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Authors:

[Joe Brammer](#)

[Alexander J. Johnson](#)

Three Critical Legal Mistakes Startup Founders Can't Afford to Make

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Founders tend to be laser-focused on building, launching and scaling their startups as fast as possible, eager to see their passion project transform into a thriving business. Yet, in the rush to get to market, founders too often leave essential legal questions unanswered.

Viewed merely as “housekeeping items,” addressing these issues often falls to the bottom of the to-do list for the already task-saturated founder. While tempting to address more acute concerns like product development or customer acquisition, founders disregarding the legal basics flirt with disaster. Lingering foundational issues too often develop into fatal obstacles the cash-strapped startup is unable to overcome.

As lawyers who have worked with countless founders over the years, we've seen time and again how intellectual property (IP) and ownership disputes tend to rear their ugly heads at critical moments, typically during acquisition talks or investor due diligence reviews. What may have seemed like a simple paperwork oversight at the time often becomes a costly and time-consuming distraction for a nascent company focusing on the next development milestone. Crucially, these issues are the most frequently cited reasons investors or strategic acquirers simply say “no thanks” and walk away.

With those cautionary words in mind, here are three common legal mistakes founders make when first starting out—and how to avoid them.

The Chain of Title Mistake

When a startup is just a kernel of an idea (and profitability is still years away), entrepreneurs often get help from friends, family,

classmates, neighbors and anyone else willing to lend a hand. But when that idea becomes a real company, it's essential to ensure the business owns any underlying IP through a well-documented chain of title.

This means that anyone who worked on projects related to the business needs to sign paperwork assigning any IP rights to the company, commonly known as an Invention Assignment Agreement. This is best done *before* there's real momentum behind the startup, since once it starts to succeed early supporters may demand large shares of the profits in exchange for signing over their rights.

This also applies to founders who work on their startups while holding down a day job. Depending on the company, the employer may assert ownership over *all* the IP the founder created during their tenure, even if it was unrelated to the job and produced outside of work hours.

The best way to head off this issue is for a founder to identify exactly what rights their employer might assert over any concept or invention. Reviewing employee handbooks, offer letters, and any agreements between the founder and current employer is an essential first step. Having legal counsel review these documents and advise of potential conflicts is also money well spent. Often, employees can ask their employer to formally waive these rights, and many agree, so long as there's no overlap between the employee's job responsibilities and the startup. But if a founder knows that there will likely be too many similarities between their day job and passion project, then it's best to leave the job and even wait a designated period before working on their startup to avoid ownership issues down the line, especially since a startup is unlikely to have the resources to fight an established company in court.

Because IP is often one of the most valuable assets a startup has, a misstep here can jeopardize the entire venture. We've seen it before: A trio working on a software startup came to us when they realized that one founder's coding contributions potentially belonged to his employer under the IP ownership provision of his employee handbook. He was unwilling to ask his employer to sign away these rights, suspecting it would get him fired. That should

have raised immediate red flags and caused his co-founders to question his commitment to the startup before they agreed to form it. Ultimately, he chose his day job and left the startup—forcing the remaining founders to scrap his contributions and start over.

The Tech Transfer Mistake

Founders affiliated with universities need to be extra careful about their IP rights. They may not think twice before accepting school resources or lab facilities, assuming that because it's their research, they must own it. Right?

Wrong. Much like employers, universities generally own the IP for research conducted by students or faculty, meaning a founder might have to pay enormous licensing fees to use the IP they worked hard to create.

It's therefore critical for founders to resolve any IP ownership and licensing issues early on, ideally before beginning any development and certainly before the company shows commercial promise. Thankfully, many universities have tech transfer offices or startup incubators that can provide resources and explain what founders need to know. One best practice: founders should try to get their hands on the university's stock licensing agreements to see how much they may need to pay to use IP created with school resources. A simple conversation at the outset between the founder and tech transfer office is time well spent and, in the grand scheme, money saved.

The Multi-Founder Equity Mistake

When a group of friends is starting a company in a garage, questions about vesting schedules, equity splits, and breakups are often far from their minds. But they shouldn't be.

If you have more than one founder, odds are someone is eventually going away. If you have more than two founders, someone is probably leaving in the first year. Perhaps this isn't a universal truth, but it's close to it. This guidance isn't to suggest the breakup will occur because of bad faith, although there are certainly bad actors in startup land. Circumstances change: people have kids, get

lucrative job offers, or burn out from the demands of running a fledgling startup. Agreeing at the outset to what a breakup looks like preserves relationships, equity, and, most importantly, the company's attractiveness to investors and acquirers.

That's why it's essential for a multi-founder startup to clearly document how much equity each founder has, when it vests, and what happens when a founder wants out (or the co-founders want to force them out)—*before* problems arise. Dead equity, when a founder is no longer contributing to a company but still has a significant ownership stake, is a red flag to investors and could jeopardize funding.

We've seen this sink startups time and again. Someone takes their ball and goes home, whether for greener pastures, a deteriorating relationship with their co-founders, or any other combination of factors. If the company has no agreed-upon mechanism to claw back the departing founder's equity (i.e., vesting mechanics), trouble and great expense typically ensue. At best, the situation is ripe for a protracted and acrimonious negotiation to repurchase the equity from the departing founder. At worst, the departing founder insists upon impossible terms or simply ghosts the company and disappears. Investors don't want to deal with that mess and the startup dies—an outcome that could have been prevented by a simple vesting agreement when the founders formed the company.

Delays Come at a Cost

These mistakes have one thing in common: failing to address problems *before* they become problems. Founders may be concerned about the costs of involving a lawyer before the company is off the ground, but legal counsel is a lot like insurance. A small investment now protects against significantly larger expenses later and avoids headaches down the line.

More importantly, identifying and addressing these concerns builds value by making the startup a more attractive investment or acquisition target. When investors and acquirers have confidence that the valuable IP is clearly protected and the founding team is appropriately incentivized with respect to their equity stake, the

startup is in a better position to negotiate higher valuations and more favorable terms—ultimately resulting in a better outcome for the founders.

Whether it's IP ownership, institutional entanglements, or founder disputes, agreeing on the resolution of a dispute before it arises is the far easier and cheaper path. Founders who want to give their startups a strong foundation for success can't afford to put legal considerations on the backburner.

FBT Gibbons' interdisciplinary Venture team works closely with innovators — including entrepreneurs, investors, and venture capital funds — from formation through exit. We focus on four key areas of legal support tailored to venture needs: corporate and fundraising, intellectual property, venture tax, and commercial agreements. Please contact the authors for assistance with any of the issues discussed above.

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