

LEGAL  
WRANGLING



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# FOUNDATIONS FIRST

5 common legal mistakes start-ups make when launching their business – and how to avoid them.

**GETTING YOUR START-UP** off the ground will be one of the hardest things you ever do. All the lingo about being nimble, agile and lean certainly holds water, but when executed too casually, could scupper your venture by creating unintended legal loopholes that come back to bite you many months, or years later. To equip your start-up for the unforgiving world of business, let's explore five common legal mistakes start-ups tend to make when launching their business.

**Nail down your founding documents**

As early as possible, you need to secure all founding documents and agreements to govern the relationship between the company and its shareholders and directors. The most important of these documents are the Shareholders Agreement and Memorandum of Incorporation.

When your start-up is making the big moola – which we all hope it does – issues between shareholders become very real.

Ensuring that you have the right mechanisms in place to solve shareholder or director issues will give your company a fighting chance to recover from such an event, or even help to avoid it entirely.

One powerful element to include in any Shareholders Agreement, for example, is a vesting schedule, best explained by bringing our typical start-up co-founder, Oom Piet into the mix. Oom Piet, as mentioned in a previous article of mine, is working hard

at his entrepreneurial vision of creating an online peer-to-peer lending platform, Peer Lending R Us. Oom Piet's co-founder, and 50% shareholder in the business, is Frikkie van Rensburg.

After a year of slaving away to make this vision a reality, Frikkie is forced to take cognisance of the commercial realities of starting and supporting a family, and Peer Lending R Us, although looking positive, is not doing well enough to support Frikkie

and his family financially. Accordingly, Frikkie makes the tough decision to take up a job in the corporate world with a salary and no longer be actively involved in Peer Lending R Us. Frikkie thus resigns as a director, but says that he will remain a 50% shareholder of Peer Lending R Us. This enrages Oom Piet, to the point where he considers shutting shop, as the burden to grow and run Peer Lending R Us is now all on his shoulders, despite Frikkie having and retaining the same equity stake in the business. Short of making Frikkie an offer to purchase his shares, without a vesting schedule, Oom Piet is stuck with this 'deadweight equity'.

If provision had been made in their Shareholders Agreement for a five-year vesting schedule, for example, the situation would have been more palatable for Oom Piet. This five-year vesting schedule could have stated that Frikkie's 50% shareholding would divest to him in equal portions of 10% per year over the five-year period, which means that when he left after a year, Frikkie would only be entitled to 10% shareholding, and not the full 50%.

**Register your brand as a trademark**

Due to the trademark process taking around 24 to 36 months to complete, start-ups really cannot afford to waste time building their brand over a number of years, only to discover at a later stage in the lifetime of the company, that their company name is not available to be registered as a trademark. The energy, cost and lost goodwill associated with re-branding can often cripple an established company, let alone a fledgling start-up.

Another reason to trademark, which is growing ever more important these days, is Google keyword poaching. Take Oom Piet's Peer Lending R Us for example. One day Oom Piet decides to search Google and see how high Peer Lending



**“Learning how to manage your founding documents, trademarks, copyright and contracts will help you to avoid unintended legal loopholes that could scupper your start-up.”**

R Us is ranked on Google's search results. He soon notices that, when searching 'Peer Lending R Us', their competitor, RocketLend, shows up as the top Google Adwords result. Oom Piet is horrified to learn that RocketLend is using Peer Lending R Us as a keyword to show RocketLend's own Google adverts. In approaching Google to remove the offending keyword for RocketLend's campaign, he learns that, unfortunately, without a registered trademark, Google won't even entertain his complaint. This is a sad reality, but Google allows for keyword poaching to continue unabated unless you can prove that you have a registered trademark that comprises the offending keyword/keywords.

**If you have invented a new product or process, patent it**

If you think that you have invented an entirely new and unique product or process, filing a patent needs to be done before making the invention public. This is particularly

important since public disclosure of an invention in terms of the Patent Act of 1978 voids any possibility of the patent being registered.

This obviously carries with it the huge risk of copycats, simply reverse-engineering your invention, and exploiting it for their own financial gain should a patent not be obtained.

Oom Piet, for example, only realised that his method of compressing and analysing the creditworthiness of potential borrowers on Peer Lending R Us, was unique enough to patent once he had been running Peer Lending R Us for a year. Making the invention available in the public domain, i.e. through his platform, unfortunately rendered it unable to be patented, with the result that RocketLend was able to reverse engineer his invention and use it without any adverse consequences.

**Securing your copyright over outsourced works**

Software and Internet start-ups face an added burden, imposed

by virtue of the Copyright Act of 1978, where outsourcing the creation of any works of art, such as logo design and software development, will entail that the subcontractor will own the copyright to that work, unless a Copyright Assignment Agreement has been entered into with the subcontractor.

If, for example, the software development of Peer Lending R Us was outsourced to a developer in India, the copyright to the code, allowing for Peer Lending R Us to function, in the absence of a Copyright Assignment Agreement, would be owned by the developer in India.

**Entering into contracts without fully considering them**

Start-ups need to be flexible and be able to quickly respond to market changes. Entering into a contract without fully considering the terms of it could serve to drag your company down to the point that it can't operate.

Peer Lending R Us, for example, enters into a lease agreement with a pre-furnished office rental company for a 24-month lease with an in-built 15% rental escalation clause, thinking it was a month to month agreement that Oom Piet could quite easily get out of. After one year of operating Peer Lending R Us, Oom Piet realises that he cannot afford the rental payments any longer, and tries to terminate the lease, only to discover that he is in for the full 24 months. This cripples his company to the point that he can no longer carry on trading, and has to shut shop. If only he was able to get out of the lease earlier and run the business from home, he might have been able to save his business.

These are just a few of the legal mistakes and misconceptions entrepreneurs face, and hopefully you are now better equipped to avoid such mistakes on your journey to becoming a unicorn. **EM**