

LEGAL PRIMER FOR ENTREPRENEURS

or
Controlling your Legal Problems before They Control you

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Whether you are forming, growing, purchasing or getting ready to sell a business, there are legal rights and risks that impact the economic value of the business. The rights start with the building blocks of your business, including real estate, equipment, intellectual property rights in technology, software, brand or company identity. The rights also encompass a wide variety of contract rights with employees, suppliers, distributors, customers and others. The risks are that these "rights" have not been properly acquired and protected, or that you have created rights in others that become harmful to you.

Why Worry, I Can Deal With It Later?

Unfortunately, some of the most serious legal problems are created in the formative and rapid growth phases of a business. These problems may lie dormant for a long period of time, and not manifest themselves until the business is at a major stress or transition point (raising money; the sale of the business; a dispute among founders or with key personnel; a dispute with a competitor or customer; negotiation of important strategic relationship; or, action by a governmental agency.) Then, when the legal problems surface you may not have the time, the money or the negotiating leverage to solve the problem—particularly on a fast and cost effective basis.

Costly mistakes are also made during the early stages of business transactions by trying to take shortcuts. Procedures have been developed over time for important business transactions. These procedures help "qualify" the other party and identify and resolve critical economic and risk issues up front. This applies to buying or selling a business, raising money, strategic alliances, selling complex products or services, and entering into similarly complex relationships. Most

entrepreneurs only engage in these types of major transactions on an infrequent basis. Nonetheless, they will try to handle critical early stage phases of the deal with little or no professional involvement. The problem becomes worse when the people on the other side of the transaction have far more related transaction experience. As a result, many entrepreneurs will lose a deal that they otherwise could have made, or worse, will do a deal that they later will regret because of poor economic results, excessive risk or buried problems.

So I'll Spend a Little More Later. I've Got More Important Things To Deal With (the Hidden Costs of Legal Problems).

Possible litigation expenses, damage or injunctive awards or settlement costs are only the tip of the iceberg. A major dispute can divert the attention of key company personnel, and delay or even prevent the implementation of your business plan. Even the risk of such a dispute can surface during a "due diligence" review and can kill a financing or sale of the company. Failure to use or enforce intellectual property protection agreements or restrictive covenants (non-competition or non-solicitation commitments) can result in an ex-employee or supplier becoming a major competitor. A public dispute can cause a loss of credibility and image in the market place, and the loss of important opportunities (including some that you may never even know about).

What are the Most Important Problem Areas (Our Highlight List)?

Selecting the wrong organization or tax structure for your business. This can lead to unnecessarily high taxes, poor after tax returns, tax obligations without the cash to pay them, and poor investor appeal. There is a choice of legal entity to

consider which impacts personal liability exposure.

Inadequate agreements governing ownership, decision-making or control procedures. Proper written agreements are needed to define the rights and responsibilities among founders, key employees and initial financiers. Differences of opinion among and changes in management, key personnel, and investors are common and often unavoidable. Clear procedures for resolving these situations can mitigate their effects and allow you to avoid becoming a dysfunctional business. And, the process of drawing these agreements will allow for full discussion of the expectations of each participant.

Failure to acquire and protect the building blocks of your business. You can't finance or sell what you don't own or control. Every business has important building blocks ranging from facilities to supply or distribution relationships, to technology and to people. If your critical assets can be lost quickly at the initiative of someone else, the value of your business is limited. Efforts must be made upfront to secure these assets. And, if you are not vigilant in protecting and enforcing rights you acquire, the value of the business will be compromised.

Failure to plan for adequate financing. A business should have adequate contingency reserves and should raise money in advance of when it will be needed to support growth. The cost of emergency funding, or worse of running out of money, is painfully high. There are a wide range of financing options, with differing legal and business implications. These include traditional equity and debt financing, as well as a variety of alternative business strategies such as licensing, franchises, and various types of strategic alliances. Often these alternatives involve companies that are better funded or that can provide

solutions to problems that you otherwise would have to develop and pay for yourself. It is important to remember that raising equity is a time consuming process that requires compliance with federal and state securities laws. If your company is likely to raise money from outsiders, you must take particular care in your early documentation and planning. Financial desperation tactics can permanently impair a business and create burdensome personal liability.

Failure to acquire and protect intellectual property rights. Intellectual property rights are an important foundation for many businesses. They may consist of brand protection (trademarks, service marks or trade names), important patents, or trade secrets such as confidential business information or production processes. Protection requires a conscientious process of acquiring rights, getting necessary written agreements from employees, consultants, suppliers, customers and others to control the ownership, use and disclosure of the intellectual property – and enforcing those agreements.

Failure to manage the contracting process. Contracting for the purchase and sale of products and services, or for software licenses or other rights, is an essential and ongoing part of conducting a business. These contracts are governed by federal and state laws, including the Uniform Commercial Code and the Federal Acquisition Regulations, and by industry practice, as well as the laws of other countries and international treaties. More sophisticated companies understand this and include extensive protective terms in their forms (particularly in small, light print on the back of requests for proposals, purchase orders, order acknowledgements, and invoices). The value of your contractual rights and potential liabilities varies greatly depending upon the effectiveness of your contracts and your contracting processes.

Failure to attract, retain, motivate, and protect against loss of key personnel. Your employees often are your most important assets. Attracting and keeping good employees requires a well thought out package of benefits and incentives that are appropriate for your market and business. Your employees also can become your most serious problem. Assignment and confidentiality agreements are important to capture the intellectual property that you are paying them to develop. Restrictive employment covenants (typically post termination non-competition, non-solicitation and non-disclosure agreements) can help you avoid creating a new competitor or strengthening existing competitors if the employee leaves you. Poor employment practices can leave you vulnerable to actions for wrongful termination, discrimination, harassment, and other employment related claims.

Poor financial and tax planning. A financial structure and operating practices designed to minimize income tax and maximize the personal benefits of the owners of a business may cause the business to look very unattractive to a prospective buyer, investor, or banking sources. On the other hand paying unnecessary taxes benefits no one (except the taxing authority). There often is more than one way to achieve a business objective, with differing tax and financial statement consequences. Incorporate routine tax and financial statement planning into your business decisions.

Poor regulatory compliance practices. Many industries have special industry specific problems. Special licenses, permits or approvals may be required. Environmental problems may be inherent in some production situations, or a class of employee related problems may exist ranging from immigration to health and safety to union organization issues. It is essential that you know about these special issues, and that you establish procedures to assure compliance. In addition to the

obvious economic cost of non-compliance, you can develop a reputation of non-compliance with attendant unwelcome court orders and on-going regulatory scrutiny.

Failure to manage "Special" legal issues associated with your business. In addition to regulatory issues, some business present special legal issues that must be identified and managed. This can include almost anything: having a non-U.S. "strategic partner" that makes it necessary to comply with foreign law as well as triggering U.S. laws such as those dealing with technology exports; the existence of market power that gives rise to enhanced antitrust scrutiny of your business practices; being forced by important large customers to assume high risk contractual responsibilities that in turn require special efforts to manage the risks such as expanded insurance coverage; or, having a business that relies upon e-commerce based contracts.

The Solution is the Right Plan and the Right Team.

Managing your legal health is not as daunting a task as it may seem. Whether you are developing a new business, acquiring a business or getting your business ready for sale, the approach is essentially the same. Incorporate legal planning into your business planning. Make certain that you have a highly experienced, strategic business lawyer on your team to help you identify, prioritize and manage the legal risks of your business. Strategic legal assistance need not be particularly expensive or time consuming because experienced business lawyers can recognize quickly and deal with most of the issues as they work with you on your business plan and planning process. Limited telephone or email communications can provide you with ongoing guidance once the initial strategic direction and priorities are established.

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