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Top Ten Legal Mistakes Entrepreneurs Make

(and how to avoid them)

Here are my top ten legal mistakes entrepreneurs make and how to avoid making them, based on this author's 26 years of experience providing legal advice to entrepreneurs. The focus is on how to avoid getting into legal trouble, rather than a checklist of specific legal documents that you might need. In my experience entrepreneurs often get into trouble when they do not follow this advice.

1. Failing to conduct your business to avoid litigation.

Of paramount importance when starting and managing a new company is to avoid ending up in litigation. Litigation is a terrible way to resolve disputes. It is very expensive, and even more importantly, it takes away your mental energy. While you are in litigation win or lose, your company will suffer. Much of the rest of this top ten addresses ways to avoid litigation.

2. Failing to put it in writing.

All of your major agreements should be in writing. It may sound obvious, but there are many types of agreements that often don't get put in writing.

When a company has only a small number of owners, there should be a written shareholder or partnership agreement among the owners. Often people will tell me that they are good friends and they don't need an agreement. They are wrong. Friendships sour, people change, and people die. Peoples' priorities change when money is involved. It is far easier to put that agreement in writing now while you get along with each other rather than after you are already fighting.

Often founders of a company will bring technology, valuable trademarks, or other proprietary information that they have already developed, with them into the company. After the company is formed, who owns this intellectual property? There should be a written agreement that clarifies ownership.

When you start to work for a new company, or when your company hires a new senior person, the basic terms of employment should be in writing. These terms include salary, bonuses, stock options, job responsibilities, and term of employment. If the new hire has to move to take the new job, is there a minimum period of employment? Does the company pay moving expenses? Any stock related agreements should also be in writing (see # 6 below).

3. Rushing into agreements.

Do not rush into agreements. Read all important agreements before you sign them. Have your attorney review all major documents. Too often, in the rush of making a business grow, entrepreneurs sign whatever is put in front of them, especially if it comes from someone they think they can trust, such as one of their partners or a venture capital firm. There is always time for review. You can and should look after your own interests. This does not mean that you are trying to kill the deal or be an obstructionist. Whoever drafted the contract took some time to prepare the document. You are entitled to take some time to review it and make sure it says what it is supposed to say, and treats you fairly (or at least as fairly as venture capitalists can treat entrepreneurs).

4. Not planning for the unexpected.

You may think nothing is going to go wrong. It is healthy to have that kind of optimism when starting a new company, and entrepreneurs are inherently optimistic people. You have to be to start your own company. But things do go wrong. You need to plan for the unexpected.

Go over your plan of action for your company and try to think what could go wrong and what would happen if it did. For example, what would happen if one of the founders died unexpectedly?

Anticipate that founders will have disputes. Fifty percent of all marriages end in divorce. The divorce rate among entrepreneurs is probably much higher. You may think that “even if the founders have a dispute or one of us leaves the company, we will be able to work out our differences. After all we are all reasonable intelligent people and we are friends. Nothing will come between that.” But it often does, especially when money is at stake. Plan for the unexpected now while you are still friends.

This is another reason to use attorneys. Clients rarely come back to their attorney to tell them the agreement worked exactly as planned; it is only when something goes wrong that they call their attorney. So attorneys are used to thinking about and planning for the unexpected. Your attorney can help you anticipate problems and prepare to avoid them or at least find a way to deal with them in an orderly non-litigation fashion.

5. Trusting people who say “You can trust me.”

If someone says “We don’t need the lawyers” or “We don’t need fancy contracts because you can trust me,” run, do not walk, and run away fast. Someone who can be trusted never has to say “trust me.” They have nothing to hide. They say, “Sure, we can put it in writing” and “Sure, have your lawyer review this.” and “What else do you need from me to assure you?” (For further discussion of this issue, see my blog entry Don’t Trust People Who Say You Can Trust Me.)

6. Using vague terms in agreements.

Try to use specific terms in any agreements you enter into. Watch out for vague almost meaningless terms like ‘*profits*’. The amount of profits in a venture is whatever the accountants want it to be. Don’t agree to giving or getting a percentage of profits, or any other subjective term. Use objective easy-to-measure terms instead, like ‘*revenue*’. Warner Brothers produced the highly successful Harry Potter movie series, with over a billion dollars in revenue. The company agreed to give a percentage of the profits from the movies to various people and companies. But according to the Warner Brothers accountants, these movies have not made any profit. (See STUDIO SHAME! Even Harry Potter Pic Loses Money Because Of Warner Bros' Phony Baloney Net Profit Accounting.)

Specify stock options in detail. It is common in an offer letter that the company gives senior staff stock options worth around 3% of the company and that is all the letter says. At what price can you purchase the options? When do they vest? When do they expire?

Another vague term is '*percentage of the company*.' What do they mean by 3% of the company; 3% of outstanding issued stock, with or without taking into account vested and unvested stock options; 3% at the time the letter is written, or at the time of vesting (after several diluting stock events) or when exercised (often after several more stock diluting events)? Be specific when offering or accepting stock or stock options.

7. Not having your own attorney.

Don't expect venture capitalists (VCs) to look after your interests. When your company is ready to raise funds, the fund provider, usually a VC or two, will be represented by legal counsel. The VC will usually insist that the company hire a fancy law firm that has experience with corporate finance and securities. But who is representing the entrepreneur? Often, no one. You need your own independent legal counsel. You may be hesitant to hire an attorney because you do not want to kill the deal or seem like you are getting in the way. But a good attorney will look out for your interests in a way that does not hurt the company. The same is true if the company is going to be bought by another company.

But be sure to hire an attorney who is experienced in dealing with entrepreneurs and venture capitalists. Your family attorney or your friend's divorce attorney will not be able to provide you with the counsel you need. Their poor advice will reflect back on how the VCs perceive you.

I remember reading once that the husband and wife founders of Cisco Systems, Inc. wished they had seen their own attorney before signing the documents presented to them by the venture capitalists. They say that they walked away with only 100 million dollars. (One article says before they left the company, they had also sold shares worth another 100 million dollars for a total profit of 200 million dollars.) That may not seem bad, but it is nothing compared to the billions the venture capitalists made.

Hiring your own attorney does not mean that you are causing trouble. It just means that you are looking after your own interests. I once represented an early founder who was no longer with the company, but still had a less than totally clear legal interest in the company. The company arranged to be bought by a larger company. My client was to receive very little of the sale proceeds. I stepped in on his behalf. But I made it clear that my client was not trying to kill the deal. Nor was he trying to be greedy and force the company to buy him off if they wanted the deal to happen. All he wanted was his fair share. Once the remaining founders understood that, we were able to negotiate an agreement quickly and the sale took place on schedule, and everyone was satisfied.

8. Not facing problem areas up front.

It is human nature to want to avoid conflict. There is the hope that if you delay a problem, it will go away. That does not work. The problem does not go away, it just gets worse. If there is a problem area in your future, try to deal with it now. Don't kid yourself. The problem will come up, and if it comes up later, your options are more limited, and you are much more likely to be unable to resolve the dispute and end up in litigation, which is something you want to avoid; see #1 above.

Most startups are short on cash and on time. The founders can focus on only so many problem areas at once. Work with an experienced attorney who can help you anticipate problems and will advise you when you should take various legal steps. A good attorney will not tell you what to do--that is your job. Instead, the attorney will give you a risk assessment, tell you what kinds of problems can arise, what will happen if they do, and what you can do to prevent them. Then do not put off dealing with these issues because you think they will not happen or you can deal with them later when they do. Make sure that resolving problem areas sooner rather than later is part of your business strategy.

9. Expecting too much value in return for sweat equity.

Sweat equity is not worth much. Be aware that if you contribute sweat equity to a company, you may never be compensated. In many startups the founders forgo salary during the first year or two. They work hard for the company and expect to be compensated once the company is successful. This hard work is called sweat equity. Usually the salary accrues on the books as company debt. Meanwhile, investors have put up money and taken stock and/or stock options. Don't expect to get paid for your sweat equity unless the company is really successful. Money always trumps sweat equity. The people who contribute the money will be able to dictate terms and will be sure that they are paid back first, before the founders are compensated for the time they have put into the company. I often see that the founders have not put their employment agreements in writing (see #2 above). Then, when the company folds and everyone is fighting over the assets, or the company is sold and everyone is fighting over the proceeds, the people who have worked hard for the company for a long time find that they are on the short end. No one wants to pay them for their past work.

Sometimes founders will avoid having to borrow money for a while and will build up accrued sweat equity compensation in the form of deferred salary and stock options. But even if you have this value on the company books, do not expect to ever see any of it. As soon as you need to raise money, the new investors will insist on erasing all of the sweat equity debt. They do not want to invest money in a company to pay for past performance. They will only want to invest in the future.

10. Failing to keep current on taxes and wages.

Timely pay the IRS and pay your employees or shut down. It is that simple. If you do not pay the IRS and some of your employees, you will probably end up personally liable for these debts.

Most entrepreneurs are optimists. They have to be to choose to be entrepreneurs. They always think that the company is on the verge of taking off and becoming successful. In many startups money is tight and gets tighter over time. Entrepreneurs have a strong temptation to forgo paying employee payroll taxes, and sometimes arrange not to pay their senior staff at all. They figure that they can make up these company obligations as soon as the product ships and sales take off. Instead they use the money that should have been spent on payroll taxes and employee wages to fund the development and marketing of the product. This is not a good idea.

Generally the company will be held liable for back taxes along with penalties and interest, and will also be liable for back wages. In many states including my home state of Washington, the company is liable for twice the amount of wages and any attorneys' fees incurred collecting the wages. In many states including my home state of Washington, it is not a valid excuse that the company could not afford to pay the wages. If the company did not have the money to pay the employees, then the company should not have let them work and accrue wages; it should have laid them off instead.

But the real nasty surprise is that under the federal tax law, anyone who has any responsibility for writing checks and paying taxes will be held personally liable for unpaid taxes. In many states (perhaps all of them; I have not checked), these same people are also liable for unpaid wages, plus penalties and interest. I successfully represented two senior employees of a failed dot.com and obtained a large personal judgment against the founders of the company for back wages plus penalties and interest.

It is your responsibility to make sure that you do not ask people to do work that your company can not pay for. If the company does not have the money to pay wages and payroll taxes, then shut down before your employees do the work and you accrue company debt that you can and will be held personally liable for.

Other Articles on this Subject

Here are two other good top ten lists with a different focus from my list. You may want to check them out too.

Top Ten Legal Mistakes Made by Entrepreneurs by Harvard Business School Professor Constance Bagley

Top Ten Legal Mistakes Made By Entrepreneurs, by J Mathew Lyons, Andrews Kurth, Austin, Texas

Gary enjoys working with creative people including entrepreneurs, small business owners, people who create new technology, and artists. His practice includes:

- Computer/Internet Law & Litigation
- Intellectual Property (copyright, trademark, trade secret & licensing)
- Art & Entertainment Law
- Corporate/Business Law
- Complex Business Litigation

Other Publications by this Author

The following publications are available for free download at the Law Offices of Gary Marshall website on the resources page at http://www.marshallcomputer.com/resources.html.

Publications for Entrepreneurs

Top Ten Legal Mistakes Entrepreneurs Make (and how to avoid them) (pdf file): Advice on how to avoid the most common legal mistakes that entrepreneurs make when starting and growing a business.

Intellectual Property (IP) Licensing Agreements Top Ten (pdf file): The ten most important factors you should keep in mind when drafting licensing agreements.

Legal Issues for Online Sellers (pdf file): An overview of the legal issues you need to be aware of as an online seller.

Legal Issues for Online Publishers (pdf file): An overview of the legal issues you need to be aware of as an online publisher.

Publications for Artists

Copyright Basics (pdf file): A brief overview of Copyright law - the basic form of legal protection for most artistic works, including maximizing protection for your works, copying someone's else's works, recent changes in copyright law and the impact of the Internet.

Dangerous Talk: Speech and the Law (pdf file): A basic overview of speech law, including the ongoing battle between the constitutional protections of First Amendment Free Speech and Freedom of the Press versus restrictions on criminal and obscene speech, personal liability for harmful effects of speech, defamation (libel and slander), and rights of privacy and publicity, and how this balance is changing in the post September 11th world.

Publication and other Literary Contracts (pdf file): An overview of publication contracts and agent agreements, including what to ask for and what to look out for. Also covers the basics of simple contracts you should be writing in the course of the ordinary day-to-day business of being a writer.

Electronic Rights and the Writer (pdf file):A guide to the ever changing world of electronic rights for writers. The Publishing Market is increasingly turning to electronic distribution on the Internet, computers, E-books, cell phones, iPads and other types of mobile electronic devices. In a way this is the new wild west for writers. Because it is a market that is expanding rapidly and changing all the time, the rules regarding electronic rights are also changing all the time.

Publications of General Interest

Top Ten Intellectual Property (IP) Law Traps (pdf file) Intellectual property (IP) law is a deceptively complex area of law. IP law is very rules based, and the rules vary depending on the type of IP protection. Non-IP attorneys and individuals who attempt to practice IP law without the assistance of an IP attorney often run into trouble. This article presents ten common traps.

For additional advice and commentary on Law, Business, the Internet, Society, and Social Responsibility, check out Gary's law blog at http://marshall2law.com

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