Three legal lessons for startups

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The dizzying pace of a startup company frequently leads to legal mistakes that could shake a budding company to its core. Entrepreneurs, take note: Here are a few things to keep in mind.

By Benjamin K. Riley, contributor

Startup or emerging growth companies have to act decisively, efficiently and quickly. But the frenetic pace and other challenges these companies face often lead to serious legal mistakes. All too often, these companies fail to distinguish and understand the differences between an agreement that is legally enforceable and one that is not; keep inadequate documentation of the legal rights and responsibilities among joint venture partners; and fail to identify and protect the company's trade secrets.

What makes an agreement enforceable?

An entrepreneur should recognize the differences between different kinds of agreements. With a few exceptions, an oral agreement is enforceable but will often be hard to prove. Without documentation of the agreement, understanding of any agreement will likely differ between two parties. If you want to make all the terms of an agreement enforceable, document it in writing.

Once a written agreement is prepared, make sure you understand what is actually enforceable. There are three basic types of written agreements, depending on the language of the agreement: agreements to agree, letters of intent, and a fully defined, binding agreement.

Agreements to agree simply state the intent to continue negotiating. While other terms might be tacked on, these agreements only commit the parties to continue to work towards a final agreement.

Letters of intent, however, normally state the basic terms of an agreement, but leave the finer details for later. With letters of intent, it is critical that you understand whether the agreed terms are immediately binding or if there will be no binding agreement until all terms are nailed down. With a letter of intent, it's a good idea to include a clause that defines which provisions are presently enforceable and which are not. And when you reach a final agreement, fully document it in writing.

Document your joint venture agreements

Startups often collaborate with other companies and individuals on technology or financial issues. In most situations, partners will first sign a confidentiality agreement, obligating each to safeguard and respect the confidentiality of the other's information.

If you go ahead and form a relationship without any further documentation, you're asking for trouble. For example, a geologist named John Walker entered into an agreement with LaFarge North America in 2006 to conduct a joint venture on a stone quarry project in Haiti. Walker provided LaFarge with geologic data, financial projections, startup costs and marketing analysis, but the parties never put together a written joint venture agreement. The relationship later fell apart and LaFarge took Walker off the project. Walker sued for breach of an oral agreement, but the court dismissed Walker's claim because of the absence of a formal, written agreement.

In these joint development situations, startups will often sign a confidentiality agreement or stamp confidential on its documents and then work with the other company for six months or more before one party severs the relationship. At that point, the dismissed party finds itself with oral understandings about rights to use technology or to receive equity or payment, but no documentation. The other party may be confronted with claims against its business model or property. Courts will often reject both parties' claims on account of inadequate documentation. Even worse, the parties might find that they have lost or compromised their trade secrets or confidential information.

Don't begin working with a partner without first documenting the relationship. If the relationship with your partners changes, make sure the written agreement reflects the new terms. Draft a full and complete contract.

Protect your trade secrets

Finally, startup companies must document and protect their trade secrets. A trade secret may include any information, process or technology that provides economic value to the secret holder that is not readily known to others. Trade secrets are different from patents in part because they are broader and must be kept secret. Virtually every startup will have many valuable trade secrets which may or may not someday be patented.

Employees should sign an employment agreement mandating that company secrets be used only for company business. The same language protecting trade secrets should also be included in joint venture agreements with other companies and third parties.

Next, the company needs to take steps to internally identify its trade secrets. The chief technology or legal officer should encourage employees to identify and document the company's key trade secrets. Once documented, you should take reasonable measures to protect the trade secrets, including limiting employee and third party access, marking key documents and electronic files as confidential, and requiring special password protection.

The company also needs to keep tabs on the trade secrets being developed by its employees, making sure that new trade secrets are documented and folded into the protection program. When employees leave the company, they (and often their new employer) should be advised of the prohibition on using the company's trade secrets at their next job. If there's any suspicion of improper use of the trade secrets, segregate the former employee's computer and files, and hire a forensics expert to investigate the situation.

Finally, engage in defensive hiring. Make sure new employees understand they are being hired for their brainpower and skill, not to obtain trade secrets from former employers. Startups are often damaged — sometimes irreparably — by over-zealous employees who believe they need to shortcut the development process by using confidential, trade secret information from their former jobs. In 2006, a former IBM (IBM) employee sent his then new bosses at HP (HPQ) a confidential IBM memorandum containing trade secret business plans and technology. HP was forced to fire the new employee, report the incident to IBM and federal agents, and cooperate with a multi-year federal investigation and prosecution of the pilfering employee.

Don’t let this happen to your company. Make it clear to new employees that they should not bring confidential materials or information from previous jobs with them, nor should they use others’ trade secrets.

By documenting your key contractual relationships, avoiding oral or informal joint venture agreements, and safeguarding your trade secrets, your company will avoid many of the most common legal pitfalls that startups encounter.

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