

Top 20 Legal Mistakes by Startups (or Small Business)

Nancy Fallon-Houle © 2025 | Velocity Law, LLC

nfallon@velocitylaw.com 630-963-0439 x 22 <https://www.velocitylaw.com/>

1. **Using LegalZoom to Incorporate Business (or other non-corporate lawyer Provider).**

Please don't use LegalZoom, BizFilings Inc, ZenBusiness, Swyft, CorpNet, or any non-lawyer filing service, or an accountant, a general practice lawyer, or a non-corporate lawyer (even if the lawyer is a friend of yours or gives you a good deal), or a flash of DIY, to form a business entity or advise a startup.

An experienced corporate lawyer representing StartUps, is the right person to form a startup that will have more than one owner (now or later), or will have partners, employees receiving equity, or investors; or a business that will do business over the internet outside of its home state; or a business that has not done a thorough name and trademark search.

"Startup Law" is a niche area of law practice, which requires experience to avoid costly mistakes. It costs more money to fix a botched Incorporation or LLC formation, than it does to use an experienced corporate start-up lawyer at the outset.

2. **Skipping Conversation with a Tax Accountant With Experience in Startups.**

Please consult an experienced tax accountant, who has worked on the nuances of tax matters for startups, before forming the entity. Cover with CPA: Entity type, S Corp Election, 83(b) election, QSBS (Qualified Small Business Stock) election and the 1202 capital gain exclusion, classification of your workers as 1099 Contractors or W-2 Employees, whether to establish payroll tax accounts, and how to record your capital contributions into accounting software.

Be your own Registered Agent, Do not pay one, unless forming out of state.

3. **Noncompete or NonSolicit or NonDisclosure with Your Current or Former Employer.**

A NCA or NSA or NDA can delay, or stop, your business. Read the NCA, NSA and NDA. Noncompete Agreements: Yes, a new 4/23/2024 federal FTC law makes some NCAs illegal for employers to impose on employees or former employees. However, NCAs are allowed if you had sold your business to the person holding the NCA. Even though Noncompetes may now be illegal, the former employer is still allowed to hold you to a NSA and NDA

Nonsolicitation Agreements are still allowed: They prevent you from taking customers or employees from your former employer before, or after, you leave.

NonDisclosure Agreement ("NDA") a/k/a "Confidentiality Agreement," prevents you from taking ideas, information, data, or any IP, before, or after, you leave employer.

4. **Ideas Jointly Developed, That You Don't Exclusively Own.**

Co-developed IP between you and others, is not 100% yours to use. You'll need written permission, or a license agreement, or an assignment of IP, from the co-owner.

5. **Name Search Shortfalls, Or Believing Domain Name Availability Means Trademark or Name Use Availability.**

Please do your name search all over Internet, on USPTO, on states where you are formed and will operate, and more. Search all name permutations, not just exact name spelling. Search root word/key word first by itself in USPTO and look for hits in the TM Classes

you operate in. If you plan to sell products or services on the internet, then a full scope name search is required in all states and USPTO. Do full national, thorough name search, including trademark search, in databases besides Google and Register.com (*before* using the name). The Name Search Process is time-consuming, complex, frustrating, brain damage inducing, full of starts-and-stops, disappointing, and costly; please be prepared for that.

6. **Giving Ownership/Equity Shares for Project Work, Temp Work or Fleeting Relationship:**
Don't give shares to a Person who is only doing a project for you, or part-time work, or holds an insignificant role in your business: That person will be a *lifetime owner* of your business, even after the project is done. You can fire employees and consultants. You can remove and de-elect officers, directors, and managers. But you cannot fire or remove *owners* to whom you have issued shares (Given, or sold). Must buy them out at current market value!
7. **Workers Classified as 1099 Contractors, Who s/b W-2 Employees:**
 - A. **Tax Risks** IRS & IL Dept. Revenue enforcement and fines, and other legal issues.
 - B. **Intellectual property ownership Issues** 1099-ers own IP they create for you, unless contract.
8. **Entity type (Corp vs LLC) Errors, Wrong LLC Type, Wrong Corp type, Wrong State of Formation.** Corp vs LLC decision needs tax accountant and lawyer input. Don't use Delaware, Nevada, or Wyoming: Instead, use your home state (unless you are raising investor capital then maybe DE, but not required.)

Don't form a "member-managed" LLC, only use "manager-managed" LLC. Beware that "member managed" is the (incorrect) default on Illinois secretary of state website and on other state sites.

C Corp vs S Corp. Consider carefully QSBS Status, and S Corp Status, and perception of investors.
9. **Issuing All of The Authorized Shares; Too Low # of shares Authorized; Issuing "no-par" Stock; Thin Capitalization; Share Changes not Reported to State.** 1000 shares Authorized, and all 1000 Shares complete Issued at formation, is a common LegalZoom and DIY mistake; company then has issued all of the shares available to issue. Need much larger Authorized Shares
10. **Shares Not Issued; No Stock Ledger; No % of Ownership Determined; Shareholders Didn't Pay for Shares; Shareholders Didn't Agree to Price Per Share or %.** Need documentation of who paid in what capital for their shares; who owns what shares, what % they own. SHs and LLC members must write a check for shares, or legally assign over their contributed property, or they don't own the shares.
11. **S Corp Election on 2553 Not Timely Filed, or Not Filed at All.** Due 75 days after formation.
12. **IRS Section 83(b) Election Not Filed.** Election must be **filed with IRS 30 days after stock is issued** on any cheap stock, no-cost, or low-cost Shares to employees or consultants. No waivers, no extensions, hard deadline after which you lose the tax benefit.

13. **Business Not Qualified in States Where It's Doing Business, or Has Employees, Office, or Property.** Must Qualify entity in other states where employees work, office rented, property owned, or doing business. File with State Dept. Revenue, Payroll Tax, Income Tax, Sales tax, Use Tax, Privilege Tax registration. File Business License and industry license. File Assumed Name if different from corp name. File annual report for corporation or LLC with secretary of state. Omitted filings causes financial risk and penalty risk.
14. **Board of Directors/Managers Not Elected; Officers Not elected.** And Confusing Board Members with Shareholders.
15. **Corporate Operational Docs Omitted; Resolutions Authorizing Transactions Omitted -** Corporate formalities not present or being followed. Missing Authorizing Resolutions that elect officers and directors, or approving spending, voting rights, transactions in shares, or major transactions with company. Missing operating documents with voting rights, and mechanisms for distributions, dissolution, sale of company, or buy-sell provisions.

Using Corporation Docs for an LLC; or using LLC docs for a Corporation.
Litigants can "Pierce the Corporate Veil." Investors and bankers will balk.
16. **Neglecting to Protect Your IP** – Please protect your intellectual property from leaking out: Impose and get signed Nondisclosure agreements and NonSolicitation Agreements. Take internal steps to protect Trade Secrets with policies. Have employees and paid consultants sign PIAA (Personal Invention Assignment Agreement). File Trademarks, File Patents.
17. **Mixing Finances** in multiple businesses, or mixing business to personal finances. Disorganized accounting records.
18. **Issuing Equity (selling or giving) Without Effecting Securities Law Compliance:** Issuing shares to investors, partners, employees, or consultants requires securities law compliance. At a minimum, notice filings are required, but disclosure docs and other filings might also be required.
19. **Selling Securities on the Internet without Proper Securities Exemption Compliance**
Investors have rescission rights to get their money back if SEC Rules not followed.
20. **Contract Mistakes, or Contracts not in Writing.** Can sink a deal or a company.

Read all paragraphs of any contract you sign, and make sure you understand it, and can operate within its bounds and can deliver on all the requirements in the contract.
21. **Fiduciary Duty Breached or Neglected; Not Recognizing Conflicts of Interest.**
Impose strict ethical rules and guidelines, and monitor following them.
22. **Due Diligence Failures.** Background Checks. Business, Legal, Financial Documents: Be Ready when requested by banker, investor, partner, buyer. Run background checks on your partners to protect the company.
23. **Website Mistakes, Email Marketing Mistakes,** CANN Spam Act ignored.