Top Ten Legal Mistakes of Startup and Early-stage Companies

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CEOs of startup and early-stage companies have their hands full. There are too many things to do and too few hours in the day. While legal matters usually are not ignored, they rarely are treated as carefully as they should be. Here – not necessarily in order of importance – are the top ten legal mistakes that I have seen among startup and early-stage companies:

1 Failing to comply with corporate formalities

Although many businesses start as sole proprietorships, partnerships, or limited liability companies (LLCs), businesses that expect to seek significant outside funding usually are formed as corporations.

Prudent investors, as part of their due diligence, will examine the company's compliance with corporate formalities. Here are examples of some of the most important compliance obligations:

- Hold annual shareholder meetings and regular board meetings.
- Keep signed meeting minutes and other documents in a corporate records book.
- Properly document shareholder loans to or from the corporation.
- Keep corporate bank accounts and financial reports separate from the founders' bank accounts and financial reports.

2 Pretending that employees are independent contractors

Small companies usually need to conserve cash, so they often turn to independent contractors rather than employees. That way, the company avoids making unemployment and social security contributions and does not pay benefits such as health and life insurance, retirement plan contributions and personal time off.

There can be problems, however. If the individual really is doing the work of an employee, the Internal Revenue Service or the Employment Development Department might reclassify the individual as an employee, erasing the presumed financial benefits. Given the complexities of applicable laws and multiple government agencies, this is an area where CEOs should be extra careful.

3 Neglecting to provide and update an employee handbook

An employee handbook is a compilation of a company's policies, procedures and other important information. It supplements, and should be referenced in, employment agreements and offer letters.

The handbook tells employees what their rights and obligations are in such areas as pay and benefits, personal time off, personal use of company resources, and discipline and termination (discussed further below).

4 Failing to establish or adhere to discipline or termination procedures

While "at will" employment (either party can terminate the relationship at any time for any reason) is the norm, companies need to be careful when terminating employees, especially those who are in protected classes based on race, sex, age, etc.

Except in the most serious cases (such as criminal activities), where immediate termination is appropriate, the company should have a procedure for notifying the employee about the problem, giving the employee an opportunity to improve his or her performance, and terminating employment only if there is not sufficient improvement.

5 Failing to ensure that the company owns its intellectual property

Startup and early-stage companies typically use the services of both employees and independent contractors. In each case, it is essential toown any intellectual property (IP) that is created.

Agreements with employees and independent contractors need to provide for:

- Assignment of all rights (including IP rights) in work product to the company.

- An obligation to help the company perfect those rights.
- Confidentiality obligations.
- Protection against IP infringement claims by third parties.

6 Believing that "open source" means "no restrictions"

During the past several years, commercial acceptance of open source software has skyrocketed. As a result, many software developers are trying to figure out how to incorporate open source software into their business models.

Because open source software often is provided at no charge, some developers think they can do with it whatever they want – not recognizing that by incorporating open source into a company's product, under the applicable license agreement they may have made the company's product open source, too! Accordingly, any software developer needs to keep tight controls on whether, when and how open source software is used.

7 Thinking that all NDAs have the same terms

While companies' nondisclosure agreements (NDAs) tend to have similar provisions, there are differences – for example, in how confidential information is defined and how long confidentiality obligations last.

Another significant difference is the presence or absence of a "residuals" clause, which excludes from confidentiality obligations information that the recipient's personnel retain in their memories. This is disadvantageous to disclosers of information, who should try to remove such provisions.

8 Believeing that websites can unilaterally change their terms of use

Websites routinely present terms of use that the user must acknowledge and agree to. Frequently, the terms include a provision stating that the website owner can change the terms at any time and, by continuing to use the site, the user accepts the changes.

However, a 2007 decision of the U.S. Court of Appeals for the Ninth Circuit stated that website owners must do more if they want the changes to take effect for existing users: The user must be notified, and must have an opportunity to review the changed provisions, before they can take effect.

9 Using another company's standard-form agreement

Trying to save money, some CEOs use standard-form agreements from other companies – perhaps a former employer, or another company in the same industry.

This approach rarely is successful in the long run. Because no two companies are alike, a borrowed agreement usually is not a good fit for the company's business or legal needs. The likely results: Customer confusion, protracted negotiations, intense frustration, and delayed revenue recognition.

10 Giving "family jewels" to an overseas supplier

To keep costs under control, many companies use outsourced, and in some cases "offshored," services. However, CEOs should be aware of the risks of putting IP in the hands of overseas suppliers. For example, despite efforts to integrate with the world's economic and legal systems, China is notorious for not respecting IP rights. And while India's IP laws are well within the mainstream, a lawsuit to enforce those rights might last five or ten years before any remedy is available.

As a result, the most prudent approach is to send overseas only IP that your company can afford to have stolen. If you need an outsource supplier to create or use your "family jewels," choose a domestic supplier.

Any company that can avoid these problems is likely to be pointed in the right direction for legal matters to support, rather than defeat, business success.

The information in this article is not intended as legal advice and does not establish an attorney-client relationship. If you need legal advice on a matter, please contact an attorney directly.

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