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TEN LEGAL MISTAKES EMERGING COMPANIES MAKE

The attorneys of Wendel Rosen's **Technology Practice Group** have compiled this list of 10 common mistakes they've seen in the trenches. Smart companies will take the time to address these issues early in formation to prevent a future situation that could turn into a company killer.

1. Choosing the Wrong Type of Entity

A big decision prospective company founders face is determining the type of entity formation their company should take – a "C" corporation, an "S" corporation or a limited liability company (LLC). In a nutshell, LLCs and "S" corporations have significant tax advantages. However, "S" corps can offer only a single class of common stock. That eliminates them as an alternative for most fast-growing tech companies, since investors typically want a different class of stock than those desired by company founders and employees.

LLCs can offer different classes of ownership interests. However, some investors dislike LLCs, because the company's income and loss will be reported on the owners' personal tax returns. Many outside investors prefer "C" corporations. Therefore, the discussion generally starts with forming a "C" corporation and then explores whether the tax benefits of LLCs or "S" corps outweigh the presumption in favor of the "C" corporation.

California companies with a social or environmental mission now have the option to become Benefit Corporations. While companies organized under the State's general corporate law must consider solely the interests of shareholders in the profits of the business, Benefit Corporations must consider impacts on society, employees and the environment, as well as the interests of shareholders in profits, and may prioritize these at their discretion. For further reading on this type of entity, please visit http://bcorporation.net/publicpolicy.

2. Not Planning for Early Exits

What happens when one of a company's founders decides to leave or the other founders decide they've had enough? The founder leaves (either willingly or unwillingly) while the other founders work 24/7 to make the company successful. And what happens to the founder's stock? Often, people don't think about that scenario when they are launching their next great idea. They think about it only when someone's walking out the door. The remaining founders may resent the fact that while they are working hard, the person who left is still benefitting from their labor. Founders should discuss the possibility of an early split in the beginning. Clear shareholder agreements provide for various exit scenarios, including the remaining founders' reserving an option to buy all or a portion of the original founder's shares.

3. Not Documenting Stock and Equity Promises

Sometimes, company founders make vague promises to employees that they will receive a certain number of shares of stock or that they will get a "percentage" (e.g. 2%) of the company as an equity incentive. These promises are typically verbal or contained in an email without being very specific. The founder and the employee plan to work out the details in "paperwork" later.

"Doing the paperwork later" is a common source of problems in fast-growing tech companies. People are so busy that they postpone so-called nonessential paperwork. However, doing it later opens the door to disagreements over what was intended at the time the promise was made. If an employee was offered a set number of shares, what happens if many more shares are offered to investors in the interim? Should the employee's number of shares be increased to the same percentage as would have existed at the earlier date? And, if the employee was offered a percentage of the company, is the number of shares calculated based on the number of shares outstanding when the offer was made or when the shares are ultimately issued? Moreover, if the value of the company has increased, then the price of the shares needs to reflect that increased value. The shares can't be offered at the original low bargain price without unfavorable tax effects. For these reasons and others, when a young, fast-growing company wants to offer equity, it should have a written equity incentive plan and related contracts in place first.

4. Failing to Lock Up Trade Secrets

All too often, a business realizes it has trade secrets only after a former employee or potential investor starts using or disclosing the business's proprietary information. By then, it may be too late. To protect its trade secrets, a business needs to develop, disclose and, most importantly, consistently execute policies to protect its trade secrets. To prevail in court, a business must prove that the alleged trade secrets are not readily available to others and that it took reasonable steps to protect the information. The courts look at what is reasonable under the circumstances. For example, a court will require a greater effort by Apple regarding its marketing strategy for its next "i" product than it would for a venture capital company's list of investors. Customer and prospect lists frequently spark trade secret disputes, because they are the lifeblood of almost every business. The simplest way to evaluate whether you have trade secrets that need protection is to ask yourself, "If some of our key employees left today and joined a competitor, is there any information they could take that would hurt my business?"

5. Carrying Inadequate (or No!) Insurance

Business is inherently unpredictable and risky. For example, it's not unusual (although highly frustrating) to be sued – sometimes for a frivolous and baseless claim. You don't want the first time you read the fine print of your insurance policy to be after you've been served with a notice of a pending lawsuit, only to find out that the claim is not covered.

Every company needs to assess its potential risks to make sure the more likely ones are covered. There are insurance policies for nearly every imaginably risk (although some of them may be cost-prohibitive), from your standard Commercial General Liability policy, Error & Omissions policy, Employment Practices Liability policy, and property insurance policies to policies for intellectual property claims, privacy claims, and loss of electronic data. And, of course, the amount of your coverage should be sufficient to allow you to carry on with continued operations.

6. Using Outdated Privacy Policies

Online privacy is an ever-shifting area. New laws are being proposed in both the U.S. and abroad. The European Union is in the process of overhauling its privacy regulations, and Latin American countries are expected to follow. Scholars and policymakers are in dispute over the fundamental theoretical framework for the regulation of online privacy issues. Emerging technology changes the way companies collect and use data, with new uses cropping up constantly – both online and through mobile apps. Against this backdrop, does your company have an adequate – and updated – privacy policy and privacy notice? Transparent and detailed notices and policies should be the starting point for all businesses that handle and collect private data.

7. Not Getting Written Assignments of Intellectual Property Rights

Intellectual property rights are the key assets for most new technology companies, but often young companies fail to secure rights in IP. An assignment of copyright or patent rights must be in writing, not an oral agreement. Work product, such as software code created by an independent contractor, may not qualify as a "work for hire" under the federal Copyright Act. Assignments of trademarks must also include an assignment of the goodwill associated with the mark. In addition, company founders or early employees often register domain names, blogs and social media accounts in their own names; these should be transferred to the company.

8. Failing to Register Patents, Trademarks and Copyrights

Along the same lines, emerging companies often put off or delay applying for registrations for patents, trademarks, and copyrights in order to save a bit of money. For patents, this can be fatal due to the "one-year bar" requiring an application be filed within one year of public use, sale, offer to sell, or description of the invention in a published document. For copyrights, failure to register may prevent one from obtaining certain remedies in court, like statutory damages and fees. For trademarks, one advantage of registration is that it establishes nationwide constructive notice of the mark, even if a company has not yet used its mark in every state.

9. Treating Social Media as the Wild West

Social media sites, such as Facebook, LinkedIn and Google+, present new challenges to companies in terms of marketing issues, intellectual property protection, and employee confidentiality and privacy. Too often, however, companies have few guidelines for monitoring use of their intellectual property on such sites or employee usage of social media. These issues confront both established and emerging companies, but emerging companies need to be particularly mindful of such issues, as they may not have the resources to litigate disputes. It's a good practice to establish and follow a formal social media policy.

10. Mismanaging an International Launch

Today, emerging companies are often ready to immediately offer goods and service to foreign markets. Too often, however, they are not ready or have not researched how to deal with the laws and regulations of foreign countries. For example, as noted above, European privacy and data protection laws differ markedly from U.S. laws and are continually evolving. An emerging company that collects certain consumer information from consumers living abroad must be mindful of these differences.

As you can see, there are a number of challenges companies need to anticipate. With a little forethought and preparation, you can make sure your company avoids some of these costly ones.

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