

Entrepreneurship and the Law: Practical Considerations



**THOMAS FAMILY CENTER FOR
ENTREPRENEURSHIP
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OVERVIEW



- I. Principles of Entrepreneurship**
 - I. Value Proposition; Risk Mitigation; Strategy Execution
- II. Corporate Formation**
 - I. Entity Selection and Jurisdiction
- III. Corporate Structure and Control**
 - I. Operating Agreements; Capital Structure; Employees
 - II. Healthcare Reform – Implications for Business
- IV. Exit Strategy**
 - I. Dissolution and Liquidation

Execution is Everything...



“Starting companies are like having babies – fun to conceive but hell to deliver.”

-- Anonymous

Executing the Entrepreneurial Strategy



- What is the opportunity?
- How do we create the product/service?
- What is our strategy?
- How do we market and sell it?
- What are the potential sales?
- How do we build a company out of it?
- How do we create wealth out of it?



All Starts With: What is the value proposition?

Business Activities that Drive Value Creation



ACTIVITY

STAGE

1. Value Proposition

CONCEPT

2. Opportunity Identification

3. Company Startup Operations

SEED

4. Technology Management

5. Product Development

6. Pitching a Deal

GROWTH

7. Finance I (startup financing)

8. Scale-up

9. Finance II (operations)

SUSTAINING

10. Customer Engagement

11. Marketing Communications

12. Building Shareholder Value

EXIT

ENTREPRENEUR NEEDS TO KNOW ALL THE ABOVE

So....Lets Form a Company

Key Legal Documents



- Mutual Non-Disclosure Agreement
- Articles of Organization
- LLC Operating Agreement
- Employment Agreement or Independent Contractor Agreement
- Employee Proprietary Information And Inventions Agreement
- Intellectual Property Agreement

Role of the Corporate Lawyer



Legal Advisor
Business Advisor
Network Facilitator
Sounding Board
Confidant

ENTREPRENURIAL RISK



Types of Risk (Risk = Money & Time)

- Liability Risk → Avoiding personal liability
- People Risk → Limiting the venom...
- Technology Risk → Identification, Registration and Enforcement
- Scale-up Risk → Investors are very good at assessing this...so should you

Every Deal Has a Different Mix of These Risks

Issues During Start-Up Formation



Making Initial Decisions

Forming Legal Entity

Planning for the Future

- Choice of Entity
- Incorporation jurisdiction

- Founder's Equity Allocation
- Incorporation
- Bylaws

- Board
- IP Assets
- Tax Issues

Choice of Entity



- Sole Proprietor
- Partnership
- LLC
- Corporation (C-corp. & S-corp.)

Choice of Entity

Eight Factors



- Administrative Issues
- Personal Liability
- Management and Control
- Term of Existence
- Tax Issues
- Raising Capital
- Fiduciary Duties
- Transferability of Ownership Interests

Sole Proprietorship & Partnerships



- Common for “lifestyle” companies
- Simple (no filing required to form)
- Business owned & operated by one person (two or more in partnerships)
- Business and owner(s) are one and the same (personal liability)
- Flow through taxation
- Partnerships are guided by contract & UCC

Corporation & LLCs



- Separate legal entity from owners
- Limited liability
- State law governed (file articles with state)

Choice of Entity



C Corporation

- Continuity of existence
- Ease of transfer of ownership
- Easier to raise capital
- Separate entity from owners

S Corporation

- Regular corporation meeting IRS test
- Difficult choice for startups
- “Incorporated Partnership”
- Tax issues in liquidity events

LLC

- Flexibility in operating agreements

Limited
liability for
stockholders

Corporation



Advantages

- Limits personal liability
- Corporations law is well settled
- Raising capital/funding

Disadvantages

- Double taxation for C-corps.
- Restrictions for S-corps to qualify as “pass through”
- Strict corporate formalities (e.g. ownership)

LLC



Advantages

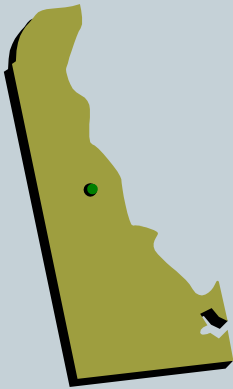
- Limits personal liability
- Flexible structure (e.g. sweat equity)
- Pass through taxation

Disadvantages

- Complex and costly to form. Operating agreement must be clear
- Law is not as well settled as Corp law.
- Tax: publicly traded partnership status means taxed as C corp.

State of Domicile

- **Delaware**



- Developed case law
- Business-like attitude
- Willingness of counsel to provide opinions
- Ease of governance

- **Other jurisdictions**



- Differences on specific points of law
- Local allegiances
- Administration issues

Process of Incorporation



- **File Charter**



**Charter is a
public document**

- **Follow up on organizational matters**

- Corporate Name – Need for Distinction
- Par Value of Stock – Significance
- Initial Officers and Directors
- Adopt Bylaws
- Payment for Stock

- Appoint Board
- Issue stock
- Foreign qualifications
- Tax ID number

LLC vs. C-corp Filing

Certificate of Formation v. Certificate of Incorporation

- LLC
 - entity name
 - process service agent
 - registered office
 - date of formation
 - signature
- <http://sos.delaware.gov>
- C Corp
 - EVERYTHING in LLC PLUS
 - statement of legal business purpose
 - authorized shares
 - ✦ Par value (or no par), total number of authorized shares, classes, series, numbers of such classes/series and their rights and privileges.
 - Name and address of incorporator
 - Sometimes the initial directors

Bylaws & Operating Agreements



- Are the key documents among the shareholders/members that generally includes provisions related to
 - Regulation of the entity's affairs
 - Conduct of the business and
 - Governing the relations among members (and managers, if any)
 - Member/Manager managed
 - Equity Share
 - Voting Rights



Going Forward- Legal and Management Issues



IP Assets

- Identification & Perfection of IP Rights
- Assembling management team – identify needs – cash and equity compensation

Founders' Equity

- Allocation and vesting of Founders' equity
- Dilution v. protection of Founder Interests

Taxes

- I.R.S. Section 83(b) Elections
- Importance of Timing and Consistency in Valuation of Stock
- Avoiding Taxable Income

Start-up Legal Mistakes – Human Resources



- Improper or non-existent non-compete and invention assignment agreements.
- Employment agreements with out-of-market terms for severance or other items.
- Inappropriate use of titles
- Inconsistent Compensation Strategy
- Federal anti-discrimination laws
- Subjective Team Selection

Start-up Legal Mistakes – Human Resources

Federal Employment Law Statutes



- Title VII of Civil Rights Act of 1964- Prohibits employers with 15 or more employees from discriminating on basis or race, color, religion, sex or national origin.
- Age Discrimination Act – prohibits discrimination against employees age 40 and over.
- Lilly Ledbetter Fair Pay Act – prohibits discrimination in compensation
- Americans w/ Disabilities Act – prohibits discrimination against qualified individuals with a disability

Start-up Legal Mistakes – Human Resources

Federal Employment Law Statutes



- The Fair Labor Standards Act – governs payment of at least minimum wage and payment of 1.5x regular wages over 40 hours
- Immigration Reform and Control Act – unlawful to hire an alien who is not authorized to work in the US
- N.C. Retaliatory Employment Discrimination Act (REDA) - prohibits retaliatory action against an employee who makes a good faith claim under Workers Compensation Act

Start-up Legal Mistakes – Corporate Governance



- LLC
- Operating Agreement
- Formalities
- C-corp
- Not establishing a board of directors.
- Not having bylaws.
- Not taking minutes and recording them.

Start-up Legal Mistakes – Technology and Intellectual Property



- Using open source code in a proprietary product requiring it to also become open source.
- Poor or non-existent patent writing (and strategy).
- Failure to maintain patents.
- Failure to file international patents and maintain them.
- Poor license agreements for in-licensed technology.
- Out licenses with partners which give rights away without compensation. (Selling the company w/out selling it.)
- Failure to Copyright or Trademark proprietary materials
- Failure to Fully Consider Implications of Trademarks

Intellectual Property Management



IDENTIFY – PROTECT – SURVEILLANCE - ENFORCEMENT

- IP is an asset like any other
- Intellectual Property = Intellectual Capital
- Stuff that you know or your company knows that can generate profits for the company
- Patents
- Trademarks/Service Marks
- Copyright
- Trade secrets
- Any knowledge we have that is not commonly available

Patient Protection & Affordable Care Act

Implications for Business



- Businesses with <50 FTEs exempt from non-coverage penalties
- Pay or Play mandate applies to employers with > 50 FTEs; penalty = \$2,000/ee (excluding the first 30)
- Dependents may remain on parents plan until age 26
- Businesses with >25 FTEs may be eligible for tax credits up to 35% of the employers contribution (2010-13)

Patient Protection & Affordable Care Act

Implications for Business



- In 2014 eligible employers with >50 FTEs that purchase through the SHOP exchange (small business health options prog.) may receive a tax credit of up to 50% of the employer's contribution
- In 2016 employers with up to 100 FTEs can participate in SHOP
- Business with >100 FTEs are eligible for grants for Wellness Programs

Patient Protection & Affordable Care Act

Implications for Business



- Employers are required to provide employees with a standard “Summary of Benefits and Coverage” form explaining what their plan covers and what it costs.
- Beginning January 1, 2014, individuals who are eligible for employer-provided health coverage will not have to wait more than 90 days to begin coverage.
- Medical Loss Ratio Rebates insurance companies must spend at least 80% of premium dollars on medical care rather than administrative costs.

Potential Sources of Capital

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- **Personal Funds:**
 - No equity dilution; no issue regarding management/control.
 - Usually not a deep source; owners put everything on the line, personal risk
- **Family & Friends:**
 - Some equity dilution, usually not a deep source, unsophisticated parties/unrealistic expectations, allocating management/control can create hassle/tensions and ***impact personal relationships***

Potential Sources of Capital

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- **Bank loans/debt**
 - No equity dilution
 - Usually requires personal guarantee, need cashflow to cover interest payments, outside party watching over owners' shoulders.
- **Angel investors**
 - Industry and business expertise
 - Tougher negotiators, more equity dilution, usually only enough \$ for one...maybe two...rounds.

Crowdfunding



- The JOBS Act allows companies to raise up to \$1M in 12 month period w/o the same strict SEC regulations
- Investors can be nearly anyone, subject to the Act.
- Investments must be made through an intermediary (e.g. www.kickstarter.com)
- Other restrictions apply

Potential Sources of Capital

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- **Venture Capital/Private Equity**
 - Deep pockets, good contacts/expertise in management, finance, etc. experience with early stage companies, advice/insight, fast track growth means opportunity for greater success
 - Substantial equity dilution, founders give up significant strategic management control, outside party participating in the business, fast track growth means greater risk of failure. Fast track and liquidity event demanded by VC investors.

Exit Strategy

Dissolution and Liquidation



- **Events Causing Dissolution**
 - Upon application
 - Failure to File Reports with Sec. State
 - Running of time as per Articles or Operating Agreement
 - Members' unanimous consent
 - Other Specified Event (Dissolution event as per Articles or Op. Agreement)
 - 90th Day after withdrawal of last remaining member
- **Procedures for Dissolution and Winding Up**
 - Collect Assets
 - Discharge Debts
 - Dispose of Property
 - Distribute Remaining Assets in Accordance with Priorities of Distribution
 - Creditors; Members in satisfaction for liabilities; and then to Members relative to Contributions

Procedures for Dissolution and Winding Up



- **Collect Assets**
- **Discharge Debts**
- **Dispose of Property**
- **Distribute Remaining Assets in Accordance with Priorities of Distribution**
 - Creditors
 - Members in Satisfaction for liabilities; and then to
 - Members Relative to Contributions
- **Disposing of Claims Against the LLC**
 - Provide Notice with Request for Description and Deadline, otherwise barred
 - Unknown Claims – Publish Notice One Time in Newspaper
- **Tax Issues**
- **Formalities, Recordkeeping and Reporting**

... and Then What ...



“Only one thing is certain about a new venture:
It’s going to turn out very different from its business
plan.”

-- William Congolton, Venture Capitalist

QUESTIONS



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