



**Educational Lunch Session
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Your First Steps of Entrepreneurship: The “ABC’s”

Legal Aspects of Business Formation

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I. Forming the Business

- A. Business Name. Your business name must not be too similar to other businesses formed, or doing business, in the same state. In addition, if you expect your business to have a national presence or a “brand,” it’s a good idea to conduct a formal tradename/trademark search before committing to a name.
- B. State of Formation. Deciding where to form you company is an important decision. State laws relating to business entities differ and these differences can affect rights and obligations of a company’s directors, officers and investors. Certain states, such as Delaware, are used because of the well-developed case law and business-friendly statutes.

II. Type of Business Entity

There are different types of business entities and each has advantages and disadvantages:

- A. Partnership. There are two general types of partnerships:
 - 1. General. All partners have rights to bind company and unlimited personal liability for debts of the company.
 - 2. Limited. Only general partners have rights to bind company and unlimited liability. Limited partners (investors) have limited liability and limited rights to participate in the management of the business.
- B. Corporation. Run by a board of directors and executive officers. Shareholders have limited rights to vote on corporate matters, but enjoy limited liability.
- C. Limited Liability Company (LLC). Can be run by members or by a board of managers. Even if run by members, they enjoy limited liability.

D. Important Considerations:

1. **Protection from Company Liabilities.** In general, shareholders of corporations, members of LLCs and limited partners of limited partnerships are not liable for the debts and obligations of the company. All general partners (whether in a limited partnership or general partnership) are exposed to general liability for the company's debts and obligations.

Limited liability can be lost by shareholders or LLC members who run the company as their "alter ego" and do not respect the separateness of the company from their personal affairs (known as "piercing the corporate veil"). Similarly, limited partners who take an active role in the company's affairs may lose their protection from personal liability.

2. **Capital Structure.** If the Company needs to raise additional capital, it will generally find that it will need to adopt a corporate structure where shareholders' interests in the company are measured by the number and class of shares held by them rather than the amount of capital contributed. VC investors will typically want to own preferred stock with specific preferences compared to the common stockholders.

Partnerships and LLCs can have "creative" capital structures (i.e. various classes of owners with different rights to profits, losses and cash distributions), but this can lead to complex tax accounting. Ultimately capital accounts must control owner's interest in the company.

3. **Tax Considerations.** Discussed below under Accounting Aspects of Business Formation.

III. **Raising Money - Federal and State Securities Laws.**

Capital raising activities must be conducted in compliance with federal and state securities laws. These fall into three broad categories:

A. Registration Requirements.

1. All sales of securities must be registered with the SEC and/or state securities commissions unless they are conducted pursuant to an exemption from the registration rules. Registration is costly and time consuming and will require the company to continue to file reports with the SEC. Selling securities in violation of these rules gives investors an "automatic put" for the full amount of their investment.
2. Smaller and start-up companies will typically take advantage of the exemption for "private offerings" under Section 4(2) of the Securities Act and Regulation D.
 - i. This exemption limits the manner in which the company can sell its securities. No "general solicitations" are allowed.
 - ii. The number and types of investors are also restricted. Generally will want to limit sales to "accredited investors"

(high income or net worth individuals or companies meeting certain requirements).

- iii. The securities will be subject to restrictions on resale. Investors will not be able to easily sell their securities.

B. Antifraud Rules.

1. Even though an offering of securities is exempt from registration, it is not exempt from rules designed to make sure that investors have all “material” information about the company before investing. Materiality is defined by whether the information would reasonably affect an investor’s decision to purchase the securities.
2. Failure to accurately disclose all material information can lead to liability to investors for losses they suffer as a result of the company’s misrepresentations and omissions of material facts. As a result, most companies prepare a formal document (a “private placement memorandum”) that looks very much like a prospectus used in a public offering.

C. Broker/Dealer Issues.

1. It is generally illegal to sell securities on behalf of others unless you are registered as a broker/dealer with the SEC. Individuals must be “registered representatives” of a broker/dealer and pass standardized and difficult tests.
2. There is a narrow exemption for employees of the company issuing securities that allows them to participate in the offering as long as they have other substantial duties with the Company, do not receive special compensation for selling securities and are involved in offering securities not more than once every 12 months.

IV. **Protecting Intellectual Property.**

Often times the major source of a company’s value is its portfolio of intellectual property rights and these must be protected just as you would protect your other capital assets.

A. Types of Intellectual Property.

1. **Patents.** Patents provide the inventor of novel innovations a limited monopoly right (e.g., can prevent others from using the innovation) for 20 years. Requires in-depth and expensive application process with the US Patent and Trademark Office. Patents are difficult to get. For example, if the Patent Office deems an invention to be “obvious” or “anticipated” in light of previously published or patented innovations (i.e., “prior art”) it will not grant patent protection. Patents must be rigorously enforced by the patent holder or its scope of protection may be eroded. Enforcement is expensive. Also, patents tend to be construed narrowly and do not always provide protection against competitors.
2. **Copyrights.** Copyright protects your original form of expressing a concept or idea from unauthorized copying or other misappropriation. Everything

from software code to artistic works can gain Copyright protection. Company can obtain copyright protection for works of its employees through employment agreements that contain “work made for hire” provisions. Copyrights are registered with the US Copyright Office. The term of protection for company-owned copyright lasts for 95 years from its first publication or 120 years from creation, whichever is shorter.

3. Trademarks and Tradenames. Trademark protection grants a company the exclusive right to use, market, and affix its name/logo or slogan in conjunction with its products or services. While registration with the United States Patent and Trademark Office is not required to gain trademark rights, registration provides several legal advantages with regard to enforcement, scope of protection and validity. As mentioned, your trademark or tradename should be sufficiently distinct from other similarly situated companies in order to prevent a likelihood of confusion in the marketplace.
 4. Trade Secrets. Trade secrets can be a secret formula (e.g., the formula of Coca-Cola), a process, a customer list, or any information not generally known to the public. Trade secrets must confer some sort of economic benefit on to the company and the company must make reasonable efforts to maintain their secrecy. Trade secrets can last forever. But, anyone can reverse engineer or independently develop the same process, information, etc. So long as they did not unfairly or nefariously use your trade secret, you cannot prevent such conduct.
 5. Licenses. A license is a grant of limited rights in someone else’s intellectual property. Licenses are a creature of contract. They often cost money, but are necessary to run a business (e.g., Microsoft Office).
 6. Other Intellectual Property. This is a catch-all for other know-how, non-patentable or otherwise federally protectible works. They are usually protected by contractual arrangements.
- B. Protecting Your Intellectual Property Through Contracts. Generally, a company should require independent contractors, vendors, etc. to enter a Non-disclosure/ Intellectual Property Assignment Agreements to protect company intellectual property and sensitive business information from unauthorized use or disclosure. In addition, company employees should sign an Agreement containing a “work made for hire” provision and non-disclosure provision (these are often incorporated into a broader employment agreement). These provisions protect the company’s rights in the innovations of its employees and prevent their disclosure.

V. **Employment Laws.**

Hiring employees subjects a company to a wide variety of federal and state laws. These laws include:

- A. Wage and hour laws (minimum wage, overtime pay, child labor etc.).

- B. Equal Employment Opportunity laws (non-discrimination based on various protected classes).
- C. Worker's Compensation (must carry state mandated insurance for employees injured on the job).
- D. OSHA (various regulations designed to protect the safety and health of workers).
- E. ADA (hiring practices with respect to persons with disabilities).
- F. Family and Medical Leave (allows workers to take unpaid leave for emergencies without loss of their job).
- G. Employee benefits (ERISA, health insurance portability and other laws designed to protect employees from loss of these benefits).
- H. Employee vs. Independent Contractor. Businesses sometime seek to avoid legal requirements associated with having employees by using independent contractors rather than their own employees. Whether a person is an independent contractor or an employee is not always easy to determine. The issue is not controlled by a single factor, but depends on how much control the company has over how the work is done, whether the person works solely for the company or for others, and similar factors. The IRS is very suspicious of these arrangements.

VI. **Franchising**

- A. Many new businesses are franchises.
- B. Franchising is controlled by the Federal Trade Commission.
 - 1. Uniform Franchise Offering Circular. This document is delivered by the franchising company and is supposed to provide all the information that the franchisee needs to know about the franchise arrangements.
 - 2. Franchise agreements are very complex documents.

Accounting Aspects of Business Formation

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- I. **Determining the viability of the prospective business.**
 - A. Assistance with the business plan
 - B. Marketing strategies
 - C. Financial statement projections
 - D. Determining financing needs

II. **Choice of Entity.**

Consider the various tax and nontax advantages and disadvantages of each form.

- A. Proprietorship
- B. Partnership (both general and limited)
- C. Corporation (regular, S and personal service)
- D. Limited Liability Company

III. **Filings.**

Identify all relevant filings; obtaining and completing all relevant forms; and ensuring that they are mailed or delivered to appropriate authority. Including: Federal Identification Number (filing Form SS-4 with the IRS) and other similar identification number required in certain states and municipalities.

IV. **Taxes**

Businesses are subject to a variety of taxes, including:

- A. Income taxes
- B. Sales taxes
- C. Employment taxes. Properly withholding and depositing payroll taxes and filing the required returns (there are severe penalties for not doing so).
 - 1. Withholding.
 - 2. Medicare/Social Security (FICA - Federal Insurance Contribution Act).
 - 3. Unemployment.

V. **Licensing Requirements**

Virtually all start-up businesses encounter some kind of local, state or federal licensing requirements.

- A. Federal Licensing – unless operating in a highly regulated area, most small businesses are not subject to federal licensing requirements.
- B. State Licensing – these different types of licenses or permits generally are granted on the basis of some combination of requirements (such as education, experience, and examination, as in the case of professional licenses) or bonding (as in the case of businesses that contract to provide goods or services to the state.
- C. Local Licenses or Permits – most businesses are required to obtain licenses or permits from the city or county in which they operate; normally requires completing a form and paying a fee.

VI. **Insurance Coverage**

Obtaining proper coverage to meet business requirements and exposures.

VII. **Personnel Selection**

Hiring practices and personnel policies are formulated and documented.

VIII. **Record Keeping and Controls**

Establishing policies and procedures related to record keeping and control over assets.
Record Keeping can include:

- A. Selection of accounting system.
- B. Developing a chart of accounts
- C. General ledger and accounting records.
- D. Filing system for the documentation to support accounting records.

Banking Aspects of Business Formation

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I. **Determine capital needs**

Banks rarely fund a brand new start-up business without a track record.

Plan a 10% contingency for "Murphy's Law".

The average Inc 500 firm started with roughly \$25,000 – more than a quarter started with less than \$5,000.

II. **Less than \$25,000**

- A. Bootstrapping – use your own money to get started and plow income back into company. Can include family and friend as a loan or gift, make it clear which is which. Start saving Now! Build a nest egg on your own.
- B. Credit Cards – Short Term Debt Only!
Keep balances to less than 50% of limit.
Always pay more than minimum if not in full each month.
Remember: A \$1,000 purchase at 18% paying the minimum with no new purchases takes 12 years to repay and costs you \$1,115 in interest.
- C. Vendor Financing – vendors may carry you as an incentive to purchase their product.
- D. Loans –Bank/Credit Union.
Home equity; refinance autos; collateral based loans.
Credit Scoring.
SBA Micro Loan Program.

III. **Greater than \$25,000**

- A. Bootstrapping (see above)

- B. Loans – Bank/Credit Union/SBA
- C. Angel Investors
- D. Venture Capital
- E. Specialized Sources - USDA/Small Business Innovation Research/etc.

IV. **What Bankers Expect**

- A. Review of the 5 “C’s” of Credit
 - 1. Cashflow or Capacity
 - 2. Capital
 - 3. Collateral
 - 4. Conditions
 - 5. Character
- B. Generally 30% of project cost in equity.
- C. Personal guaranty.
- D. Projections of Balance Sheet, Income Statement, Cash Flow Statement.
- E. Collateral available for pledging.
- F. Exit Plan – the “what if” question.

WHAT FUNDERS WILL WANT

You will be asked to provide the following information:

1. MANAGEMENT

- Resumes/experience of key personnel in the business
- Management plan for the business (who will be in charge of daily operations, bookkeeping and accounting, etc.)

2. CASH FLOW

- Past financial statements for existing businesses (tax returns, audits, year-to-date internal statements)
- Projected financial statements for the next 1-2 years
- If a start-up, personal tax returns for the past 2 years

3. EQUITY/DOWNPAYMENT (How much money you are putting into the project?)

- Fund balance/equity on balance sheet
- If a start-up, personal savings to invest
- If purchasing a business, is seller financing available?

4. COLLATERAL (Security for the loan)

List of possible collateral including:

- Real Estate
- Cash pledges in banks or credit unions
- Marketable securities (no retirement accounts)
- Equipment/vehicles
- Names of possible co-signers if collateral is weak

5. CREDIT HISTORY

- Personal and business credit reports
- History of rental and utility payments (if have no or little credit history)

6. OTHER INFORMATION

- Market information (who are your customers and why will they come to you?)
- Business Plan (which should include all of the above information)
- Secondary source of repayment (how will you pay your debt if your business is not earning a profit yet)