
START-UP COMPANIES - AVOIDING KEY LEGAL MISTAKES CHECKLIST

This checklist highlights the key legal issues that should be considered when a company first starts up. Such issues include choosing the appropriate legal entity for the company, acquiring and protecting intellectual property (IP), complying with the federal and state securities laws, compliance with federal and state labor and employment laws, utilizing social media to achieve business ends, cybersecurity and privacy issues, and supplier and customer relationships. This checklist also identifies areas where missteps commonly occur and the serious impact and disruption such missteps may cause to business operations, achieving the founders, or gaining a return on investment for the start-up's investors.

Understanding and managing the legal risks associated with starting up a business can substantially reduce and, where unavoidable missteps occur, help substantially mitigate the damage inflicted on the business because of such missteps. This checklist will help you identify some of the more common legal issues and advise your clients accordingly as they start-up their business.

✓ Select an Appropriate Legal Structure for the Start-Up

- Reflect on the type of legal entity most likely to be consistent with the founders and investors legal, tax, and early-stage, as well as later-stage, investment objectives.
- Obtain legal advice about the dangers of having to change legal entity structures in the future (i.e., need to avoid disruptive (and problematic) legal entity changes which can not only be costly and time-consuming, but potentially catastrophic under certain circumstances).
- Obtain legal advice why some entity types most commonly recommended or selected for some business types may not be appropriate for a start-up, particularly in situations where the start-up may be seeking significant outside funding or intending to rely on employee equity participation to secure talent during the earliest stages of the start-up.
- With advice of counsel and your CPA, choose the type of legal entity most appropriate for the type of business you will be operating. Factors to consider include:
 - Plans for future growth;
 - The type and amounts of funding proposed to be raised; and
 - How much equity, if any, to offer outside investors.

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1



- Obtain legal advice for the best way to prevent inadvertent exposure of founders to personal liability (i.e., avoiding entity types that pose unlimited liability for owners, such as general partnerships, etc.).
- Keep founders' personal interests separate and apart from the company's interests to ensure that the legal entity is the legally responsible party conducting the start-up's business (i.e., all business

✓ ***Determine Availability of, and Possible Protection for, Proposed Business and Brand Names, Logos and Domain Names***

should be conducted through the legal entity, once formed).

- Have counsel check the current availability (and legal protection that can be afforded) the start-up's proposed, non-patent intellectual property (NPIP). Clearance of the NPIP is essential and should be done as earliest as possible during start-up process, preferably while the company is still in the conceptual and planning stages.
- Ensure that the company will have the right to:
 - Use its NPIP in selling its products or services and conducting its business; and
 - Stop competitors (and other individuals or companies with similar businesses or product offerings) from competing with the company by using any of the company's NPIP.
- File to protect the NPIP, not only in the United States, but in any foreign jurisdictions in which the company reasonably anticipates doing business, including:
 - List all jurisdictions in which the start-up intends to operate and select from that list those jurisdictions in which business can afford the costs of filing (i.e., attorney fees and filing costs).
 - Take advantage of the U.S. trademark registration intent-to-use process for those situations where the start-up is not yet shipping product across state lines or otherwise engaging in interstate commerce involving its products. This process requires that the start-up has a genuine intent to use the mark in the future on those goods or services specified in the intent-to-use application.

✓ ***Document Founders' Roles and Responsibilities in Writing Using Clear and Unambiguous Language***

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2

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- Remember, for the most part, jurisdictions (including, now, the United States) operate on a first-to-file basis.
- Document, in writing, using clear and unambiguous language, the precise nature of the relationship among the founders and between each founder and the start-up itself. Avoid informal and undocumented descriptions of those relationships.
- Provide a reasonably detailed outline, in writing (and get the founders to agree to the description), of the role and responsibilities of each founder, focusing on the day-to-day operating responsibilities of each founder.
- Once you have prepared the outline, have counsel incorporate that portion of the outline pertaining to a founder into the employment agreement between that founder and the start-up.
- Create a cap table which reflects the relative percentage ownership of each of the founders and of each of the other owners of the business.
- Determine the procedures to be used in making important decisions (e.g., how much capital will be needed and when should it be raised; exit strategy for the business, etc.).
- Determine how disputes among the founders will be resolved (e.g., in the event of a tie, provide a mechanism for resolving the impasse).
- Provide specific instructions on resolving disputes as to valuation and termination benefits due in the event a founder wishes to exit from the business prior to a company-wide liquidity event, including:
 - Whether the departing founder's stock will be subject to repurchase by the start-up.
 - The limits, if any, on the departing founder's right to retain and vote their stock even though they are no longer affiliated with the business.
 - Whether there will be restrictive covenants to which the departing founder will be subject, governing the departing founder's post-termination behavior.

✓ *Take Steps to Ensure that the Start-Up Secures/ Retains Key IP Rights*

- Develop a comprehensive IP strategy for the start-up, including:
 - The initial creation of the IP;
 - The need (and the methods used) to acquire additional IP; and
 - How to protect both the IP created internally, as well as the IP subsequently acquired.

- Have counsel draft and have the founders sign invention assignment **agreements** to ensure that the start-up's core IP is contributed to the start-up by the founders.
- Have counsel draft standard forms of comprehensive confidentiality, invention assignment **agreements** for signature by other employees and independent contractors, assigning to the company any inventions and other IP created by such employees and third-party contractors on company paid-for time or using company materials or other resources.
- Ensure that any assignment of rights of such IP to the start-up have been properly perfected by the filing of any necessary applications with essential governmental entities to secure, as a matter of law, legally recognizable ownership of such IP in the start-up.
- Determine the type of intellectual property protection likely to be available for any company-owned IP, considering the answers to the following questions:
 - How likely is it that the start-up will ultimately be able to obtain such protection?
 - What kind of time investment and incurred costs will be required to obtain the type of protection contemplated?
 - What is the relative strength (and likely duration) of the proposed form of protection?
- Determine whether trade secret protection, rather than patent protection, might be the better option to protect the company's inventions and proprietary processes.
- Take all necessary steps to ensure that the start-up's early-stage creations and business activities are protected from disclosure and / or theft, including:
 - Ensure generous use of confidentiality and nondisclosure **agreements** throughout the start-up's organization to protect its confidential information and protectable business processes.
 - File copyright registrations with the U.S. Copyright Office for any valuable copyrightable materials.
 - Perform trademark searches to establish the availability of proposed trademarks and service marks for use with the sale of contemplated products and services.
 - Once cleared for use, file appropriate applications for registration of the cleared trademarks and service marks with the United States Patent and Trademark Office.
 - Use appropriate notices to signal the start-up's claim of ownership on its trademarks and service marks (i.e., "TM" or "SM" for not-yet registered or unregistrable marks and a "®" for already-registered marks).
 - Protect any proprietary software created or owned by the start-up.
 - Protect the key data and databases created or owned by the start-up.

- Put in place, to the extent permitted by law, appropriate social media policies regulating the behavior of employees to prevent social media engagement likely to be harmful to the start-up's interests.
- Educate employees on how to comply with various company confidentiality, social engagement, and privacy policies to ensure compliance by them with such policies.
- Ensure that any third-party created content can be used safely by the start-up by creating a process for adequately clearing such property including considering what rights must be obtained both for marketing and advertising, as well as for other non-commercial uses.

✓ ***Ensure the Start-Up's Capital Raises Comply with the Securities Laws***

- Understand federal and state securities laws and regulations and how they potentially impact any proposed capital raises.
- Do ***not*** offer or sell securities without either first registering such securities with the appropriate state or federal agency or securing a valid exemption from such registration.
- Avoid:***
 - Behavior likely to subject company to action by the securities regulators
 - Exposing company to a potential right of rescission by disappointed shareholders
 - Jeopardizing company's ability to secure later-stage, larger-scale investment, or an opportunity to sell the company in the future due to missteps in selling equity.
- Have counsel help the company with its capital raises by:
 - Identifying appropriate exemptions from federal registration
 - Assisting it in ensuring its compliance with state blue sky laws

✓ ***Comply with Labor, Employment, Non-Discrimination, and New COVID-19 Laws***

- Create procedures designed to ensure compliance with all federal and state wage, hour, and non-discrimination laws and to ensure correct classification of employees into appropriate exempt vs. non-exempt categories. Such procedures should include ways to ensure:

- Accurate classification of each employee under federal minimum wage and overtime regulations adopted under the Fair Labor Standards Act (FLSA).
 - Required level of compensation for all non-exempt employees under the minimum wage and overtime rules and regulations.
 - That employees classified as “exempt” are in fact performing jobs that are consistent with such classification and are not actually non-exempt employees in disguise (i.e., they work under such terms and conditions and for salaries at a level necessary to qualify for exemption under FLSA).
 - Compliance with all state or local wage laws that provide for terms of employment or compensation at a level higher or more than the FLSA requirements.
 - Accurate classification of independent contractors. Failure to do so can create substantial liability for overtime pay taxes and penalties and employee benefits.
- Ensure compliance with 2021 COVID regulations.
 - Put in place a functioning payroll and benefits administration capability. Do not allow the start-up’s management to complacently rely only on an outside professional employer organization (PEO) or temporary staffing agency to ensure that the company is insulated from liability for employment law violations.
 - Specify in all employment-related documents that the employment relationship is one that is at will and that, except for those key employees with binding employment agreements providing for severance and other benefits, employment can be terminated at will, with or without cause.

✓ ***Structure Equity and Supplemental Compensation Plans for Key Executives and Employees***

- If you decide to use equity to compensate employees (or, where cash is in short supply and the client is forced to use equity as a compensation tool (e.g., options, restricted stock, or stock appreciation rights)) make sure that the company understands the legal, tax, and accounting implications of each type of equity award.
- Determine whether vesting requirements will be placed on the awards and if imposed how that imposition will impact the start-up’s financial position.
- Determine:
 - The size of the equity pool dedicated to the employees.

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6

- How, and to what degree, the proposed equity plan will impact the start-up's efforts to raise funding from future investors.
- Discuss with counsel how the securities laws apply, not only when fundraising, but also when issuing equity compensation to key executives and other employees.

✓ ***Create an Appropriate Cybersecurity Policy and Policies Covering Employee Internet Use, Expectation of Privacy, Social Media Engagement, Data Collection, and Use of Mobile Devices***

- Recognize that the casual nature of social media and other internet use by employees does not mean that such activities are incapable of inflicting significant harm.
- Secure the company's ownership of all social media and cyberspace-created assets, including the company's website and other company-created internet spaces.
- Where relevant, educate the start-up's employees regarding the laws related to endorsements, contests, and promotions.
- Adopt a policy protecting the privacy of the start-up's website users and take steps to ensure the company's fidelity to it.
- Elevate management's awareness of the need to comply with laws governing how the company collects, uses, secures, transfers, and disposes of user data and other sensitive private information.
- Create an appropriate "terms of use" for the company that can be utilized to govern the public's use of the company's website.
- Educate employees to refrain from commenting on prospective or pending company fundraising efforts.
- Create an awareness among the start-up's employees about the need to seek legal counsel when it comes to discussing the company or any of its business on social media (i.e., the danger of "loose lips sinking ships" when it comes to various aspects of the start-up's business).
- Discuss issues with the company's management related to e-commerce and how it is impacted by the laws regulating interstate commerce, business tax and sales tax payment obligations, privacy, sales, and data security).

✓ ***Create Appropriate Agreements Documenting Customer, Supplier, Employee, and Third-Party Relationships with the Company***

- Never rely on oral arrangements with customers, suppliers, or employees; disagreements that often arise, even with friends and existing business contacts, can have a significant impact on the company's business where the disagreement is not ultimately amicably resolved, and the existing arrangement has not been adequately documented beforehand.

For more information regarding preliminary considerations for a start-up, domain names and protecting trademarks, employment law issues for start-ups or privacy policies, contractual agreements referenced above and other key issues, PLEASE CONTACT [TAMARA L. HARPER, A PROFESSIONAL CORPORATION AT TAMARA@TAMARAHARPER.COM](mailto:TAMARA.L.HARPER@TAMARAHARPER.COM) OR VISIT OUR WEBPAGE AT TAMARAHARPER.COM.

- Do not assume, in every case, that the start-up must capitulate to a larger company's contract demands to secure the larger firm's business and understand how vendors and customers can allocate risk between themselves by utilizing standard indemnification, exclusive remedy provisions, limitations on liability, and warranty protection clauses.

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