Founders’ Pre-Formation Duties and Liabilities

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§1 Introduction

A good deal of the planning for a new business occurs before a new legal entity, such as a corporation, has been formed and founders need to understand that even though a legal entity does not exist they still have certain duties and are subject to potential liabilities to one another, to the new entity and to investors and other outsiders. For example, founders and promoters are in a fiduciary capacity with regard to the business entity to be formed and to the other founders and promoters of the entity, if any. As fiduciaries, founders and promoters have a duty to disclose to the entity and its other founders and promoters all material facts relating to transactions with or on behalf of the business entity, and are liable to the entity for any secret profits. Founders and promoters may also be liable to investors under federal and state securities laws for a breach of a fiduciary duty, a failure to disclose material facts, or an omission of material facts in the offer and sale of ownership interests in the new entity.

Founders and promoters, like corporate officers and directors, cannot ordinarily be held personally liable for the acts or obligations of their entity. However, they may become liable if they directly authorize or actively participate in wrongful or tortious conduct. Founders may be held liable for contracts they make for the benefit of a business entity to be formed if they personally make them, unless the other party agrees to look solely to the business entity when formed for performance. However, founders are not liable for contracts made in the business entity's name and solely on the business entity's credit. It is important that the founders realize that in their dealings with outside parties during the pre-formation stage they should make it clear to those parties that any contractual relationship that is being discussed would only be effective if and when the entity is formed and that only the entity would be liable to those parties. Unfortunately for the founders however, since most new business entities do not have sufficient capital or credit history to enter into significant contracts or borrow money on their own outside parties will often insist on personal guarantees of the founders that will remain in place until the entity can stand on its own two feet.

§2 Founders’ duties to current and former employers

Many people decide to launch a new venture while they are still working for another entity and will start the planning process described above well before they terminate their existing employment relationship. During their current employment, the founders may have been exposed to the technology of the current employer, its business practices, financial condition and customers, all of which have competitive value to the current employer and which can be protected from unauthorized misappropriation by the founders for use in their new business. It is also common for prospective entrepreneurs to develop technology that is competitive with or related to the technology developed and
sold by his or her current employer, and/or sell to the same customers of the employer. All of these scenarios create various restrictions on the founders that must be borne in mind as they prepare to launch the new business.

Employees owe certain general duties to their employer regardless of whether or not the employee has a specific employment-related contract. The scope of the duty, and its impact on any new venture that the employee intends to pursue, will depend on a variety of things, such as whether the employee is deemed a skilled or unskilled employee. A key employee (e.g., officer or senior manager) of an existing enterprise owes a duty of loyalty to their company that would prevent them from taking actions that would harm the company while still in the employment relationship. Examples of such harmful actions include activities such as operating a competing business or usurping a business opportunity that has otherwise been offered to the employer. Similar duties also apply to employees with specialized skills, such as engineers, marketing specialists or sales representatives. On the other hand, unskilled employees who are not working in positions of trust, or otherwise restricted by a written agreement, may generally work on a new business as long they do not do so on their employer’s time or use the employer’s facilities or resources.

The type of new business is also an important factor in determining whether an employee violates his or her obligations to a current employer. In general, a person may not engage in a competing business while still working for his or her employer; however, an employee may, in the absence of a written restriction in an employment agreement, establish a noncompeting business so long as it does not interfere with the employee’s ability to properly discharge his or her obligations in the current position. But, the employee must be careful not to use the employer’s resources to conduct the new business and must also limit his or her activities to periods outside of regular working hours. In addition to the restrictions on competition that apply during the employment terms, former employees may also be under contractual restrictions, which are discussed in detail below, that continue to apply for some period of time following the termination of his or her employment relationship.

§3 Disclosure of future plans

Employees preparing to leave should be honest with their employer. When employees are vague or evasive regarding their future plans, employers become suspicious. An element of mistrust is created and the employer is unlikely to give the benefit of the doubt to the departing employee. The employer will closely scrutinize the employee's actions, especially his or her post termination business activities. The disadvantage to being honest is that the advance notice gives the employer time to strike first by filing a lawsuit or to immediately terminate the employee when the employee was counting on receiving additional compensation until the termination date. If possible, a former employee should take a long vacation prior to establishing the new business. The longer the time between the departure date and the establishment of the new business, the less likely it is that a claim for misappropriation of trade secrets will prevail. In addition, if possible, the departing employee should do consulting or accept employment with another company.
for an interim period. Assuming that the consulting projects or new employment do not directly compete with the former employer, this supervening event may cut off liability for trade secret misappropriation. A departing employee should attempt, if possible, to avoid directly competing with the former employer.

§4 --Return of property

Individuals that terminate their employment to start a company should not utilize any of the tools or instrumentalities of the former employer including telephones, computers, manufacturing equipment or other items for planning or starting the new company. Use of such items may give the employer a claim to ownership of the new business or its assets and generally appears unfair to the employer, which will hurt the former employee if litigation results.

Often, former employees take with them such things as their rolodex, engineering notes, sales prospect list, and other items. These items are often taken innocently under the belief that they were created by the employee and thus belong to the employee. This can be a fatal mistake for a departing employee. No matter how innocent or useless the items appear to be, the departing employee should not take any property of the former employer. With many employees working from home, there is a significant temptation to keep files on the employee's home computer and other items developed at home. Nevertheless, such items should be returned to the employer.

On the date of the employee's departure, the employee should have a representative of the company present when the employee cleans out his or her office. In addition, the employee should prepare an inventory of the items left in the office, obtain the signature of the employer's representative and provide a copy to employer's representative who is witnessing the packing of one's former office. If an inventory is prepared and signed by a representative of the employer, the former employer will have difficulty making a trade secret misappropriation claim.

§5 Founders’ agreements with prior employers

One common, and always challenging, scenario that arises in connection with launching a new technology-based business is sorting out ownership and usage rights of ideas that were initially conceived by the founders while they were still working for their ex-employer. Consider, for example, the questions that might confront two colleagues who leave their positions with a company that develops and manufactures a line of basic widget products to form a new company that will specialize in the development and manufacture of more sophisticated widget products to be marketed into niche markets not currently served by their ex-employer. One of the founders was a design engineer at the old company and will head up the initial product development efforts at the new company. The other founder has a marketing background—in fact, he was a senior product manager at the old company—and will be responsible for sales and marketing at the new company with an initial focus on contacting prospective customers. Each of them signed one or more employment-related agreements with their old company that
covered not only their compensation and other terms of employment but also certain obligations relating to protection and use of technology and trade secrets and engaging in activities that might compete with the business and operations of their old company.

As noted above, the founders will generally have various common law responsibilities to their current and former employers that will apply regardless of any contracts that may exist regarding employment relationships of the founders. In addition, however, it should not be surprising to find in the US that the founders have signed several agreements with current and/or former employers, or a single agreement covering all of the areas that might be addressed by separate agreements—an employment agreement; a non-disclosure and assignment of innovations agreement; a non-competition and/or non-solicitation agreement; and a stock purchase and/or option agreement. Each agreement raises specific concerns for the new business, and each of the founders on a personal level, which are discussed in the following sections.

§6  --Employment agreements

Employment agreements lay out the mutual understanding of the parties (i.e., the employer and the employee) with respect to the fundamental terms of the employment relationship—duties and reporting requirements; salary, bonuses and other cash compensation; benefits; reimbursement of certain expenses; term and termination; and dispute resolution. While all of these issues are important to founders as they reach the point where they want to launch the new company it will be the provisions relating to termination of employment that are most relevant as they consider when to break their ties to their old company and officially launch their new venture. In general, they would have the right to terminate the employment relationship at any time and for any reason; however, senior executives and managers may have conditions in their employment agreements that require them to forfeit certain prospective benefits if they fail to remain employed for a minimum period of time (e.g., forfeiture of unvested stock and options and/or repayment of bonuses). There will be a temptation to continue receiving the salary and other benefits from the old company for as long as possible if financial support for the new venture is not in place; however, this is a risky proposition since engaging in all the activities associated with launching the new venture while still employed by the old company may trigger a right in favor of the old company to terminate the employment agreement “for cause” and seek damages from the employee. Even in cases where the founders are required to provide advance notice of their intent to terminate their employment relationship they should expect that the employer will ask them to leave immediately and demand strict compliance with any agreements the founders may have made regarding return and protection of confidential information of the employer.

§7  --Non-disclosure and assignment of innovations agreements

Many new ventures are built on a foundation of confidential business information or ideas which, properly applied, provide the enterprise with a competitive advantage. This information can be protected as a “trade secret” so long as it has value to the business owner and is not generally known or readily ascertainable in the industry. Such
information also will be protected by the law if the company expends the necessary effort to maintain the secrecy of the information. While most states prohibit the use of trade secrets regardless of whether or not the employee signed an agreement prohibiting use or disclosure, it is common practice to have employees, particularly key employees, sign a non-disclosure, or confidentiality, agreement to impose contractual obligations on them not to engage in unauthorized uses of the trade secrets and other proprietary information of their employer. In addition, employees engaged in creative activities, particularly the development of new technologies and products that may qualify for protection under patent and other laws recognizing and enforcing proprietary rights (e.g., copyright and trademark laws), will be required to enter into agreements that assign and transfer any rights they may have in these “innovations” to their employer. The scope of the assignment is generally quite broad and includes all inventions conceived, developed or created by the employee during the course of employment. The assignment requirement typically extends beyond inventions eligible for patent protection to include material that would be covered under the copyright laws while employed by the company. In many ways, such agreements reinforce the employer’s common law rights to ownership of inventions conceived by an employee when the employee was “hired to invent.” However, they often go further than that and require that the employee assign inventions that are created within a specified period of time, such as one year, after the employee leaves the company.

These agreements create duties that extend beyond termination of employment and may definitely have an impact on what the founders can and cannot do in launching and building their new business. Failure to comply with these agreements may expose the founders, and their new company, to civil liability and possibly criminal penalties; however, the scope of potential liability to a former employer will depend upon what the founders did in their prior job, the generally accepted level of knowledge in the industry, the availability of certain information in the public domain, and the anticipated duties and activities of the founders at the new company.

Regardless of whether there is a specific contract on the matter, employees are not permitted to take tangible or intangible information that is deemed to be “owned” by their employer with them when they leave the employment of the company. Deciding just what is owned by the employer can be a challenge and there is a great deal of uncertainty that may create risks for employees when they are attempting to engage in activities that are similar to those of their ex-employer. The founders would be entitled to take their knowledge and skills with them; however, issues may arise with respect to replicating and using methods, processes and systems that were conceived or otherwise learned while they worked for the ex-employer. The level of scrutiny that the ex-employer may use in monitoring the activities of the founders will depend on their positions and whether or not they had access to particularly sensitive information. Issues in this area are not confined to employees engaged in inventive activities and there may be risks for employees who served in sales and marketing positions and seek to use information that the ex-employer considers to be a trade secret (e.g., customer lists and data base information about customer requirements). Misappropriation claims may be rebutted by
Founders who have been employed as scientists or engineers or otherwise directly engaged in research and development activities with their former employers will typically be required to execute an assignment of innovations agreement. The scope of the assignment is subject to specific limitations and restrictions that may be imposed by applicable state laws (e.g., it must be shown that the employee used equipment and tools provided by the employer and conceived the invention or innovation during the time that he was obligated to perform duties on behalf of the employer); however, the effect of the assignment is to preclude the employee from freely using the invention or other innovation in his or her future business activities even if the ex-employer is not actively exploiting the invention or innovation. If the founders intend to build their new business on improvements and enhancements to technology developed at their ex-employer they should consult experienced patent counsel to determine whether the anticipated improvements and enhancements will fall within the scope of the ownership rights of the prior employer. If an actual or potential conflict arises the new business may be badly crippled from the start if the former employer asserts an infringement claim and/or demands that the new business obtain a license to use the technology that the founders worked on while employed by the ex-employer.

§8 --Non-competition and non-solicitation agreements

Many employees, particularly executives and mid-level managers, may be required to enter into covenants with their employer that restrict their ability to engage in competitive activities and/or solicit customers, employees and other business partners of their employer during and after their term of employment. The existence of a non-competition agreement can be a significant problem for the founders if they intend to engage in business activities that are similar to those of their ex-employer even if they reasonably believe that the new business will not harm or impact the ex-employer. Non-solicitation agreements can be problematic when the founders approach customers of their ex-employer or consider staffing their new venture with qualified colleagues that they worked with at their ex-employer. One of the most valuable assets of any business is the pool of employees who understand the company and how it works. As such, it is not surprising restrictions are placed on attempts by a departing employee to actively encourage other employees to join the new company and many contracts actually prohibit the hiring of any other employees of the old company for a certain period of time after the departing employee leaves regardless of whether there has been active solicitation.

While such covenants are common, they will only be enforceable if they satisfy certain strict requirements and in the US the enforceability of non-competition agreements varies widely from state-to-state. In most cases, the contract must be designed to protect the legitimate interests of the employer, be limited in scope, and not be contrary to the public interest. However, some states frown on such agreements as inappropriate restrictions on the ability of employees to freely pursue their livelihood. In California, for example, such agreements are generally unenforceable on public policy grounds although there are
some limited exceptions to the general rule of unenforceability that may apply and employees are certainly precluded from using the trade secrets of a former employer to compete with it.

When forming a new company founders often underestimate the importance of all these issues or naively assume that their ex-employer will not be concerned because the new company will be developing products or seeking entry into markets that were not of current interest to the ex-employer. In fact, one reason that talented scientists and engineers leave larger companies is because they are frustrated that their senior managers are not willing to invest resources in the opportunities that they are planning to pursue with their new company. However, even if the ex-employer is not active in the area of focus of the new company the founders must nonetheless expect that the ex-employer will want to protect its intellectual property rights and either seek compensation from the founders for the right to use its patents and other technology or preserve the option to sell or license those rights to other parties that the ex-employer considers to be better situated to create value from exploitation of the rights. Even if the new venture does not create issues of intellectual property ownership the founders may be deemed to have fiduciary duties to their ex-employer not to divert business opportunities that came to them as a result of their employment with their prior company.

§9 --Stock purchase and option agreements

Employees may have purchased shares of their ex-employer and/or received options to purchase such shares. Upon termination of their employment with their ex-employer the founders must consider how the event will impact their rights with respect to such shares or options. It is common for companies to impose “vesting” conditions that are intended to ensure that employees remain employed by the company for a specified minimum period of time before they obtain full and non-forfeitable ownership rights over their equity interests in the company. For example, an employee may be allowed to purchase 10,000 common shares; however, the acquisition of the shares may be subject to vesting restrictions that allow the company to repurchase all or a portion of such shares at the price paid by the employee if the employment relationship terminates before a specified date. Typically these repurchase rights partially lapse as the employee satisfies certain milestones with respect to his or her tenure with the company. In the case of the example above the repurchase right may continue for four years but the percentage of the shares that the company may repurchase may decrease by 25% on each annual anniversary of the original purchase of the shares. The right to exercise an option may also be subject to vesting requirements and options to purchase shares that have vested prior to termination of employment usually must be exercised within a short period of time following termination or will be deemed to have been forfeited.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the bestselling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 90 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan is currently a partner of GCA Law Partners LLP in Mountain View CA (www.gcalaw.com) and has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, and the services he provides through GCA Law Partners LLP, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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