

Legal Landmines Every Startup Should Avoid

Legal issues are the last thing most founders want to think about when forming a new company. One of the biggest mistakes that startups and their founders often make is not involving counsel early in the life of the business to navigate a variety of difficult and sometimes complex legal obstacles, including company formation, equity grants, capital raising, intellectual property protection, securities laws compliance, and labor and employment law compliance. The following high-level summary (i) identifies many of these legal landmines, any of which can delay or complicate business operations, and/or negatively impact the company's ability to raise capital and, ultimately, its prospects, and (ii) suggests ways to help manage and mitigate the risks associated with those issues.

1. Failing to Form a Business Entity (Early)

Limit your personal liability. Form or incorporate a Limited Liability Corporation (LLC), Limited Partnership or Corporation. Generally, the entity's assets are on the hook liability-wise and investors' liability is limited to the amount invested.

Keep it simple. It is typically preferable to structure the business as a Delaware C-corporation for companies that plan to get venture capital funding.

2. Paying Too Little Attention to Corporate Formalities

Piercing the corporate veil. This legal doctrine applies when a plaintiff is allowed to look beyond the business entity to recover damages from the business's owners. Minimize such risk by adequately capitalizing the entity, ensuring that there is no co-mingling of personal and entity funds in a single bank account and conducting all business activities through the entity (e.g., the entity should be party to agreements).

3. Failing to Appropriately Address Equity

Properly approve and document all equity issuances and grants. All equity issuances and grants have to be approved by the board of directors (or equivalent) to be valid. All oral agreements need to be properly documented.

Create and maintain a capitalization table. Record ownership percentages among the founders and any other owners of the business.

Founders' stock and employee equity. Founders' stock is usually issued at a nominal price and subject to vesting (a repurchase right by the company that lapses over time). Companies that plan to offer stock options to employees need 409A valuations. A 409A valuation is an appraisal of the fair market value of a company's common stock that determines the exercise price for options. Granting options without a 409A valuation risks adverse tax consequences.

4. Failing to Raise Enough Capital

Comply with securities laws. All offers and sales of securities must be SEC registered or have valid exemptions from federal and state registration or qualification requirements. Consult with qualified securities counsel before issuing any securities to non-founders.

Do not fear dilution (too much). Raise as much capital as you can when you can. A company never went out of business due to dilution.

Fundraising is all-consuming. Raising capital distracts the founder(s)/management team from just focusing on growing the business.

Spend money wisely. Hire conservatively and purposefully. Consider equity compensation (with vesting). Keep in mind that things tend to cost twice as much and take twice as long as expected.

5. Failing to Protect Intellectual Property (IP)

Use IP assignments. Ensure that IP contributed by founders, employees, consultants, advisors, or any other service providers is owned by (or securely licensed to) the business.

Develop and implement a comprehensive IP strategy. An IP strategy should cover IP creation, acquisition, and protection, and should anticipate growth. IP includes utility patents, design patents, plant patents, trade secrets, trademarks and copyrights.

Use confidentiality & non-disclosure agreements. Before sharing or discussing the company's IP or confidential information with any third party, consider requesting that the third party execute a non-disclosure agreement.

6. Not Checking for Availability When Naming the Company and Products

Search for existing trademarks and tradenames. Selecting a company or product name should take into account existing trademark and tradename searches, which are relatively inexpensive to commission. Not all names can be trademarked (e.g., a name that is purely descriptive). Also, consider whether preferred domain names are available.

7. Not Having Key Documents from the Start

Put key documents in place. At a minimum, the following key documents should be in place at the beginning among founders and with any employee or service provider:

Among Founders:

- IP Assignment Agreements
- Key Corporate Documents

All Employees or Other Service Providers:

- Offer letter or employment agreement
- Properly drafted bonus and commission plans, if offering such incentive compensation
- Proprietary information and inventions assignment agreement, including protection for confidential and proprietary information and trade secrets of the business, plus any necessary restrictive covenants for employees
- Arbitration agreements or other alternative dispute resolution policies, if desired by the business
- Key employment policies, often in the form of an employee handbook or compliance manual
- Proper consulting, contractor, or advisor agreements for other service providers

8. Failing to Properly Classify Employees and Independent Contractors

Know the classification rules. Determine whether each service provider is classified as an employee or contractor. For employees, determine whether each individual is properly classified as exempt or non-exempt from overtime and is properly paid under state and federal law. Once the proper classification has been determined, all service providers must sign formal agreements assigning all IP rights to the company and agreeing to keep the company's IP confidential.

9. Misunderstanding the Scope of Restrictive Covenants

Know the scope of restrictive covenants and how they can impact the business. First and foremost, any business, especially startups, should be aware of, to the extent possible, restrictions on service providers the business intends to hire or may have employed, especially founders and key personnel. These restrictions can include, in addition to IP assignment, non-compete, non-solicitation, no-hire, non-interference, and related provisions. Ignoring these can potentially result in costly litigation and potential injunctive relief prohibiting the use of an employee, product sales, and distribution as well as disputes over lost profits.

10. Failing to Understand and Abide by Applicable Wage and Hour Rules

Understand the relevant wage and hour laws. Every business should ensure compliance with the wage and hour laws applicable in each city and state where the business maintains employees, regardless of the size and number of employees. Wage and hour laws govern a variety of compensation scenarios, including minimum wage, overtime, how bonuses and commissions must be handled, severance, layoffs, accrued vacation time, and other areas. Failure to understand these rules can result in class actions, wage and hour audits, tax audits, and a variety of other costly legal disputes, which can quickly drain company time and resources.

11. Indiscriminately Using Social Media

Be careful in the use of social media, especially in the hiring or termination of an employee. While informative, using social media during the hiring process may lead to failure to hire claims, as well as unintended harm based on learning that an employee is in a protected category. Similarly, when terminating an employee, use of social media may lead to a variety of other legal pitfalls, especially if posts and use of such social media by the employee is the reason or becomes one of the reasons for terminating the employee.

12. Assuming all States Have the Same Laws and Legal Standards

Before branching into other states, be sure you know the ground rules for doing business there, including on each of the issues in this summary. Importantly, there are multiple overlapping rules and regulations relating to business operations, which create many variations between state and federal government, between two states, and even between cities. Accordingly, do not assume, for example, that you can use forms or policies for Texas employees for employees in other states (or countries for that matter).

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