Legal Considerations for Startup Founders

Venture Capital & Emerging Growth Companies Alert

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There are many business questions founders need to ask (and hopefully answer) before taking the plunge with a new venture. Often overlooked, however, are some of the *legal* questions founders should consider. Asking and answering the questions below will help you start your business on firm legal footing.

Do I have any obligations to a former employer or former business partner that could impact my new business?

If you've left a job or a former startup venture to strike out on your own (or if you're thinking of doing so), you need to determine whether you have any obligations to your previous employers or former business partners that would impact your new business. For instance, many employees sign an agreement, usually at the time they are hired, that gives their employer rights to intellectual property developed by the employee that relates to the employer's business. The same may be true if you were involved in another startup. These agreements may also prohibit you from using or disclosing certain confidential information after you leave the company, and sometimes they even prohibit you from operating a competing business. Some restrictions, such as a prohibition on competing with your previous employer, lapse after a period of time (usually about six months to two years), but others, such as the obligation not to disclose your employer's confidential information, can last forever. If you violate one of your obligations, your previous employer may be able to sue you for monetary damages and require you to shut down your business.

If you're concerned about the terms of an agreement with a previous employer, speak with a lawyer before starting your business.

Do I have (or can I obtain) rights to the IP my business needs?

Intellectual property is the most important asset of most startup companies, so making sure it is protected is crucial. This often involves filing for patent, copyright or trademark protection of your intellectual property, but it also requires that a company have written agreements with its founders, employees and other service providers to make clear that the company owns the intellectual property developed on its behalf and that the intellectual property cannot be used by anyone else without permission. If the founders do not already own the rights to the intellectual property the business needs, it is important to determine whether it can be obtained at a price that isn't cost-prohibitive.

How should ownership of the business be structured?

How you divide up initial ownership among the founders of your business is entirely up to you, but you will want to think hard about what should happen to a founder's ownership interest if he or she decides to leave the business. Let's say you start your business with three other founders and divide ownership of your company equally among the four of you, but after a few months one founder decides to leave. It may be unfair for the departing founder to continue to own a quarter of the company, but that's what happens unless the company has the right to get some or all of the shares back. A common solution is to require that each founder's shares vest over time, which grants the company the right to take back the unvested portion of that founder's shares (and in some instances the vested shares as well) when he or she leaves. The number of shares the company has the right to take back usually depends on the length of time the founder has been with the company and sometimes on the circumstances surrounding his or her departure.

The terms of the relationship among founders are most easily defined early on, before a problem arises – and the last thing you want is to spend your company's resources suing your partners or to be unable to raise capital because a departing founder has certain veto rights. We strongly advise our clients to consider putting a founders' or similar agreement in place at the time they are forming the business.

Should equity incentives be offered to employees and others?

Because most startups need to conserve cash, they often prefer to compensate employees and contractors at least in part by issuing them stock options or other equity incentives. Even if you don't plan to hire employees or engage contractors early on, adopting an equity incentive plan is beneficial because you can also grant equity as compensation for the work of consultants and other service providers. Startup technology companies typically reserve 10%-20% of the total equity of the company for incentive grants pursuant to an equity incentive plan, but businesses that expect to make significant hires early on may want to reserve a bit more. (The amount reserved under the plan can be increased at any time, but generally only with board and shareholder approval.) Equity grants are usually made subject to various conditions that are spelled out in the incentive plan or in the grant itself, including that the grants vest over time or upon the occurrence of some event, and that a participant forfeits any unvested awards should he or she leave or be terminated.