BRAVERMAN LAW

7 COSTLY MISTAKES STARTUPS MUST AVOID

Launching a startup is an exciting but challenging endeavor. In the rush to get their business off the ground, many founders make critical mistakes that can lead to serious legal and financial consequences down the road.

Here are seven of the most common missteps startups must be aware of and avoid:

1. Failure to Form a Business Entity or Choosing the Wrong Business Entity

One of the first important decisions entrepreneurs face is to choose the right legal structure for their business. Many founders make the mistake of not incorporating their business and instead operate as a sole proprietorship (if there is only one founder) or a general partnership (if there are multiple founders). However, failing to incorporate your business exposes the owners to personal liability for all the debts and obligations of the business. Even worse, in the case of a general partnership, each partner could also be liable for the negligent conduct of any other partner. Hence, it is not advisable to operate as a sole proprietorship or a general partnership.

Once a decision is made to form a business entity, the next question is which type. A complete survey of all the various types is beyond the scope here, but two of the most common choices are limited liability companies (LLCs) and C-corporations, which differ primarily in their tax treatment. LLCs are (usually) taxed as partnerships, with the company's income and losses flowing through to the owners' individual tax returns. LLC members report their share of net income and pay tax at their personal rate, avoiding double taxation. However, LLC owners are subject to self-employment tax on their entire share of net income, and the LLC may need to file returns in multiple states if it has out-of-state members. C-corps, in contrast, are separately taxable, paying corporate income tax on net taxable income. Any dividends distributed to shareholders are then taxed again at the individual level. Almost all venture capital investments are made in C-corps because of fund-level restrictions on the investments.

It is best to make the correct entity choice at the beginning, as converting can be costly and time-consuming.

2. Lack of Clear Founder Agreements

Founders are often colleagues and friends, so putting agreements in writing may feel unnecessary or even distrustful. However, operating without clear, documented understandings between founders is a recipe for conflict.

Key terms to hammer out early on include:

- the equity split and vesting schedules
- roles and responsibilities, time commitments, and compensation
- decision-making procedures
- provisions for founder exits (for example, if a founder leaves, can the remaining founders buy back their shares, and at what price? What happens if a founder needs to be terminated as an employee?)

While these can be difficult conversations, memorializing founder agreements at the outset strengthens the foundation of the startup.

3. Inadequate Recordkeeping/Reporting

Maintaining meticulous records is a key ingredient for building a successful and sustainable business. While founders often focus on product development and customer acquisition, being attentive to recordkeeping can help avoid potential legal and financial complications down the line.

Take equity issuances. Failing to properly document stock options and keep the cap table current can cause major headaches when seeking funding or preparing for an acquisition. No investor or buyer wants to close a deal only to have an unexpected shareholder emerge demanding a payout. Poor recordkeeping can also fuel disputes between founders.

Another common foot fault is failing to keep track of regulatory requirements. For instance, the Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury, recently implemented new beneficial ownership reporting requirements that apply to most private companies, including startups. These regulations mandate that companies disclose information about their beneficial owners—the individuals who ultimately own or control the company—to FinCEN. Failing to comply with these evolving reporting obligations can result in severe penalties. To meet these requirements, startups must stay vigilant (or hire outside counsel that is).

4. Employment Law Violations

Even small startups with lean teams must navigate a thicket of complex and ever-changing employment laws. Two areas where founders frequently stumble are wage/hour compliance and employee terminations.

Many founders don't realize that they must pay hourly employees at least minimum wage plus overtime for any hours worked over 40 per week unless a specific exemption applies. At the same time, misclassifying employees as exempt to avoid overtime can also spur a lawsuit. In other words, it is important to get the classification right and to pay accordingly.

Another pitfall is improperly handling terminations. At-will employment doesn't give startups carte blanche—firings can't violate anti-discrimination laws or constitute retaliation. Having sound, well-documented processes around performance issues and terminations is vital.

5. Inadequate Employee Onboarding Documentation

In the rush to move quickly and get new hires up and running, founders may rely on casual, verbal agreements about compensation, duties and other matters. However, this lack of formal, written onboarding documents can lead to serious misunderstandings and legal liabilities down the road.

To prevent confusion and protect the company, companies should use carefully drafted offer letters for all employees, from entry-level hires to senior executives. These letters should clearly outline key employment terms, including:

- Job title, roles, and responsibilities
- Compensation, including salary, bonuses, and benefits
- Terms of incentive compensation, such as options or profits interests
- At-will employment status
- Confidentiality, non-disclosure, and invention assignment agreements
- Dispute resolution procedures, such as mandatory arbitration clauses
- References to employee handbooks or other company policies

For high-level hires like C-suite executives, founders should consider using even more detailed employment agreements that cover additional topics such as severance provisions, change of control clauses, and post-employment restrictions like non-solicitation clauses.

Having clear, comprehensive paperwork establishes expectations, mitigates legal risks, and forms the foundation for productive, long-lasting employment relationships.

6. Intellectual Property Missteps

For many companies, their intellectual property is their most valuable asset—the secret sauce that gives them a competitive edge. But too often, founders fail to take the necessary steps to properly secure and protect their company's IP rights. This leaves the door open for costly disputes.

One of the most critical steps is ensuring that all founders, employees, and contractors have signed ironclad invention assignment agreements. These contracts make clear that the company, not any individual, owns the rights to all IP assets developed for the business. Failing to obtain invention assignments is a common mistake that can allow rogue employees to walk away with crucial technology or claim ownership stakes.

Startups must also be proactive about identifying and protecting any patentable ideas. Consulting with experienced patent counsel early on is essential for developing a comprehensive IP strategy.

Trademarks are another key area of IP that startups often overlook. Conducting a trademark clearance search before settling on a company or product name can prevent expensive rebranding efforts down the road.

Startups should also use non-disclosure agreements (NDAs) and implement strict access controls to shield trade secrets from misappropriation.

In today's knowledge economy, founders cannot afford to be lax about securing IP rights.

7. Ignoring Securities Laws

Companies must navigate complex regulations when raising capital by selling securities. The general rule is that all securities offerings must be registered or qualify for an exemption from registration. This rule is implemented at the federal and state levels through a series of overlapping regulations.

Failure to comply with applicable securities law requirements can result in significant financial penalties, including giving investors the dreaded right of "recission"—the ability to require that the company repurchase all shares at their original issue price, regardless of the availability of funds. There can also be fines and other penalties (civil and criminal) imposed for failures to comply with the securities laws.

To mitigate these risks, founders should work closely with experienced securities counsel to choose the appropriate exemption, draft compliant offering documents, and ensure adherence to both federal and state requirements. Cutting corners when raising capital is never advisable—the short-term savings are rarely worth the long-term legal and financial fallout.

In our years of experience advising startups and businesses of all sizes, we have forged strong relationships with entrepreneurs and business owners and helped them avoid these common pitfalls.

Contact NY Startup Legal today to ensure your business steers clear of these mistakes, as well.

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