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Seven Legal Pitfalls Your Startup Should Avoid

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Fail fast is a catchy phrase intended to suggest moving on quickly if a business idea flops. It should not be taken as a license to recklessly trip over basic legal, regulatory, or fundraising principles. Far too many promising startups stumble or fail because of easily avoided mistakes in formation, governance, intellectual property (IP) protection, legal and regulatory compliance, and fundraising.

This article borrows a few key points and themes from my book *Startup Law and Fundraising for Entrepreneurs and Startup Advisors* (https://www.amazon.com/dp/0578236702) (https://www.amazon.com/dp/0578236702) to highlight seven common early-stage mistakes and pitfalls that derail promising startups. The book includes 51 colorful case studies on all the ways startups can be derailed. We briefly describe these common mistakes below.

1. Accidental Partnership

Entrepreneurs are frequently encouraged to bounce their business ideas off of a wide range of possible advisors and co-founders. This can be valuable when done with the protection of non-disclosure agreements (NDAs) and/or reasonably guarded sharing.

Nowadays, many entrepreneurship teachers and advisors are skeptical of NDAs. One recently suggested to me:

"… in my experience, many investors, teachers, advisors & others refuse to sign NDAs, which means the entrepreneur simply ends up talking to a lot fewer people about his/her idea."

There's some validity to this point. Knowing when to require an NDA and when not to requires common sense and good judgement. As one example, venture capital firms never sign NDAs. Asking a VC for one is a rookie mistake. A new entrepreneur also should not require an NDA from their entrepreneurship professor or other *trusted* friends and advisors, assuming actual trade secrets are not going to be shared.

Don't over-share

Where trust has not yet been established but an NDA would be inappropriate or unwelcome, founders should simply be guarded about what they share, i.e., to avoid "over-sharing." It is usually possible to share enough of an idea to gauge interest and solicit feedback on product-market fit, execution, or fundability without giving away the "secret sauce" regarding critical product features and details, core innovations, and go-to-market strategies. It is always perfectly acceptable to say something like, *"I need to be careful exactly how much I share with you to avoid losing our trade secrets or ability to file a patent application."*

In addition to the less likely possibility of IP theft like that depicted in the movie, *The Social Network*, when entrepreneurs bring others into their business model's development before an entity has been formed and without using NDAs, they risk forming a "general partnership" under state law, also called an "accidental partnership."

If you spend enough time hashing out your business plan, innovative ideas, and go-to-market strategy with others over beers or coffee, you risk losing ownership and control over your startup. Under a general partnership, each co-owner has an equal ownership interest and can control and bind the entity. Suddenly, the people you used as sounding boards can rightfully view themselves as co-founders. It is rare, but it happens.

Avoid creating accidental co-founders by selecting and forming an entity before engaging with others about a new business idea. The mere act of forming an entity avoids this concern. Then always use NDAs whenever possible. You can also bind others to an NDA in your personal capacity before forming an entity, but write into the NDA that you can assign all rights and obligations to a subsequently formed entity. But do not rely on NDAs as an excuse for delaying entity formation.

Founders agreements

Documents called Founders Agreements are another, more complex way of dealing with ownership and governance issues before forming an entity. Founders Agreements are common in academic R&D environments. They add a layer of cost, uncertainty, and complexity that I prefer to avoid when advising entrepreneurs, but here is a link to one from the University of Pennsylvania Law School that also includes helpful commentary and guidance: https://www.law.upenn.edu/clinic/entrepreneurship/startupkit/founders-agreement.pdf.

At all stages of development, founders can be savvy IP protectors while still following lean startup-type techniques and methodologies like iterative input-seeking and collaborative idea refinement. Form an entity quickly. Then use common sense and good judgment in assessing acceptable risks and rewards in discussing IP. And always protect key trade secrets and the ability to later seek patents for core innovations.

We consider IP issues again under *#3 - IP Snafus*.

2. Wrong Co-Founder or Relationship

The idea that you can pick the wrong co-founder presumes that one should have at least one or more co-founders. While some disagree with this premise, and there are exceptions to every rule, I believe it is safe to say that most investors prefer to see an organization with more than one founder. Single founders are a single point of failure should their interest or ability to continue with the enterprise cease, as sometimes happens. Single founders also provide a less robust foundation in breadth of expertise, competencies, experience, and connections.

In considering potential co-founders, it is critical to assess everyone's compatibility. There are numerous great articles(https://eiexchange.com/content/284-how-strategy-and-industry-should-shape-your-choi) and posts on this topic. Most advocate thoughtful discussions before committing to co-founder relationships. After signing an appropriate NDA, key topics should include:

- What are we building and how are we going to market?
- Who will have what roles, titles, and responsibilities?
- Who is working full time and who is working part time?
- Who is bringing what IP, expertise, competencies, experiences, and connections to the enterprise?
- How will ownership interests be allocated and structured?
- Can ownership interests be clawed back if a co-founder leaves or reduces their commitment in order to prevent "free riding?"
- Will the co-founders be required to contribute initial bootstrapping capital, and in what amounts and when?
- Will funds be raised from outside parties, and if so, in what amounts, at what intervals, and from what types of investors?
- Is this a high-growth startup to be flipped within a certain timeframe, or will it be more of a lifestyle company that provides the co-founders a long-term income?
- If an exit is envisioned, what is the timeframe and what are the likely possibilities?
- Related to exit possibilities, will a smaller, faster exit be the goal, or a much larger exit after a longer development and growth period?
- What about the company's culture and work environment: remote, casual, and less hierarchical, or more toward the in-office, structured, and traditional end of the spectrum?

Discussing these and related issues before co-founding a business is critical for avoiding co-founder disputes and other team "disharmony," which cause approximately 13% of all startup failures according to a well-known report by CB Insights from 2019, called "*The Top 20 Reasons Startups Fail*," found at this link: https://www.cbinsights.com/research/startup-failure-reasons-top/.

3. IP Snafus

Losing your IP to accidental co-founders, as already discussed, is a form of IP failure, but just one of many. Here are several other common IP mistakes to avoid:

Missing IP Assignments

IP assignment gaps are among the most common and most serious IP mistakes. Founders must always assign their relevant IP to their startups. This should occur as part of the transaction in which they receive their equity in the startup, often called their "founder stock." Every employee should also commit to assigning to the company all relevant IP developed or conceived during their employment. This is particularly important as to patentable inventions. In onboarding, startups should require every employee to sign a robust Offer Letter Agreement and a Proprietary Information and Inventions Agreement, commonly referred to as a PIIA.

Lastly, and perhaps most importantly, every consultant and independent contractor who will or might create IP for the startup must also agree to robust IP assignment provisions. These provisions must include "work made for hire" language to counteract the fact that the actual creator of any copyright-eligible work is its "author" under copyright law and hence its owner. Be careful about using California-based creators, though, as a little-known California law (CA Unemployment Insurance Code Section 686 (https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=UIC&sectionNum=686.)) converts any contractor signing "work made for hire" language into an employee.

Weak Trademarks

Do not pick a company name or product name that is unprotectable under trademark law or, worse yet, that others can successfully challenge as infringing a stronger, senior (earlier) "mark." Avoid "generic" or "descriptive" names like Best Shoes. Instead, choose "fanciful" or "arbitrary" names that nobody else is using, like Zillow, Google, or Expedia. Also avoid names that constitute actual words in any foreign language, as they might be unusable in countries where that language is spoken.

Copyright Infringement

Misappropriating copyrighted works or content is another common startup mistake. This usually involves borrowing pictures or content created by others. When those works have been registered with the U.S. Copyright Office, the copyright owners have strong claims for "statutory" damages, no matter how innocent, harmless, or flattering the borrower's intent. On the flipside, registering a startup's copyrighted works, whether software, graphic, video, or written content, is easy and inexpensive and provides strong rights to recourse when others infringe.

NDA Mistakes

NDA mistakes are extremely common. A big one is simply trusting too much in NDAs. Never share more with a third party than is necessary to accomplish your objectives in the particular discussion. Enforcing an NDA requires going to court and prevailing. This is no small task, and certainly a lot more expensive and distracting than simply not over-sharing. Other NDA mistakes include signing in the wrong name or capacity, not receiving back fully-signed NDAs after sending over your own signature, signing NDAs with loopholes like "residuals" language (anything I can remember I can steal), and signing NDAs that provide only temporary protection for trade secrets.

Regarding signing in the wrong name, a company CEO signed an NDA in his own name instead of as CEO of the company, shared the company's secrets with a competitor, and a court ruled those secrets had been irrevocably given to the competitor with no use or confidentiality restrictions. His intent was irrelevant.

Trade Secret Mistakes

A trade secret is any secret that has commercial value by virtue of being kept secret and that is also subject to "reasonable" protections to maintain its secrecy. Trade secrets are protected by state and federal statutes carrying both civil and criminal penalties.

Once secrecy is lost, by any means, trade secret protection is lost. Trade secret status is also lost simply by loose protection, such as not always requiring NDAs before sharing, failing to retrieve the laptops or other caches of trade secrets from departing employees, or even failing to contractually forbid reverse engineering in software licenses, product sales agreements, and end-user terms of use.

Startups should maintain a confidential trade secret inventory, restrict sharing internally and externally to a need-to-know basis, and consistently use strong NDA and employee exit processes to protect their trade secrets.

Failure to Protect Core Innovations

Under the America Invents Act of 2011 (AIA), the U.S. adopted a "first-to-file" patenting standard, abandoning its long-standing first-to-invent standard. This means a startup that invented something first can be prevented from practicing that invention by a company that subsequently obtains a patent for the same invention.

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In addition to not beating others to the patent office for a particular invention, startups also sometimes launch their products before filing patent applications. In the U.S., patent protection can still be sought for one year after launch or announcement, but in most other countries, patentability is lost immediately upon launch, announcement or other disclosure if an application has not been filed. This is because the invention is no longer deemed new or novel.

Startups should work on a comprehensive IP strategy right upfront to determine what will be protected through trademark, copyright, trade secret, or patent strategies. Early mistakes can be difficult to fix.

4. Wrong Entity-Type

While an accidental partnership is perhaps the worst entity mistake, simply forming an LLC when a corporation would have been the better choice is far more common. And even though it is possible to change from one entity-type to another, it is not as easy as sometimes described. If any amount of growth, development, and/or fundraising has occurred, an entity conversion will likely require costly help from both a lawyer and a tax advisor.

Virtually all high-growth startups that intend to bring in third-party investments and that intend to compensate employees with options or other equity awards should be formed as corporations.

There are many reasons for this, including cost, predictability, ability to attract third-party investment, ability to grant commonly-understood employee equity compensation and therefore reduce cash payroll costs, and ability to allow founders, employees, and investors to enjoy tax benefits available only to corporations. These include special tax provisions for incentive stock options, or "ISOs," and for Qualified Small Business Stock under Section 1202 of the Internal Revenue Code, which can eliminate up to $10 million in capital gains taxes (per taxpayer) for founders and early investors.

Some of these issues are too deep to go into here, but you can look up *tax treatment of ISOs* and *tax-free founders stock under Section 1202* and see that these are significant tax benefits available *only* to corporations and not to LLCs. Beyond these more complex issues, though, are some more obvious problems with forming high-growth startups as LLCs.

Cost and Complexity

Despite the deceptive ease of forming an LLC, properly forming one that will have multiple investors (owners) requires complex, expensive drafting. While templates are readily available for every document required to form and govern corporations, the same is not true for LLCs.

Every LLC, for example, should have an Operating Agreement, sometimes called a Company Agreement, or Company Operating Agreement. These are often about 35 pages and they are relatively complex. They are necessary to structure every aspect of the relationships among all of the owners and the entity. This is because, while corporations are largely creatures of statutes and court-made case law, LLCs are primarily contractual. Without a comprehensive and well-drafted Operating Agreement, highly counter-intuitive state law "default rules" kick in, potentially producing strange results, like giving every owner the same vote no matter what their respective investments.

More Disputes, Greater Uncertainty

Further, while modern corporation statutes have been around since the late 1800s, LLCs were invented in Wyoming in the 1970s. As a result, while corporate law is highly developed with rich case law addressing virtually every conceivable issue, there is almost no case law regarding LLCs. Two consequences of LLCs being largely contractual and so new are that (i) disputes seem more common and (ii) predicting how they will be resolved is much harder than for similar disputes in the corporate realm.

Smaller Pool of Potential Investors

The pool of potential investors for LLCs is smaller than for corporations. While many investors are put off by LLCs due to lack of familiarity, no venture capital fund (VC) can invest in an LLC. VCs invest in corporations, not LLCs.

This is because LLCs are "pass-through" entities for tax purposes, meaning all taxable income flows through to the investor-owners. But investors in VC funds, called limited partners, are often tax-exempt trusts and foundations that cannot receive what is called unrelated business taxable income, or "UBTI." So by forming an LLC, you would be eliminating all possible VC investment. That is, unless you create an even more elaborate structure involving "blocking corporations." But why?

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Severely Limited Equity Compensation Options

Unlike with corporations, it is extremely difficult and complex to issue equity compensation to employees of an LLC. In fact, as soon as you do, they become owners, and no longer employees, in the eyes of the IRS.

I can hardly count the number of times founders of LLCs have come to me asking for help in issuing stock options to their employees. It is NOT POSSIBLE to issue stock options to LLC employees, because LLCs do not issue stock. They issue something more complex: LLC Membership Units. In short, it is impossible to issue any kind of equity to employees of an LLC with any of the easily understood and administered attributes of stock options, restricted stock, or restricted stock units. If equity compensation for employees will be important, avoid forming an LLC.

When should founders form a startup as an LLC? An LLC is often the right choice for closely held lifestyle companies with little need for outside funding and no plans to issue employee equity compensation. Many small businesses fit this description. An often-cited advantage of LLCs is being able to net development-stage expenses (losses) against the founders' other taxable income. Again, all tax consequences, both positive and negative, flow through to all LLC owners, generally pro-rata to their ownership, and regardless of cash distributions. Flow-through tax losses can reduce a founder's other tax obligations.

LLCs are also the right structure if regular cash payments (distributions) to the owners are anticipated. This is not usually the case with high-growth startups, but it is always the case in lifestyle companies, where the idea is to provide income to the owners sufficient to support a desired lifestyle. Similar payments from a corporation (unless S Corp status is selected) trigger "double taxation," in that a corporation pays taxes on its net income and then corporate shareholders also pay taxes on any dividends from the corporation.

Asset sales can also trigger double taxation. This is one reason that all property-intensive businesses such as oil and gas enterprises, property development companies, malls, and storage unit facilities are conducted through partnership structures or LLCs.

LLC founders also have more latitude under the US tax code to unevenly allocate distributions and tax impacts among themselves, within certain "economic reality" constraints. Although this is not supposed to be done for tax avoidance purposes, that is often the reality behind such allocations.

Closely held family businesses are often LLCs for the reasons already described, but also to facilitate wealth management. LLC founders can reduce their taxes by issuing LLC ownership interests to specific family members in lower tax brackets and then use distributions to those family members to cover health, medical, school, and other expenses that the founder already intended to cover. A founder's overall tax burden is reduced by covering those expenses with LLC distributions to persons in lower tax brackets.

5. Entity Formation Errors

Even when founders choose the correct entity for their enterprise, entity formation errors are common and can cause big issues. The most common entity formation mistake with LLCs is failing to agree upon an Operating Agreement until weeks or months after formation. At that point, it is extremely difficult and sometimes impossible to negotiate fair ownership, governance, and economic allocations. State default rules can tip the negotiating advantage in favor of lessor contributors, as the default rules often give them more than would be fair. And even when Operating Agreements are executed simultaneously with the filing of the LLC Certificate of Formation, they are often deficient in numerous respects, owing to the sheer complexity of the issues that need to be addressed.

When forming corporations, founders frequently fail to appoint a board, appoint officers, issue themselves equity, and/or assign their relevant IP to the entity. Actions taken by persons holding themselves out incorrectly as officers, like signing contracts, can be challenged later as unauthorized, as can actions requiring board approval when no board existed.

There are a handful of things to do in forming any entity, and they should all happen as soon as possible. For corporations, once the secretary of state has confirmed the entity's existence, the "sole incorporator" should sign resolutions creating the board and adopting bylaws. The board should then appoint the company's officers so that their actions in signing leases, contracts, offer letters, and other documents are not subject to invalidation.

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6. Founder Equity Issuance Mistakes

Another week-one step in forming a corporation is for the board to approve the pre-negotiated sale of founders shares (common stock) to the founders. The purchase price is often a cash payment equal to par value for the shares in question, plus each founder's signed IP assignments. If each founder were to receive 3 million shares and the par value per share is $.00001, each founder would write a check for $30.00.

These shares should generally be subject to time-limited repurchase by the company if a founder walks away from the startup. This type of "reverse vesting" is known as a "clawback" right. It prevents "free riding" by less committed founders and limits "dead equity" on the cap table (table of shareholders). Substantial amounts of equity owned by persons no longer contributing to a company are called dead equity. Dead equity represents lost fundraising and recruitment capacity and can drive away third party investment.

Each founder with shares "subject to forfeiture" should promptly file a Form 83(b) with the IRS and pay any nominal taxes on the purchase, based on any difference between the par value purchase price and the actual value of the stock. Doing so prevents income taxes from being owed as the repurchase rights lapse and when the stock's value is likely to be higher. Issuing founders their stock immediately and filing Forms 83(b) also starts the five-year holding period under Section 1202 – the "tax-free founders stock rule" discussed earlier. Following this course minimizes employment taxes and possibly also capital gains taxes.

7. Employee Equity Granting Errors

Delayed Option Grants

Another prudent step to take soon after forming a corporation is for the board to approve an Equity Compensation Plan and approve any initial grants to key employees. Those grants might be stock options or restricted stock awards. As with founder equity, issuing grants to employees as early as possible and filing the correct paperwork can maximize the value of those grants and their power to help retain employees and keep them motivated.

On the other hand, waiting six or more months to issue key employee grants can result in much higher exercise prices, among other concerns. Negligently issuing equity grants much later than was promised in an Offer Letter Agreement or other document usually reduces their value and can result in tensions, disputes, and liabilities.

Inconsistent Equity Awards

Startups make lots of other types of employee equity compensation errors that are difficult to fix. These can be reduced through consistency and discipline. Decide what kind of grants will be made, usually either stock options or restricted stock grants, and be as consistent as possible in offering the same terms to all employees, changing only the grant sizes. This is because it is almost impossible for any startup to properly administer equity compensation grants that are anything but completely uniform. And even innocent mistakes can result in disputes and liabilities.

If the grants are stock options, make them all ISOs or NSOs (incentive stock options or non-qualified stock options). And stick with the same vesting schedules and post-termination exercise provisions. Vesting is most commonly pro-rata over four years, with no shares vesting the first year if the employee departs – i.e., a "one-year cliff." After an employee leaves, it is most common to have only 90 days to exercise their options or forfeit them back into the option pool.

Sticking to these standard, robust stock option terms incentivizes employees to stick around. It also causes more shares to remain in the pool for future grants and limits the number of persons who end up on the company's cap table by limiting the number of options exercised. Startup employees who depart rarely exercise the options within 90 days, as doing so requires writing a check for illiquid shares with uncertain value.

Once companies start granting special vesting and post-termination provisions to certain employees, it is more difficult to resist demands for similar concessions from other employees.

Lack of Restraint

Do not give away stock options like candy. Equity is not unlimited and should be treated as a highly precious commodity. Establish policies upfront regarding which levels of employees will receive equity and keep grants within predetermined ranges for multiple tiers of employees or compensation levels. Establish similar policies for subsequent "annual grants" for employees

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meeting and exceeding performance expectations.

Lastly, resist the temptation to issue equity to every advisor, mentor, independent contractor, and vendor that asks. If equity is granted to such persons, be sure to closely track and cut off vesting when their services end and make sure that unexercised options are forfeited back into the pool after the stated post-termination period. This can be difficult with advisors and consultants if their contract terms and obligations are unclear. These agreements should be terminable by the company at will and they should have outer term limits of one to two years unless renewed in writing.

409A Compliance

Another common startup mistake is issuing any stock option without first obtaining a Rule 409A Valuation Report. Options must be issued at fair market value. A valid 409A Report provides presumptive evidence that options issued at the per-share price reflected in the report were issued at fair market value. Failure to issue options at fair market value can result in draconian tax penalties for both the employees and the company, significantly wiping out the options' value. Do not issue any options without a current 409A Report. They are good for one year, absent material changes impacting the company's value. I generally avoid relying on 409As that are more than six months old, out of an abundance of caution.

Vesting and Post-Termination Mismanagement

Equity awards must be managed competently. This invariably requires using platforms like Carta, Shareworks, or their latest competitors.

But having a great equity compensation platform does not eliminate the need for competent administration by the company. Grants, vesting schedules, post-termination exercise periods, and employee terminations must be accurately and timely input. As noted earlier, tracking terminations can be difficult with advisors, consultants, and independent contractors, as the HR department is less likely to be involved. Vesting should be stopped and post-termination exercise periods should be triggered when third parties are no longer providing services. Doing this cleanly requires sending timely notices of termination to such persons.

If an employee or other "service provider" leaves, and their departure is not noted in the system, their options will not be timely forfeited and returned to the option pool. And worse yet, they might exercise their options beyond their post-termination exercise period, resulting in tax consequences and share issuances that must be unwound.

Summary

These are some of the more common early-stage errors I am asked to fix. Once a startup is launched and operating, new opportunities for legal, regulatory, and fundraising mistakes arise. I address those in a follow-up EIX article located here (https://eiexchange.com/content/more-Legal-pitfalls-that-startups-should-avoid) that picks up where we left off.

For much more on building any startup on a solid foundation, avoiding common legal and regulatory mistakes, and fundraising successfully and legally, check out *Startup Law and Fundraising for Entrepreneurs and Startup Advisors* (https://www.amazon.com/dp/0578236702) (https://www.amazon.com/dp/0578236702) .

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