Top Ten Legal Mistakes Made by Entrepreneurs

10. Failing to incorporate early enough. One problem that arises here is the so-called "forgotten founder": a partner involved in starting the venture subsequently drops out. When the venture gets financing or is ready to go public, this partner returns, perhaps with an inflated view of what his or her contribution was, demanding equity. This problem can be eliminated by incorporating early and issuing shares to the founders, subject to vesting. As partial consideration for their shares, each founder should be required to assign to the new corporation all inventions and works related to the company's proposed business.

Incorporating early, before significant value has been created and well in advance of any financing event that establishes an implicit value for the shares - also helps prevent potential tax problems for "cheap stock." Incorporating too late, and issuing inexpensive stock to the founders at the same time that much more expensive stock is being sold to investors, can create tax problems when the IRS argues that the difference in stock price is actually income to the entrepreneur.

9. Issuing founder shares without vesting. Simply put, vesting protects the members of the founding team who take the venture forward. If people remain on the team and are productive, their shares will vest. If they leave earlier, that stock can be retrieved and given to whoever is brought in to replace them.

8. Hiring a lawyer not experienced in dealing with entrepreneurs and venture capitalists.

Many venture capitalists say that they often rate the judgment of entrepreneurs by their choice of legal counsel. Lawyers who have no experience working with entrepreneurs and venture capitalists will most likely focus on the wrong things while failing to recognize some of the more subtle potential traps. It's better to hire someone who has played the game, who knows what's standard and what isn't, and who will get the deal negotiated and closed promptly.

7. Failing to make a timely Section 83 (b) election. If the advice in 9 is followed, then shares will be issued, subject to vesting, to the founders as well as new employees. If stock is acquired and it's subject to what the IRS calls a substantial risk of forfeiture, then the IRS doesn't view the purchase as being closed until that risk goes away. When the stock vests, that risk evaporates, so the IRS considers the deal closed. The IRS then calculates the difference between the price paid at the outset and the fair market value at that later date, then taxes this difference as ordinary income. An 83 (b) election allows the tax computation to be made based on the value at the time the shares are issued, which is often pennies per share.

6. Negotiating venture capital financing based solely on the valuation. Valuation is not the only thing one should consider when selecting a venture capitalist or when negotiating the deal. There are many other ways for venture capitalists to get compensated if they end up paying a high price for shares. These include requiring participating preferred with a high cumulative dividend, redemption rights exercisable after only several years, and ratchet anti-dilution protection with no cap.

One must ask, what's the reputation of this firm? Do they have a history of standing by the entrepreneur if the entrepreneur stumbles? Do they have good contacts in the industry? In trying to build alliances, do they know the big players? A no-name firm offering the highest valuation is often not the best source of equity.

5. Waiting to consider international intellectual property protection. Patents are granted on a country-by-country basis (with a single application available for the European Union). In the United States, if an invention is sold or made public, there's a year's grace period to file a patent application. Everywhere else, if the invention is sold or publicized prior to filing the patent application, the invention is unpatentable in that country. For example, if the invention is publicly disclosed to a Japanese national visiting a tradeshow in the United States, then under Japanese patent law, if no patent application has been filed, that disclosure makes the invention unpatentable in Japan. The same is true with trademarks. A tremendous amount of money might be spent in developing a brand in the United States, yet when the product is shipped overseas it could violate trademarks of companies dealing in similar goods outside the United States. One must make intelligent choices of where they think their markets are, and how much money to spend at an early stage in order to insure that the brand is available in those markets.

4. Disclosing inventions without a nondisclosure agreement, or before the patent application is filed. If patent protection hasn't been obtained, or in cases where a patent is not available, the only protection is to maintain something as a trade secret. To do so, one must show that they've taken reasonable steps to keep it secret from competitors.

Is it wise to get potential venture capitalists to sign a nondisclosure agreement? In the best of all worlds, yes, but most won't. Before disclosing to anyone, one must learn who has a reputation for integrity in the industry. In dealing with most people, it's wise to require them to sign nondisclosure agreements. It needn't be elaborate, but it should say that they acknowledge they may be exposed to trade secrets, and they agree not to use or disclose them without permission. Business plans should expressly state on the cover page that they are confidential and proprietary. That's not as strong as a nondisclosure agreement, but laws in some states suggest that if a person knows they have been exposed to a trade secret, they can't use it or disclose it without permission from the owner.

3. Starting a business while employed by a potential competitor, or hiring employees without first checking their agreements with the current employer and their knowledge of trade secrets. The law is clear that if someone is currently working for a company, particularly if her or she is a key employee, they cannot operate a competing business. Even just incorporating may spark a lawsuit from the current employer. Would-be entrepreneurs should first go to their current employer and either resign or tell them what they're doing and ask them if they'd be interested in investing. Amazingly, that's often a very smooth way of ending that relationship. Under no circumstances should they misrepresent the nature of the new business.

Even after leaving the current employer, one still cannot use or disclose the company's trade secrets. Under the so-called inevitable disclosure doctrine, if someone has been exposed to trade secrets at their job and leaves to work for someone else, and if their responsibilities in the new job are sufficiently similar, some courts will conclude that it's inevitable that they will use the information that they had from the earlier position. They could face an injunction prohibiting them from working for the new employer until a number of months go by and whatever trade secrets they had are stale.

It also helps to know whether potential recruits are subject to covenants not to compete. States vary in terms of how enforceable they are, but one shouldn't assume they are not. One should also check to see what assignments of inventions might have been signed. Personnel files should be reviewed, and recruits should check theirs, to be certain that a covenant not to compete or an assignment of inventions wasn't tucked into a signed non-disclosure agreement.

2. Promising more in the business plan than can be delivered and failing to comply with state and federal securities laws.

If someone promises to do something and knows that they can't perform that promise, that's considered fraud. In a business plan, one must make an honest appraisal of what's doable and set forth their assumptions, so the person putting up money can judge whether they are realistic. Can entrepreneurs be sued by their funders for fraud? Yes. Trying to squeeze out a little extra valuation by fudging the numbers erodes credibility, makes investors less trusting, and ultimately impairs the ability to get subsequent rounds of financing.

Finally, anyone selling stock or other securities must comply with both the federal and state securities laws by either registering the securities (rare for a start-up) or meeting all the requirements for an applicable exemption. Ignorance of the law is no excuse. As one judge put it in a decision upholding criminal convictions for violating the securities laws: "No one with half a brain can offer 'an opportunity to invest in our company' without knowing that there is a regulatory jungle out there."

1. Thinking any legal problems can be solved later.

There's a tendency to think, "Once I get my funding, once I'm up and running, then I've got time to hire the lawyers; right now, I'm running as fast as I can to get my business plan done and raising money." This is shortsighted logic. Many of the points made here are problems that can't just be patched up later. Does that mean that one should devote all of their time, effort, and money to the legal issues? No. That's a good reason to hire a competent lawyer. Excellent legal talent can be retained for relatively little money up front at the early stages. It will cost much less to get it right at the beginning than to try to sort it all out later and correct it.