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Legal Issues in Entrepreneurship

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Common Corporate Mistakes Made by Entrepreneurs

- Creating a “cheap stock” tax problem by
 - Failing to incorporate early in the life of the company (i.e. well before a funding event that will set the price of the stock); or
 - Failing to include all “founders” in the company until just before a funding event that will set the price of the stock
- Failing to create a vesting schedule for founder’s stock (if all vests immediately, may create unfair reward to those who do not continue to support company)
- Failing to make 83(b) election on stock issued in return for services
- Failing to consider employee’s or founder’s obligations to other employers
- Failing to comply with securities laws as you raise capital
- Considering only the valuation as you negotiate an investment


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Common IP Mistakes Made by Entrepreneurs

- Failing to properly register trademarks
- Failing to secure rights from founders to all needed IP by assignment or licensure
- Failing to address how jointly owned patents are to be licensed and utilized in joint development situations
- Failing to file US patent application within one year of public disclosure or other statutory bar
- Failing to consider international patent protection prior to disclosure (no one year grace period)
- Failing to use nondisclosure agreements


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Company Structure




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Common Business Entities

- ▣ Sole Proprietorship
- ▣ Partnership
- ▣ S Corporation
- ▣ C Corporation
- ▣ Limited Liability Company
- ▣ Single Member Limited Liability Company




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Factors to Consider in Selecting an Appropriate Business Entity

- ▣ Liability – Limited Liability v. Personal Liability
- ▣ Tax Implications
- ▣ Complexity of Formation and Management
- ▣ Capital – effect on ability to raise capital through angel investment, venture capital, or initial public offering (IPO)
- ▣ Credibility in the business world



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Sole Proprietorship

- An individual (or husband and wife team) carrying on a business for profit
- Unlimited personal liability
- Single level of income tax – all income and expense items reported on Schedule C of the owner's 1040
- Relatively simple to start
- If business conducted other than under the name of the sole proprietor, assumed name publication needed
- Managed by the sole proprietor
- Any transfer of the business would be of the underlying assets as opposed to a transfer of shares in the business
- Capital needs – addressed through loan to sole proprietor



General Partnership

- Association of two or more co-owners carrying on business for profit
- Partners have unlimited personal liability for partnership debts
- Pass through tax treatment (partnership files form 1065 but all income and expense items pass through to individual partners on schedule K-1)
- Relatively easy to start – partnership agreement is typically entered into but is not legally required
- Managed by the partners or as described in the partnership agreement; Problem: any partner can bind the partnership
- Ability to raise capital limited since most investors would prefer to invest in an entity offering limited liability
- LLC is almost always the better choice if partnership tax treatment is the goal



S Corporation

- Limited liability for shareholders even if they participate in management
- Pass through tax treatment under most circumstances but not as complete as for the LLC
- Formation steps include filing Articles of Incorporation with the Secretary of State, filing sub s election with the IRS, adoption of bylaws, and, usually, adoption of a shareholder (buy-sell) agreement
- Limitations on the number of shareholders and the type of shareholders limits ability to raise capital
 - Limit of 100 shareholders
 - Only one class of stock is allowed so ability to give priority return of capital to investors compromised
 - Differences in voting rights is allowed
 - Partnerships and corporations cannot be shareholders
 - Only citizens or residents of USA can be shareholders
- Is easier to convert S corp to C corp than it is LLC to C corp in event venture capital is sought



C Corporation

- Limited liability for shareholders even if they participate in mgmt
- Tax at both corporate and shareholder level. This double level tax can be avoided to some extent by payment of reasonable salaries to shareholders in exchange for services actually rendered
- Formation similar to S corporation except sub S election not filed with IRS
- Typically required for publicly traded corporations, businesses that require venture capital, or if a broad based stock option program is utilized
- No limits on type or numbers of shareholders
- Different classes of stock allowed thus enabling different priority for return of capital
 - Common Stock
 - Preferred Stock



Limited Liability Company

- Combines limited liability provided by a corporation with pass through partnership tax treatment
- LLC files a partnership tax return with all income and expenses being passed through to individual owners of the LLC
- Formation steps include filing articles of organization with the Secretary of State, contributing an appropriate amount of capital, and adopting an operating agreement
- Can be managed by the members or, more often, by managers selected by the members. Can also elect officers
- Self employment tax treatment less favorable than for S corporation
- Offers several advantages over the S corporation:
 - No limitation on the number of members
 - No limitation on who may invest (corporations, partnerships, and non US residents can invest)
 - Treatment of gain on distribution of appreciated property more favorable
 - Different classes of ownership are allowed so there is the flexibility to provide for a priority return of capital to investors




Single Member Limited Liability Company

- Limited liability for owners makes it a better choice than a sole proprietorship unless cost of formation or maintenance is a controlling factor
- Disregarded entity from an income tax perspective
 - All income and expenses are reported on the sole member's tax return and no income tax return need be filed by the LLC
- Formation process similar to multiple member LLC except that the operating agreement will likely be less complex
- In addition to circumstances where a sole proprietorship would be considered, a single member LLC is often used by a corporation or LLC to insulate the liability associated with a particular line of business



LLC vs. Corporate Structure


LLC	Corporation
Members	Shareholders
Managers (optional)	Board of Directors
Officers (optional)	Officers



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Bylaws and Shareholder Agreements for Corporation

- ▣ **Bylaws**
 - ▣ Procedures for shareholder and director meetings
 - ▣ terms of directors and how elected, types officers and officer duties, and indemnification provisions for officers and directors
- ▣ **Shareholder Agreements**
 - ▣ restrictions on the transfer of ownership (including upon death, disability, or cessation of employment)
 - ▣ provisions for resolving deadlock among the shareholders
 - ▣ method of establishing price of shares
 - ▣ rights to purchase additional shares issued by the corporation (preemptive rights), rights to sell shares if other shares of the corporation are sold (co-sale rights), rights to cause a minority shareholder to sell its interest in the corporation when the majority votes to do so (drag along rights)
 - ▣ ownership of intellectual property



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LLC Operating Agreements

- ▣ Take the place of both the bylaws and shareholder/buy-sell agreement used for a corporation
- ▣ Address issues such as type of membership interests, who owns the membership interests, rights and duties of members, whether the LLC is member managed or manager managed, rights and duties of any officers, capital accounts, allocation of profits, transferability, and indemnification of managers, employees and agents



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Piercing the Corporate Veil

- ▣ Limited liability associated with a corporation or an LLC can be lost if appropriate formalities are not followed
- ▣ Corporation or LLC should be appropriately capitalized upon setup
- ▣ Annual meetings of shareholders and directors (or members and managers if an LLC) should be conducted and minutes of those meetings placed in the corporate or LLC book
- ▣ Separate financial records and bank accounts should be maintained for corporation or LLC



Employment Agreements

- ▣ Nondisclosure of information/trade secrets
- ▣ Noncompetition
- ▣ Nonsolicitation of employees and customers
- ▣ Assignment of ownership of intellectual property to company (Illinois Employee Patent Act)
- ▣ Employee duties
- ▣ Compensation
- ▣ Term of agreement and ability of parties to terminate



Using Company Equity to Motivate and Retain Employees

- ▣ Incentive Stock Options
- ▣ Nonqualified Stock Options
- ▣ Restricted Stock
- ▣ Phantom Stock



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Business Financing

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General Concepts


- ▣ Risk vs. return
- ▣ Equity (i.e. stock ownership) vs. debt (i.e. a loan)
- ▣ “Smart” money vs. “dumb” money
- ▣ “Free” money
- ▣ Dilution
 - ▣ Substantial outside equity investment at early stage of company will cause loss of control whereas same dollar investment when company is more mature and more valuable might not
 - ▣ Small piece of big pie worth more than 100% of marginal company

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Business Plan

- ▣ Written business plan required by most financing sources
- ▣ Even if outside funds are not being obtained or a friend or relative is providing the funds, a written business plan is a good idea

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Sections of the Business Plan

- ▣ Executive Summary
- ▣ Description of Business
- ▣ Marketing
- ▣ Financial Plan/Statements
- ▣ Management Team



Business Plan – Sources of Assistance

- ▣ Attorneys and accountants
- ▣ SCORE
- ▣ SBDC



Sources of Funding

- ▣ Personal funds
- ▣ Friends and family
- ▣ Champaign County Regional Planning Commission
- ▣ Banks (SBA)
- ▣ Loan brokers
- ▣ Bootstrap (company profits)
- ▣ Government and foundation grants
- ▣ Joint development agreements
- ▣ Angel investors
- ▣ Venture capital
- ▣ Bonds
- ▣ Initial public offering (IPO)



Personal Funds

- ▣ People who are considering loaning you money or otherwise investing in your business are more likely to do so if they see that you are also investing some of your own funds



Friends and Family

- ▣ Run the risk of losing a friend or straining family relationships if there is difficulty with repayment
- ▣ Best reserved only for situations where the friend or family member can afford to lose the money



Banks

- ▣ Asset based lenders
- ▣ Risk averse but the cost of borrowing is less
- ▣ Require good credit record
- ▣ Will want to see a written business plan
- ▣ Typically want 20% financed by you
- ▣ SBA loans through banks can allow bank to take on more risk



Champaign County Regional Planning Commission

- ▣ Provides debt and equity financing to qualifying small businesses in Champaign County
- ▣ Preference towards capital intensive and/or technology oriented businesses
- ▣ Must create a specific number of full time jobs
- ▣ Can't constitute more than 50% of the total project investment
- ▣ Work with a local bank as well



Bootstrap

- ▣ Use company profits to grow the business
 - ▣ Revenues from sale of product
 - ▣ Revenues from consulting used to support product development
- ▣ The old fashioned way
- ▣ Not possible for some businesses



Grants

- ▣ Available only under very limited circumstances
- ▣ Typically not available for retail, restaurants, etc.
- ▣ "Free" money but not "easy" money
- ▣ Don't have to repay
- ▣ Typically retain ownership of intellectual property
- ▣ Submit in response to a specific request for proposal (RFP) from a government agency
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Joint Development Agreements

- ▣ Big company interested in small company's technology will "give" small company money and resources to refine product
- ▣ May lead to eventual license of intellectual property (IP) to big company
- ▣ Be careful with respect to ownership of IP generated under the JDA
- ▣ Nondisclosure agreements needed
- ▣ Risks associated with dealing with big company include superior litigation resources available to big company in event of dispute



Angel Investors

- ▣ Angel investors are typically high net worth persons or an entity owned by these individuals
- ▣ Three types
 - ▣ Passive
 - ▣ Ones that add value to company through expertise or contacts
 - ▣ The kind that think they add value but really don't!



Venture Capital

- ▣ Difficult to obtain
- ▣ Very costly
- ▣ Only available for certain types of businesses (commercializing a technology for example)



Stages of a Venture Capital Transaction

- ▣ Courting process
- ▣ Letter of intent
- ▣ Term sheet
- ▣ Due diligence
- ▣ Final agreements
- ▣ Ongoing input from VC
- ▣ Assistance with location of follow on rounds
- ▣ Exit



Bonds

- ▣ Debt whereby the issuing company or governmental body promises to pay the bondholders a specific amount of interest for specific amount of time and to repay principal on expiration date
- ▣ Can offer a very favorable interest rate and no loss of equity
- ▣ Typically feasible only for substantial amounts of capital



Initial Public Offering

- ▣ Very few companies actually go public
- ▣ Most exit through sale to another company or just operate and then wind down
- ▣ Very expensive
- ▣ Very difficult to go public in current market and economy



Attorney Roles

- ▣ Advisor – assist in identifying appropriate funding sources and preparing a credible presentation to financing sources
- ▣ Referral source – to venture capital firms, bankers, private investors
- ▣ Assist by reviewing and negotiating terms of the financing and by making sure you understand what you are signing



Intellectual Property Law



Importance of Intellectual Property (“IP”) to a Company

- ▣ Increasingly important as a business asset
- ▣ May constitute the most valuable asset in early stage technology based companies



Why do Companies Care about IP?

- ▣ **Freedom to Operate** – make sure someone else’s IP will not prevent your company from carrying out its business objectives
- ▣ **Competitive Advantage** – protect your company’s IP so it can be used to gain a competitive advantage in the marketplace through precluding others from utilizing the IP



Ways to Protect IP

- ▣ **Copyrights** – original works of authorship, including software
- ▣ **Trademarks** – word, symbol or device that identifies the source of goods
 - ▣ Company logos
- ▣ **Patents** – right to exclude others from making, using, or offering for sale the invention
- ▣ **Trade Secrets** – secret information that gives owner a competitive advantage
 - ▣ KFC’s secret recipe



Hershey’s Kisses

Protected by Four Types of Intellectual Property Protection

- ▣ Trademark for its shape (#1,584,608)
- ▣ Patent for its method of reducing fat levels in cocoa used (#5,464,649)
- ▣ Copyright for commercials made to advertise (PAu-697-741)
- ▣ Trade secret on its recipe for producing the milk chocolate candy



Copyrights

Exclusive Rights of Copyright Owner

- Reproduction
- Prepare derivative works
- Distribute copies
- Public performance or display



Copyrights - Ownership of Work of Others

- Employers** – gain copyright over works of employees if the work was created *within the scope of employment*
- Work for Hire** – company commissioning the work may or may not become the owner
- Prudent to document these issues in a signed agreement which also contains language addressing assignment of copyright



Copyrights - How to Gain Protection

- Protection exists from the date the work is created in fixed form even without publication or registration
- Marking a work with the © symbol provides notice to the world that the work is protected but is not required for newer works
- Registering a work with the U.S. Government provides the highest degree of protection, allowing for the recovery of statutory damages in addition to injunctive relief



Trademarks - Source of Goods

- ▣ Trademark: a word, symbol or device that identifies and distinguishes the *source of goods* of one party from those of others
 - ▣ Service Mark - similar to trademark except that it identifies services as opposed to goods
- ▣ Allows first actual or constructive (i.e. federally registered) user to *prevent others from using the trademark* for goods or services on same or related goods or services



Trademarks - Items That Can be Protected

- ▣ Can protect:
 - ▣ product names and logos
 - ▣ the name Nike and the Nike swoosh
 - ▣ sales slogans
 - ▣ container shapes and distinctive packaging
 - ▣ Shape of a Coke bottle
 - ▣ Sounds
 - ▣ Intel chime




Trademarks - Obtaining and Keeping

- ▣ Perform a Search
 - ▣ Make sure the potential trademark is not already being used
- ▣ Avoid generic or descriptive terms
 - ▣ Arbitrary marks that have no relation to the product stand the best chance of being recognized as a mark
- ▣ Make wide use of the trademark and make sure that it is used and marked properly
- ▣ Register your trademark at the federal and state levels




Patents - Definition

- ❑ RIGHT TO EXCLUDE others from making, using, selling, or offering for sale the invention in the U.S. or importing the invention to the U.S.
- ❑ Can have a patent but not be able to use the invention if it would infringe on another patent
- ❑ Generally US patents last 20 years from when application filed with USPTO




Patents - Requirements

- ❑ Useful and fit into one of the following categories:
 - ❑ Process, machine, manufacture, composition of matter, ornamental design, or biological plant
- ❑ Novel – must not already be in the public knowledge or in public use
- ❑ Nonobvious in the view of prior art and knowledge to a person having an ordinary level of skill in the pertinent area



Patents - Issues Prior to Filing Application

- ❑ Is there already a patent or a patent pending for a similar device?
- ❑ What is the life-span of the invention?
 - ❑ A short life-span may make a patent impractical
- ❑ Is a patent the appropriate protection?
 - ❑ Would disclosing the information required to patent give an advantage to competitors?
 - ❑ Would company goals be better served by holding the information as a trade secret?



Patents – Prior to Filing Application

- ❑ US a first to invent country (rest of world first to file)
- ❑ Documenting date of invention (conception and reduction to practice) important – use witnessed laboratory notebooks and invention disclosure forms



Patents – Bars to Patentability

- ❑ US Patent – must file U.S. application within one year of public disclosure of the invention
- ❑ Foreign – most foreign patent applications must be filed prior to public disclosure of the invention
- ❑ Use of nondisclosure agreements is important in order to prevent public disclosure
- ❑ Section 102 is complex and has bars to patentability that include printed publications, sales or offers for sale, public use, public knowledge, and invention by another – check with patent attorney prior to taking action with respect to potentially patentable invention



Patents – US Provisional Patent Application

- ❑ An option that can be utilized to avoid, for a certain time, loss of patent rights through public disclosure
 - ❑ Example: article containing enabling disclosure of the invention will be published in scientific journal
- ❑ Filing date as of the date of filing the provisional application
- ❑ Must file a regular application within one year or lose your filing date (and ability to obtain a patent if public disclosure made)
- ❑ Does not count against the 20 year term



Trade Secrets – Definition

- Any formula, pattern, device or compilation of information used in a business that gives the trade secret owner an *opportunity to obtain an advantage* over competitors who do not know it. The trade secret can not be public knowledge.
- Examples: KFC secret recipe, Coke formula



Trade Secrets – Protection

- If information is secret and *reasonable measures are taken to keep it secret*, it will be protected by law
- The law does not create a monopoly for use on the secret like other protections of intellectual property, but it only *protects* the secret from being *improperly appropriated*
- Unlike patents, trade secrets may be “reverse engineered” and thus no longer secret



Trade Secrets – Protection

- Businesses need to take proper steps to ensure the security of their trade secrets
 - Security within the plant or office
 - Contractual safeguards with employees and business partners such as non-competition agreements and confidentiality agreements
 - Workplace controls to prevent the dissemination of trade secrets to individuals that do not need access to them



Licensing Issues

- ❑ Exclusive vs. Nonexclusive
- ❑ One or a few fields of use vs. all fields of use
- ❑ Territory – worldwide vs. geographic restrictions
- ❑ Right to sublicense
- ❑ Royalty rate and sharing of sublicensing revenues
- ❑ Term or duration



Licensing Issues in a University Setting

- ❑ Inventor in University setting required to disclose invention to University
- ❑ University will evaluate and decide whether to patent
- ❑ If University pursues patent it will become the owner of the patent



Licensing Issues in a University Setting

- ❑ University will frequently license the patent to startup company owned by inventor if the startup is serious about commercializing the technology
 - ❑ Be a company
 - ❑ Be capable of meeting market demand
 - ❑ Have written plan to commercialize the technology
 - ❑ Address conflicts of interest (time constraints for faculty, influence over students, influence on junior faculty, effect on research)



Licensing Issues in a University Setting

- ▣ Due Diligence milestones
- ▣ Minimum royalty payments
- ▣ Repayment of patent costs advanced by University
- ▣ Equity in startup to be taken by University?
- ▣ Issue fee
- ▣ License of trademarks
- ▣ www.otm.uiuc.edu



Why do Companies Care about IP?

- ▣ Freedom to Operate – make sure someone else’s IP will not prevent your company from carrying out its business objectives
- ▣ Competitive Advantage – protect your company’s IP so it can be used to gain a competitive advantage in the marketplace through precluding others from utilizing the IP



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Mr. Singleton provides legal services to business clients in corporate, intellectual property, securities law, and real estate areas. He has frequently assisted entrepreneurs select and organize an appropriate entity and obtain capital. He has formed limited liability companies, subchapter S corporations, subchapter C corporations, professional corporations, and not-for-profit corporations, including publicly supported organizations and private foundations. Mr. Singleton has also assisted clients with mergers and acquisitions and with implementing stock option programs.

A member of the patent bar, Mr. Singleton has represented clients in patent prosecution, trademark registration, negotiation of licenses, research and development agreements and joint development agreements. He is familiar with the University of Illinois policies on technology transfer and has negotiated licenses of University technology. Mr. Singleton's real estate law experience includes purchases and sales, leases, installment contracts, like kind exchanges, and zoning and land use issues.

Mr. Singleton is active in both the business and educational communities. He has served on the Advisory Councils of numerous technology companies and served on the list of advisors at the Illinois Technology Center. He is a member of the business plan review group Second Saturday and has served as a judge for the Academy for Entrepreneurial Leadership Innovation Teams Competition and V. Dale Cozad Business Plan Competition.

Mr. Singleton maintains an adjunct faculty appointment with the University of Illinois College of Medicine. He has given guest lectures for the University of Illinois MBA course on technology commercialization, the senior Capstone Design Course in the Department of Agricultural and Biological Engineering, the Academy for Entrepreneurial Leadership Idea to Enterprise Workshop, the Technology Entrepreneur Center, the Advanced Invention to Venture workshop, the University of Illinois College of Veterinary Medicine and for medical residency programs throughout the state.

The recipient of the 2008 Entrepreneur Advocacy Award, and of the Chemical Rubber Company Chemistry Award as an undergraduate student, Mr. Singleton earned a Bachelor of Science Degree in Geology from the University of Illinois in 1988 and a Juris Doctorate from the University of Illinois College of Law in 1991. Following law school and prior to founding Singleton Law Firm, P.C., he practiced with Webber & Thies, P.C. as an associate and then shareholder.

Mr. Singleton is currently a member of the American Bar Association Sections on Business Law, Intellectual Property Law and Science and Technology Law, the Illinois State Bar Association Sections on Corporation and Securities Law (Member, Section Council) and Intellectual Property Law (Member, Section Council), the American Intellectual Property Law Association, the Intellectual Property Law Association of Chicago, and the Midwest Business Brokers and Intermediaries.

Mr. Singleton has chaired the EDC/techCommunity Mentoring Program, has served on the board of the Don Moyer Boys and Girls Club, and serves on the boards of the Mahomet Area Kids Endowment Foundation and the Mahomet Area Youth Club.

Mr. Singleton is married to local family practice physician Deborah Singleton, M.D. They have three children.

Singleton Law Firm, P.C. is dedicated to serving the legal needs of business and individual clients of east central Illinois and beyond with an emphasis in the areas of corporate, intellectual property (including patent) and real estate law. The firm was founded by attorney Alan R. Singleton and paralegal Elizabeth C. Kellner following Mr. Singleton's practice at another local firm as an associate and then shareholder. Ms. Kellner's experience includes work at the University of Illinois business incubator and then service as the coordinator and then executive director of techCommUnity. Both Mr. Singleton and Ms. Kellner are active in their efforts to grow the local business community. Both maintain contacts in the local business community and beyond which allow them to serve as a team to meet the needs of business and individual clients through the provision of value added quality legal services.