early helps ensure that trademarks, which generally go to the first to use them, are available, that trade secrets are not lost by disclosing them and that patents can be obtained.



## #4 Making Improper or Untimely Disclosure of Confidential Information or Personal Information

Entrepreneurs want to share the ideas behind their ventures. But untimely disclosures can forfeit rights. Importantly, public disclosure of an invention before filing a patent application forfeits the right to many foreign patents, and puts limits on the opportunity to seek a US patent. Similarly, disclosure of otherwise confidential information usually means it cannot be protected as a trade secret. In general, all important business and technical information should be designated as “confidential,” and all employees should understand that they have a duty to keep such information confidential. There should be no disclosure or use of such information outside the company without special consideration and protection, such as the use of non-disclosure or other agreements. The smart entrepreneur decides what is disclosed, when it is disclosed and to whom, and otherwise ensures that information is not disclosed or improperly used.

Moreover, certain personal information that a company collects from individuals, including patients and general consumers, may be protected by state, federal or international privacy laws; in particular, personal health information is protected under strict federal laws, including HIPAA. Increasingly, consumer-related information is protected by new strict and comprehensive state laws, such as the California Consumer Privacy Act, which came into effect on January 1 of this year. It is critical to understand and comply with such laws in handling health-related or other personal information, as failure to do so may result in fines and damage to a company’s reputation.

## #5 Not Having Proper IP Assignments or Rights

A famous politician once quipped, “Companies are people, too.” While companies are legal entities that can own property, including intellectual property, they do not usually create it in the first place. And by default, most rights to IP go to the creators. Such rights must be transferred or “assigned” to the start-up. A person may assign rights to IP that has yet to be developed, for example, by signing an employment agreement that includes such a provision. Use of such agreements is the best way to ensure that all IP developed by workers of a start-up is owned by the start-up. Alternatively, or in addition, IP can be assigned to the company on a case-by-case basis.

Failure to have IP rights assigned to the company can result in costly disputes over the rights to the IP. As just one example, a disgruntled inventor that retains his or her patent rights could give the start-up’s direct competitor a license to the patent, thereby destroying the value of those patent rights. The smart entrepreneur will ensure that all IP created for or on behalf of the start-up is assigned to the start-up.

## #6 Not Incorporating Early

Companies are legal entities that can own property, enter into agreements, and have debts and obligations. The creation of a company allows a founder to separate business dealings from personal dealings. In particular, creating a company, whether an LLC or corporation, insulates founders’ assets from the debts and liabilities of the business. By incorporating and issuing founders equity early, a founder can put a low value on founder’s shares and, thus, avoid potential personal tax bills associated with receiving equity worth more than nominal value. For at least these reasons, the smart entrepreneur will incorporate and will incorporate early.

## #7 Improper or Unwise Issuance of Equity

Entrepreneurs that incorporate will have equity ownership in the company that can be assigned to founders, employees, investors and others. Equity that is provided to employees should vest according to some specified period – so that employees are incentivized to continue working for the company and help earn their ownership. Equity can also be used to barter for services and funding at later stages in the development of the company. Smart entrepreneurs will ensure that they do not immediately assign all equity but, rather, use vesting periods and reservations of equity to allow for the growth and development of the company.

Smart entrepreneurs will also ensure that all assignments of shares comply with the federal and state securities laws. The basic rule is that all securities that are sold must be registered unless exempted from registration. Transactions involving directors and officers of the company are exempt. Transactions involving persons and companies of substantial means are generally exempt from the registration requirement. But transactions involving persons of limited means – e.g., family or friends – may not be exempt if not issued in the right manner. Failure to comply with the registration requirements may hinder a start-up’s ability to raise funding, since it allows purchasers to recover purchase price plus interest.



## #8 Lack of Proper Written Agreements

Entrepreneurs are busy people making lots of deals, and many of those are made – at least initially – with a handshake or over drinks. The smart entrepreneur puts important agreements in writing, ideally with input from a qualified lawyer.

Putting an agreement in writing is important for many reasons. Written agreements are good for business because they commemorate and set forth terms explicitly. They are not subject to the vagaries and inconsistencies of memory, and thereby help ensure that there is a mutual understanding of the terms of the agreement. They may also require more critical assessment than a conversation, and so may represent a more precise and stronger commitment. For the same reasons, they have more legal clout than an oral agreement.

Many entrepreneurs may think that they do not need written agreements because they are working with friends and they do not want to impose upon those relationships. But written agreements are not an insult to friendship or an affront to an informal partnership. Rather, they are a standard business practice, and one that may serve to protect a friendship. If someone is unwilling to put an agreement in writing and sign that agreement, you either do not have a friend or you do not have an agreement. In either case, asking for a written agreement is the best approach.

## #9 Non-compliance With Employment Laws

The smart entrepreneur complies with employment laws and knows that these laws may differ from city to city and state to state. Employees must be paid at least the minimum wage plus overtime, in cash, at least once a month. Certain roles are exempt from overtime requirements, including administrative and white collar positions. But employees can never work for deferred compensation or for equity only. Ideally, employees will sign an employment agreement or offer letter that identifies their wages, position and basic duties so that there is no dispute about what is due or what their role is.

The smart entrepreneur also understands that the use of contracts cannot be used to avoid the employment laws. Contractors are different from employees in substance, not just form, and the criteria are difficult to satisfy. In general, if a contractor position looks like that of an employee, or if company makes its money from what the contractor is doing, the contractor is really an employee and must be compensated like an employee.

## #10 Over-promising to Investors

Entrepreneurs are optimists – creative, highly motivated, energized and willing to believe what seems impossible. The smart entrepreneur is careful, though, to avoid making statements, projections or promises that are unreasonable and/or untrue. Optimistic views, aspirations and stretch goals should be explicitly characterized as such. Such statements may otherwise violate the anti-fraud provisions of state and federal securities laws, and can result in the loss of credibility with prospective investors. A smart entrepreneur should not assume that because an investor is seasoned that they understand which statements being made by the entrepreneur are aspirational and which are factual. Having a well-vetted business plan with solid projections and being honest about the risks your business faces is the best way to stay on track to success – and avoid legal problems.



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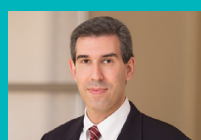
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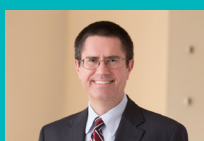
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