



TOP GOTCHAS

WHAT MISSTEPS DO ENTREPRENEURS MAKE?

By: Stephanie L. Chandler, Attorney, Jackson Walker L.L.P.

I have had the pleasure of working with entrepreneurs throughout my career and enjoy the energy with which they attack the problems they solve. In the effort; however, to move the ball forward as quickly as possible entrepreneurs consistently make the same missteps as their follow company founders. If these minor missteps could be avoided, then the foundation for success could be better laid and the future less complex for sure! Those missteps are as follows:

- ✓ *Not Protecting Ideas As Early As Necessary.* Inventive minds throughout the world typically know that protection is available for new and useful inventions. They often know that that protection can consist of a mixture of patents, trademarks and copyrights along with trade secrets. What they might not be as aware of is that the protection of intellectual property can be very time-sensitive. In particular, many countries have a requirement that any public disclosure of an invention before filing a patent application for the invention bars the inventor from obtaining a patent for the invention in that country. This is often referred to as an "absolute novelty" requirement. In other words, an invention must be completely new to the general public at the time a patent application is filed, or the invention will not be considered "novel" for the purposes of obtaining a patent. However, even when an inventor is barred from obtaining patent protection in one country operating under an absolute novelty requirement, patent protection may still be available in other countries that have more lenient patent laws, such as the United States. The United States, and certain other countries, offer grace periods to inventors following a public disclosure of an invention. During these grace periods, inventors may still file for patent protection even though the invention has already been publicly disclosed. For example, Title 35 of the United States Code, Section 102 states that patent protection is not available if "the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States". Accordingly, unlike those countries that operate under an "absolute novelty" requirement, the United States offers a one year "grace period" for inventors to file a patent application following a public disclosure of the invention. Obtaining advice of counsel as to these

and other requirements and building the appropriate budget into your business plan is imperative.

- ✓ ***Investing in the Wrong Brand.*** In a similar vein, filing for trademark protection creates certain priority rights which can help you grow your brand, but if this is not motivation enough, can you imagine investing in building your brand and then learning that you have to change the business or product name. Prior to expending substantial resources choosing a name, developing a logo and launching a marketing campaign, entrepreneurs should invest in determining whether the name is one they will be able to continue to utilize as they grow. Additionally, by obtaining trademark protection for their brand, an entrepreneur can make sure that the brand is a platform for growth.
- ✓ ***Failure to Address Intellectual Property Issues with Independent Contractors.*** The default rule is that if an independent contractor develops intellectual property (customer lists, software, etc.) that they maintain ownership of those developments. A company should also protect its proprietary and confidential information through contract when independent contractors are utilized. Early stage companies often fail to obtain intellectual property assignments from all contractors which can cause substantial uncertainty in future investors.
- ✓ ***Failure to Get Invention Assignment and Confidentiality Agreements with Founders and Employees.*** A company should execute an invention assignment and confidentiality agreement with each founder and each employee. Absent such an agreement, employees and founders may have rights to the company's intellectual property and the company may have no recourse if a rogue employee or founder discloses the company's confidential information. If an investor discovers in conducting diligence that a company has failed to obtain these agreements with each employee and founder, the investor may cease negotiations with the company.
- ✓ ***Failure to Get Non-Disclosure Agreements.*** A company should execute a non-disclosure agreement with each person and entity prior to providing the person or entity any proprietary or confidential information. Failure to do so may substantially restrict the company's future ability to get proper intellectual property protection – which can equate with devaluation of the company or worse, company failure. Investors are the only exception to this rule - although you should ask an investor to sign a non-disclosure agreement, it would be unusual for an investor to agree do so.
- ✓ ***Not Maintaining Corporate Records in a Usable and Presentable Format.*** A company should maintain its corporate records such that if the reins are passed to a new owner (such as a buyer or an heir), they can quickly understand the history and locate all important information. Failure to maintain the records in this format may result in confusion or, worse, a buyer deciding the company is worth less or deciding not to proceed or an heir not being able to run the company successfully.

- ✓ ***Promises Regarding Owning a Piece of the Pie.*** Entrepreneurs often make promises to employees and business “partners” that they will own a certain portion of the company once it is a success. Unfortunately, many of these individuals often do not meet their obligations to the company or part from the company under less than desirable circumstances. However, their departure may not eliminate claims they have against the company and its principals to an equity interest in the venture. A good rule of thumb is to consult with competent securities counsel before issuing stock, warrants or options, or making any less official promise of an ownership interest in the venture.
- ✓ ***Failure to Comply with the Securities Laws.*** All sales of stock must either (1) be registered with the SEC and state securities commissions (which is very costly) or (2) comply with some exemption to the requirements to register such shares. These exemptions often turn on whether the investors are wealthy and/or sophisticated enough to protect themselves (i.e. offerings are limited to solely accredited investors). Additionally, the requirements are typically triggered not by the actual sale of shares, but by the offer to sell shares. Failure to comply with securities law violations can have severe repercussions for companies and can substantially hinder their ability to raise future funds. Failure to comply with securities laws can also result in civil and criminal penalties and investors may become free to take advantage of rescission rights.
- ✓ ***Giving Founders Equity with No Strings Attached.*** Founders should consider vesting the stock they receive when starting the company. A fairly typical vesting is four years with a one year cliff and monthly vesting thereafter. Often founders do not vest their shares because they either do not think of it or they do not believe it is possible that one of the founders will leave the company or be forced to leave the company. However, it is common that one or more of the founders will leave the company to pursue other opportunities, for personal reasons, or for other reasons. If one of the founders leaves and his or her shares are not subject to vesting, he or she may retain a significant stake in the company without providing any additional services to the company resulting in the other founders working for the departed founder. The vesting of shares is often a hard conversation to have with founders, but it is something that should at least be discussed. Additionally, founders should carefully consider buy-sell agreements that address contingencies such as the founders death, divorce or a purchase offer from an outsider. Additionally, if the goal of founders is to build the company to a size where it can be sold, then considering drag along rights where the majority or a super-majority of the owners can force minority owners to participate a sale so long as they receive the same deal.
- ✓ ***Utilizing Money Finders.*** Locating capital is one of the biggest hurdles that an entrepreneur must overcome. There are numerous individuals in the marketplace that may promise to assist an entrepreneur with raising capital. If the party is not a registered broker-dealer, then there are substantial limitations on how they can be compensated and what activities they can partake in. Entrepreneurs should be wary

and make sure counsel advises them about compliance issues if they intend to hire someone to raise funds for them, especially if they are doing so for a floating amount which varies due to the amount such an individual raises. If a company fails to comply and it is subsequently determined that a finder should have been registered as a broker-dealer, the SEC is authorized to seek a civil injunction or monetary penalties, and refer the matter to the United States Attorney General for criminal prosecution. In addition, the purchasers of securities sold with the assistance of an unregistered finder may have a right to rescind their entire investment from the issuer (also referred to as rescission rights) causing the company to be required to return the entire amount of investment to the investor. This is very problematic in situations where the value of the shares declines, as investors who were introduced to the company by the unregistered finder might be even more motivated to exercise their rescission rights. Furthermore, the company has no post-closing means of protecting new investors from any liability that could arise from the prior sale for which rescission rights exist. New investors would be subject to these rescission risks until the applicable statute of limitations period has expired. Additionally, often these finders are not successful, so the contract you have in place needs to clearly define termination procedures and how you determine whether funds raised result in payments to these individuals. Anyone who assists with raising funds needs to comply with broker-dealer regulation.

This article is published as an informational resource. It is not intended nor should it be used as a substitute for legal advice or opinion which can be rendered only when related to specific fact situations. For more information, please contact the author:

Stephanie L. Chandler

210.078.7704; schandler@jw.com