Top 10 Legal Mistakes That Startups Make

(Except Yours, Now That You’re Here)
Who we help
Seed and early stage entrepreneurial ventures that have not yet raised significant amounts of outside capital

What we do
Legal advice and assistance in formation, intellectual property protection, commercialization strategies and operational issues

Who we are

*Student-Attorneys*
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*Supervising Attorneys*
Jeff Ward
Darrell Fruth
Mistake 1

“We Trust Each Other. We Don’t Need a Founders’ Agreement.”
Yes You Do.

1. Founders Are Happy
   - “Our Startup is great!”
   - “This is fun!”
   - “Let’s work really hard!”

2. Two Founders Disagree
   - “I thought I was CEO”
   - “You’re basically a janitor.”

3. Chaos Ensues
   - LAWSUIT
Benefits of Founders’ Agreements

Firm Commitment:
- Role in company
- Responsibilities and corresponding incentives

Clear Goals:
- Negotiation = Communication
- Literally write them out

Power and Process:
- How to vote
- Who pays what & when
- Special circumstances

Backup Plan:
- Noncompete
- Nondisclose/confidentiality
- Exit procedures
Mistake 2

“I’ve heard you should just keep all your tech under wraps.”
No! Be clear about technology transfer issues.

Student Tech
• Usually not a huge issue

Employee Tech
• Can be a bigger issue
Mistake 3

Accidental Partnerships & Sole Proprietorships
Don’t even *think* the word Partner.
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“But what if we never signed any contracts or wrote up any formal documents?”
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“But what if we’re just about to file our Articles of Incorporation? We’re basically a real business now.”
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Why is this bad?

Shared Profits

Unclear Terms
- *Partnership Agreement

100% Liability
How to Make Sure You’re Not a Partnership

Choose entity
- C Corporation
- S Corporation
- LLC
- Benefits Corp
- Cooperative
- Other variations

File Documents
- Articles of Incorporation
- Bylaws
Mistake 4

“LLCs Are the Only Way to Go.”
C Corporations

**PROS**
- Perpetual existence
- Easier to incentivize investment:
  - Well-known laws
  - Transferability easy

**CONS**
- Double taxation
- Expensive yearly filings
- Operational formalities
S Corporations

**PROS**
- Well-known laws
- Transferability easy
- NO double taxation
- Pass-through
- Split into reasonable compensation & investment income (excluded from taxable self-employment income, unlike LLC)

**CONS**
- Expensive yearly filings
- Operational formalities
- Single class of shares
- Proportional earnings
- US Resident/citizen
- Harder to get funding (compared to C Corps)
Limited Liability Companies (LLCs)

**PROS**
- Flexible
- Based on contract, not regulations
- Can insulate management from members
- NO double taxation

**CONS**
- Harder to incentivize investors
- Less transferability
- Less predictable (newer laws)
Nonprofit, Tax-Exempt Companies

**PROS**
- No taxes
- Donations from individuals or organizations
- Fiscal sponsorship options
- Labeled a nonprofit

**CONS**
- Additional reporting requirements
- Restrictions to remain qualified under 501(c)(3)
- No equity ownership of company
<table>
<thead>
<tr>
<th>PROS</th>
<th>CONS</th>
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<tr>
<td>• Operates as a corporation</td>
<td>• Additional reporting requirements</td>
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<tr>
<td>• Transferability easy</td>
<td>• Only available in 24 states</td>
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<td>• <em>Some</em> well known laws</td>
<td>• Investors sometimes turned off by fiduciary duty change</td>
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<td>• Insulated from investor pressures</td>
<td>• Additional shareholder right of action</td>
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<td>• Fiduciary duty includes social mission</td>
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B-Corp Certification

**PROS**

- Clear, recognized stamp to lend credibility
- No restrictions on type of entity
- In peer network with Patagonia, Ben & Jerry’s, New Belgium Brewing, etc.

**CONS**

- Expensive yearly fees ($500+)
- Rigorous evaluations every two years (4+ hrs)
- Potential audits every year (6-8 hrs)
Mistake 5

Permits, Licenses, and Certificates
Food Service

NC Department of Agriculture & Consumer Services

Food & Drug Protection Division

Food Branch

- Inspections
- Food product label reviews
- Licenses

Wholesale and retail frozen dessert manufacturers

Cheese and butter manufacturers

Milk haulers and testers

Automotive antifreezes
Tax-Exempt Nonprofits

Charitable Solicitation License
- File online form
- Register license online

Protects donors from fraudulent solicitation
Access to online registry
Mistake 6

“Nana’s Investment Isn’t a REAL Investment.”
Taking Money → Security → Registration

Taking Money → Security → Exemption
Avoiding registration

**Exemptions**
- 4(a)(2) Private Placement
- 506(b) or 506(c)
- Intrastate offering

**Alternatives**
- Grants
- Incubators
- Start-up Contests, Crowdfunding, etc.
Why worry about securities violations?
Even more headaches...

**Reporting Costs**

- Public disclosures to the SEC

**Tax**

- Shareholders could get hit with major taxes
“You’re an investor? Well let me tell you about this awesome trade secret we’ve got!”

Mistake 7
Common IP issues

- Ownership
- Use
- Liability / Lawsuits
Avoiding IP problems

Docs

Strategic Choices

Thorough Research
Mistake 8

“Let’s Name our Company... Google.”
Why does name choice matter?
Avoiding problems with names

- Choosing a Name: Brainstorm multiple flexible names
- Trademark and Copyright
- Thorough, diligent searches
Mistake 9

Policies and Standard Documents: “We’ll Just Wing It.”
The benefit is in the process

- Thorough discussions early on
- Readily available form docs
- Strong bargaining positions in the marketplace
Mistake 10

Do-It-Yourself Lawyering
What can lawyers add?

Savings

Focus

Experience
“Our business plan... is to be awesome.”
Yeah, that’s nothing.

Thorough

- Helps clarify goals & next steps

Ready to present to investors

- PowerPoint
- 10/20/30 Rule

You must know all of it
Questions?