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The 5 Biggest Legal Mistakes Tech Startups Cannot Afford to Make

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It is an exceedingly rare successful startup that gets to where it is without having made a few potentially fatal mistakes early in its life. Some are business-related missteps, such as rushing out to market with a flawed product concept or targeting the wrong audience. The startups that weather these business flubs have to learn from them and eventually pivot their way to success-success that, in many cases, would not have been possible without learning from those early failures. Hence, the Silicon Valley mantra “fail early, fail often,” which celebrates these mistakes as hallmarks of the process of innovation.

Legal mistakes, on the other hand, typically lack that sort of silver lining. On the contrary, certain avoidable legal mistakes that many startup founders make early on are hard to overcome and can lead to a startup’s premature demise.

Mistake No. 1: Waiting too long to seek out experienced legal advisers.

Most founders wait until they have already made a number of preventable legal mistakes before first consulting with a lawyer. Founders often have two traits that make them less predisposed to reach out to a lawyer early: They are risk-seeking and cost-averse. These traits serve them well in many respects. In order to leave the security of a steady paycheck and take the plunge into starting a new business venture, founders need a certain appetite for risk. Smart, bootstrapping founders also try to start building their companies using as little cash as possible so that they can retain more of their equity.

However, these traits can also sabotage young companies when founders take unnecessary legal risks because they don’t want to-or don’t think they need to-pay for legal advice. The costs of cleaning up legal issues (if it’s even possible) vastly exceed the costs of obtaining legal advice at the outset. The cleanup can also delay or potentially scuttle fundraising (the company’s lifeblood) or an acquisition.

When founders do seek legal advice, they should find lawyers who have experience working with early stage startup companies. Hiring any old lawyer won’t do. Founders who were previously lawyers themselves and believe they can do their own legal work to save money (despite having no experience with startup law) often end up making many of the same mistakes as nonlawyer founders.

Mistake No. 2: Overcomplicating legal arrangements.

The second biggest mistake after not getting good legal advice early enough is not taking that advice. Savvy startup lawyers know that keeping legal costs low by simplifying and streamlining initial legal arrangements is extremely important for young, cash-starved companies. Despite many founders’ cost-aversion, they often have a competing desire to “optimize” their formation, employment and financing documents by planning for every conceivable scenario. Although that approach may make sense in a billion-dollar merger (where the additional legal fees are justified by the dollar amounts at stake), this sort of contractual customization is usually too costly, overcomplicated and ultimately counterproductive for early stage startups. In addition, many of those complicated early arrangements will likely be wasted effort in the end, as future institutional investors often undo much of them when negotiating the terms of their investments. Founders should listen to their lawyers and try to keep it simple. They can use the savings to build the business (a far better use of that cash than optimizing legal agreements).

Mistake No. 3: Avoiding hard conversations among co-founders.

The relationship between startup co-founders is often likened to a marriage. As with any marriage, communication is vital. Many founders put off difficult conversations with their co-founders about fundamental issues, such as how to split equity, whether to subject their stock to vesting, which operational roles each will undertake and what expectations they have of one another. Punting on these issues for fear of rocking the boat allows tensions among co-founders to fester until they explode in spectacular fashion in a messy founder divorce. Founders should work through these difficult issues and document them properly early on (which a good startup lawyer can

facilitate). Time-based vesting, in particular, can be a lifesaver by keeping founders who exit early from keeping all of their
equity at the expense of those who remain.

Mistake No. 4: Running afoul of agreements with previous employers.

Founders often start working on a startup concept while they are employed by other companies. Those previous employers may present a major liability for a startup company, depending on the founders' legal obligations owed to those companies under employment arrangements such as noncompete agreements, nonsolicit agreements and company policies regarding moonlighting and use of company property. One slip-up and much of the startup's intellectual property may end up being owned by a founder's previous employer. Early stage startups have no cash to defend lawsuits from bigger companies, so even the threat of litigation can make a young startup radioactive for potential investors and commercial partners. To avoid this situation, founders should fully understand their obligations to their existing employers before beginning work on a new startup concept.

Mistake No. 5: Violating employment laws.

Startup founders often believe in many myths about employment laws that can land them in seriously hot water with government regulators or catch the attention of hungry plaintiffs lawyers, which in turn has a chilling effect on prospective investors and acquirers. Many believe, for instance, that "labor laws only apply to bigger companies, not startups." False. Or, "We don't need to hire employees, withhold taxes, or pay overtime-we can just use consultants." Wrong. How about, "I pay my assistant an annual salary, so we don't need to pay him extra for working overtime." So wrong. And finally, one of the most popular myths, "Nobody pays summer interns!"

Violating these employment laws can quickly lead to lawsuits because plaintiffs lawyers are often awarded attorney fees for bringing them. It's not a matter of "if" the company will get sued for these practices but "when," and the settlement amounts and regulatory fines can be staggering. Startups should work with employment lawyers to avoid these pitfalls as soon as they start hiring beyond the founding team. For a guide to navigating the numerous federal employment laws and human resource issues facing new and growing employers, including tax reporting and notice requirements, immigration compliance, insurance, employment and independent contractor relationships, and workplace policies and practices, view the Employment Law Issues for Startups, Entrepreneurs, and Growing Businesses Checklist from Practical Law.

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