

Common legal mistakes startups make and how to avoid them

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Read this if: you aren't sure what common legal issues arise when scaling your startup

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Mistakes are an important part of growth. However, legal mistakes can be costly and significantly impact how your business operates. Here, we walk through the common legal mistakes that startups make to better prepare you for the road ahead.

Startup structuring mistakes: to incorporate or not to incorporate?

How you structure your startup will determine your tax rates, fundraising ability, personal liability and a host of other factors. There are several structure options, however, most startups are incorporated.

Founders often wonder if incorporating their company is worth the money, especially when bootstrapping or in cases when funding is low. The general answer to this question is: yes, it is important to incorporate your startup as soon as possible. As most venture-backed companies are corporations, incorporating allows you to meet the industry standard—something VCs will expect.

Where you plan to operate, and whether you have any plans for expansion, will determine your jurisdiction of incorporation (i.e., federal or provincial).

- A federally incorporated business can conduct business under its corporate name in every province. If you plan to use your corporate name throughout Canada, then you will likely want to incorporate it federally. Otherwise, you will have to obtain permission from each province to use the name when you start doing business there.
- If you expect the corporate name to be used in only one province, provincial incorporation may be the most suitable.

Intellectual property mistakes: own and protect your assets

A significant portion of your startup's value comes from your intellectual property (IP), so not securing your company's ownership can open you up to issues at a later stage and be a dealbreaker for investors.

Your company—not you, your co-founder, advisors, consultants or employees—should own all the IP that it is developing, and this ownership should be fully documented. This is another reason why incorporating is important, as it will help ensure that all the work is held in, and owned by, the company, reducing potential diligence issues later during funding rounds.

The following steps will help secure ownership of your startup's IP:

- Everyone who works for, advises or consults with your startup should sign an appropriate confidentiality and IP assignment agreement.
- As a founder, you are not exempt from this requirement: you will need to assign all IP, including any pre-incorporation IP, to the company.
- If you started working on your company as a side gig while being employed elsewhere, it is important to ensure that your previous employer doesn't have any claim over the IP you developed during that time.

What is the best intellectual property strategy for my startup?

You must employ the correct IP protection strategy for the kind of product you are building. If you have a SaaS business, you are likely hyper-focused on protecting your source code, so you may keep parts of the code a trade secret. This differs significantly from what a D2C eCommerce business selling products through Shopify might consider, which would typically focus more on trademark protection of their brand and products. Learn more about the various [types of IP protection](#).

Equity documentation mistakes: tracking your distributions

All equity must be properly documented so that it is crystal-clear who owns what. Founders, especially in the early days, will often promise equity to individuals or companies who are helping them, without properly documenting and tracking it. This can result in a misunderstanding of the company's ownership should a liquidity event take place.

Common documents used to track equity distribution are employment agreements, board resolutions and option grant agreements. Equity granted to employees, advisors and consultants is often subject to vesting. Vesting means that equity will be granted/released to stakeholders on a pre-determined schedule, rather than in a lump sum. If an employee leaves before their equity is fully vested, they forfeit any unvested equity back to the company.

Founder and non-founder shares mistakes: make a paper trail

Discuss founder shares early and then get it in writing. Don't assume there is a 50/50 split or that a verbal agreement is enough. Unfortunately, disagreements among co-founders happen, and issues over ownership can result in legal action.

Ensure that you have clear documentation showing the issuance of founder shares (i.e., a board resolution authorizing the issuance of shares, a share purchase agreement or payment for shares). It is important that vesting schedules are clearly documented and tracked, and that the recipients of the equity understand what the vesting requirements are.

Founder shares are often subject to reverse vesting (i.e., founders are awarded shares upfront instead of after a period of time). For founder shares that are not reverse vested, the standard vesting schedule is four years with a one-year cliff. This means no shares vest for the first full year, 25% vest immediately following the one-year cliff period, and the remainder vest monthly or quarterly in equal installments until the fourth anniversary of the vesting start date.

How do non-founder shares and employee options work?

Consultants and advisors generally have shorter and simpler vesting schedules (often only 2 years, with monthly vesting and no cliff).

Any options issued to employees should be properly approved by your board of directors and issued under a formal option plan. All options should be broken down and documented in employment agreements and option grant agreements. Make sure there are no undocumented “promised options”.

Customer transparency mistakes: Terms of Service and Privacy Policy

The Terms of Service explains the terms and conditions that the users/customers of your service/website must adhere to. The Privacy Policy describes the company’s treatment of personal data collected from your users and customers and how that data may be used, sold or released to third parties.

These are legally binding contracts which work to [protect you and your customers](#), so they should be in place prior to entering the market.

Securities law mistakes: finding the right exemption

All equity issued by your company must be in accordance with a valid securities law exemption. Usually, startups rely on the “friends and family”, “accredited investor” or “private issuer” exemptions. For example, the friends and family exemption would allow you to sell equity in your startup to certain family members.

You should talk to your legal counsel to determine which exemption your company falls under. Relying on proper exemptions may help limit the number of securities reports required, although founders should be aware that there may still be required filings.

First financing round mistakes: finding the right financing structure

In addition to considering the legal and economic implications of your first financing round, you also need to think through how the structure of that inaugural round can impact your ability to close future financings. You should be focused on what rights are being granted to investors in these early-stage rounds, as mistakes can haunt a company going forward. For example, if you agree to a [liquidation preference](#) that is greater than 1x, or if you grant a preferred share class seniority over other [preferred share classes](#), that is likely to be replicated in future rounds.

Depending on the amount you’re raising, a convertible instrument such as a [Convertible Note or Simple Agreement for Future Equity \(SAFE\)](#) may be the best instrument to use given their relative simplicity. On the other hand, Preferred Shares should be used for larger raises because they provide a more robust set of protections for both your company and investors. [Learn more about instruments that early-stage investors use](#) to invest in startups.

Valuation cap mistakes: don’t make it complicated

Adding a valuation cap is a common way to structure convertible securities ([convertible notes](#) and [SAFEs](#)).

Your lawyer should advise you on how to avoid issues with multiple valuation caps. They can also help you evaluate your next financing round and assist with the selection of a fundraising structure that properly aligns with your expected growth.

Employment law mistakes: should I hire employees or contractors?

The decision to hire employees versus contractors depends on the specific needs of your startup, including the nature of the work relationship, the level of control the contractor/employee has, and ownership of tools and equipment. Regardless of which option you choose, there are key employment laws that need to be followed when building out your team.

One of the most common diligence issues we come across is the misclassification of contractors as employees. It is important to make sure your team is properly categorized. You do not want to run into a scenario where someone you've categorized as a "contractor" is legally considered to be an employee. Misclassifying contractors as employees will make you liable to the Canada Revenue Agency for failing to make the proper source deductions. In addition, you may become subject to claims from misclassified employees.

For any employees, make sure you are making required source deductions from their salary, including income tax, Canada Pension Plan and Employment Insurance. You must also make company contributions to the Canada Pension Plan and Employment Insurance regimes. Payroll providers are great resources to help new companies navigate employment obligations.

Whether your team is in the same office or working remotely, you must also ensure you're complying with all provincial and federal mandatory workplace policies. This may include a workplace Violence Policy, Workplace Harassment and Bullying Policy, Employee Health and Safety Policy and Disability Accommodation Policy.

To discuss these issues, please contact the author(s).

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