

Checklist to avoid 4 major legal risks for startups

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As a corporate executive, I tried to bond with lawyers who were businesspeople first and foremost and not just ones trying to tell you why you cannot do something. However, over time, I learned that having a good legal mind attached to your project/business is critical for success. Why? Because a good business attorney is critical to manage the risks (and there always are risks) of the business.

If you remember the movie **The Social Network**, one of the original founders, Eduardo Saverin, did not pay attention to the terms of a contract he signed with Facebook's Mark Zuckerberg. That cost him dearly although I have a hard time feeling bad for someone worth in excess of \$5 Billion. It makes you think though that perhaps startups are different animals than normal businesses and perhaps the participants – the founders, employees and even the contractors – involved in a startup need to pay attention to several aspects of the business. By so doing, these participants can avoid the things that can go bump in the night.

I therefore, welcomed the opportunity to listen to Mark Skaist, co-chair of the corporate practice of Stradling Yocca Carlson & Rauth, one of the leading law firms in California, talk about the Legal Pitfalls in Entrepreneurship. And it is particularly relevant for me as a consultant to start-ups, a member of the boards of start-ups, a potential employee of a start-up, and as an angel investor with TechCoastAngels. I provide the following information as a convenience to the readers to be aware of these elements and strongly suggest that for legal advice see an attorney as they can help you avoid major issues. I took his talk and developed a simple checklist which can be used to ensure vital points are covered.

Mark laid out four areas that can create pitfalls. These areas are:

- Capitalization/Equity
- Taxes and financial obligations of company and executives
- Intellectual Property
- Employment

Checklist

1. Capitalization/Equity

- a. Have you documented all the equity transactions? Type? Class of stock? To Whom? Number of shares?
 - b. Have you sold to accredited or non-accredited investors? Were the rounds distinguishable?
 - c. For equity to the founders, have you adequately described voting rights, vesting terms?
 - d. Do you have a contract with the founders regarding performance, trade secrets, non-competes and similar items?
 - e. Do you have any “bad actors” as executives whose prior issues might result in a problem for future investors?
 - f. Do you have acceptable deal terms for original and successor investors, specifically issues relating to non-dilution rights (which could be a problem) so you don’t have an investor having leverage over the company?
 - g. Do you have convertible notes with a valuation cap (if so, make sure it’s not too low)? When is the maturity date? Is this date after the potential raise for the next round?
2. Taxes and financial obligation of company and executives
- a. How is the stock that is granted to the different shareholders and the executives valued? Will there be a tax liability based on the valuation of the company as reflected in the share price? Are they truly founders shares worth only a few cents or has a prior round, e.g. friends and family, been offered at a higher value per share which may create a financial obligation to the grantee of the stock?
 - b. Is the stock to be granted restricted stock or stock options and what type of options are they?
 - c. How is the company being valued? Have you or will you use a third party for valuation of the equity?
3. Intellectual Property
- a. Have all IP developed by the employees, founders and third parties been formally assigned to the company?
 - b. Have all the graphic designs, logos, domains, visual representations, iconography been assigned correctly to the company?
 - c. If the company is licensing IP, are the agreements to license been signed and reviewed by attorneys?
 - d. Is there a clear definition of trade secrets so there is no misunderstanding as to what constitutes a trade secret?
 - e. If an employee leaves the company, how are you protecting the company against loss of trade secrets? Are your internal procedures clear to safeguard trade secrets?
 - f. Are all trademarks registered to the company?
 - g. Are all domains, logos, tag lines and other marketing items available for use and registered in the company’s name? Do they conflict with a third party’s rights?
 - h. Is the company name registered to minimize the potential for a legal battle with a larger better capitalized company?

- i. Are you using open source code? And if you are, are you co-mingling open source code with proprietary code such that the entire code tree is tainted and therefore treated as open source?
 - j. If you intend to patent an invention, have you inadvertently “publicly disclosed” the invention (which could affect your ability to later patent it)?
4. Employment
- a. Do you include non-competes in contracts with the executives, employees and contractors (if so, in some states this could be a problem)?
 - b. Are all contractors clearly third parties and contracts in place between the company and them?
 - c. Is there anything in the way you operate that could be construed as contractors are in essence employees of the company e.g. titles, office space, working hours, benefits, stock grants? Are contracts with individuals for less than one year?
 - d. Do your contracts with suppliers state that the contract may be terminated for any cause with 30 days or less notice?

Clearly the checklist is not complete and most likely other questions will arise for your particular case. Hopefully, though, this checklist is a good start to use in working with your co-founders and attorneys in structuring the best deal for the company. Many attorneys have special rates for promising startups and my suggestion is to talk with them to understand what they can do to protect your business and its Intellectual Property. Without this protection, things can go bump in the night. I know as I have been on both sides of the fence.

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