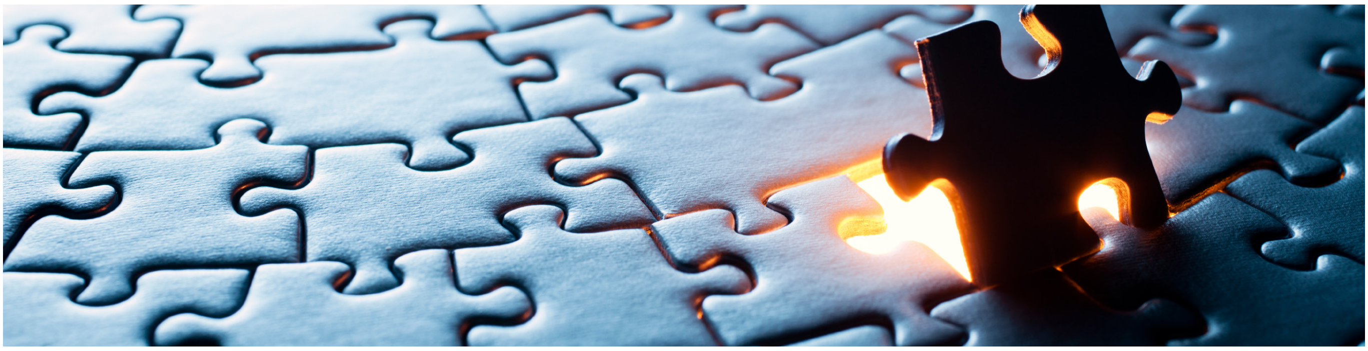
The Top 10 Legal Mistakes Made by Early-stage Companies

A "Field Guide" for Family Office Investors

Venture capital investment opportunities can be among the more intriguing features of the alternative investment landscape, combining the potential for outsized investment returns with the excitement of being part of game-changing scientific and technological innovation.

Increasingly, our global Family Office team finds our clients expanding their investment horizons to include venture- and early-stage companies. While these opportunities can present attractive options for investment and direct engagement in the growth and direction of a new enterprise or technology, venture- and early-stage companies fall prey to a number of legal pitfalls that are uniquely theirs. Here, we explore 10 of the most common legal mistakes made by venture- and early-stage companies – for family office investors considering venture capital investing, regard this a "field guide" that we hope will help you identify, and avoid, these common legal pitfalls that can impair, delay or jeopardize the ultimate success of an early-stage company.



1. Postponing Proper Legal Action and Advice

Many entrepreneurs, understandably, focus on their technology, products and services and the business of developing and commercializing them, and postpone getting appropriate legal support. They avoid speaking with a knowledgeable lawyer, assuming that their fledgling business cannot afford it. Instead, they may take advantage of do-it-yourself legal products or copy documents they find on the internet. This approach may save money in the short term, but it can create insurmountable problems down the road.

Avoiding lawyers and using standard forms increases the chance that entrepreneurs will not address critical legal issues in a timely fashion. Do-it-yourself legal products can address a number of common situations, but may or may not work for the particular set of facts that entrepreneurs face. An entrepreneur needs to first identify the legal issues 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, there are some mistakes, such as the failure to file for intellectual property rights in a timely fashion, that cannot be fixed. Be on the alert for do-it-yourself legal documents and "we haven't involved a lawyer yet" explanations.

2. Making Legal Solutions Too Complicated

Entrepreneurs are, by their nature, creative people. This can be a great attribute for product development and determining how to access markets to make their business successful. However, sometimes this creativity can lead to a start-up company adopting legal solutions that are too complicated, or at least not taking a well-traveled legal path when one is available. Legal solutions, even those that address complex problems, do not necessarily have to be complicated. We find that, especially with start-up companies, a complex legal solution can often lead to more problems than it solves. Complex 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 the parties' intentions. Instead of developing complicated legal documents, the key challenge is issue spotting, so that the company can identify critical legal issues and make good, informed decisions about its legal options – ideally with clear, simple and easy-to-understand legal documents. Seemingly undue complexity can mean something is being hidden, or it can just mean that extra time (and money) will be required to unscramble that egg.

3. Failing to Identify Intellectual Property and Protect It

Most entrepreneurs know the value of patent protection for their intellectual property (IP). However, obtaining patent protection can be an early-stage company's single largest legal expense – and for that reason, it is often deferred. But waiting to file a patent application can mean not getting a patent. This is because US patent laws have changed in recent years and it is now the first inventor to **file for** a patent that gets the patent – not the first person to **make** the invention, as used to be the rule. This timing can be critical if more than one person has invented the same thing, and that risk increases the longer one waits. If there is ostensibly patentable technology but applications have not been filed, ask why.

More generally, companies should consider all the options for protecting their intellectual property and develop an overall IP strategy as early as possible. This is particularly important where a start-up's business is built around an abstract idea or a naturally occurring process, which may not be eligible for patent protection. But every company can benefit from a strategy for the complementary use of trademark, trade secret, copyright and patent protection. Doing so early helps ensure that trademarks, which generally go to the first to use them, are available, that trade secrets are not lost through disclosure and that patents can be obtained. Find out what the company's overall IP strategy is, and how this suite of assets – often the only meaningful assets in an early-stage company – is being protected.

4. Making Improper or Untimely Disclosure of Confidential Information

Entrepreneurs want to share the ideas behind their ventures, but untimely disclosures can irrevocably forfeit rights. As one example, the public disclosure of an invention before a patent application is filed can forfeit many potential foreign patent rights, as well as limit the opportunity to seek a US patent. Similarly, disclosure of otherwise confidential information usually means that such information 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. In addition, there should be no disclosure of such information outside the company without special consideration and protection, such as the use of non-disclosure agreements. The smart entrepreneur decides what is disclosed, when it is disclosed and to whom, and otherwise ensures that information is not disclosed. Find out what discussions have been had, and with whom, and what those discussions have disclosed.

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 IP, they do not usually create it in the first place. And by default, under US law, most rights to the ownership of IP go to the creators of that IP, and such rights must be transferred or assigned to the company. A person may assign rights to IP that has yet to be developed, for example, by signing an employment or "work-for-hire" agreement that includes a blanket IP assignment. Use of such agreements is the best way to ensure that all IP developed by employees, consultants, contractors or advisors to a company is owned by the company. This fundamental issue – the ownership of the company's IP – is too often addressed carelessly, and that carelessness can create significant legal issues and erosion of investor value at the point in time when the company's technology becomes commercially viable.

6. Not Incorporating Early

Corporations and limited liability companies are legal entities that can own property, enter into agreements, and have debts and obligations. The creation of a legal entity allows the founders to separate business assets, liabilities and capital from their personal assets, liabilities and capital. In particular, creating an entity insulates the founders' assets from the debts and liabilities of the business, and can provide important clarity for investors looking to understand the scope of the assets and liabilities in which the investor will be participating. Make sure that the entity in which the investment is being made has been properly incorporated and is truly separate from the founders' other activities, assets and liabilities.

7. Improper or Unwise Issuance of Shares

The formation of a legal entity creates the opportunity to compensate founders, employees, investors and others with equity in the entity. Equity that is provided to employees should vest according to some specified period, so employees are incentivized to continue working for the entity and help create value for the equity – theirs, the founders' and the investors'. Carefully managed companies will take care to ensure that all issuances of equity are approved prior to issuance, correctly documented and comply with applicable securities laws. The basic rule is that all securities that are sold must be registered unless exempted from registration. Failure to comply with both state and federal registration requirements may delay future funding and can give rise to costly rescission rights and regulatory compliance costs. A company that has skipped or "short-handed" these technical requirements in connection with early capital raises has set itself up for costly compliance issues down the road – and for disputes with former employees, advisors, consultants and others arising from badly documented (or undocumented) "promises" of future equity participation.

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. In reviewing an early-stage company opportunity, be wary of placing reliance on informal arrangements and unwritten "contracts." Many entrepreneurs may think that they do not need written agreements because they are working with friends and do not want to impose upon those relationships. But, while unwritten agreements may be testaments to friendship or informal understandings, they are unreliable and create legal uncertainty for the start-up and its investors. We advise our early-stage clients that if someone is unwilling to put an agreement in writing and sign it, they either do not have a friend or do not have an agreement. Be skeptical of "handshake" deals and unwritten commitments, and do not hesitate to ask for written documents be put in place before you invest. After all, an entrepreneur needs a reason to get documentation in place, and getting an investment is a great one.

9. Non-compliance With Employment Laws

Early-stage companies can often have serious misconceptions about employment laws and may not know that the laws applicable to employees in one state could be different in another. As a general matter, employees must be paid at least the minimum wage plus overtime, in cash, at least once a month or more often, depending on state law. Certain roles are exempt from overtime requirements, including administrative and white-collar positions, which have a multifactor test to qualify. Employees cannot work for free, for deferred compensation or for stock only. Another frequent area of misinterpretation is the difference between an "employee" and a "contractor." Contractors are different from employees in substance, not just form, and the criteria can be difficult to satisfy. Employment-related liabilities and misclassification of employees are all too common, and can be costly, time-consuming and distracting.

10. Over-promising to Investors

Entrepreneurs are by nature optimists – creative, highly motivated, energized and willing to believe what seems impossible. Investors need to understand this orientation when approaching early-stage investment opportunities, and to recognize optimistic views, aspirations and "stretch goals" for what they are. Excessively optimistic business plans may not have been thoroughly vetted by professional advisors and can result in a loss of credibility with investors and disappointing results. Making sure that the business plan is solid and that the company's projections are understandable and based on reasonable assumptions is the first step on the path to success.

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