

Behind Every Successful Startup, a Battle Over Ownership

By Cheryl Miller

SACRAMENTO—Tucked into Square Inc.'s May 5 earnings report was a piece of jarring news: The company had paid \$50 million to settle a lawsuit brought by Robert Morley, an electrical engineering professor who said he was the true inventor of the mobile credit card-reading device that made the San Francisco startup a multibillion-dollar hit with investors.

In a 2014 complaint filed in the U.S. District Court for the Eastern District of Missouri, Morley said co-founders Jack Dorsey and James McKelvey Jr. forced him out of Square and then cashed in on his invention. At the time, a Square spokesman called Morley's claims baseless and said the company would vigorously fight them. Two years later, Square has paid \$50 million to make the accusations go away with no explanation and little more than an aside in an earnings report.

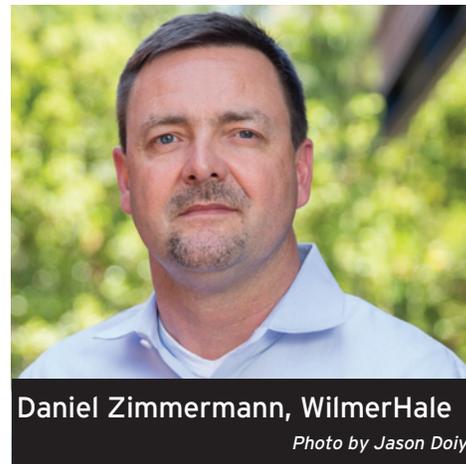
It's a familiar story. When it comes to drama, Shakespeare has nothing on modern-day founder fights. These battles among purported creators of the Next Big Tech Thing feature morality tales of deceit, ambition, greed and metaphorical back-stabbing. Disputes can linger in litigation, threatening financing deals and stunting a fledgling company's growth. They can lead to multimillion-dollar settlements and sullied reputations. And they can

provide full-time employment for litigators, who have to sift through opposing claims, text messages and pacts that were never put to paper.

Peel back the story of just about any successful former startup—Snapchat Inc., Uber Technologies Inc. or, of course, Facebook Inc.—and you'll find a chapter about a legal fight over who owns what. It's not that tech companies are inherently prone to attracting founder fights, lawyers say. It's just that they tend to deal with a lot of valuable intellectual property, and they blossom in size and financing very quickly. And, as Willie Sutton said when asked why he robbed banks, that's where the money is.

"The astounding amount of money involved when a startup takes off leads people to exhibit behavior that, for lack of a better word, is questionable," said Los Angeles plaintiffs attorney K. Luan Tran. "To put it bluntly, people are more susceptible to screwing each other. That's just human nature. "Tran represented Reggie Brown, the Stanford University English literature major who teamed up with fellow fraternity brothers Evan Spiegel and Bobby Murphy in 2011 to develop an app that would make photos disappear seconds after someone viewed them.

Snapchat skyrocketed in popularity, attracting billion-dollar buyout offers from Facebook and Google Inc. Brown accused Spiegel and Murphy of pushing him out of the



Daniel Zimmermann, WilmerHale

Photo by Jason Doiy

company. Brown sued his former partners and Snapchat in 2013. A confidential settlement followed in 2014. It was accompanied by a press release giving Brown credit for creating the idea for Snapchat's vaporizing picture messages.

"We acknowledge Reggie's contribution to the creation of Snapchat and appreciate his work in getting the application off the ground," said Spiegel, who remains the company's CEO.

The facts change in startup disputes, but the narratives repeat: Friends with little or no business experience scratch together an idea from a class assignment or over beers and, without memorializing anything in writing, jump into the Silicon Valley funding tornado. At some point the money starts raining down and the relationship frays—not necessarily in that order—and a fight breaks out over equity stakes.

“When you start up something informally, you don’t pay attention to the formalities,” Tran said. “That’s the last thing you think about when you’re in college.”

Co-founder disputes happen in every industry. What makes emerging tech companies different, said Silicon Legal Strategy partner Andre Gharakhanian, is the speed in which these startups change and grow.

“Head count and revenue explode, seemingly overnight,” Gharakhanian said. “Huge exits happen in just a matter of a few years. It’s when these dynamic changes happen that the holes in the paperwork become apparent and can bite founders. In other industries, the changes are slower and the paperwork issues take longer to bubble to the surface.”

‘GET IT PAPERED’

Gharakhanian’s advice to startup founders who actually seek it out is threefold: transfer all preincorporation intellectual property to the company; set up a process whereby the company will own work product created by anyone who joins the company; and clearly delineate who owns what percentage of the company, and how that ownership vests over time. And there’s one more thing, he said, almost shouting. “Get it papered, now!”

But even founder agreements with vesting provisions are not dispute-proof. Attorneys who work with startups tell horror stories of desperate partners pushing out co-founders who don’t carry their weight, only to have investors pare back the remaining partners’ equity. Wilmer Cutler Pickering Hale and Dorr partner Daniel Zimmerman recalled that happening to the founders of one company, which was eventually sold. After the sale, one partner was fired and walked away with nothing. The

others retained stakes, but they were smaller and worth significantly less than the one given to a co-founder previously ousted for slacking. “I always tell people that being a co-founder is much worse than getting married,” Zimmerman said. “There is no way to get divorced.”

An inventor could try to go it alone. But venture capitalists don’t usually like that either, Zimmerman said. The VCs want a startup team with members who complement each other’s strengths and can build a company, “not egomaniacs,” he said.

DAMAGE CONTROL

Most co-founders settle their disputes before a lawsuit is filed, attorneys said. Silicon Valley is still a relatively small world, and with the next great idea potentially lurking around the corner, jilted creators can be hesitant to risk irritating future investors by taking their beefs public. And founders still working on the company don’t want to add any hurdles in their race to an IPO.

“There’s a lot at stake,” said Tran. “If you have a decent case and a fair amount of evidence, you know what’s going to happen. They’re going to settle.”

There’s always the risk, too, of plaintiffs with, at best, questionable claims seeking a big payday. In 2010, New Yorker Paul Ceglia filed a breach of contract suit against Facebook, claiming a contract signed by Mark Zuckerberg gave him a 50 percent share of the social network. In March 2014, a federal judge tossed Ceglia’s claim, concluding that the contract he produced was a fraud. Facebook and Zuckerberg responded by filing wrongful prosecution claims against the three firms that represented Ceglia. A New York state appeals court threw out Facebook’s lawsuit in December.

Claims to a stake in an emerging company take a lot of time to vet, especially if the early business agreements were all verbal, Tran said. There are mountains of text messages, emails and simple he-said, she-said accounts to sift through.

The task doesn’t daunt Tran, who said he receives calls every week from potential plaintiffs claiming to be co-founders done wrong.

“Kids nowadays, they don’t even call each other,” he said. “They text each other. They leave an amazing trail for litigators.”

For defense counsel, such cases provide the same type of documentation problems. They also have to consider the potential harm to a booming business’s reputation, the risk of bad publicity and any challenges posed to continuing growth. There’s also the problem of fighting the sympathetic image of a poor plaintiff pushed aside by greedy former friends now dreaming about billions of dollars in stock options. Think “The Social Network.”

“These disputes can be long, incredibly costly, distracting and emotionally and physically exhausting,” said Gharakhanian, who is currently advising a founder in a dispute that’s been dragging on for five months. He recently sat through a nine-hour mediation that he said “yielded only moderate progress. “The emotions are so raw,” he said. “And there just doesn’t seem to be a light at the end of the tunnel. These disputes just aren’t for the faint of heart.”

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