How to Set-up Your Start-up

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As anyone who has been part of a technology start-up likely knows, the founders’ to-do list for ramping-up the business is long, and there are only so many hours in the day to get through it. However, one step that should always be given the proper time and attention is the legal structure of the business. Below are several of the key legal steps that most start-up tech businesses should do either before, or as they start doing business.

Incorporate

Incorporating has many benefits for a start-up, and the most important is likely the limitation of the shareholders’ liability from claims made against the business. Many entrepreneurship textbooks and articles tell start-up entrepreneurs that they can save a few dollars by incorporating without the help of a lawyer. It’s true that it may be less expensive at the outset, but chances are the start-up will end up paying more later to have its Articles of Incorporation amended and the corporate structure modified. Or worse, if the incorporation and corporate organization are done incorrectly, the start-up could be setting itself up for a costly lawsuit, and its shareholders may even fail to benefit from the company’s limited liability protection. It is prudent to seek accounting and legal advice before incorporating and incur the cost of having the incorporation and corporate organization done correctly. The founders can then enjoy the peace of mind, and the extra time to work on other things, that comes along with it.

Issue Shares

The founders of a start-up will typically be its shareholders. The proportion of shares (percentage of ownership) allocated to each shareholder needs to be determined when the start-up is incorporated and organized, and will often depend on factors such as the level of skill, experience or funds contributed to the business by each shareholder.

Many tech start-ups like to issue shares to founders that have special restrictions that prevent the shares from immediately vesting to a founder, but instead the shares are designed to vest (become fully owned) over pre-determined intervals. These shares normally include a requirement that for the shares to vest the founder must still be working for the company, thereby providing an incentive and reward to founders who stick around with the business.

Get a Shareholder Agreement

At the same time as the start-up is being incorporated the shareholders should be entering into a shareholder agreement to establish, among other things, the rules for how fundamental decisions about the business will be made, how the business will initially be financed (including possible obligations on the founders to provide funding in a cash-call or give personal guarantees to a lender), and how share sales by a shareholder, or the sale of the entire business, will be dealt with by the company.

Create Incentive with an Employee Stock Option Plan

Many start-ups seeking rapid growth choose to issue stock options to key employees to give an incentive to the employees and to align the employees' interests with the company's. Giving an employee stock options can also be an effective way for a start-up to avoid paying the employee a high salary before the business can afford to do so. The rules and requirements of the stock options will be established in an employee stock option plan, which will govern things such as when and on what conditions the employee will be able to exercise the options to obtain shares. Typically, an employee's ability to obtain the shares will depend on certain performance objectives being met by the employee or the business, as well as the employee still being employed with the business at the time the shares are issued. If the start-up intends to have an employee stock option plan, the shareholder agreement should be structured to accommodate stock options being issued and future shareholders coming on board.

Protect the Business with Employment Agreements and Restrictive Covenants

Many businesses go on to regret not having their employees enter into employment agreements and restrictive covenants (such as non-competition and non-solicitation agreements) when the employees are hired. By having employment agreements in place the business can establish the employee's performance expectations and termination entitlements for notice or severance pay. Under an employment agreement the business and the employee can agree to severance entitlements which may be substantially less (or more) than the employee would otherwise be entitled to receive if no employment agreement were entered into. Employment agreements can also include provisions confirming that any intellectual property produced by the employee in the course of his or her employment becomes the property of the business. Employment agreements should be entered into before the employee starts working.

In the tech sector in particular, ensuring that founders and employees enter into non-competition and non-solicitation agreements (or including these restrictive covenants in employment agreements) can be critical for protecting the start-up's marketspace, customer base and employees when a founder or employee leaves the business to work elsewhere.

The foregoing provides a short overview of several of the common legal steps and agreements that a tech start-up should typically complete to establish its legal structure, position itself for growth and protect itself and its shareholders. If you have any questions or would like help with starting or growing a business, please do not hesitate to contact us.
