R.E.A.L (Real Estate Action Leaders)

***Business Law Issues for the Real Estate Investing Business***

*(For Real Estate Entrepreneurs, Start-Ups, or Growth Companies)*

Presentation by Nancy Fallon-Houle, April 11, 2012

1. **Noncompete with current or former Employer?** 
   * Does your current, or former, employer, customer or vendor agreement, other consulting agreement you’ve signed, contain a Noncompete Agreement or Employment Agreement or even an employee manual, which **impedes your starting your business? (Or** if already 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?
     + Only limit specific customers or employees?
   * 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.
2. **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 until 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.
3. **Trademark Issues, Starts with Name Check Before Formation, Use of Tag Line or Use of Product Name** 
   * 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, and 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 lose it.

1. **Sole Proprietorship or Business Entity? (Corp or LLC)**

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 corporation 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 corporation must also be done for a sole prop, therefore there isn't a huge difference in cost.

1. **Filings Required Regardless of Sole Prop or Entity**

* Federal Tax ID and State Tax ID
* DBA
* Illinois Department of Professional Regulation
* Business License in local jurisdiction
* Sales Tax
* Employer Payroll Tax Accounts
* Business Bank Account

1. **Proper Entity Formation is Key –**

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

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

B**. Checklist for Business Formation** –

Corporate formalities for incorporation

Steps, Tasks for formation

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

1. **Corporate Formalities After Formation – No Piercing the Corporate Veil**

* **Proper incorporation or LLC formation.**
  + **Botched Do-It-Yourself Incorporation common; clean up often needed at 1.5 to 2 x the cost.**
    - Common Mistakes in LLC or Corporate Formation:
    - Name not fully searched & not available under common law or outside IL; Trademark Lawsuit Risk
    - Not Enough authorized shares, too low par value, wrong # of issued shares, thin capitalization;
    - Registered agent not biz owner, wrong county/state
    - Mistakes in board or managing members
    - Wrong tax type, no accounting/tax advice
    - Errors in, or Missing, “business purpose” (Resulting in loss of name protection, since industry is not stated.)
    - Missing addendum to Articles (Contains restrictions, removes effect of unfavorable IL statutory or case law provisions.)
    - No Stock or LLC Interests Issued, no ownership % decided no share ledger, no capital contributions.
    - No Organizing Resolutions Adopted (Company does not legally operate until adopted, Agreements cannot be signed.) Or no other legal Agreement.
    - No corporate formalities.
    - Using online service, accountant, or Do-it-yourself does not save $: Botched entity formation clean-up costs 1.5 to 2x cost to correct. (Filing amendments, re-documenting, correcting tax ID errors, name change, share fix.)
* **Corporate Formalities**
  + Operate like a business, not like a hobby
  + Its Business, not friendship (customers and employees)
  + Implement processes and documentation of how you do what you do
  + Buy QuickBooks
  + 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 & Corporate Maintenance
  + File Annual Report
  + Sales and Use Tax Reporting
  + Maintain Insurance
  + Sign only in the company name, not in personal name
  + Maintain separate actions, identity and contracts
  + Minute books, Resolutions, bank accounts, taxes, shareholder loans (notes), security of note (UCC statements)
  + Investor due diligence on these
  + All material info about the Company must be in the offering memo or disclosure document if raising capital from investors

1. **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. In addition, confused business description, on corporate docs and on website, will confuse customers.

1. **Business License, Tax, and Sales Tax: Regulatory & Corporate Compliance** Whether Incorporated or unincorporated businesses: Business must make filings for: County filing, business license, sales tax, employment, professional licensing, qualifying to do business in other jurisdictions, annual filings, maintain insurance, use contracts. Certifications such as WBE or government contractor.
2. **Resolutions – Corporate Authority, and Fleshed Out to Address Very Basic Issues Normally in the Shareholder Agreement (LLC Agreement) between Founding Partners (Owners)**

-----Business partner - Shareholder agreement between you and **your business partners –founding partners**

-----If you are in business with someone and a corporation 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.
* 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.
* Corporate Authority
* Spending Limits
* Officers Election, Directors Election
* Business Partners versus Alliance Partners – not to confuse, don’t make Alliance Partners owners in your company.

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

1. **Partner & Shares Do’s and Don’ts**

* Don’t make spouse partner unless spouse works substantially in the business. For estate planning, use a will, not shares or interests in the biz.
* Don’t confuse relationships, i.e. Business Partner vs. outside Alliance Partner.
* Avoid temptation to give away equity as monopoly money because you don’t have real money to pay people for services.
* Equity only to your closest partners inside the business. **Once you issue equity, you can’t take it back, unless you buy it back at FMV**
* Going into business with someone & no entity formed = Partnership by default. Partnership case law applies, not corporate or LLC case law.

1. **Shareholder Agreement (or LLC Agreement) – Basic - 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 corporation or LLC is not formed, Partnership is created by default. Partnership case law applies.

**The Business Pre-Nup between you and your partners**

-----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?
* Percentage vote to pass an issue?
* What voting rights will each person have?
* Title, Role, Responsibilities
* Profit and Loss allocation?
* What happens I someone leaves
* 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 corporation]

----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

1. **Changes in Ownership**

**Partner Buy-Outs and Corporate Split Ups**

Adding or removing shareholders. – Legal docs required

Corporate Split up

Selling the business

1. **Fiduciary Duty and Conflicts of Interest, Ethics & Disclosure; Referral Fees**

* Fiduciary Duty to your company & to the other owners.
* Fiduciary Duty to all companies of which you are officer, director or control person. Must Balance.
* Avoid Conflicts of Interest, disclose them to those who would be affected by them, would scrutinize them, or would later object to them when disclosed.
* Avoid Conflicts of Interest in client relationships; Finders Fees, Referral Fees must be disclosed.
* 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. I feel best to avoid 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.
* Ethics – Reputation is like virginity; once it’s gone you can’t get it back.

1. **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, licensure history
     + 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 to Investors or Loans from Bankers or Professional Lenders]
     + [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/Customer, and their collection problems.
       - Always in a rush, does not plan 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 here from Out of State
       - 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
       - Make sure you know your bed mate before jumping into bed with them.
       - 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.)
2. ***Protection of Intellectual Property***

* Is Protection of your IP Possible? Patented? Business Process Patent? Copyright? (Software, writings, art), Nondisclosure Agreement?
* Is the Company Name, Tag Line or Product Name Trade-mark-able?
* Don’t blow IP protection by putting your ideas in public domain before protecting! Tradeshow, conference, website.
* You don’t own the business idea ‘til you own the IP!
* Impose NDA’s & Noncompetes on your Employees: Reasonable in scope and duration

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

* Basic Noncompete and Non-Solicitation 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 / non-solicitation agreement.

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1. **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 Mislead People, 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. 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

-Email Newsletters

* The CAN-SPAM Act establishes requirements for e-mailed commercial messages. Penalties for violations.  Summary of the rules:
* ***Don't use false or misleading header information.*** You’re "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.
* ***Don't use deceptive subject lines.*** The subject line must accurately reflect the content of the message.
* ***Tell recipients where you're located.*** Your message must include your current street address or a post office.
* ***It’s illegal to spam people*** who don’t want advertising emails, even your newsletters! Ask permission of recipient first.
* ***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.
* ***Honor opt-out requests promptly.***

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
   * **Assignability, or Not?** 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
   * Negotiation - Do’s and Don’ts
   * 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 Your Business (or Buying a Business) (High level only)**

A Few Due Diligence Points:

* Keep your corporate records (legal and accounting) in top shape in case a buyer comes around.
* Document the processes: If it’s all in your head, your company is not worth much
* Business Coach or Management consultant check up
* 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
* Caution about using business brokers
* Use a lawyer and accountant before sealing the deal. [Handout “Selling or Buying a Business” by email request]

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.)

Even part time employees, who work small number of hours, are often considered employees.

Illinois Laws now require that you categorize even part time employees as employees.

Result is: Set business up as a payroll tax employer

**Illinois Employer Act** – reporting of new hires now required

B. 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. Also, Illinois requires “new hire reporting” online, with social and birthdate.

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. You can discriminate against customers, just not employees.

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].

F. “Dangerous work” requires attention to other regulations and specific precautions in insurance and contracts.

1. **Use Technology to Operate Your Business**
   * 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)
   * No such thing as “I’m not good at technology” or “I don’t use email”. Saying that will make you look foolish
2. **Business Ducks in a Row –** 
   * Research and know your industry – Is this a viable business?
     + Starting and operating a business always costs more and takes longer than expected. Make sure the business will make enough to make it worth it.
     + Plan ahead and plan for the unexpected. The “emergency” start-up is a red flag of things to come.
     + 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)
3. ***Other 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 any 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

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.