June 30, 2010

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Top Five Legal Mistakes Entrepreneurs Make

Many new entrepreneurs are very knowledgeable about their technology and their markets, but not so much about legal matters. Unfortunately, that means they may receive bad advice and take actions that will come back to haunt them months or years down the road and could potentially be fatal to their company. What follows is a list of five of the top mistakes entrepreneurs make, and how best to avoid them.

1. Choice of Entity.

For entrepreneurs who hope to receive outside capital, i.e. from an angel or venture capital group, incorporating as a C-corporation will typically be the best way to go. With limited exceptions, almost all venture capital funds and most angel funds will only invest in C-corporations for tax, cost and administrative reasons. Although double taxation is often cited as a reason for not organizing as a C-corporation, most new start-ups are not profitable early on, and in fact are likely to exit before they become significantly profitable, so these concerns are often not applicable.

To the extent you have already organized as a limited liability company or S-corporation, all is not lost as you can always convert to a C-corporation at a later time. Keep in mind however, that you will likely be padding your attorney's wallet during the conversion process.

2. Securities Laws Issues.

Many entrepreneurs, in their quest for capital, will first turn to their family and friends. Many will sell shares of the company's common stock or other securities without proper disclosure documents. Many more will sell those same securities by undertaking general advertising or solicitation. And still more will issue the company's securities to individuals who do not meet the definition of an "accredited investor." Each of these actions can have very severe consequences, which can include refunding investor's money (plus interest), fines, penalties and possible criminal sanctions (read time in jail). There are an abundance of securities laws out there and they do allow sales to friends and family, but you need to be well counseled to properly navigate them.

And while we are discussing securities laws issues, no, a private placement memorandum ("PPM") is not the answer to all of your problems. PPMs have their own place in issuing company securities but start-up company capital is typically not one of them.

3. Employment and Intellectual Property.

Many entrepreneurs begin working on their new idea or business while still employed by another company. Your bills still need to be paid, right? The problem with doing so however, is that unless you are very careful any intellectual property (ideas to be patented, logos to be trademarked, etc.) you create, may very well belong to your current paying-your-bills employer. Common employment-related agreements contain invention assignment clauses, which basically say, anything created by you, while working for us, with assistance from our stuff or on our time, belongs to us, whether or not it is related to our business. These agreements may also extend this obligation for a set period of time (i.e. six months) after you leave your employment with them. This is a very tricky issue and you should start by becoming familiar with what exactly you signed up for in your employment agreement – and then consult entrepreneur friendly (and experienced) counsel.

Entrepreneurs should also consider discussing potentially patentable ideas with legal counsel prior to publicly disclosing their ideas. A conversation with merely one person, who does not have an obligation to maintain secrecy (link to NDA article to be written) can be detrimental, including loss of all foreign patent rights and limited U.S. patent rights.

4. 83(b) Elections.

Founders of start-up companies will generally hold their founders' stock in the form of restricted stock, subject to vesting (if not initially subject to vesting, investors often require that at least some portion of the founder stock be made subject to vesting as a condition to the investment). Under certain tax laws, the vesting schedule will be treated as a substantial risk of forfeiture, which will prevent the shares of stock from being taxable to you when they are initially received. No taxes? What's the problem, right? Well, assuming your company is as successful as you believe it will be, by the time your shares are taxable (at the time they vest), they could be worth multiples of what they are currently worth. So you have effectively deferred a small amount of taxes now to pay a large amount of taxes later. Not such a great idea is it?

Fortunately, the Internal Revenue Service gives you thirty days, from the date any vesting restrictions are imposed on the stock, to file an 83(b) election. This election will allow (yes, I said allow) you to pay taxes on the stock at the time of its issuance: when it likely has very little value, for tax purposes. When the stock actually vests, you will not need to pay anything. An additional bonus is that you can start your capital gains period on the date the stock is issued, as opposed to the date the stock vests, giving you a jump start on the one-year holding period for capital gains treatment.

5. Trademark Registration.

While trademark registration is easier in comparison to applying for a patent, it is still by no means simple. Due diligence must be performed to determine if there is any possible conflict with another entity's trademark rights. Many entrepreneurs will attempt to save legal expenses by applying to register their own trademarks, which can be successful at times. However, it is often the case that complex legal responses are required when responding to communications from the U.S. Patent and Trademark Office.

In addition, incorrectly submitted trademark applications can result in loss of rights and the need to re-file, thereby losing your place in the trademark line of priority. Trademarks are often the most valuable assets of a company (See Google®, eBay®, etc.) and thereby require careful consideration.