

Top Ten Legal Mistakes Made By Entrepreneurs

Presented to



TECH RANCH
AUSTIN

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“Understand the ways in which the law is a constraint, but also the ways in which it is a tool to help you create and capture value.”

--Constance Bagley, Harvard Business School

Failure to Incorporate Soon Enough

- Establishes vehicle with limited liability
- Specifies relationship among founders, including share ownership
- Creates “vehicle” to hold IP, business plan / ideas
- Provides impetus to organize
- **CONVERSE:** Incorporating too soon

Creating Tax Issues with Equity

- Blowing the 83(b) election
- Founders “cheap stock” when sold below “fair market value”
 - e.g., price sold to investors
- IRC §409A: Issuing “discounted” options
 - Result: Employee suffers additional 20% income tax, at the time of vesting
 - Company matching and withholding obligations and potential for lawsuits

Failure to Subject Founders Shares to Vesting

- Vesting protects those who take venture forward
- Regardless of the reason for the departure, someone must be compensated to replace the departed founder

Angel/Friends & Family Financings

- Sales to non-accredited investors
- Often overpriced
 - Creates barriers to future rounds
 - Dilution and disappointment
 - “Dumb money”
- Inadequate resources to continue to invest and “protect” prior investment
- Administrative hassles
 - Expensive to administer and may deter VCs
 - Complex Structures for small dollars

Failure to Adequately Protect IP

- Patents
 - U.S.: Filing required one year from “public disclosure” or sale
 - Rest of world: Filing required prior to public disclosure or sale
- Trademarks
 - Failure to protect valuable brand
 - Overinvesting in unprotected/unprotectable brand
- URLs, Facebook, Twitter, etc. accounts
- “Bootstrapping” with consulting services without adequate ownership of services/product delivered
- Copyrights: Must register CR before pursuing legal remedies against infringer. In the case of web software (e.g. iphone app), often costs less than \$1,000.

Failure to Seek or Receive Adequate NDAs

- Can lose patent/trade secret protection without NDA or other reasonable steps to protect
 - Watch out for termination dates, residuals, concurrent development clauses
 - Failure to police
 - Using inadequate or outdated forms
- Business plans and offering memorandums
 - At least include confidentiality statement
 - VCs will not sign – choose carefully before sending

Hiring Employees Without Regard to Prior Employer Agreements

- Non-competes, non-solicitation
- Trade secrets, inevitable disclosure
- Software code, open source
- Prior employer documents in possession
- No short cuts!

Inadequate Agreements with Employees and Contractors

- Employees
 - Documented offer letters
 - IP assignments, non-competes, non-solicits
- Contractors
 - Misclassification when acting as employee
 - IP assignments; restrictions on competition

Failure to Maintain Proper Documentation; Capitalization Errors

- Inadequate Capitalization Hygiene
 - Too many “promises”; too little documentation
 - Promising a %, especially when non-dilutable
 - convertible note should not convert into a % interest, but rather a number of shares based on share price formula
 - Failure to approve at Board level
 - “handshake” deals
- Inadequate Recordkeeping
 - Failing to maintain adequate organizational records
 - Failing to track agreements (e.g. NDAs)
- CONVERSE: Too many agreements

Fundraising Errors

- Seeking institutional capital too early
- Soliciting the wrong type of investor for the venture
- Choosing the “wrong” VC
- Selecting a “strategic” in the first round
- Must do your diligence on the investors

Choosing Wrong Attorney for Venture (or not using one)

- Expertise, experience, personality must be a match
- Relationships; understands terms, market, process
- Make the complex simple
 - Avoid doing too much, too early
 - Focus on right things, avoid subtle traps
- Pay me (a lot less) now, or (a lot more) later...
IF it can be fixed
- Not being involved in the legal process

Q&A

Thank you!



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Open discussion / Q&A



A Focus on Emerging Growth

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Matt Lyons is an Austin partner with Andrews Kurth, where he specializes in representing private and public emerging growth companies and entrepreneurial interests. He advises on all aspects of forming new businesses, raising capital, M&A, and securities laws & regulations. He also regularly counsels companies and their boards on corporate governance and executive compensation. Matt represents and maintains relationships with a number of prominent venture capital, private equity and investment banking firms.

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