



## **Come Out of the Gate Running: Avoid the common legal pitfalls for early stage companies**

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During the early stages of a company, it is natural for entrepreneurs to focus their attention on starting and growing the new venture (a.k.a., the fun stuff) by developing products, hiring employees, securing customers, and generating revenue. The many legal issues applicable to start-ups, on the other hand, can easily get put off as minutiae. Unfortunately, failing to understand (and avoid) the many legal pitfalls germane to start-up companies can mean the difference between your company's success and failure. At the very least, entrepreneurs should be mindful of the following legal issues that may (and likely will) arise:



### **Choose the Appropriate Corporate Entity**

Most entrepreneurs understand that to avoid putting their personal assets at risk with a new business venture, they must create a company through which the business will operate. To determine the ideal corporate entity for any new venture, entrepreneurs should understand the advantages and disadvantages of the many corporate entity options available, including C corporations, S corporations, limited liability companies and partnerships. Specifically, there are tax related factors (*i.e.* applicable tax rates, the elimination of "double taxation," pass through tax structures, etc.) and non-tax related factors (*i.e.* the nature of the business, the ownership and management structure, regulatory requirements, etc.) that will determine the ideal corporate entity for your new business. Because every business is unique, the type of corporate entity selected to operate each business should be made on a case-by-case basis with the immediate and future business goals in mind.

### **Maintain Good Corporate Records**

The process may seem tedious, but failing to keep proper corporate records can result in a number of problems for companies, and more significantly, may lead to significant liability for the companies' owners and management. It is important to ensure that your company's corporate records meet the legal requirements, including adequate minute books, stock certificates, stock transfer records, or other ownership documents, and compliance with all state reporting and filing requirements. Creating a checklist with calendared reminders can turn an easily forgettable corporate formality into a fairly painless exercise.

### **Avoid Operating Deadlocks**

Entrepreneurs should negotiate up-front to avoid corporate structures involving equal owners with equal voting power, even in situations with two initial partners. All partners may be on the same page initially, but inevitably the honeymoon will end, and legitimate disagreements will arise among the owners. Because a majority is generally required for corporate action, the company will be handcuffed by a 50-50 ownership structure and a corporate deadlock will result. To avoid this problem, owners should negotiate up-front to grant one party the power to make the final decision in the event of a disagreement, whether through voting stock ownership, board control or contractual rights.

## **Raise Funds Legally**

It is not uncommon for young companies to require some sort of capital infusion at an early stage. Entrepreneurs who can't (or choose not to) personally finance the company's early capital needs will turn to other financing sources, including third-party investors. As soon as even one share of stock is offered or sold to just one person, federal and state securities compliance issues are implicated. Even small private offerings to family and friends must comply with securities laws which prescribe a number of requirements, including the manner in which investors can be solicited, the contents of the solicitation documentation, and required regulatory filings. Violating these securities laws will not only jeopardize the offering, but can also result in civil and criminal liability for the company and its owners.

## **Protect Your Intellectual Property**

Even at an early stage, entrepreneurs should take the appropriate steps to protect their company's intellectual property, such as the company's new product, method of doing business, or proprietary customer list. Putting sufficient protections in place, including the following practices, will ensure the company both owns, and can protect, its valuable intellectual property assets:

- All employees and consultants who assist in the creation of the company's intellectual property should enter into an agreement assigning all of the intellectual property they create to the company.
- Third parties should not be permitted to use the company's intellectual property—whether it be inventions, creative content, software, etc.—without a license agreement in place.
- The company should implement steps to maintain confidentiality of its proprietary information, including requiring employees and other third parties to execute nondisclosure agreements.
- The company should consult a lawyer to determine the best filings and other available protections for the company's intellectual property through the use of patents, copyrights, trademarks and other proprietary protections.

## **Protect Your Brand Identifiers**

As a company grows, its brand identifiers (*i.e.*, its name, logos, or jingles that identify the company) can also become valuable assets. Incorporating these brand identifiers into its products at an early stage is vital for a company to distinguish its products and brand name from competitors. Although some protections are afforded even without registration, federal trademarks and copyrights are the best way to protect and enforce the company's rights to these brand identifiers. Purchasing a domain name will likely also be insufficient to protect the brand name, and instead, owners and management should consult with an attorney to determine what levels of protection are available.

## **Understand (and Read!) Your Contracts**

You may not be in the habit of reading every contract you sign—does anyone read the 65 pages of fine print in the iTunes terms of service?—but carrying this practice over into your business subjects your company to unnecessary risk. Because risk is allocated between contractual parties in every provision of an agreement, business owners should understand all of the terms and implications of their contracts, not just the basic business deal points. The provisions concerning representations and warranties, indemnities, governing law, and arbitration may be tiresome to read, but these provisions are not mere boilerplate, they are vital to protect your company and ensure that you receive all negotiated benefits.

## **Don't Go It Alone**

In spite of the potential upside of a business and the high-level business acumen of its owners, any up-and-coming company can get derailed by just one of a number of legal pitfalls facing start-ups. Legal counsel can be a valuable resource to navigate young companies and their owners through the issues. An effective lawyer not only understands the relevant legal issues, but, importantly, will understand your business and offer practical advice and recommended solutions. Your lawyer should help you spot (and avoid) these legal pitfalls so you can focus your expertise where it is best applied—on the success and growth of your business.