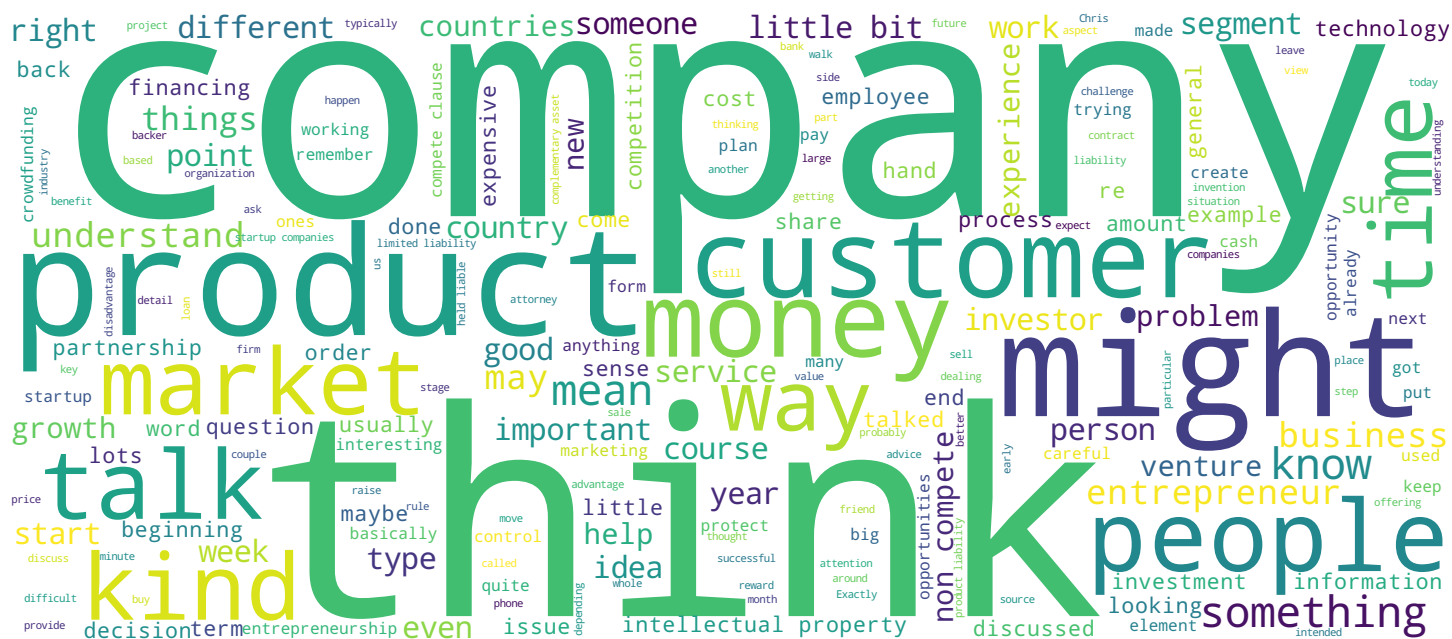


Prof. Chris Tucci and Prof. Marc Gruber





- Liability
- Incorporation
- Vesting shares
- IP filings outside your country
- Non-compete contracts
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Disclaimer: This should not be construed as legal advice!

Launching New Ventures

Welcome back to 5.3. Today we're going to discuss legal aspects of entrepreneurship and just to give you a quick overview of kind of top level issues that you should be thinking about right now, while you are considering starting a company, and my disclaimer, again, is this should not be construed as legal advice! (laughs) So I can't give you any legal advice, I'm just throwing some information out at you here that you might find interesting, and you should definitely talk to a lawyer if you have any of these issues. We are going to discuss what is *liability*, we'll talk a bit about *incorporation*, *vesting shares*, what does it mean. We'll talk about *intellectual property filings* outside of your country, what is a *non-compete* clause or contract, how do you deal with *product liability*, what is it, then, we'll also give you some suggestions on how to find a lawyer. So let's move right along right now, with *liability*.

Notes

Summary



0m 05s



- When you are held **responsible** for something that you did (usually something bad) from a legal point of view
- There are many reasons that you might be considered liable for – things you did in the course of running your business
 - Bad business decision
 - Fraud
 - Negligence
 - Employment / HR problems
 - Your products caused damage

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What is liability? Liability is when you are held responsible for something that you did. It sounds bad usually, because it is bad. There's usually something bad happening and therefore, people are trying to, as we say, "search for the guilty", try to find the person who is responsible from a legal point of view. So, liability is when you are held responsible for something bad that's happened. As an entrepreneur, there are many reasons why you might be held responsible; we're going to try to talk about some of these major ones today. In the course of running your business you may have made a bad business decision which injured somebody, monetarily or otherwise. It could be that you are acting in a fraudulent fashion; that you're hiding information, or you are lying, etc. Negligence, which is when you are neglecting something that you know to be wrong or harmful. There could also be employment or HR problems in which you are held liable, and it could be, finally, that your products cause damage to somebody, --could be physical damage or could be monetary damage-- and you might be considered liable for those as well. So let's walk through this bad list here, and try and understand the issues for each of these things.

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We already touched on incorporation in Module 4, but I wanted to give a little more detail this time around. When you talk about liability, you have your own personal liability. And then, depending on how you incorporated your company, you may have liability for the whole company. So it depends on the country, but most countries do make a distinction between something that has unlimited liability and other forms that have limited liability. So, usually, when you are the only owner of the company --we'll call that *sole proprietorship*-- and that is an extension of you; you are basically making money on the side, and you have your own little operation. And there you, unfortunately, have unlimited liability. So, when something happens to that company something goes wrong with that company, then you may be on the hook to cover any damages that you've caused, any monetary damages or physical damages, based on your own assets. Usually, sole proprietorships are done at the very beginning, or for very low impact-type businesses. You have your own consulting company, you don't have very many clients, but it's fine, you do your own thing and it's very unlikely that you are going to injure somebody and therefore, you are not that worried about your assets.

Notes

Summary



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A partnership is similar, in many cases; now different countries have different rules about partnerships, but the most basic form of partnership is that you go into business with a partner, and depending on the kind of partnership it is, and the country, but in many cases, both partners are liable for everything that happens with that business. Or if there are multiple partners, they are all liable, and there are certain kinds of partnerships where some partners are not liable, passive partners, limited partners, etc. But in general, when partners are coming together in a partnership and they are in fact jointly liable for anything happening with that company. So partnership, in general, does not protect you from liability problems. Then you have different kinds of what people call limited liability companies, and those limited liability companies have different names in different countries, but the basic principle is that you either have a private corporation, which means you have a very limited number of shareholders --we talked about that a little bit, when we talked about crowdfunding-- or you have a public corporation, which is when you have many, many shareholders, and when you make some statements and disclosures about how your company is run, and you have it open to the general public to buy shares in that company.

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What do these forms have to do with each other? They trade off ease and low cost against protection from liability. So, sole proprietorship is very easy, you can do it immediately pretty much, in most countries. On the other hand, it does not protect you at all from liability. Then, the more you move toward a limited liability company, then, it's difficult, because you have to go through lots of steps to register the company, etc., but on the other hand, that does protect you from the liability point of view. So, it's something to think about, how you want to plan that progression as you move toward producing and commercializing your product. It does not protect you; none of these legal forms protect you from fraud and negligence. Not that you are planning on being fraudulent or negligent. We'll talk about this one in few minutes, but if you know about something that's happening, then you should react quickly. You should not try to cover things up, or hide problems, etc, especially problems that can cause damage to your customers, etc. In such cases in most countries you can be found liable for problems that were caused by your fraudulent activities even if you have some kind of limited liability company.

Notes

Summary



0m 08s



- In most countries, there are **distinctions between corporate forms with regard to ownership and liability:**
 - Sole proprietorship
 - Partnership
 - Limited liability company (private corporation)
 - Limited liability company (public corporation)
- These forms **trade off ease / low cost against protection** from liability
- In most cases the entrepreneur is **not** held **liable** for actions undertaken by an LLC
 - **except fraud and negligence**

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So, be careful here, and what this *does* protect you for is bad business decisions. In general, in most countries, you cannot be held liable because you've made a bad business decision.

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OK, let's talk about employment issues now. Employment issues are dealing with the agreements that you make with your co-founders and with your employees. So, what I'm recommending here is that, in the very early stages, I mean, once you think you might start a company and that you might want to work together with some people, you should draw up a kind of a preliminary agreement. You should involve everybody who's involved with the business idea at the beginning, and you should figure out a way to compensate them or to reward them, and they should accept it, to prevent disagreements later. So you kind of laying up the story of the company, who is participating, who contributed, and what are they going to get from it. What does this avoid? This avoids missing founders type of situations, where somebody contributed at the beginning, then they disappeared, and then, if the company is very successful, they reappear and say, "I am the one who thought about all these ideas, it was my idea in the first place, I want you to pay me...", etc., etc. So there you've got problems with people showing up after your company is already successful.

Notes

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These kinds of agreements early on are also better for tax planning in case, at some point, this thing takes off then you will have thought through perhaps some of the tax issues, because there are tax implications of when you can count as income certain compensations that you received. Let's talk about vesting for a minute. Founder shares, and early employees too, they should always vest over time. So what you don't want to do is make an agreement at the beginning where everyone owns a lot, and then, one of the people leave and this person leaves, and then they've got all these shares that you gave them at the beginning. Should be a reward for staying in the company is that you should get more and more shares. What usually happens is there's some shares allocated to the different founders, and then, those shares do not take effect until certain milestones have passed, either business milestones, or time milestones, so that it rewards people who stay longer and do more work. They end up having more ownership and control of the company.

Notes

Summary



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- Entrepreneurs should **draw up an agreement** rather early with all founders to prevent disagreements later
- **Avoid ambiguities** of “missing” founders
- Also better for **tax planning** purposes
- Founders’ shares should always **vest** over time (**people who stay longer have more ownership and control**)
- The same principles apply to **early employees**

Launching New Ventures

And all of these apply to early employees as well, so you want to spell out what they are doing, spell out their compensation, whether it be for money or for shares, equity of the company, and then, all early employees should also have shares that vest so that makes them feel committed to the company, and they are actually rewarded for the amount of the time that they spend in the company.

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Speaking of employment issues, let's also discuss non-compete clauses or non-compete contracts. They are very tricky. It's something that you need to think about for yourself --we'll talk about that in a minute-- and for your co-founders and for your employees. What is a non-compete clause? A non-compete clause is a kind of a contract that's drawn up between an employer and an employee, and it prevents the employee from competing with the employer in the future. So I might sign a contract, I might go to a company, I want a job and they say, "Fine," or "Sign here." And it says, "you cannot compete in this industry again, and you have to work for me forever, (laughing) and if you leave, you can't do anything, for any amount of time in the future, that has anything to do with this business. That's a very broad definition. It can also say, you are not allowed to contact any of our current customers, and you are not allowed to hire away any of our current employees. That's a very broad non-compete contract. Most countries don't allow such...

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that's called, in general, slavery, so, "you can never work anywhere in the world, you can't do anything except for work for me." That's not very good, most countries disallow those super broad contracts, and what they are looking for to be enforced is something that's got a very limited duration, a very narrow scope, both geographically and technologically, or product-scope, so it could be, you cannot compete in this particular region, two years after you leave this company, and it can only have to do with products in this certain area. So that would be a more enforceable non-compete clause. So, why do we care about non-compete clauses? Because you may have one now if you are working for a company, and you have to be careful how this is handled. If you are going to quit the company and start a competing company, then you might start with a legal problem right off the bat. On the other hand, if it's a big boiler plate, with lots of generic terms, you're probably OK, although, again, I can't give you any legal advice, because you have to check with your own country, and your own rules, in your own region, etc.

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If you are trying to hire some employees, if they've signed one with the current employer, you have to be careful about that and see how that works, make sure that they are not violating it, or if they are, if they are violating it because is so general. And then, finally, once you hire people, you might want to think about how you want them to behave as non-competing employees, so once they leave, what compensation you are going to give to them, what kinds of restrictions. So again, I would advice against this very generic, very broad, and try to make a narrow contract with your own employees when you are hiring them, and the best time to do that is before you actually offer them the job, or during the negotiation to hire them so that you can resolve all these problems before. Bad time to do it is after the person already left. Right before they're about to leave, you might have another opportunity, but then you are talking about compensating them, and you have to have them sign something. By the way, the more the employee negotiates, the more enforceable the contract is, in general. Boiler plates stuff is not so enforceable in general.

Notes

Summary



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- Non-compete contracts are drawn up between employers and employees **forbidding the employee from competing with the employer** in the future
 - Could also prohibit approaching customers and hiring away employees
- Most countries do not allow very broad interpretations
 - **Duration must be limited**
 - **Scope should be specified**
- This has implications for:
 - **You** – if you have already signed one with a current employer
 - **People you are trying to hire** – if they have signed one
 - **Your own potential employees** while you are negotiating with them

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Things that people negotiate where they cross off a line here and say they want to do this and that other thing, once you start negotiating then it's considered to be a valid agreement that you have some power over when you signed it. Be careful with non-compete clauses both for yourself, when you are leaving another company, and the ones that you are setting up with your own employees.

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OK. Let's talk a little bit about intellectual property strategy. Here, we've already discussed this week, IP in general, and now what we want to think about is what do you do when you want to move outside of your own borders, of your own country. If you don't think about this early on, sometimes you can get stuck in a situation where someone else owns an invention that you made. So that's why it's important to think this through. Some intellectual property filings can only be done early on. Some countries have these rules, "first inventor to file" rule, so if you are multiple inventors, the first one to actually put the forms in is the one that has the right to the intellectual property. Worst one is even "first to file". Not many countries do this anymore, but still, that means that anybody who hears about anything, who brings the forms in to the IP office, then they are the ones to have the patent on it, regardless of whether someone invented before them or not. When you have an international filing, this could be a little tricky, because you are working in your own country, which makes sense, but then, when you want to go to another country you find out that someone else already has intellectual property based on your invention.

Notes

Summary



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Think about IP strategy and international expansion early

- Try and get web sites, trademarks, and patent filings **in all jurisdictions** you think you might want to operate in
- Filing for patents is **expensive!**
- Consider a **Patent Cooperation Treaty (PCT)** application
- Think about **strategic disclosure** to prevent others from obtaining patents, especially if you don't have the money to expand

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So you need to think about this on the early side. Try and get the websites, trademarks, even in other jurisdictions, other countries, you might want to try and get websites and trademarks in other countries, patent filings if you can. Patent filings are expensive to undertake in multiple jurisdictions, so it's a little bit tricky, and we understand that it costs a lot, so you might not be able to do all these things. One thing you might consider is a patent-cooperation treaty application which is PCT, which is valid and recognized in multiple jurisdictions, or, if you think that it's too expensive to do any of these things it might be advisable to think about a disclosure, especially if you have IP in your own country, to think about how you might disclose it and publish it. That prevents other people from getting patents on it. When you want to go to their country, then, at least, you have what people call freedom to operate in the sense that you don't have to worry about violating or infringing on someone else's patent, when you move to a new jurisdiction.

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Now let's talk about product liability. What if your product or service has the possibility of doing damage to users? And again, this could be actual physical damage. Someone could cut themselves on your product, or it could be monetary damage where you advised to do something and they follow your advices or they use your service, and they lose a lot of money. These are what you generally call product liability problems. You need to think this through a little bit, make sure if you are designing something, that they don't have problematic features. The classic example here is children's clothing that doesn't have a draw string around the neck, so kids don't chock themselves on it. Make sure you want to avoid sharp edges on the edge of a product like a phone, you don't want to cut yourself on it. And then, once you've made sure that the designers know how to avoid these features, then, what you want to do is make sure that the manufacturing process also doesn't introduce defects. And that means iterating with the design group if it ever gets to that point. to make sure that when building these things that they don't have defects in them that can cause damage; you know, you don't want to blow up, you don't want them to cut people, etc.

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Clarify the intended use of the product. What does that mean? That means in certain countries you could actually be held liable for something that your product caused damage on, even if it wasn't used in the way that you intended. So, if you could imagine someone trying to shave with a cell phone, and poking themselves in the eye, and saying, "A-ha! Your product hurt my eye." "Well, my product is not intended to be used as a razor. My product is intended to be used as a phone. So you have to think these so called intended uses through, and make sure that people who buy your product or service know what the intended use is. You want to get insurance, there's all kinds of product liability type insurance in the market, and you should probably think about that, especially if you have a lot of customers at some point and you think that the product might be possibly misused, you can try, it can't hurt, although it's unlikely. You can also get some of your supply chain partners sometimes you can get the retailers to indemnify you if there is a problem, so try and negotiate with your supply chain partners to share in the risk. Recall the product if it's necessary.

Notes

Summary



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What if your product (or service) has the possibility of doing damage to users?

- Make sure designers know to **avoid problematic features**
- Make sure your **manufacturing process** is not introducing defects
- **Clarify intended use** of the product or service
- Get **insurance**
- Try and get **supply chain partners** to share in the risk
- **Recall if necessary**
- Do **NOT** ignore problems when they are brought to your attention!

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If you find that there is something wrong with the product, then recalls are very expensive, we know they are, but they are less expensive than you being held liable for fraud or negligence, because you know about something and you didn't do anything I hear about these stories, all the time in the news, and it just doesn't make sense. Do not ignore problems when they are brought to your attention. Because as soon as you ignore something, and someone can say: "A-ha! You were negligent in dealing with this problem. You knew about this problem and yet, you told no one about it and 10 more people die because blah, blah, blah. So, don't ignore problems when they are brought to your attention. Use the recall, obviously, the cheapest solution is to fix things in the design phase. And then, it's a little more expensive to fix them in the manufacturing, and then it's released to market and of course, depending on the industry, you've got beta test, you've got updates, etc. Once it's out there and commercialized then recalls are the most expensive options. Beyond that, the worst option is being sued, held liable for fraud, negligence, because you knew about a problem early on and you decided you didn't want to fix it because it was going to be too expensive to fix. Be careful there, and make sure that you understand these kinds of issues.

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OK, hopefully, I have not scared you away from actually... (laughs)...working on your startup! Because working on your startup is really the most important and fun part about this whole thing, and it's true that there are a lot of legal issues here that may make it a little less fun. So, usually, the best thing to do is to actually talk to an attorney. And you have to find one. What I've done here is I've given a little list of things you can think about when you are looking for an attorney. The first thing, does this person have experience with startup companies? This is super important. You don't want to get anybody, this friend of a friend; "Oh, yeah, I've done some wills, I can incorporate your company for you." So there it's tricky because you really, really, really want to work with someone who has experience with small companies. Preferably, someone with experience in the specific sector in which you are operating. So, if you are doing a software product, and you find an attorney who's an expert in biotech companies, you know...yes, the person's had some experience with startups, but maybe not in your sector, and it can also be some very sector-specific things that you need to know about.

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So it's preferable if you can find someone with experience in the sector in which you are operating. Has this person defended startups? They had problems in the past. Has this person *stood by* startup companies in the past, or did they just run away? So you want to make sure that the startup lawyer, has had some experience, working with and dealing with, and sticking with startup companies, all the way through different processes. Has this person worked on financing negotiation? Because it really is nice if your lawyer understands the kinds of financing you are going to get, that you expect to get, and can help you with negotiations because there are a bunch of tricky legal issues, There's tax complications, tax consequences on a lot of decisions that you make early on, and so, it's good if this person has also worked on some kind of financing negotiations, similar to the kind that you think you are going to need. And of course, the last two are more personal things, but do you have a referral from a trusted colleague? Given the choice between two lawyers, one of whom was recommended by a friend of yours, or by someone who was in the same industry as you, that you know personally, and someone else you don't know anything about, then, even if that person is a little more expensive, it might make sense to go with the referral.

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Checklist for finding a good lawyer:

- Does this person / company have **experience with startups**?
- Does this person have **experience in the specific sector** in which you are operating?
- Has this person **defended startups** that had problems in the past?
- Has this person **worked on financing negotiations**?
- Do you have a **referral** from trusted colleagues?
- Do you have **personal rapport**?

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And finally, do you have a personal rapport with the person? In other words, do you get along with the person, can you trust the person, can you reveal things to the attorney, and can you get an honest opinion, and give your honest opinion as well. So that's a very, very important part of this.

Notes

Summary



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- Try your best to **understand all potential legal problems early on**
- Aim to **mitigate risk**
- **Don't be caught by surprise**
- **Deal with legal issues as soon as they come up!**

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So, that's it for legal issues, as again, I hope I haven't been too scary trying to lay out all the potential problems that you have; But I think, in general, for startup companies, it's good to understand the potential problems early on, and try to figure out a way to mitigate them, rather than being surprised by problems later on in the process. So I hope you find this useful, and stay tuned, we're going to come back next and talk about growth.

Notes

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