

Velocity Law, LLC

Law Firm for Business

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Legal Issues for the Small Business Owner

(For Entrepreneurs, Start-Ups, or Growth Companies)

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Pre-Startup Preparation

1. Noncompete with Current or Former Employer or Partner?

- A. Do you have a Noncompete Agreement with your current or former employer, or business partner?
 - Courts may treat differently if you left versus if you were terminated versus if company sold.
 - University Employees subject to strong noncompetes, giving the university the right to develop the IP, not the student or professor.
- B. Do you have an Employment Agreement with your current or former employer? (Sometimes Employment Agreements contain noncompetes).
- C. Does your employer's employee manual, or intra-company website, contain a Noncompete provision or prohibition on side work?
- D. Do you have an agreement with your customers, vendors, or consulting clients, which may contain a noncompete?
- E. Do these, or any other agreement, **impedes starting, or expanding, your business?**
 - Distribution Agreement or Limits on one?
 - Licensing Agreement Limits
 - Lender/Bank Limitations or Restrictions?
 - Franchise Agreement
 - Regulatory Licensing
- F. To what degree? Prohibit altogether?
- G. Industry Limit?
- H. Geographic scope limit? (usually for bricks and mortar retailers, or hyper local service companies)
- I. Time limit?
- J. Prohibited customers? Only limit specific customers or employees?
- K. Applicable after you leave?
- L. **Remember that anything is negotiable, Even if you are tied to a restrictive agreement.** Perhaps you can amend agreement to allow your intended business or compete in their space, but not take their customers, or employees.

- M. **Don't mess with the customers or the revenue of a competitor with whom you had, or have, a Noncompete.** They might be willing to overlook your competing, they may leave you alone if you don't tread in their turf. But when you hit them in the pocketbook, you will tick them off and start a dispute, which could turn into a lawsuit.

2. Who Owns Intellectual Property Being Used to Start & Run Business?

- A. **Developed** Where? While employed elsewhere? Might employer have claim to it?
B. **Co-developed** with another party? Does the other party own part? If so, are the legal rights all assigned to you? If not, it's not yours to further develop, or you may need to buy the IP rights from the co-developer.

Note: You don't own the business idea, until you own all the IP on which it is built.

<http://www.lexology.com/library/detail.aspx?g=24ea2beb-d653-4b6d-bc88-92863193fe8d&l=7TY9UZH> Cherly Miller and Daniel Zimmerman, WilmerHale Law Firm.

3. Protection of Intellectual Property

- A. Is **protection of your IP** Possible? Patented? Business Process Patent option? Have you blown that protection by putting your ideas in the public domain? An Intellectual Property Lawyer will address these points with you.
B. **Use Nondisclosure Agreements** for Employees and Partners
C. **Name selection and trademark** (see below and talk with a trademark attorney)
D. **Balance how much to** discuss with business partners, alliance partners, customers, vendors, and investors, and in business plan, investor documents and offering memos. Protect proprietary info.
E. **Disclosure to Investors.** Business Plan Narrative about IP, what the founder or the company own, state what, who owns, how protected. All IP info in the disclosure document / offering memo.

4. Name Selection; Trademark Conflicts; Name Check Before Informal Name Adoption, Formation, or Use of Product Name or Tag Line

- A. Critical to conduct a proper search before business formation, domain selection, D/B/A use, "working product name", or business growth. Importance of global name check, given the global use (and surveillance) of business names through Internet.
B. All business names, DBAs, product names, logos,
[See – "Name Search & Selection Checklist" and "Trademark Goods and Services Classes" to help you search correctly], search vehicles & techniques for "knock out" search]
1. Business Name, Service Tag Line, Product Name, App Name: Issues Apply to New Product Names and Tag Lines, as well as to Business Names.
2. Name Search and Selection Pitfalls under Trademark Law:
3. Internet changes the landscape and scope...name must be checked everywhere.
4. Details of how to conduct a proper name search in "Name Search..." doc.
5. Secure rights to business name, logos, product name, web logo, by using them in commerce, and making trademark filings if you can. No Use = No Trademark Rights; "Use it, or lose it."
6. Can't use same, or *similar*, name in the *same industry*. Even homonyms, same root words, or phrases prohibited if "likelihood of name confusion" may result.

7. A federal judge ordered Houston College of Law to change its name in 10/2016, after University of Houston Law Center sued Houston College of Law in a trademark fight.

5. Research and Learn Your Industry & Competitors – Viable business?

- A. What is the Revenue Model?
1. How will you charge people?
 2. Will people really pay for your product or service, or is there a free or cheap alternative out there on the internet? You are a startup, so people expect discounts off of regular market rates.
 3. How will you get paid? Consider technology such as Square, accepting credit cards, QuickPay, PayPal, Venmo
- B. What are your business expenses needed to start the business, and then to operate it? Including all costs, like full taxes, paying employees what they are worth, and paying all your suppliers and vendors timely. What are the realistic expenses? (Not the low ball, “I hope I can get it for cheap” expenses? It is possible that the lean startup can be too lean.)
1. If you are getting people to work for free, you are not a viable business.
 2. People not getting paid will leave, risk factor to the company.
 3. Don’t brag about getting people to work for free or getting services or suppliers for cheap.
 - It makes you look cheap, and
 - business is not sustainable to be getting stuff for free or cheap
- C. Charge enough to pay all the expenses, including payroll tax and income tax and pay yourself. If these basics are not covered, then it is not a viable business.
- D. Starting and operating a business always costs more and takes longer than expected. Make sure the business will make enough income to make it worth it for you to spend your time on.
- E. Save enough money before starting, to pay for the things needed to properly start the business
- F. Plan ahead and plan for the unexpected.
- G. No such thing as “no competitors”. What are your potential customers using as the current substitute?
- H. Daily or weekly Internet searches to keep your info current, check your competitors, your alliance partners

Business Filings and Compliance Requirements **(For All Businesses - Even Sole Props)**

6. Filings and Steps Required for All Businesses: Even If Business is a Sole Proprietorship

- A. Name Search applies to unincorporated businesses.
- B. DBA/Assumed Name for either Corp, LLC or Sole Prop (if different than corp name).
- C. Seek advice of corporate counsel and tax advisor on entity type, formation state and name selection.

- D. Federal Tax ID.
- E. State Tax ID – Illinois REG-1 (Payroll Tax, Sales Tax, Use Tax, Income Tax).
- F. Business Bank Account.
- G. Illinois Department of Professional Regulation – License - Nurse, Mortgage Broker, CPA, Law, Architect, medical, Landscape architect, Surveyor, hundreds of others.
- H. Business License (Local City, Village) – Most all cities and suburbs require it, even for a home office. Simply a ½ page form, \$50 filing fee.
- I. County License (health or food related businesses, or those that physically touch people or animals).
- J. Specialty Licenses for Food, home health, massage, dog kennel and many others.
- K. DBA – Assumed Name.
- L. Employer Payroll Tax Payment Accounts EFTPS and IL Tax Net.
- M. Sales Tax Account and Use Tax Account in IL and States in which business done.
- N. Business Income Tax Account – Not required for Sole Prop.

7. Business License, Tax, and Sales Tax: Regulatory & Corporate

Compliance. Whether Incorporated or unincorporated businesses: Business must make filings for: Local business license, sometimes county filing, sales tax, employment, professional licensing, qualifying to do business in other jurisdictions, annual filings, maintain insurance, and use contracts.

8. Certifications as Small Business, Women Owned, Minority Owned, Veteran Owned – Optional.

Optional: Certifications such as WBE, MBE, VBE that pave way for receiving work under government contracts and corporate affirmative action contracts.

Business Structure and Formation

9. Sole Proprietorship or Form Business Entity - Recommend an Entity

Operating as a Sole Prop, vs. forming a business entity (Corp or LLC) for your business:

- A. Personal Liability in sole prop,
- B. Separation of financial & tax matters, tax returns easier if entity.
- C. Insurance Difficult to Obtain for sole prop,
- D. Larger Companies require corps around business owners,
- E. Perception of customers,
- F. Easier to obtain a Loan if you look like a "real business",
- G. Due Diligence goes more professionally and easily if people can conduct Due diligence on you on Sec of State site;
- H. If company will ever raise capital by issuing stock to investors or employees, must have entity;
- I. Required to file a DBA with any County in which you have a location or in which you do businesses. Cost can add up, to more than the cost of the forming entity.
- J. Required to file an Illinois Reg-1

- K. Therefore much of the time consuming cost of forming an LLC or corporation must also be done for a sole prop = not a huge difference in cost between all the sole prop compliance and the LLC formation.

10. Two Businesses = Two Business Entities

For the same reason to form an entity around your business to separate liability, income expense. Form separate business entities around each differing business. Don't try to smash together an IT consulting business with a real estate investment business or a retail store. Confused business description or name will result (corp docs, website, and in eyes of confused customers.)

11. State of Formation – Use Your Home State

- A. Form in the state in which you are located.
- B. "Qualify" in other states as you add them to your customer-base.
- C. Don't form in Delaware, NV or WY or other "foreign" state, only Delaware if you might go public, or will have venture capital investors.
 - a. If so, also must qualify the entity in your home state and
 - b. Must hire a registered agent in the distant state.
 - c. Adds formation cost and annual cost, with no benefit, unless you go public.
- D. Filing in NV or WY to save money on filing fees, makes you look cheap, and ends up costing more than the savings, due to local home state qualification and registered agent. Filing in WY or other states that don't disclose the business owners, will give a tip off to anyone doing due diligence on you that you choose to stay anonymous for a reason, which may draw suspicion.
- E. Form in Delaware if you are certain (realistically) that you will go public. Highly unlikely for 98% of the companies out there. You can change to Delaware later, by doing a "migratory merger" with a new Delaware C Corp.

12. Corporation vs. LLC

Corp vs LLC is mostly a tax decision, see your tax advisor.

But some corporate law factors and business decisions contribute to decision of whether the business should be Corp or LLC. Talk to your accountant or tax advisor (good experienced business accountant), or we can refer you to one. In general:

- A. Form as a corporation, if you plan to:
 - 1. Raise money from outside investors (outside of founders or close small group). Outside investors include angels, VCs, employees, friends and family;
 - 2. Issue equity to employees as partial compensation, or adopt employee stock option plan, or
 - 3. Offer a 401(k) or other retirement plan to owners and employees (see your tax advisor, many factors)(possibly can be LLC taxed as Corp), or
 - 4. Build a company that has an astounding, game-changing, disruptive idea for a product, invention, or service that might take the company public one day in a large underwritten deal on NASDAQ Global Select, or on NYSE. In that

case, the company should be formed as a Delaware C Corp, or a corp in your own state for now.

- B. Real estate investment companies are always formed as LLCs.
- C. Investment and Trading businesses are always formed as LLCs.
- D. Service companies (professional services) are sometimes formed as LLCs:
 - 1. LLC if the owners will never take W-2 Payroll Checks and will always receive only periodic partner distributions (such as in a real estate ownership venture)
 - 2. LLC if the business may add two classes of partners, such as "Income Partner" and "Capital Partner", or "Profits Interest" vs "Ownership Interest".
 - 3. LLC can be taxed as partnership, as sole prop, as S corp or as C corp.
 - 4. Not LLC if you want to have a 401(k) plan, unless you chose LLC taxed as a corp. (See your tax adviser.)
 - 5. Some accountants prefer that service companies be S corporations (See your own tax adviser.)
- E. Retail Stores or Manufacturing businesses selling goods and products, with store or production employees, are often established as corps (Can be LLC if your accountant approves).
- F. Operational docs for an LLC are more complex than for a corporation.

13. **Formal Business Entity Formation (Corporation or LLC)**

- A. Problems having formed Corp or LLC by yourself, or formed by an accountant, or by Legal Zoom, or Business Filings Inc., or other online incorporation service, or by a real estate lawyer or a divorce lawyer. The cost to repair missteps will far exceed cost of hiring an experienced corporate lawyer at the outset. **Please use a lawyer to form your entity.**
- B. Set of Steps for Proper Business Formation, more than just filing a certificate, and many steps come before the certificate filing – Corporate formalities.
- C. **Steps for formation, Important to Maintain Entity Status.** [Filing Fees].

Corporate Formalities to Avoid Piercing the Corporate Veil

14. **Corporate Formalities After Formation – Avoid Piercing Corporate Veil**

- A. Proper incorporation or LLC formation.
- B. Botched Do-It-Yourself Incorporation or LegalZoom formation; clean up often needed.
- C. Keep corporate records straight, especially ownership records, particularly if there is more than one owner.
- D. Issue Stock Certificates
- E. Stock ledger /LLC ledger – Record share issued and who owns what percentage. This is you corporate check book for you company's bank account of shares
- F. Separate finances, actions, contracts:

1. From personal and
2. From other businesses
- G. Diligent accounting records
- H. Follow Corporate Formalities
 3. Sign only in the company name, not in personal name
 4. Corporate Resolutions
 5. Corporate Records (even if only electronic), bank accounts, taxes, shareholder loans (notes), security of note (UCC statements)
- I. Investor due diligence on corporate formalities and records
- J. If doing a transaction either borrowing, raising money from investors, or selling the business, then all material info about the Company must be in the business plan, offering memo or disclosure document if raising capital from investors [Handout – Corporate Maintenance. Checklist]

15. Resolutions – Authority to Act; Flesh Out to Address Very Basic Issues Normally in the Shareholder Agreement (LLC Agreement) between Founding Partners (Owners)

- B. Business partner - Can Act as a limited shareholder agreement between you and your founding business partners
- C. If you are in business with a person or entity, and a corporation or LLC is not formed, then a de factor Partnership is created by default. Partnership case law applies.
- D. Establishing relationship, financial and legal, with your partner:
 1. Who contributes what in the way of cash and property
 2. Who will contribute what aspects of the sweat equity? Who will do what portions of the work? Who will bring in business?
 3. Who owns what percentage
 4. What voting rights will each person have?
 5. Who will get what when the company dissolves or splits up, include possibly a noncompete agreement.
- E. LLC act requires that dissolution permitted only with 100% of the owners. So provide a lower percentage in the Resolutions, Articles of Formation or LLC Agreement.
- F. Corporate Authority to sign documents and bind the company
- G. Spending Limits on Officers or Managers absent approval of Owners or Managers
- H. Officers Election, Directors Election
- I. Business Partners versus Alliance Partners – not to confuse, don't make Alliance Partners owners in your company.

[Hand out available. Checklist of discussion items among partners in corporation]

Workers and Partners

16. Worker Classification – Employee (W-2) vs. Contractor (1099): The Catch 22 of Small Business

- A. Classification of Workers as Employees or Contractors; Distinction between; IRS presumes "Employee" Status. Legal conclusion revolves mainly around who has control over the worker?
 - 1. Location of work,
 - 2. Hours dictated
 - 3. Tools used
 - 4. Does Contractor have other clients or other outside jobs?
 - 5. IRS uses 8-12 factors to determine. [Handout];
- B. Even part-time employees, who work small number of hours, are often considered employees.
- C. Illinois Laws now require that you categorize even part time employees as employees.
- D. Result is: Set business up as a payroll tax employer, when in doubt or even a little gray, treat them as employees and withhold payroll tax.
- E. Illinois Employer Act – reporting of new hires now required
 - 1. Illinois Employer Act – Classification is stricter than federal in some cases. Even a 10 hour per week part time person can be deemed an employee.
 - 2. Illinois requires “new hire reporting” online, with social and birthdate within 30 days of hire.
 - 3. Some legal issues arise from hiring employees, such as Unemployment Liability. Importance of terminating someone within 30 working days if they don’t work out, to avoid unemployment claim.
- F. Harassment and discrimination prohibitions apply to even smallest of businesses; the owner can incur financial liability when her managers harass or discriminate and employee sues the company.
- G. Document employee behavior; use written reviews; document and hold the interviews under the same standards for everyone. You can discriminate against customers, just not employees.
- H. Federal and state laws apply to 10 or more, or 20 or more, employees. There are many statutes and very specific provisions that can apply to employing employees. [Hand out from employment lawyer]
- I. “Dangerous work” requires attention to other regulations and specific precautions in insurance and contracts.
- J. Technology, BYOD, privacy, reading emails, or FB posts,

17. Compensating Employees

Money payroll is typically best, as far as saving cost to employer.

Paying workers under equity plans is exciting and can generate high morale, but they are very expensive to implement (tax costs, legal fee costs, fiduciary advisor cost, must implement a formal written plan).

18. Employment Law - [Many Topics, See an Employment Lawyer]

- New Hire Reporting Rules in IL
- Unemployment – Terminate before 30th Day
- Overtime Rules – Employee making $\leq \$47,500$ must be paid over time, cannot be classified as “exempt”.

19. Partner – Should You Have Partners? Pros and Cons – Shareholder Dos and Don't's

- Don't Make Just Anyone a Partner or Shareholder:
- You can fire an Officer, Manager or Employee. You can Remove a Director. But you cannot fire or remove a partner without buying them out at current value.
- Equity only to your closest partners inside the business, only if trust intimately.
- Don't give away equity as monopoly money when you don't have real money (consultants, employees, partners)
- Don't give or sell equity to consultants, employees, partners, investors, without understanding long-term consequences, and securities law compliance items.
- Don't confuse Business Partner vs Alliance Partner;
 - Alliance Partners share profit/losses on a transaction.
 - Business Partners Share P & L in the entire business
- Partnership or Share ownership is a Marriage. Splitting Up Requires Divorce (+“alimony” or “estate division”).
- Jointly in business with person if no entity formed = Partnership by default. Partnership law applies, not corporate or LLC law. General Partner = Personal liability
- Should he or she be a partner? Or a paid employee instead? Split work and skills, ideas, delegation
- Shareholder agreement between you and business partners: Discuss Arrangement Among Partners
 - Email partner discussion points & agreement among partners
 - Provide dissolution mechanism and Vote
- Don't make spouse partner.
 - Unless works significantly in the business. More than admin.
 - Use a Will for Estate Planning, not shares.

K. Should the potential partner be an employee, not an owner?

Pros

- L. Looks better to outsiders if you are not just “one mad scientist in garage”
- M. Allows you to focus on your skill set, while partner does other skill sets.
- N. Delegating is hard for Entrepreneurs

Cons

- O. Hard to get rid of partners – Must buy them out.

While you can fire an employee, contractor, consultant or officer; you can remove a board member or managing member if things don't work out, or when the project is complete. But you can't fire an owner or partner in your own business if it doesn't work out or if the project is complete. Instead you have to buy them out at the current fair market value of their ownership interest in your business. If it has increased in value, then you could be looking at paying them a substantial sum to get them out of your business, plus legal fees. Solution: Make them a contractor, consultant, employee or officer, but not an owner.

Also, who owns the IP if co-developed between you and partner?
Solution to the co-developed IP issue: Form a separate LLC for the project.

- P. More Costly corporate operational docs if partners rather than employees, consultants or officers.

20. Operational Docs Basics: Shareholder Agreement or LLC Agreement Among Owners

The Business Pre-Nup between you & partners:

- Who invested What, How much, what %?
- What percentage of ownership
- Percentage Vote to pass an Issue?
- Title, Role, Responsibilities
- Profit & Loss Allocation, Ownership Allocation
- Buy Sell Provisions – Death or Disability
- Departure of a Shareholder? Noncompete?
- Dissolution Provisions – How to Shut Down

21. Conflicts of Interest, Ethics & Disclosure; Referral Fees

- Avoid Conflicts of Interest, disclose them to anyone you can think of who would scrutinize them. A Conflict can be waived or made more palatable, if disclosed and discussed in advance of the transaction.
- You can take referral fees, but disclose that to your client, Make sure there isn't a conflict of interest in the referral fees, among the parties you referred together.
- Pricing and price fixing – The entire industry can't get together to determine pricing. But it is fine to talk to your peers about what they charge and charge the same.
- Ethics – Reputation is like virginity, once it's gone you can't get it back.

22. Adding & Removing Partners, Partner Buy-Outs, Corporate Split Ups

1. Documentation is required to change ownership up or down.
 - i. Internal docs
 - ii. State filing docs
 2. Assure that added partners pay for their shares and you have the check copy on which they paid.
 3. Removal of partner means you'll need to pay to buy out that partner.
 4. Many legal steps required
- Adding/Removing Partners Requires Legal Docs.
 - Corporate Split-Up requires a transaction with \$.
 - Selling the Business: Plan years in advance;
 - For any of the above, keep ducks in order; Corporate Records, Legal, Accounting, Processes Documented, Good Management, limit debt.
 - Realistic expectations as to selling price and timing. May need to obtain professional valuation.

23. Shareholder Agreement (or LLC Agreement) – Basic - between Founding Partners (Owners)

- A. What if you have a business partner? Shareholder agreement between you and your business partners –founding partners.
- B. If you are in business with someone and a corporation or LLC is not formed, Partnership is created by default. Partnership case law applies.
- C. Establishing relationship, financial and legal, with your partner:
 - Who contributes what in the way of cash and property
 - Who will contribute what aspects of the sweat equity? Who will do what portions of the work? Who will bring in business?
 - Who owns what percentage
 - What voting rights will each person have?
 - Who will get what when the company dissolves or splits up, include possibly a noncompete agreement.
 - Business Partners; Alliance Partners, :Planning for the unexpected”:

- How to remove a partner
- What if one dies, quits, cheats or divorces company, or goes to work for a competing company?
- Buy Sell Provisions

Technology Making the Business Work Better

24. Use Technology to Operate Your Business

- Use Tech, or you'll be left in the dust. Must use email, electronic brochures, website online for due diligence (include location, address, phone; people want to know where you are); CRM Programs, Billing software, aggregation platforms, software tools, and social media if appropriate for marketing
- No such thing as "I'm not good at technology" or "I don't use email". Saying that will make you look foolish
- Efficiency
- Disaster Recovery
- Cyber Security
- Save Enough Funds Before You Start to Afford Tech

25. Website Use; Email Distribution and Spam

Business Side: Website is a powerful tool to generate business. Use professional web developer who understands the whole process and how it will drive business to your site, including metatags and "search engine optimization". What words and buzz words are on the "hit list" of people searching for your type business?

Legal side:

- Domain Name must be cleared and available to use. Don't use any fake permutations of it. If it's not available in the .com, then the entire name might be taken. See Trademark issues above. Add another word to the name.
- High level rules are simple: Don't Lie, Don't Steal, Don't Mislead People, Don't Spam, and Don't Trick Kids, Don't Show Inappropriate Stuff to Kids.
- What you say on your site about your company must be **true**
- You must **own the intellectual property** on the site, or instead must have permission to use it. Make sure your website developer's agreement assigns the ownership of your site to **you!** (Jury still out about using content of others and links to content.) Always credit the writer.
- Can't allow minors to use a site not appropriate for kids

-Social Media

- Facebook and Twitter – Very powerful, but also be mindful of your customers or clients privacy, and be mindful of whether you look professional talking about your clients and customers.

-Email Newsletters

G. The CAN-SPAM Act establishes requirements for e-mailed commercial messages. Penalties for violations. Summary of the rules:

1. **Don't use false or misleading header information.** The "From," "To," "Reply-To," and routing information – including the originating domain name and email address – must be accurate. Must identify the message sender or initiator.
2. **Don't use deceptive subject lines.** The subject line must accurately reflect the content of the message.
3. **Tell recipients where you're located.** Your message must include your current street address or a post office.
4. **It's illegal to spam people** who don't want advertising emails, even your newsletters! Ask permission of recipient first.
5. **Tell recipients how to opt out of receiving future email from you.** Your message must include a clear explanation of opt out procedure, or provide working "unsubscribe" link.
6. **Honor opt-out requests promptly.**

H. For credit card privacy (PCI DSS

- https://en.wikipedia.org/wiki/Payment_Card_Industry_Data_Security_Standard) - this is serious stuff, businesses can be liable for losses due to fraud if they are negligent. Any small organization accepting credit cards is to just use a payment processor like Stripe, Braintree, Square, Paypal etc. They charge a nice 2-3% fee, but unless 2-3% of your revenue is enough to hire a team of information security experts, there's no reason to try and do this yourself.

I. Data Collection Privacy Rules Apply

Protecting the Business Owners & the Business

26. Use Noncompete and Nondisclosure Agreements with Your Employees, Customers, Contractors, Consultants, Vendors

- A. Protect your IP with your Employees, Contractors, Consultants, Customers, Clients, by using a basic Non-disclosure, Noncompete and Non-Solicitation Agreement. "Mutual" or "Reciprocal", not "one-way".
- B. Consequences of Intellectual Property or Trade Secrets "leaking out"?
 1. They can lose status as a Trade Secret
 2. Former employees or contractors, or business alliance partners, or competitors, taking customers from your customer list or stealing your employees.
- C. Address the reverse issues if you are an employee or contractor asked to sign a noncompete / non-solicitation agreement.

27. Due Diligence –

- A. Due Diligence Others Conduct on You –
 1. **Your Clean Background is Key**

2. Due Diligence that Investors will conduct on Principals

- 3. Background checks**, criminal, regulatory, tax liens, bankruptcy, licensure history
- 4. Principals** (D's & O's, Control Shareholders), the entity itself, and prior business and legal history) – All of above, plus business reputation
 - a.** *All material info about the principals must be in the offering memo*
 - b.** [Hand out – Due Diligence Questionnaire for Private Placements to Investors or Loans from Bankers or Professional Lenders]
 - c.** [Hand out – Article “Is Your Business Investor Ready”? and [“20 Questions VCs Will Ask”]

B. Due Diligence You Conduct on Others

1. Conducting Due Diligence on Clients, Alliance Partners, Suppliers and Lenders:
2. You are judged by the Company You keep
3. How to Avoid the Toxic Client/Customer, and their collection problems.
 - a. Always in a rush, does not plan ahead, wants a discount, wants custom items, doesn't have money up front
 - b. Owes other people money,
 - c. Changed suppliers or service providers to you (who before you? Any money outstanding?)
 - d. Moved here from Out of State
 - e. Litigation costs more than most small business contracts are worth, so protect yourself through who you deal with and don't get into a bad situation
 - f. Make sure you know your bed mate before jumping into bed with them.
 - g. Protect yourself against non-payment with a contract and down payment (Contract is not assurance of getting paid, but at least you have a document that could be litigated if a dispute arises.)

28. Professional, Prepared, Organized Image - Ducks in a Row

- A. Continue to know your Industry
- B. Suppliers in place, as close to letter of intent or contract as possible.
- C. Customers in place, if appropriate or possible, even one or two customers
- D. Industry Compliance – hire experts
- E. Due Diligence on Company you Keep – Those you partner with can affect your business reputation (judged by the company you keep)

Contracts for the Business Operations and Partners

29. Contracts: Use them; Tips & Tricks to Negotiating

- B. Two general elements of contract:
 1. Business Points – You write (or you give bullets to your lawyer to write)
 2. Legal Points – Your lawyer writes
 3. If you don't get something, ask

- C. Read the contract and understand it
- D. Contracts must be in writing to be enforceable
 - 1. An Email is a writing, make it clear who is saying what
- E. **Oral Relationships Time to Get Real Before Going to Lenders**, Investors and Alliance partners will **not invest on deal built on them**, no matter how solid. Make the deal, but eventually paper it
- F. **Realistic Expectations as to Cost, Timing, Involvement**
 - 1. Your first services contract your first product contract is going to be expensive. Even if you do work on, it will be a couple to few thousand \$
 - 2. Your first services contract is important, it is the entire basis on which your business will be built. It will be a larger cost investment at first, but later contracts can be copied from this.
 - 3. You will need to be involved in this interactive process with the lawyer.
- G. Retroactively papering agreements is very expensive to, so don't get too far down the pipe with too many oral agreements.
- H. **No such thing as a "template" that works for everything** Customization is required and is what protects you. We can make you your own company template, customized for your business, but it still will need to be filled out and customized for each customer.
- I. **"Reps and Warranties"** – If it says you will do something, make sure you can do it. If it says something is true, make sure it is true. If the rep says that you have insurance coverage, then you must get the coverage before signing the contract. Confirm that the fact you state is true at the time you sign the agreement, not "later". i.e. You have insurance
- J. **Assignable?** Be sure that your contracts with Vendors and Customers and Employees, as well as nondisclosures and noncompetes, are assignable and transferrable in case you sell the business
- K. Negotiation – Do's and Don'ts
 - 1. Negotiate out the business terms, but don't sign, "I need to get my lawyer's approval before signing"
 - 2. Don't sign a final deal. There is no "attorney approval period" in any contract other than a residential home purchase
 - 3. Don't try to go too far on the deal without involving counsel
- L. When to Involve Counsel
 - 1. Bullet Point list to lawyer of business points you want; don't try to write the whole contract
 - 2. Get a copy of the Contract in Word, not in PDF, which will save you money in legal fees
 - 3. Other Do's and Don'ts Before Bringing the Contract to Counsel:
- M. **Common trips in legal agreements:**
 - 1. Staged Payments with conditions on payment, that you cannot control
 - 2. Release of Claim,
 - 3. IP Due diligence not done.
 - 4. Indemnification for Liabilities and Breach,
 - 5. Insurance Requirements,
 - 6. "Complied With All Laws" provision,
 - 7. Reps and Warranties with breach, that you can't comply with = breach of the entire contract

- N. For lender or investor or private equity buyer, summarize all material contracts in the Business Plan, Disclosure Document or Offering Memo for Lenders or Investors. Deal must be papered in order for securities lawyer to summarize it.

Business Advice Topics

30. Common Mistakes in Business Start Up:

- Salaries to Founders (or paying back founder loans), too early in the game, when company needs working capital.
- Pie-in-the-sky projections, or
 - only one set of projections or
 - no back up for the projections
 - excel sheet that does not add up
- Using AOL or hot mail or as your business email account,
 - looks unprofessional and
 - emails of big size will bounce,
 - can't store emails to keep as business records
 - Says "I'm too cheap to spend on technology", or "I'm not a sophisticated technology user"
- Unrealistic expectations in many aspects –
 - Cost of starting up and operating
 - About % of equity give-up for adding partner, or investor funding
 - Others.....
- Ignoring Due Diligence Issues in backgrounds of principals, officers and directors
- Wrong Motivation for starting the business
 - Examine your motivation
 - Not a get rich quick scheme based on exit quick strategy – long haul
- Dispensing stock loosely, to everyone including the cleaning lady
- Asking your lawyer or accountant to be on your board, or to find funding sources or investors for you
- Not keeping your writing skills polished.

Exit or Providing Capital Strategies

[Optional – Only if Time – Brief Touch]

- 31. Selling the business, Buying a Business, or merging with a Business.**
Review all points above, to assure compliance as they all need to be done as corporate due diligence. Selling your business is a very long-term exit strategy for a startup. Plan from day one for the exit and keep all the ducks in a row.

[See Handout "Sale of a Business - Due Diligence Planning for Asset Purchase or Stock Purchase]

[Selling Your Business - At a Glance – This is a topic for another entire seminar.]

A Few Due Diligence Points:

- Keep your corporate records (legal and accounting) in top shape in case a buyer comes around.
- Document the company processes, procedures, secret sauce. If it's all in your head, your company is not worth much when you leave.
- Business Coach or Management consultant checkup – Keep Good Management Team in place for the sale
- Realistic expectations as to price of business, it's not worth as much as you, the seller, thinks it is – Get a professional Valuation
- Realistic expectations as to timing – Many months
- Caution about using business brokers, some are registered and some are not
- Use a lawyer and accountant before sealing the deal.
- Be prepared for Due Diligence on every corporate record, contract and relationship; financial records for the past few years, list of Debt, list assets and inventory, list IP and tech, list contracts, list owners and % owned, list employees, list litigation, pass a cyber security audit (you order your own), permits and licenses, regulatory compliance, get a valuation; negotiate a Noncompete; being held to a year or more consulting agreement, a Seller Note (buyer borrows some of the money from Seller); reps and warranties, and think about your estate planning
- See separate [Handout "Selling or Buying a Business" by email request]

END OF Typical Business Owner PRESENTATION

32. Borrowing From Lender vs. Investor Capital Raising – Equity advantages over Debt:

- Lenders easier to find than investors
- Debt faster to negotiate and close.
- Debt less costly than equity in a few ways.
- Equity (Investor money) more expensive than debt due to securities compliance costs. Deal must be larger to make it worth cost
- Equity: Issuer gives up a piece of the company
- Investors share fully in profits & losses and only get paid if there are profits; while lenders get paid regardless of profits & losses.
- Lenders often prefer debt because of lender priority in liquidation or dissolution.
- If equity deal crashes, issuer's owner is generally **not personally liable** (However, issuer's owner is **personally** liable in equity raise, if he has in any way, misled investors or misstated any fact, or even a shade of meaning in the disclosure, and they sue issuer and owner in a securities fraud lawsuit)
- Equity Broadens the company's horizons because decisions will now be made by "committee" of investors and larger board, rather than narrower decision factors determined by bank loan officer and you and you're small, closely held board.
- Equity – Access to capital not based on loan-to-value, or personal collateral available for security. This is especially attractive for early stage companies who don't qualify for equity.
- Investors share fully in issuer's losses (and profits!), Bank lender does not share in issuer's profits and losses; they put the loss responsibility on you to pay back the loan, no matter what.

33. Borrowing Debt, vs. Raising Investor Equity (When Loans are Not Securities)

Security (Investor):

- Investor shares equity ownership in the property or investment
- Investor owns a percentage or \$ value of the LLC or LP or corp.
- Investor shares in profits & losses (lenders received fixed payments)
 - Note or Loan Convertible into stock or equity ownership.
 - Participating Note, or Loan, where borrower's payments only due, or lender makes more \$, if investment makes profits. No fixed P&I.
 - Expensive & Time-consuming to raise investor capital, more transaction cost than bank loan

Not a Security (Lender):

- Debt, Loans, Notes (generally), Borrowing a loan from lenders
- Fixed payments, payment dates & obligation amount
- Payment Not Based on Profits or Loss: Borrower's payments due even if business becomes financially unsuccessful
- Lender has priority rights over investors in liquidation
- Bank Debt is faster and cheaper than equity

34. **Raising Equity Capital From Investors:**

[Series of Separate Documents about issues triggered by raising money from investors.]

- Capital raising process for small businesses = a series of cash infusion events in several stages.
- No such thing as 12 months to IPO, and it's a myth that a company can "go public" on its first capital raise, or even within 5 years of start-up. Generally 5 to 10 years to IPO, generally companies with 300+ employees and \$1 million in net income.
- Normal route is that a company is funded in the many stages:
 - Seed capital from founders' personal savings & credit cards
 - Family & close friends
 - Angels / friends/ business associates
 - VC round
 - More VC rounds
 - Then "liquidity" event:
 - Continued self-funding by the businesses revenue
 - Acquisition
 - Merger
 - IPO, or
 - Management buy-out of investors.

35. **Securities Sales and Laws and Exemptions**

- Issuing *any* equity interest in your company, in exchange for cash, property, or services, or a vendor/supplier contract, is a securities issuance. Even selling stock to your mother is a securities sale.
 - Any share of stock, LLC interest, or LP interest,
 - An "investor" is any person who gives you money, property, or free services, in exchange for equity, with intention of making return or profit on their investment in your company. Such a transaction is the issuance of a security.
- Even issuing, *or giving*, **equity interests to employees**, board members, advisors, or consultants, in exchange for services, is deemed a securities issuance.
 - A "Securities" issuance includes shares, options, warrants, any employee plan interest, (employees and advisers), even for services and no cash
- If we have the issuance of a security, then registration or exemption required.
- Key to find exemptions from registration.
 - However, there are *no exemptions from disclosure – the "Offering Memo"*
- **If we have the issuance of a security, then registration or exemption required.**
- **Key to find exemptions from registration.**
- **However, there are *no exemptions from disclosure – the "Offering Memo"***
 - ***Exemptions are from registration, and not from disclosure or notice filings.***
 - ***Disclosure is the SOLE requirement of the 4(2) and Reg D exemptions in most cases, if all investors are accredited.***

- ***Disclosure is the CYA, the insulation against a lawsuit if deal crashes.***
- Even **disclosure can be curtailed**, but not omitted, in a few instances of
 - ***Seed capital, first small money in after founder's money***, and
 - Only in cases where all investors would ***never*** sue you even if you lost all of their money (I call it the “folks who would never sue you exemption”)
 - Very limited in number, like 1 to 3 investors
 - Immediate family (parents siblings), small number, providing start-up seed money (perhaps up to 5 immediate family members)
 - “Single, Sophisticated” investor providing single shot of startup seed money, someone well-known to the company and principals.
 - Other very limited situations by **judgment** of the attorney after discussion with attorney about the facts of the investors
 - Even without a traditional disclosure document, you still need to provide disclosure somehow, and comply with the requirements. Don't do this at home without professional advice and help
 - Land mine of errors that, in the worst case:
 - Have to give back the money (rescission), and/or
 - Can forever bar you from raising additional money
 - Other methods of accomplishing disclosure under 10b-5: Providing everything investors need, or ask for, all material information, in the form of a “document stack and financials”. Include full disclosure of all due diligence info.
 - 4(2) – exemption, very small group
- **Exempt from complex disclosure, but investors often require complex terms and investment documents before they will invest**
- **Or Use the safe harbor of a Reg D 506 with Offering Memo**

36. New Crowdfunding, New Reg D 504 Exemption at \$5 million, New Rule 147A Intrastate, and new SEC Requirements to File Form D for all Reg D Deals or disqualification results [separate doc]

37. Disclosure Document / Offering Memo

• **The “CYA” Document**

[Handout – Why Offering Memo Required]

- Securities law rules require Disclosure of all info material to investment decision
- Not promising to make money, not promising a fair deal, just telling facts of people, industry, strategy
- If you are uncomfortable disclosing it, it's probably material
- Protect, not insulate, from liability
- Cost: Is a \$25,000 insurance policy
- Initial Cost is high, but the first private placement memo can be recycled and enhanced with each successive deal, more complex deal, and even act at the foundation for the IPO prospectus.
- Saves you time as a business tool, so that you are covering much of your presentation first in writing
- No need to repeat same info to multiple parties over and over.

- CYA so that you are saying the same thing to each investor – no deviation
[Handout – Why Offering Memo Required]
- **Disclosure Doc Highlights Bios, U of P, Cap table, Industry Analysis, Risks**, Corporate and Personal Due Diligence, Summary of all material agreements.

38. **Notice Filings Required for EVERY deal and Every Sale to Investor**

- **Notice filing required with the SEC** - SEC Form D if Reg D
- **Blue Sky Law** - Notice filings are required in each state in which investors reside;
 - Whether it's a Reg D or not
 - For sales or issuances to family, friends, employees, angels, VCs and sometimes institutions.

1. **Filings required in almost every state**

2. Tell company counsel & securities lawyer immediately when investor checks come in, because filings are required within 15 days after sale.

[Hand out summarizing 50-state notice filing requirements.]

39. **Securities Law Issues for Private Offerings**

- **Private vs. Public**
- **Why It's Illegal to Offer Your Stock on the Internet**
- **Limitations on Solicitations**
- **Manner of Offering – No general Solicitation**
 - Private vs. Public Fund – Don't want to be a public fund
 - Illegal to Offer Your Fund on the Internet,
 - IPO.Net and Lamp Technologies apply to brokered funds only
 - Cold Calls, Advertising prohibited
 - Pre-existing relationship or private introduction
 - Cold calls to Professional VCs are probably OK, but gray area

A. **What Is an SEC Reg D 506 Offering?**

- **Compare to 4(2)**
- **Why Reg D 506 most preferable** Why Reg D 506 most preferable – Blue Sky – But disclosure required
- **Limits on # of investors 35**

[Handout – Private Offering Exemption Q & A Chart]

B. **Investor Qualifications - What is an Accredited Investor?**

- **Why prohibit, or limit, sales to them** sophistication
- **Audited Financials requirement for nonaccrediteds**
- **What about family who are not accredited?**

C. Risk of non-compliance is rescission (give back the money)

40. **Selling the deal –**

- **Full disclosure**, whole truth and nothing but the truth.
- **No superlatives. No BS**
- **Separate selling your product** and the virtues of your company from selling the stock in the company, Turn off the marketing press.
- You're **not selling real estate or a used car** – “if you don't buy into the opportunity today, it will be gone” is not appropriate
- Will be **partners with your investors** for a long time, and want to develop and maintain a good relationship with them, don't BS them.
- **Lawsuits for misstatements or even misleading statements**

41. **Using Money finders to sell your stock:**

- **Illegal if they are not registered** securities brokers, under 1934 Act. Ask for their CRD number and run it through www.nasdr.com.
- **Be careful**, as the finder pool contains a high percentage of **disbarred** stock brokers and lawyers, de-licensed insurance brokers and real estate brokers, and convicted felons.
- **Check references** and experience level
- Make sure they have **good book of investor** business
- Red Flag if they are advertising in the paper or on Internet “money available”.

[Handout “Deal Structure and Term considerations”]

42. **Common Mistakes before Capital Raise:**

- A. Salaries to Founders, or paying back founder loans, early in the game
- B. Pie-in-the-sky projections, or
 - only one set of projections or
 - no back up for the projections
 - excel sheet that does not add up
- C. Using AOL, Yahoo, or hot mail or as your business email account,
 - looks unprofessional and
 - emails of any size will bounce,
 - can't store emails to keep as business records
 - not secure
 - You don't own your emails, the free services does
- D. Spend on technology
- E. Unrealistic expectations about % of equity give-up for the funding you so desperately need.
- F. Ignoring Due Diligence Issues in backgrounds of principals, officers and directors
- G. Dispensing stock loosely, to everyone including the cleaning lady

- H. Waiting too long to start preparation for a capital raise, creating an emergency out of it.
 - Desperate will be written all over your face and your financials
 - Intention is to overlap between the next capital raise and the end of the current money.
 - Allow 12 to 18 months to do the preparation, find the money and close the deal.
- I. Wrong Motivation for doing capital raise – to Cash you out
 - Examine your motivation
 - Not a get rich quick scheme based on exit quick strategy – long haul
- J. Believing that your lawyer or accountant will find your investors for you
 - Definition of private placement
- K. Believing that your lawyer, accountant and other professionals can be paid out of proceeds of offering
- L. Thinking that a Business plan is an offering memo;
- M. Not realizing that Sophisticated Investors will negotiate terms, you can raise a lot from them, but they will hold you hostage to their terms. Friends and family will not negotiate terms, but you can't raise much from them.
- N. **UnRealistic Expectations as to Cost, Timing, Involvement** –
 - Months not weeks
 - Cash from your pocket – Money where your mouth is
 - Not free or cheap, no payments out of proceeds
 - Operational Documents Needed: [NFH] Founders Agreement; Offering Memo; Shareholder Agreement; Subscription Agreement. No detail required here.
 - Full time job while it's in process