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Beware of Traps In Advisory Board Agreements

By David Leffler

Advisory board agreements are like orphaned children — overlooked and ignored — and clients frequently sign them without your review. Yet, they sometimes contain provisions that significantly restrict the signer and even make breaching the agreement almost inevitable.

The Devil Is in the Details

Successful individuals tend to be invited to serve on advisory boards of growing companies. There is rarely any cash compensation for services rendered. Instead, the potential board member is offered some form of equity. It seems like a "friendly" arrangement. No cash exchanges hands. So, there is little motivation for clients to invest the time and money to retain an attorney to execute a careful review of the contract. The typical "penny-wise and pound-foolish" thought process is, "I'm not being paid any money to serve on this board, so how bad could this agreement be?" Not the best logic, but often it is this thinking that leads clients to sign advisory board agreements without your review, only to call you when problems arise later.

Why is that a problem? Because what clients don't know can hurt them. Three of the most significant exposures most often found in client advisory board agreements are:

1. overreaching noncompete clauses;
2. inappropriate assignments of the board member's intellectual property rights; and
3. illusory compensation.

Did Your Client Inadvertently Violate a Noncompete Clause?

It's critical to pay attention to the language of your client's advisory board agreement. Too often, these documents contain clauses that would seem more appropriate to an employment agreement than board membership. For example:

Consultant agrees that during the term of this Agreement, Consultant will not engage in any employment, occupation, consulting or other business activity directly competitive with or related to the Company's businesses, and will not assist any other person or organization in competing with the Company or any of its parent, subsidiaries or affiliates or in preparing to engage in competition with such businesses of the Company or any of its parent, subsidiaries or affiliates.

This paragraph looks like it was taken straight from an employment agreement. But it's not. It actually appeared in a client's advisory board agreement and it is overly restrictive. Given that the individual is a board member with other business interests and

not an employee working full time for the organization, any noncompete imposed on an advisory board member should be a lot less restrictive.

Consider the exposures and issues that could arise for a client invited to join an advisory board who signs an agreement with this kind of provision. Most advisory board members typically are involved with at least one other company as a founder or senior-level executive, often in a field related to the business of the company for which they are serving as an advisory board member. This almost certainly puts them in violation of this noncompete paragraph because it prohibits engagement in any business activity “directly competitive with or related to the Company’s business.”

There can be further exposures should the “company’s business” change due to market forces or perhaps a lack of success in its initial business. It’s not unusual for a startup company, for example, to “pivot” to a new business when its original business drive fails due to any number of missteps, such as a failure to recognize existing competitors, an economic downturn or new technology that undercuts its business. This shift to a new business direction could put an advisory board member in direct competition with the company being advised, which would be a violation of this provision.

Did Your Client Sign Away Important Intellectual Property Rights?

Advisory board agreements can contain draconian intellectual property rights provisions. Consider the following provision:

During the term of this Agreement, Consultant agrees that all inventions which Consultant makes, conceives, reduces to practice, develops, establishes or contributes to and which (i) relate to the business of the Company or any of the products or services being developed, manufactured or sold by the Company or which may be used in relation therewith, (ii) result from task assigned to the Consultant by the Company or (iii) results from the use of premises or personal property (whether tangible or intangible) owned, leased or contracted for by the Company shall be assigned to the Company. The Consultant hereby assigns such inventions to the Company.

This provision requires your client, as an advisory board member, to assign to the company all inventions made or conceived during the term of the agreement that “relate to the business of the Company or any of the products or services being developed, manufactured or sold by the Company or which may be used in relation therewith.”

That’s a pretty broad claim on a board member’s intellectual property interests. And again, more akin to an employment agreement provision. Yet it comes directly from a client’s advisory board agreement.

It is also a very fuzzy standard with blurred boundaries. Exercise great caution as this is a provision to which you do not want your client agreeing. There are too many open-ended issues. For example, what if both the board member’s invention and the company’s business are both related to the computer industry? Is that a sufficient connection to require that the board member assign over his or her rights to the

company? The bigger issues are why a company would have a claim to inventions a board member developed for her own business unless it can be proved that the board member used that company's confidential information.

Disappearing Equity Interest

Typically, advisory board members are compensated in stock, options or profits interest — not cash. Worth noting is that some agreements include "trip wires" that permit the issuing company to pull back the equity offered. This can be triggered should a board member breach the advisory board agreement, something that can be easy to do when provisions like the aforementioned are in place.

A profits interests compensation can be especially tricky. It doesn't represent an option to purchase something of value. Rather it is an interest in the issuing company's future profitability. If this is how your client will be compensated, it is important to understand that a profits interest only has value to the extent that the value of the issuing company rises after the date of issuance of the profit interest. By design, on the day it is issued it has no value.

This is risky because startup companies often morph into other entity forms. Your client can be holding a profits interest in a limited liability company that decides to change into a corporate entity because venture capitalists prefer investing in corporations or for other reasons.

If at the time of this conversion the profits interest has no value, your client gets nothing, notwithstanding that there are venture capitalists waiting on the other side of this conversion to invest millions of dollars. This is because a profits interest does not automatically follow the business into its new form. If there is no provision in the advisory board agreement or a related document that provides for the continuation of the profits interest or creation of some comparable interest in the new company, then the profits interest dies when the limited liability company ends its existence.

When you or a client consider joining an advisory board, pay careful attention to the contract you/they may be asked to sign. Most board members have many business interests, of which the advisory board(s) on which they serve is just one. Whether for yourself or when advising a client, any restrictions on business activities or other legal impositions in advisory board agreements should be minimal to avoid significant exposures that will otherwise arise. It is the lawyer's job to make sure that the terms of an advisory board agreement do not exceed this standard.

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