The Biggest Legal or Structural Mistakes Startups Make

1. Not Incorporating

One of the biggest mistakes new businesses with multiple owners make is not forming a corporation or LLC. The reason is simple—forming the LLC or Corporation forces you to sit down with your business partners and codify ownership of the business and the roles and responsibilities of the participants. It is important to do this early on because you don't want to get into a situation where you put in your valuable time and/or money into the new venture only to realize later that you don't have the job title, responsibilities, voting power and control or economics that you thought you had. I have seen promising companies blow up when this occurs. If your new venture is not successful, the lack of formal arrangements will likely have little impact. After all, if there is nothing to go around then your ownership percentage times zero equals zero. It is when a business is successful that things go awry. Money has a tendency to corrupt people and alter expectations. When there is money at stake, there is a great likelihood that one of your fellow business partners will get the idea that he or she made great, disproportionate contributions to that success and is entitled to more. That is when you want to have your agreements already in place.

2. Not Planning For the Divorce

New businesses are like marriages. You and your business partners go in with the best intentions, all for one and one for all, the Three Musketeers. But like marriages, it often doesn't work out with your business partners. You need to plan what will happen if it doesn't work out. What happens if one of the business partners quits to go back to a more stable environment at a big company? What happens if one of your business partners overpromises his or her commitment, skills or ability to deliver results? What happens if one of your business partners dies? I have seen companies become completely demoralized when one of the Three Musketeers loses interest, quits, keeps his or her ownership of the company and says (metaphorically) to the other owners: "I'm quitting and taking my ownership interest with me. Good luck with the new business! Go and make me rich!"

3. Not Knowing Who Owns the Company

It sounds simple. The business should always know who owns the shares of the corporation or "units" of the LLC. In practice, however, entrepreneurs often make big mistakes. One reason is that founders of companies often make verbal promises. "I'll give you xx% of the business if you join us and come work here." xx% right now, or does that new stakeholder get xx% forever, or after you raise that first or next round of equity capital? If you are forming a team and hiring talent, does that xx% mean right now or assume that the whole team is in place? It is surprising how often this issue comes up because the founders of companies fail to clarify their arrangements with any precision or keep good records.

If you ever want to raise equity financing or sell your business, one of the investors' biggest due diligence tasks will be to verify the ownership of your business. This is fundamental to the economics of your transaction with investors. If the investor is purchasing yy number of shares of the company, and this is supposed to be zz% of the company's stock, you can be assured that the investors will examine all of the company records (stock legers, stock certificates, stock purchase agreements, option agreements, warrants, etc.) to make sure it has an exact share count and it is getting the deal it expects to get.

4. Not Knowing Who Owns the IP

This is an issue more specifically for technology companies. Entrepreneurs don't form a company and then get the idea for its technology. The sequence is the other way around. Entrepreneurs have an idea. Then they develop that idea. White board sessions, market analysis, product or service offerings and specifications, and ultimately development toward a prototype will all take place pre-incorporation and create proprietary information and intellectual property that your business will need to own. Similarly,

companies have to be extremely mindful of polluting the company’s unfettered rights to the IP used in the business arising from the introduction of any third party IP, such as the IP (or rights to the Company’s IP) from current and former employers of the company’s employees and independent contractors. If you ever want to finance or sell your technology company, a significant amount of due diligence will focus on the company’s IP and ensuring that the company owns it. If your company is not diligent along the way, it is surprising how many problems can arise, and this is one area that can be a deal killer.

—Bo Sartain (2012)