

A Basic Framework for Considering the Legal Risks of an Early Stage Business

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As an entrepreneur plans or actually launches a new business, the focus is understandably on executing the business plan, obtaining customers and securing the necessary financing. A result of this focus may be that basic issues of legal risk, and managing those risks, are overlooked by the early stage company. The results of such an oversight can be very serious.

Since each new business and the circumstances under which it is being launched are to some extent unique, there is no simple formula or check list that will address the specific legal risks that a given company will have or how best to address those risks. This note is intended to give the entrepreneur a basic framework for understanding the points at which legal risks are likely to arise in the starting of a business. The hope is that this basic framework will provide founders of new businesses with a logical structure for increasing their awareness of where legal risks arise so that the decision on whether or how to address those risks is conscious decision.

The Business Plan

Creating a business plan is the first step in starting a new business. The analysis of legal risks should also begin at this point. There are two basic areas of risk that the entrepreneur should consider with respect to the business plan. The first is protection of the plan. Most business people recognize that disclosure of the plan should be made subject to a non-disclosure agreement. However, parties often fail to clearly indicate on the face of the business plan that it is subject to a non-disclosure agreement and may not be viewed or used by any party not agreeing to the terms of the non-disclosure agreement. This simple oversight can limit the effectiveness of the non-disclosure agreement with respect to a party who improperly received a copy of the plan.

The purpose for which the business plan is used is the second area of legal risk that needs to be considered. If the plan is used, as is likely, in connection with raising funds from investors either the plan itself, or a broader offering memorandum of which the plan is one part, must contain adequate disclosure of the risks to investors. In creating the plan, the entrepreneur may not feel the need to detail various risks which he or she understands and appreciates. The drafter may also view the presentation of all risks associated with the start-up as being excessively negative. Nonetheless, legal liability can arise from the failure to clearly inform an investor of the risks associated with the investment so those risks need to be spelled out in writing.

All business people understand that businesses, especially early stage companies, must adapt and that no business plan will completely reflect how the business actually develops. It should be obvious that company should keep its investors informed on a regular basis of material matters relating to the performance of the business. With a start-up company it is also prudent to specify how and why certain aspect of performance or operations may differ from the plan as initially presented. If an investor has concerns about certain deviations from the plan on which the investment was based, the sooner those concerns are identified the better the chances of avoiding a potentially significant problem with the investor.

Legal Structure of the Business

Selecting and creating the legal form under which the business will operate is another preliminary step in starting a business. It is generally very easy and inexpensive to create a corporation or limited liability company. However, simply creating a legal shell for the business does not begin to address the legal risks. With respect to the legal form under which the business operates, it is again useful to view the risks from two perspectives.

The first perspective is potential liability to third parties. Entities such as corporations, limited liability companies and limited partnerships are used to protect the personal assets of the principals in the business. However, if the operations of the legal entity are not clearly separated from those of the principals as individuals, the corporate shell may be disregarded and the individual principals may be held legally liable for acts, omissions and debts of the company. Common errors for small start-up companies include failing to have bylaws or operating agreements; commingling personal and business financial transactions and accounts; failing to clearly in contracts, correspondence and marketing materials that the individuals are acting as agents of the company and not in their individual capacities. In short, one not only needs to form a corporation, one needs to operate as a corporation

Of course, in selecting the legal form to be used to conduct the business, one should have a clear understanding of the tax implications of different legal forms. Profits from limited liability companies and Subchapter S corporations are generally taxed at the individual owner level and there is no separate tax at the entity level. This tax treatment makes limited liability and Subchapter S corporate forms appropriate for many early stage companies. However, it should be recognized that profits retained for growth can result in “phantom income” to the owners of the business, which can be financially painful at the individual level if no provision is made to distribute a share of the profits to cover individual tax liabilities.

Second, the legal risks associated with the legal form under which the business operates should be considered from the perspective of the relationship of the owners in the business. Once more than one person is a principal or investor in the business issues such as scope of authority, decision making processes, termination of the business and death or withdrawal of a principal arise. Many entrepreneurs have collegial relationships with their “partners” and do not see a pressing need to deal with these types of issues. Also, properly addressing such issues will likely require professional assistance from a lawyer. The cost of obtaining such assistance can provided the cash-short entrepreneurs with another rationale for avoidance.

With respect to defining the legal relationship between the principals in the business it is not a question of whether the principals will ultimately pay to have it done but rather when and how they will pay to have the relationships, duties and responsibilities defined. If the issues are ignored over the long term, payment will likely be made in connection dealing with a problem through expensive legal processes or negotiations. Developing solid governing documents (i.e. bylaws or operating agreements) should ideally be done at the outset. If not done at the outset for some reason, then the governing documents should be developed and adopted as soon as possible. As will be discussed at the end of this note, if available cash is an issue the entrepreneur

should seek an attorney who can provide a flexible fee structure that accommodates the realities of financial realities of most start-up businesses.

Raising Funds

Early stage companies are almost universally faced with the need to raise funds from outside sources. There are many legal risks associated with raising capital, and as a general rule most entrepreneurs would be well advised to have experienced, professional help in the capital raising process.

The loss of money can strain even personal relationships, so even when dealing with friends and family as a source of initial funding it is prudent to document certain points. As a basic guideline, friends and family providing capital should be provided with a written document covering the basic business plan, the risks of putting money into the business and what the friend or family member will receive for the loan or investment. When there is a close personal relationship with the person providing funding, there may be a temptation to rely on handshakes and oral commitments. Don't!

Also, even if the friend or family member may not meet the legal definition of an accredited investor under the securities law, both the investor and the principal should be comfortable that the investor can afford to lose the entire amount invested. If the friend or family member is going to put their "life savings" behind the new venture the entrepreneur should definitely make sure that professional assistance is engaged.

If the company is raising money from professional investors, such as venture capital firms or banks, the investor will likely have forms or guidelines for the documenting of the transaction. The entrepreneur may feel comfortable negotiating the business terms of the transaction. However, it may be prudent for the entrepreneur to get professional guidance in terms of understanding what various covenants or other terms may mean with respect to restrictions on the operation of the business. A failure to understand and abide by covenants or restrictions in the funding documents can create some significant legal risks. As a general principal, when deciding how much capital is needed, the entrepreneur should factor in the cost of getting the appropriate professional support.

The most significant legal risks arise when funding is sought from private investors. To begin, the investor must be "accredited" under the existing securities laws. It is very important that the particular risks with the given business and investment be clearly and in detail as part of a formal offering memorandum. An individual investor, even though wealthy and experienced in some form of business, may be held to a lower standard than a professional investor in terms of understanding the specific risks in a given investment. Prudence dictates erring on the side of more detailed disclosures of potential risks when dealing with a private investor.

The company should not rely on oral disclosures or discussions of the risks. The company should seek to limit the investor to relying on the written documents that form the formal offering memorandum. Language limiting the investor's reliance to the written offering memorandum should be clearly and boldly stated on the facing of the offering document.

Employment and Other Contracts

A business of any size will enter into contracts – leases, vendor and customer contracts and employment agreements. There are many form and sample contracts available on the Internet. There is a temptation for the entrepreneur to simply grab a form or two off the Internet and use them in the business. However, one should understand that the purpose of a contract is to define specific obligations and allocate liabilities. Such undertakings are business specific and most contracts should be as well.

The better approach than simply using form agreements is to use the contracts that are available on the Internet as a means of learning what terms are generally included in the various types of contracts. The business principal should then consider what issues are unique to his or her business and may not be adequately addressed by the forms. Armed with a better general understanding of both what is generally included in different types of contracts and the extent to which the forms fail to adequately address business specific needs, the business owner should obtain assistance from a qualified attorney. The business owner should be in a position to outline specifically what he or she wants in the contract. The business owner should ask the attorney what the attorney would recommend, based upon experience, to add to the contracts. This process should allow the business to get contracts that really address its needs while reducing the legal costs associated with obtaining the contracts.

Intellectual Property

Most start-up businesses rightly consider patents, trademarks and copyrights as means of protecting intellectual property and brand identity. Certainly, a business should avail itself of the protections afforded by the law to protect its brand and intellectual property.

However, a point sometimes overlooked by an entrepreneur is the potential infringement of another party's patents or trademarks. One can search for registered trademarks and patents on the Internet for little or no cost. If a patent is critical to the business plan, it may be worth the cost of having a qualified patent attorney run the search, as searching for relevant patents can be a tricky undertaking calling for an experienced professional.

One mistake that some start-ups make is assuming that if a corporate name is available at a state level for purposes of incorporation the name is available as a potential trademark or service mark. The ability to use a name to incorporate a state level merely means that there are no identical, or substantially identical names registered in that one state. The ability to use a name to incorporate has no bearing on whether the use of the name may infringe an existing trademark or service mark.

Insurance

Insurance is designed to provide financial protection against certain potential losses or liabilities. The key for a business in getting insurance is understanding what the realistic exposures are and

then matching the right insurance products to cover those exposures. If the business is very basic, such as a retail candy store, the insurance products are likewise basic and most local insurance agents should be able to provide the right coverages.

On the other hand, if the business is more complex, involving such areas as technology, product manufacturing or construction for example, the available and appropriate

insurance products are more complex. Companies with more complex businesses are well served by going to an insurance broker who focuses on commercial risks and represents multiple companies.

When obtaining insurance for a more complex business, the company should not merely fill out the application form and then accept the coverages offered by the broker. The business owner should ask the broker some basic questions: 1) what risks in my business will this particular policy cover; 2) why are you recommending the policy limits that are in the proposal and what are the differences in premium for higher and lower limits; 3) what is the deductible under each coverage and again what are the options; 4) why are you recommending this specific company and what were the competitive quotes you received. While one hopes that the broker is operating in the company's best interests, it must be remembered that brokers are compensated by a commission based on the total premium. Some simple questions of the broker should enhance the probability that the company is getting the right coverage at the right price.

Lawyers and Legal Costs

One thing lawyers do is manage legal risks. This means, in effect, that legal costs are just another component of legal risk. As such, the entrepreneur needs to both understand and manage legal costs.

The first point is simple. Fees charged by a lawyer not only generate income for the lawyer, but they also cover the lawyer's overhead expenses. Most early-stage companies try to reduce their overhead expenses. It follows that they should try to avoid paying the high overhead expenses that a lawyer may have. This generally means that large law firms with big staffs and fancy offices are not a good match for most early-stage companies.

By the same token, the quality and experience of the lawyer is important. It is usually not wise to simply hire the cheapest lawyer. The goal is to find a lawyer of "big firm quality" who operates in a lower overhead environment and offers quality services at a reasonable cost.

Second, while the hourly fee is the standard basis on which lawyers charge for their services, there are alternatives. Examples of other fee structures include a "flat fee" and a "not-to-exceed" fee. A flat fee is a set amount to be paid for a specific task or undertaking. A Not-to-exceed fee sets the most the lawyer will charge using an hourly fee format. Under both of these approaches it is important to properly describe the task that will be performed for the specified fee.

A common dilemma for a start-up company is that there is limited cash available at the outset and the entrepreneur prefers to spend that cash on growing the customer base or developing the

company's products. This explains why legal services that probably should be undertaken by a start-up are either not obtained or are postponed. The company should ask whether the attorney is willing to accrue fees or make a portion of the fees contingent on the company either hitting certain revenue benchmarks or receiving funding. The company should not be hesitant to explore different fee options with the attorney.

Finally, equity in the company may represent a non-cash basis for acquiring either some legal services or concessions on rates or payment terms. Most large law firms will not accept equity as part of the fee arrangement because of their partnership structures. This is another reason for the start-up to search out qualified smaller firms or sole practitioners who can provide flexible fee structures, as well as lower rates.

It is fully understandable that early-stage companies want to mitigate legal costs to the extent possible. However, trying to be one's own lawyer is almost certainly the wrong answer and may end up being a very costly mistake. The better alternative is finding a way to get the necessary legal services on financial terms that make sense for a company in its start-up phase. To accomplish this, the entrepreneur needs at least a basic understanding of where legal risks generally arise and some ideas on how to get quality legal services on financial terms compatible with the economic realities of most early stage companies.

Conclusion

The area of legal risks is obviously very broad and can be complex. This note is not intended to begin to deal with all of the legal risks that may be associated with starting and operating a business. Rather, the goal of this note is to provide the entrepreneur with a broad framework for understanding legal risks for the early stage company. The hope is that this framework will help the entrepreneur think about legal risks so the risks can be addressed appropriately when possible.

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