

7 Common Legal Traps for Startups

and how to AVOID them!



ABRIDGE LAW

Co-founder
Issues

Using
Contractors

Employee
Equity

Raising
Money

Contracts

Intellectual
Property
Ownership

Misappropriation
&
Trolls

Co- Founder Issues

- What are the relative strengths and weaknesses of each co-founder?
- How much time is each founder able to commit to the startup?
- How much money is each founder able to commit to the startup?
- What is each founder's role/function?
- What skills are missing from the founding team? How will the team acquire those skills?

Failure to have an honest conversation about expectations can lead to **disproportionate commitment to the startup** and growing **resentment** between co-founders.





Solution

A founders' agreement to cover:

- The structure of the company and the equity distribution between founders
- Vesting schedules of shares (if any)
- The composition of the board (Will all founders be members of the board? How about independent board members?)
- Restrictions on transfer
 - Right of first refusal in favor of the company or other founders prior to sale
 - Drag along rights in the event of an offer to sell the company
- Mandatory or permissible repurchase obligations if a founder's employment with the company is terminated
- Deadlock provisions

Contractor Issues

- The default assumption in NH and MA is that an individual providing services to your business is an employee.
- Merely signing a contract with an individual that says “Independent Contractor Agreement” is not enough to avoid statutory requirements.
- Does the relationship satisfy the ABC test, plus all state tests?
- Does the relationship satisfy the “work for hire” test or is transfer of ownership of work product otherwise evidenced in writing?

Misclassification makes a company liable for any financial and litigation liability concerning the misclassified employee, including:

- back wages and overtime pay;
- tax and insurance obligations;
- employment law compliance; and
- employee benefits for the entire period during which the employee was misclassified.





Solution

- Make sure the relationship passes the ABC Test:
 - a. The individual has been and will continue to be free from control or direction over the performance of such services, both under his contract of service and in fact; and
 - b. Such service is either outside the usual course of the business for which such service is performed or such service is performed outside of all the places of business of the enterprise for which such service is performed; and
 - c. Such individual is customarily engaged in an independently established trade, occupation, profession or business.
- Use a written agreement to confirm ownership of work product

Employee Equity Issues

- For startups trying to conserve cash, founders may consider offering equity in the business in lieu of cash payments to employees and/or vendors.
- Some things to think about:
 - Has the recipient displayed enough competence that they will deliver the quality work product you are expecting? If not, how do you get the equity back?
 - Depending on the current value of the equity, are you creating an adverse tax consequence for the recipient?
 - If the present value of the equity is very low or a liquidity event is uncertain, then are you actually compensating the recipient and will you therefore own the work product?



Solution

Pay cash for services as much as possible; use equity in those rare cases when the recipient can add value or skill that the founders do not possess and cannot reasonably develop.

Decide clear project benchmarks and milestones that will result in earning of equity.

Avoid talking in percentages up front. There is no standard percentage of equity for contractors, vendors, employees, etc.

Raising Money Issues

- Raising money from your closest supporters (friends and family) is a common first step for new startups.
- But is it a loan or an investment?
- Will you need to seek outside investment from an angel investor or VC?
- How will the friends/family investors look to group of outside investors?

Is it a loan?

- What is the interest rate?
- When is repayment expected?
- What rights does the lender have if the business fails to pay?

Open-ended loans that can be repaid at the company's discretion can actually be classified as a security, subject to federal and state securities laws.

Is it an investment?

- How much equity will the investor receive?
- Is there a way to repurchase the equity?
- Is there an expectation that the investor will be involved with operating the company?
- Are you prepared for this person to have access to the company's financial statements and have other input into operations?



Solution

- If you can, bootstrap and self-fund your growth.
- Consider rewards-based crowdfunding as an alternative.
- If you need to accept money from family & friends, document the terms of the loan or investment and, if equity, consider ways to buy back the stock down the road.
- Raising money takes time. Plan ahead and find it before you absolutely need it.
- Make sure that you are complying with federal and state securities law.
- ALWAYS be candid about the risks of loss of the investment; claims of investment fraud always loom.

Contract Issues

- Vague contract terms are difficult to enforce if something goes wrong.
- If the business only uses invoices at the time of sale or service, there are no remedies for late or non-payment. The law does not automatically assess penalties, interest or attorneys' fee in collections cases.
- Microsoft (and EVERY other large company) limits the damages that can be asserted against them through service and license agreements. Do you?



Solution

Develop sales and service contracts that clearly address:

- Payment terms, including late payment penalties;
- Language to limit your total liability under the contract;
- If you are creating creative works or licensing software, language to limit the customer's remedies in the case of IP infringement;
- Where your business can be sued; and
- Whether the parties should use arbitration or another dispute resolution procedure.

Intellectual Property Ownership Issues

- Inventions, writings, logos and confidential information are all part of your intellectual property.
- Each part of your intellectual property portfolio is subject to its own protection and registration process.
- Third parties that help you create elements of your product, logo, software, etc. OWN their contributions unless you agree to otherwise in writing.

Patents

- Protects useful inventions
- New inventions must be new, novel and non-obvious
- If a new invention, hire an attorney to do a patent search
- Provisional protection is possible for up to 1 year
- Full application is expensive and long
- Protection lasts 20 years
- Secrecy is a MUST in early phases

Trademarks

- Protects names and logos
- Cannot be generic or descriptive
- Protection goes to 1st user of a mark in connection with goods
- Application take up to 1 year
- Registration is not required but recommended
- Federal protection lasts 10 years and can be renewed indefinitely

Copyright

- Protects original works of authorship, music, source code, plays
- Must be “creative”
- Registration is not required but recommended
- Application process is very simple
- Federal protection lasts life of the author plus 70 years

Trade Secrets

- A trade secret is business information that is kept confidential and has value because it is not generally known to others
- Secrecy is a MUST
- Must take reasonable steps to preserve confidentiality
- Protected under state law and lasts for as long as the information remains secret



Solution

- If you have an idea for an invention, hire an attorney to do a patent search.
- If you are adopting a new name for your business or product, run a Google search and then search the USPTO trademark database.
- For copyrighted work, use a copyright notice: ©2023 ABC Company, Inc. All rights reserved.
- For trade secrets, always use confidentiality / NDA agreements.
- For patents, use confidentiality / NDA agreement until application is submitted to US Patent Office.

Misappropriation & Troll Issues

- Copyright infringement is the use of a creative work without the permission of the creator.
- Permission can be given exclusively to one person or non-exclusively to many people through a licensing arrangement.
- In the absence of creating the image yourself, buying the rights to the work from the original creator or acquiring a license or other permission to use the work from the current owner, you can be subject to a claim for copyright infringement for images posted on your website without permission from the creator.



- Copyright trolls are individuals and businesses that acquire rights in large portfolios of images and other creative works for the sole purpose of threatening to sue others who use those images without express permission from the copyright owner.
- Deleting the image doesn't erase the fact that the you as the website owner have already committed copyright infringement and ignorance as to the copyright owner's identity is not a defense.



Solution

- License fees for images are nominal. Make the investment to purchase proper licenses for images you plan to display in connection with your business.
- Remember that Google and Bing do not evaluate whether images found on search results are in the public domain.
- Always check to see if an image is subject to a limited license to use and if so, use under those limitations only.
- If you get caught by a troll, negotiate; don't ignore the problem.



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