Northern Illinois University Naperville Illinois Technology Enterprise Center (ITEC) and DuPage Technology Park

***DuPage Minority Entrepreneur Conference***

Presentation by Nancy Fallon-Houle, March 19, 2009

***Legal Issues and Business Issues: For Entrepreneurs, Start-Ups, Early Stage, and Growing Companies Starting or Growing The Business***

1. **Who Owns Intellectual Property Being Used to Start & Run Business?** 
   * **Developed** Where? While employed elsewhere? Might employer have claim to it?
   * **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.
   * **Protection of Intellectual Property**
     + Is **protection of your IP** Possible? Patented? Business Process Patent option? Have you blown that protection by putting your ides in the public domain? [Intellectual Property Lawyer will address these points]
     + You don’t own the business idea til you own the IP
     + **Use** **Nondisclosure Agreements** for Employees and Partners
     + **Name selection and trademark** (see below and [IP attorney])
     + **Balance how much to disclose** in discussions with business partners, alliance partners, customers, vendors, and investors, and in business plan, investor documents and offering memos. Protect proprietary Info.
     + Business Plan Narrative about IP types, what owned, state what, who owns, how protected. All IP info in the disclosure document / offering memo.
2. **Noncompete with current or former Employer?**
   * Does your current, or former, employer’s Noncompete Agreement or Employment Agreement **impede your starting your business or** if started**, from continuing or expanding your business**? To what degree? Prohibit altogether? Limit as to geographic scope? Time limit? Prohibited customers? Applicable after you leave?
   * Employer **perhaps may negotiable on a supplement** to the agreement that would allow you to start your business, compete in their space,
     + But not steal their customers, or employees?
   * Don’t mess with a company’s customers, you will tick them off and start a lawsuit. If you don’t hit them in the pocketbook, they may leave you alone.
3. **Trademark Issues, Starts with Name Check Before Formation** 
   * Critical before business formation or growth. Importance of global name check, given the global use (and surveillance) of business names through Internet.
   * All business names, DBAs, product names, logos,

[Hand out – Name Search & Selection Checklist], including search vehicles & techniques for “knock out” name search]

* Business Name, Service Tag Line, Product Name: Issues Apply to New Product Names and Tag Lines, as well as to Business Names.
* Name Search and Selection Pitfalls under Trademark Law:
* Use of the Internet changes the landscape and scope.
* Details of how to conduct a proper name search. (See detailed hand out as well.) [yellow]
* All Info about rights to business name, logos, product name, web logo, must be secured. Use it, or loose it.

1. **Formal Incorporation of a Business Entity**

A. Operating as a Sole Prop, as opposed to forming a business entity (Corp or LLC) around your business:

* Personal Liability in sole prop,
* Separation of financial & tax matters, tax returns easier if you are a corp or LLC.
* Insurance Difficult to Obtain,
* Larger Companies require corps around business owners,
* Perception of customers,
* Easier to obtain a Loan if you look like a "real business",
* Due Diligence goes more professionally and easily if people can conduct Due diligence on you on Sec of State site;
* If you will ever raise capital by issuing stock to investor or employees, it can't be done with a sole prop;
* Must file a DBA with IL SOS, and County and a Reg-1, therefore much of the time consuming cost of forming a corp must also be done for a sole prop, therefore there isn't a huge difference in cost;

B. Issues of having a non-lawyer form a business for you (including yourself, an accountant or an online incorporation service)

C**. Checklist for Business Formation** –

Corporate formalities for incorporation

[Hand Out] Incorporation / LLC Formation Checklist, [Hand out - Filing Fees For Business Formation]; [Hand out - Corporate Maintenance Checklist”

1. **Corporate Formalities – No Piercing the Corporate Veil**
   * Proper incorporation or LLC formation.
     + Botched Do-It-Yourself Incorporation common; clean up often needed
   * Keep corporate records straight, especially ownership records, particularly if there is more than one owner.
     + Issue Stock Certificates
     + 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
   * Separate finances, actions, contracts:
     + From personal and
     + From other businesses
   * Diligent accounting records
   * Follow Corporate Formalities
   * Investor due diligence on these
   * All material info about the Company must be in the offering memo or disclosure document
2. **Licensing, Tax, Sales Tax: Regulatory & Corporate Compliance** Whether Incorporated or unincorporated businesses: Business filings, county, sales tax, employment, professional licensing, qualifying to do business in other jurisdictions, annual filings, insurance, contracts.
3. **Shareholder Agreement or LLC Agreement between Founding Partners (Owners)**

-----What if you have a business partner? Shareholder agreement between you and **your business partners –founding partners**

-----If you are in business with someone and a corp or LLC is not formed, Partnership is created by default. Partnership case law applies.

-----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.

[Hand out available by email, Checklist of discussion items among partners in corp]

1. **Use Technology to Operate Your Business**
   * Or you’ll be left in the dust. Must use email, electronic brochures, website for due diligence
   * No such thing as “I’m not good at technology” or “I don’t use email”. Will make you look foolish
2. **Website Use; Email Distribution and Spam**

Business Side: Website is a powerful took to generate business. Pay website developer to obtain “search engine optimization”, so are on the “hit list” of people searching the web. Think of all the buzz words folks might use when searching for your type business.

Legal side, high level rules are simple: Don’t Lie, Don’t Steal, Don’t Spam, and Don’t Trick 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. (Up in the air about using content of others and links to content) Simply always credit the writer
* Can’t allow minors to use a site not appropriate for kids
* It’s illegal to spam people who don’t want advertising emails, even your newsletters! Ask permission of each recipient first.

1. **Business Ducks in a Row –** 
   * Research and Know your industry,
     + No such thing as “no competitors”. What are customers using as the current substitute?
     + Daily or weekly Internet searches to keep your info current
   * Suppliers in place, as close to letter of intent or contract as possible.
   * Customers in place, if appropriate or possible, even one or two customers
   * Industry Compliance – hire experts
   * Due Diligence on Company you Keep – Those you partner with can affect your business reputation (judged by the company you keep)
2. **Due Diligence –** 
   * **Due Diligence Others Conduct on You –** 
     + **Your Clean Background is Key**
     + **Due Diligence that Investors will conduct on Principals**
     + **Background checks**, criminal, regulatory, tax liens, bankruptcy
     + Principals (D’s & O’s, Control Shareholders), the entity itself, and prior business and legal history) – All of above, plus business reputation
     + *All material info about the principals must be in the offering memo*
     + [Hand out – Due Diligence Questionnaire for Private Placements]
     + [Hand out – Article “Is Your Business Investor Ready”? and [“20 Questions VCs Will Ask”]
   * **Due Diligence You Conduct on Others** 
     + Conducting Due Diligence on Clients, Alliance Partners, Suppliers and Lenders:
     + You are judged by the Company You keep
     + How to Avoid the Toxic Client, and their collection problems.
       - In a rush, not planning ahead, wants a discount, wants custom items, doesn’t have money up front
       - Owes other people money,
       - Changed suppliers or service providers to you (who before you? Any money outstanding?)
       - Moved from Out of State
       - Costs more to litigate than most small business contracts are worth,
       - Make sure you know your bed mate before jumping into bed with them.
       - Protect yourself against non-payment with a contract (not assurance of getting paid, but at least you have a document that could be litigated if a dispute arises.)
3. **Conflicts of Interest and Disclosure; Referral Fees**

* Avoid Conflicts of Interest, disclose them to anyone you can think of who would scrutinize them.
* You can take referral fees, but disclose that to your client.
* Make sure there isn’t a conflict of interest in the referral fees.
* 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.

1. **Employee Classification – Employee vs. Contractor: The Catch 22 of Small Business: Damned if you do, Damned if you Don’t.**

A. **Use, and Classification, of Employees /Contractors**; [white Handout] The Distinction between Employee and Contractor, and the IRS presumption of "Employee" Status. The legal conclusion revolves mainly around control, and who has it? Location of work, hours dictated other clients of the consultant. (There are several points the IRS uses to determine.)

B. Illinois Employer Act

C. Some legal issues that can arise from hiring employees, such as **Unemployment Liability** (Importance of terminating someone within 30 working days if they don’t work out, to avoid UE claim.)

D. **Harassment and discrimination** suits can apply to even the smallest of businesses and financial liability when you open up your shop to someone else. Importance of documenting employee behavior and using written reviews, and documenting and holding the interviews under the same standards for everyone.

E. F**ederal and state laws** that apply when you have over 10 or over 20 employees. There are many statues and very specific provisions that can apply to employing employees. [Hand out from my colleague Durga Burham, employment lawyer or emailed].

1. **Use of Noncompete and Nondisclosure Agreements with Employees, Customers, Contractors, Consultants, & Others.**

* Basic Noncompete and Nonsolicitation Provisions;
* Protecting your IP.
* What are the consequences of intellectual Property or Trade Secrets "leaking out"? For example, former employees or contactors, or business alliance partners, or competitors, taking customers from your customer list or stealing your employees.

Address the reverse issues if you are an employee or contractor asked to sign a noncompete / nonsolicitation agreement.

1. **Business Contracts:**   **Use them; Tips & Tricks to Negotiating**
   * Contracts must be in writing to be enforceable
     + Email is a writing, make it clear who is saying what
   * **Oral Relationships – Lenders,** Investors and Alliance partners will **not invest on deal built on them**, not matter how solid. Make the deal, but eventually paper it
   * Realistic Expectations as to Cost, Timing, Involvement –
   * Expensive to paper all agreements retroactively.
   * No such thing as a “template” that works.
   * Must summarize all material contracts in the Business Plan or Disclosure Document / Offering Memo for Lenders or Investors. Deal must be papered in order for securities lawyer to summarize it.
   * Read the contact and understand it
   * If a **“Reps and Warranty”** says you will do, or do, or have, or will not….make sure the rep is true at the time you sign the agreement, not “later”. i.e. You have insurance
   * Do’s and Don’ts in Negotiations
   * When to Involve Counsel
   * Bullet Point list of business points you want, for the lawyer, but don’t try to write the whole contract
   * Do’s and Don’ts Before Bringing the Contract to Counsel.
   * Common trips in legal agreements:
     + Release of Claim,
     + Indemnification for Liabilities and Breach,
     + Insurance Requirements,
     + “Complied With All Laws” provision,
     + Reps and Warranties with breach = breach of the entire contract
2. **Issues Involved in Selling or Buying a Business (High level only)**

A Few Due Diligence Points, Keeping your firm (corporate records, legal and accounting) in top shape in case a buyer comes around, realistic expectations as to price and timing, caution about using business brokers, use a lawyer and accountant before sealing the deal. [Handout “Selling or Buying a Business” by email request]

1. **Borrowing From Lender vs Investor Capital Raising - Equity advantages over Debt:**

* If equity deal crashes, you are **not personally liable** (However, you ***are personally*** liable in equity raise, if you have in any way, misled investors or misstated any fact, or even a shade of meaning in the disclosure, and they sue you 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 your 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 your losses (and profits!), Bank lender does not share in your profits and losses; they put the loss responsibility on you to pay back the loan, no matter what.

1. **Raising Equity Capital:**

The capital raising process for small businesses is comprised of 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.

1. **Securities Sales and Laws**

* 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 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”*
* **Realistic 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 its in process**

***Securities Sales and Laws***

* **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 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”***
  + ***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 start up 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 some how, 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**

***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, its 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.

***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.
    - **Filings required in almost every state**
    - Tell company counsel & securities lawyer immediately when investor checks come in, because filings are required with in 15 days after sale.

[Hand out summarizing 50-state notice filing requirements.

* **Securities Law Issues for Private Offerings** 
  + - **Private vs. Public**
    - **Why It’s Illegal to Offer Your 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-exiting relationship or private introduction
    - Cold calls to Professional VCs are probably OK, but gray area
    - **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]

* + - **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?**
    - **Risk of non-compliance is rescission (give back the money)**
* **Selling the deal –** 
  + **Full disclosure,** whole truth and nothing but the truth.
    - **No superlatives.**
    - **No BS**
  + **Separate selling your product** and the virtues of you 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 to day, 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**
* **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](http://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”**

***Common Mistakes:***

* Salaries to Founders, or paying back founder loans, early in the game
* 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 any size will bounce,
  + can’t store emails to keep as business records
  + Spend on technology
* Unrealistic expectations about % of equity give-up for the funding you so desperately need.
* Ignoring Due Diligence Issues in backgrounds of principals, officers and directors
* Dispensing stock loosely, to everyone including the cleaning lady
* 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.
* 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
* Believing that your lawyer or accountant will find your investors for you
  + Definition of private placement
* Believing that your lawyer, accountant and other professionals can be paid out of proceeds of offering
* Thinking that a Business plan is an offering memo;
* 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.