A Founders' Guide to Navigating the Legal Landscape

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Starting a new venture can lead you across unfamiliar territory, but you don't have to explore it without a guide.

"This is information I wish I had known when I started my business... Although some of this seems daunting when you're just getting started it will save you a lot of time, and money, later. This guide does a great job compiling everything you need to know in one place." – Mike Woitach, Founder

About the Authors: You may notice our legal disclaimer at the bottom of the pages referencing MR LAW® and wonder just who this Mr. Law person is. MR LAW is actually a registered trademark for the entrepreneurship-focused legal services of attorneys Mike McCollum and John Robinson. Mike and John are both attorneys with the law firm of John V. Robinson, P.C. in Richmond, Virginia, and have worked extensively with businesses ranging from single-member startups to international corporations. McCollum gave us the "M," Robinson gave us the "R" and the law firm provided the "law."

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Table of Contents

Introduction

Starting any new business presents opportunities and challenges, many of which are unique to each business. No doubt you are already aware of, and planning to deal with, many of the most daunting of those challenges. Sometimes, however, it is the problem you don't see, the part of the iceberg that is underwater, that can cause the most damage. The particular hidden dangers we hope to help you avoid with this guide are the less common legal dangers hidden behind a layer of statutes, legal opinions, and archaic terminology; all further obscured by rumors and false assumptions. This may sound like we're just stating the obvious, but the law often works in unexpected ways, and if you aren't aware of the legal landscape it can have serious consequences for you and your business. When in doubt, consult an attorney, because a simple consult with your legal counsel may help you avoid a problem rather than having to fix one, or even worse, deal with the fallout.

"The Law" may be *terra incognita* but it doesn't have to be dangerous territory.

What This Guide Is, What It Isn't, And Why You Should Care.

Many in entrepreneurship circles like to tout the value of experience, and no doubt experience can be invaluable. "Good judgment comes from experience, and experience comes from bad judgment" is an often repeated idea. While that is certainly true, we believe that while experience can be a great teacher, it can carry a hefty price tag. Some mistakes are simply too costly to make, especially when they can be avoided. We wrote this guide so that you can take advantage of the experience and expertise of others, rather than make the same mistakes that so many entrepreneurs make all too often.

This guide is an overview of some of the areas that typically aren't scrutinized enough by founders and early-stage companies. But this is a travel guide for the legal landscape, not personalized directions; we hope it will provide you with enough information to know when you are straying onto dangerous ground. It is intended to help you avoid problems when you can, to know what others need to be addressed, and when to ask for help finding your way forward. It is also written from the perspective of Virginia businesses; most of it is generally applicable, but every state has somewhat different laws that you'll need to check.

What this guide is not is a substitute for individualized guidance, instruction, and assistance. Businesses at different stages and with different long and short term goals will have widely varied concerns, and the approach you decide upon should be tailored to ensure that you meet those goals. Nor is it a business guide. We're not trying to tell you what it means to be an entrepreneur, or give you "5 Steps to Business Success." This guide can't tell you how to improve your marketing strategy, but it can point out how to protect the brand you are developing. It can't help you deliver a better pitch to an audience, but it can help you protect your trade secrets when you are deciding how much information to share. It won't help you find a strategic partner, or identify new team members, but it will highlight concerns you need to address when structuring a deal or onboarding a member.

This guide is a supplement that deals specifically with legal issues entrepreneurs encounter, because while you rely on business experts and veteran entrepreneurs for business advice, those resources may not be able to alert you to dangers and pitfalls in the legal landscape that they haven't faced themselves. And, because it's written largely by lawyers, we'll include the standard disclaimer that "this guide is not legal advice." If you ask yourself "why do lawyers always say that," well, the answer is because that's one of those strange, archaic requirement we were talking about, only this one applies to us.

And now the important part: why should you care? Rather than wait to the end of the guide to deliver the punchline we decided that it would be best to tell you straight up front why this information is really important to founders, entrepreneurs, and anyone running a new business. The short answer is that you should care because the law affects your business whether you want it to or not. *Ignorantia juris non excusat:* ignorance of the law excuses no one. For every business decision you make the law determines how your contracts, your employees, your deal and your business is treated. You can inadvertently create obligations for your business, incur personal financial liability, or even end up violating state and federal laws that you weren't even aware of. If you don't know what the law requires, what restrictions it imposes, or what it allows you to do, and if you don't keep those things in mind every time you sign a contract, send out a proposal, or share your proprietary information with potential investors you could miss out on an opportunity or even create a problem that you cannot fix.

Perhaps on a more relatable level, you should care because your investors are going to care. When you go to raise money from someone other than your friends and family they are going to want to know that the business they are investing in is not only a great idea with a great management team; they are going to want to know that everything has been done correctly.

Sometimes doing things incorrectly means you don't get full value from an agreement or contract. Other times, doing something that isn't even necessarily wrong, but simply doing it in a less than optimal way can cause your business to suffer tremendous losses and setbacks. So we are going to urge you, probably several times throughout this guide, not to take it for granted that the law works in a way that makes sense; don't rely on your friends, or even veteran entrepreneurs or financial subject matter experts, to point out the possible consequences of your decisions.

The entrepreneurial ecosystem is filled with misinformation when it comes to the law, even including advice from your successful predecessors; just because someone else got away with it doesn't mean it is wise to try the same approach yourself. And, because this isn't legal advice that takes your unique situation and goals into account, don't simply rely on this guide, either. When you venture out into the business world, in whatever type of business you create, you are also venturing onto the legal landscape. Be aware of the dangers and know when you need to ask for help navigating the potential minefield of legal issues.

Due Diligence

We're going to start near the end of your journey because it is vitally important to keep in mind what you are trying to achieve and what will be required to get there. One of the final set of hurdles you will face will be the process of "due diligence." If you're successful, you'll have to go through this process repeatedly, and each time the process could become more and more complex. You may have already gone through a round of due diligence even in the early stages. Most entrepreneurs have heard the term "due diligence" but may not be familiar with what it actually entails. It is important to know what is needed to cross the finish line, and to keep it in mind when you're taking all of the steps on the way there.

Due diligence is a process, although some may consider it an ordeal in the traditional sense of the word, that any company seeking outside investors is going to have to go through. It is the process by which an investor looks under the hood, examines the company, and looks for flaws. They aren't hoping to find flaws, but they want to find them BEFORE they put their money into your business. And they most certainly want to find anything that could change the valuation of the company they are investing in. No investor wants to put hundreds of thousands or millions of dollars into a venture only to find out after the fact that the company doesn't own the core systems that are essential for successful execution of the business model. Just how detailed and invasive this process is depends on the investor, but also on the amount of the investment and the stage of your company's development.

There are several types of diligence that will go on at various stages: technical, financial, legal, and market & commercial. Our focus is on the technical and legal diligence processes.

You will need to be able to trace your business' transactional history from creation to the date of the investment, show that your business was authorized to do what it did, account for your contracts, and have the documentation needed to prove that your business owns the assets that the investor is interested in. Are you the copyright owner? Show me the documentation. Are you the inventor? No? Show us the patent assignment agreement. Are your key personnel under contract? Let's have a look. Where are your articles of incorporation and bylaws? What were you before you became a Delaware C-Corp? A partnership? Did your partnership have authorization to convert to a corporation? The investors will want to assure themselves that what they are putting money into is what they think it is, so expect a thorough examination of these, and many other, documents. We have included a sample diligence checklist in the appendix you may want to review if you're curious about just what is typically going to be of interest during the process. Will all of those items be included in your early rounds of financing? No, but if you are successful most of them will be included eventually.

If you have not been keeping the proper records, or if you are missing certain contracts, authorizations, or agreements, you may be able to fix the problem, but fixing the problem takes time and money. Even worse, it may signal to potential investors that you aren't well organized, and cause them to doubt your ability to successfully run the business. It may also cause them to look harder and to request more information, because if something is out of place, what else might be missing? A perfectly viable company can fail during the due diligence process as critical deadlines go unmet. If you have any intention of raising capital for growth you need to familiarize yourself with the due diligence process, keep the likely requirements in mind, and make sure that you are taking the correct steps at every stage of your company's development.

Due diligence can be a simple process, or it can require a great deal of effort to provide all the required information. If your investors are serious about their diligence, you will be much better off if you do your best to plan for what you'll need early, and periodically check to make sure that you aren't missing something vital. A little diligence of your own can go a long way to simplifying the process when it really counts.

Common Legal Mistakes

While the mistakes businesses, especially new businesses, make can run the gamut from the mundane to the exotic head-scratchers there are some legal mistakes that tend to crop up with a fair degree of regularity in start-up businesses. For the most part, these stem from either a lack of information or misinformation; the founders simply didn't know what was required to accomplish their goals. Here is a short list of some of the most common mistakes that this guide is intended to help you avoid:

- Failing to protect yourself from personal liability
- Forming unintended partnerships with other individuals or business entities
- Failing to properly transition the business from one type of entity to another
- Not conducting a timely trademark search
- Failure to obtain good title to intellectual property
- Failing to institute a trade secret protection program
- Not properly licensing technology patented by others
- Creating imprecise contracts with vendors, contractors or suppliers
- Violating wage/hour laws and employment regulations
- Selling securities to non-accredited investors
- Violating state and federal securities laws governing private placement transactions
- Not adopting an appropriate employee stock option plan

While this may seem like quite a list, the truth is these are just a few of the most common mistakes made by founders during their journeys to create new businesses. Sometimes these mistakes can be easily remedied. Other times an oversight becomes a poison pill that kills an investment deal or ruins a company all together. However, with a bit of planning, a bit more knowledge, and the willingness to ask a few questions from the experts rather than relying on common knowledge, second-hand information, or, even worse, the internet, you can avoid the pitfalls that dot the legal landscape.

Business Entities, Legal Personhood, And You

Many people think of their business as an extension of themselves. This is especially the case in the very early stages when your business consists of you, your co-founder, and your idea. And in some respects, it is true; you and your business are one and the same. You can be the face of your business. Your clients or customers get to know you, trust you, and rely on you. You can determine what principles your business stands for (think "We proudly support our local economy and only sell products Made in the U.S.A.," or "We only sell Fair Trade Certified chocolate."). It is up to you to decide what your business does, and hopefully, that is something you are passionate about.

Where businesses are distinct from their founders, owners, investors or employees, is when it comes to the law. Businesses take on a legal existence and identity that, in most cases, is both separate and distinct from the legal identity of the founders, owners, investors or employees. Customers do business with a company, not necessarily the owner of the business as an individual. You may stand behind the deal your company makes, but that contract is between the customer and the company (in most instances, but we'll get to that later), and your employee is an employee of the business. The business can't function without you and your employees, but it has a separate and distinct existence under the law.

Perhaps the greatest benefit to this separate legal existence is that a business entity can protect you and your personal assets from financial liabilities. While we all know that our debts and obligations are ours to pay, the debts of a business ought to be the debts of the business alone, and not the debts of the owners, managers, or employees. This is not always the case; some business entities provide no personal liability protection at all, while the others do so only as long as you abide by the rules. Ensuring that your home, your car, your checking account, and your other personal assets are not at risk, beyond the amount you decide to commit to your new business, is not something to take lightly.

Nowhere is this distinction clearer than when it comes to signing contacts. It is critical that you know how to sign contracts to legally bind the business itself, rather than committing to honor the contract personally. We'll get into this in more detail a bit later on, but if you are about to sign a contract and want to jump ahead to page 43.

Business entities require people to act on their behalf and these people become agents of the business. That is where agents come in. Agents can act on behalf of the business, but they also have responsibilities and owe certain duties to the person or business on whose behalf they are acting.

Who Are Your Agents And What Do They Do?

Simply put, an agent is any person who is authorized to act on behalf of another, or in this case, your business. Why is it important to know who your business' agents are? Because an agent is someone with the power to legally act on behalf of, and to create obligations for your business. You need to know and carefully consider who will have this ability to impact your business.

You and your fellow partners (if you are a partnership – more on that shortly), or your fellow members (if you are a member-managed LLC – and we'll get to that shortly too) are agents of your business, but who else is an agent? Agents can be employees of your business, but so can contractors, consultants, or anyone else who meets the criteria to be considered an agent. The two basic questions that need to be answered to determine if someone is an authorized agent are 1) have you and your prospective agent both done something to indicate that she will work subject to your oversight, direction, and control, and 2) have the two of you done something to indicate that she will act on your behalf? These two criteria can be met through a written document, such as an employment contract, or they can be satisfied with a simple conversation.

Once an agency relationship is established the agent owes your business certain duties. These duties can be supplemented by what is in your agreement, but they also include some duties that are automatically imposed by the law, including the "duty of good faith" and the "duty of loyalty." The duty of good faith is fairly simple; it requires agents to exercise good business judgment and use ordinary, reasonable care in carrying out their responsibilities on behalf of the company. The duty of loyalty, on the other hand, is somewhat broader and requires the agent to act for the benefit of your business in all matters connected with the agency relationship. The duty of loyalty prohibits the agents from soliciting your clients, customers, or employees for themselves, or for another competing business while they are agents of your business. You can reinforce this with a non-solicitation agreement in the agent's contract, but even if you don't take that extra step (and you probably should), this sort of activity is prohibited by law.

Your agents can carry out certain tasks on behalf of your business, but they can also have the authority to enter into contracts or agreements on behalf of your business in certain circumstances. Sometimes they can even bind your business to contracts when they do not have the authority to do so, and your business may have to honor that contract. Of course, you can try to recover any losses from your wayward employee, but that takes time, costs money, and may not actually solve the problem; it is always best to avoid a problem rather than try to fix it after the fact.

While there is nothing you can do to absolutely protect yourself against the potential liabilities that come from having employees or other agents, there are a few things you can do to minimize the risks. Be very clear and consistent with anyone who is or will be acting as your agent on what they are and are not authorized to do. And whenever possible, be very clear with your customers, suppliers, contractors and service providers about whose authorization is required. But most importantly, don’t go into business with people you cannot trust.

Different Types of Business Entities

The most common forms of business entities are familiar to most people. Corporations, partnerships, and limited liability companies are businesses that we see fairly regularly. Limited partnerships, limited liability partnerships, professional corporations, benefit corporations, and the unheralded yet ubiquitous sole proprietorship are also quite common, but less recognizable to most. Each type of business entity has unique characteristics. Certain characteristics of the various entities could be beneficial to your business, and others can cause unexpected problems. It is important to remember that what is advantageous at one stage of your business' life cycle may not be the best fit for long term growth. Almost any type of business can become another type of business without too much work (although your accountant may have something to say about that, so you should always get the appropriate tax advice before converting one type of business to another).

When you are choosing between the various types of businesses, you should keep in mind that there are requirements not just for forming, but for running different types of business entities. The costs vary widely, from filing fees to drafting the documents necessary to maximize the benefits of the entity. The requirements range from simply keeping track of your profits and filing personal taxes to having shareholder meetings and votes, keeping corporate minutes, filing annual reports, and maintaining your good standing with the state corporation commission. If you choose a more complicated entity too soon, the administrative burden and costs may be more than the new business can bear. In other words, no, you don't need to form a Delaware C-Corp as soon as you come up with your idea.

As with many other areas of the law, business entities are governed by a set of rules that are laid out in the state laws. Knowing what the laws that govern a particular type of business require is an important first step in determining which type of business is right for you. Each type of business entity has a different set of "default rules" that govern their operation. These rules can vary quite dramatically from state to state, so it is vital to know which state's laws apply (and yes, that is usually pretty obvious and straightforward, but when it isn't it can cause some real headaches).

We're not going to worry about some of the more exotic forms of business entities, mostly because they are intended for specific circumstances that most start-up companies don't encounter (if you need to form a professional corporation or a land trust you'll want very specific guidance). In general, the types of business entities you may form, or may have formed at some earlier stage are listed below, along with some of the common varieties of the general types:

- Sole Proprietorships
- Partnerships
    - General Partnerships
    - Limited Partnerships
    - Limited Liability Partnerships
- LLCs
- Corporations
    - C-Corps
    - S-Corps
    - Benefit Corporations

Each type of business entity has different formation requirements; some require you to file something with the state corporation commission, while others spring to life all on their own as soon as you engage in certain activities. It is vitally important to know not only what is required to be filed, but to know when the informal types of business entities are legally recognized.

Anyone who followed the news around Cruise Automation's acquisition by General Motors in early 2016 knows the sort of trouble that can crop up when you don't properly deal with informal partnerships. Cruise Automation is a West Coast startup developing self-driving cars. Cruise identified its founders, and included an individual on the list of founders who then had nothing more to do with the company for several years. After making a breakthrough, investors were circling and General Motors announced a $1 billion acquisition, which would have included a very nice payday for anyone holding equity in the company, including the founding partners. Since Cruise never dealt with the departure of the former partner, who may have contributed quite a bit to the initial research, in writing or stock issuances, a lawsuit was filed, the deal with GM was threatened, and eventual settlement was reached. The former partner was acknowledged as a co-founder of the business and paid an undisclosed sum for his ownership interest. Because the ownership interest wasn't dealt with early on, when doing so would probably been simple and the company's value was much, much lower, the company eventually had to deal with it publicly, in a very messy fashion, and pay much, much more.

Sole proprietorships and general partnerships are the two types of informal business entity. Neither of them require any filings or paperwork, and are formed as soon as you, or you and someone else, start doing business with the intent to make an eventual profit. One troublesome issue with these informal business entities is that they don't get registered with the State Corporation Commission, which means that it can be very difficult to obtain the sort of documents many investors or business partners will require, such as a certificate of good standing.

If you are in business by yourself, you're a sole proprietorship.

Sole proprietorships only require one person to start making, selling, or transacting almost anything. General partnerships are formed as soon as two or more people agree to work together on an endeavor. It's just that easy. The ease with which a sole proprietorship or general partnership takes on formal legal existence as a business entity can be very beneficial or it can be disastrous. Many of the businesses in existence today started off as a sole proprietorship or a general partnership before they became something else. Especially because general partnerships are formed whether or not the partners actually intended to form a partnership.

Two or more people, working together for profit constitute a partnership.

For both of these types of business there is little, if any, separation between the business and the owner or owners. You are the business' agents, although you can still hire additional employees to work for you. You can sign contracts for the business, get a lease, and generally engage in the business of your business. If the business earns money that money is paid out to you. If the business owes money you owe that money. Let that sink in for a moment. Yes, you personally owe that money.

General partners have what is known as "joint and several liability." That means that if you are a general partnership and your partner incurs a debt on behalf of the business, even if he does so without your knowledge or approval, you are personally liable for the entire debt. So is your partner, and so is the business, but the creditors can choose to come after you and your personal assets directly to recover what they are owed. If that sounds horrifying, that's because it is. Neither a sole proprietorship nor a general partnership will provide you with any personal liability protection whatsoever.

In a general partnership the partners are automatically entitled to a distribution of the profits that is proportional to their individual contributions to the business; if no contributions are recorded each partner is assumed to be entitled to an equal distribution of profits. You can change this by signing a partnership agreement, but if you do not have a partnership agreement and your business earns money each partner is entitled to an equal share, regardless of whether or not they contributed to earning that money; they get an equal share just by being a partner. If you don't deal with their partnership interest, a former partner can claim an equal share, even if that partnership was years ago, you subsequently formed a new business entity, and the former partner has nothing to do with the new business. Make sure to deal with the potential partnership interests of anyone with whom you worked before you transition to a formal business entity.

Partnerships and sole proprietorships have no existence apart from the involvement of their owners. If you sell your business to another sole proprietor it becomes a completely new business entity, and all of its former obligations and liabilities remain with you unless your sale agreement covers them. If one of the partners leaves the partnership the business ceases to exist, and it is replaced by a new partnership, if there are still multiple partners, or a sole proprietorship if you are the last one standing.

While the ease of use and the simplicity of operation may be appealing, neither of these are well suited to actual business. You do need to keep in mind, however, that since they require no formalities to create you may have unintentionally created them at some point in the past. You also run the risk of creating one in the future because general partnerships don't require the intent to form a general partnership, only the intent to go into business together. So if you find yourself looking at more than a "we should talk about starting a business or joint venture" conversation you should consider whether you need to form a business entity to avoid all the problems these two can bring.

Limited partnerships may be a type of business entity that appeals to some early investors, mostly because the limited partner is "hands off" when it comes to running the business and is usually protected from personal liability. They still require at least one general partner who runs the business and who has no personal liability protection. While this may be a minimum viable entity for investors, it isn't a good option for most owners.

Registered limited liability partnerships are available in some states, including Virginia, and allow partners to formally register their business entity with the state corporation commission to receive some liability protection. LLPs give partners protection from the debts, liabilities, and obligations of the partnership, or of their fellow partners. These offer the flexibility of a partnership, but with liability protection similar to an LLC or corporation. The main drawback to a RLLP is that you don't appear on the SCC's website (at least in Virginia) which makes ensuring that you are a validly formed entity somewhat more difficult. You also won't be able to get a certifying statement from the SCC, which many businesses and investors will require you to have before they will consider doing a deal with you.

All forms of partnerships allow you a great deal of freedom in deciding how the business operates. While there are some default rules that apply, as with any type of business entity, almost all of them can be changed to suit your needs. General partnerships and limited partnerships are usually not good options for early-stage companies that are actually engaging in business, but registered limited liability partnerships may be a good choice in your early days of actual operation.

Any time you form a partnership you should (read "MUST") have a partnership agreement. Partnership agreements are essentially a contract between the partners, and the agreement can change the way the partnership operates. They are not binding on anyone else, so you can't alter your liability to a third party, for instance, but you can require the partnership, or the other partner, to be responsible for any lawsuit that stems from their actions. You can also use these agreements to alter the distribution of profits or losses and to divide up the responsibility or authority of the partners.

For all their drawbacks and limitations, partnerships are still very common, and can be very good option for the very earliest stages of your business; think "pre-revenue only." Partnerships have very few requirements, can be adapted to any number of situations, and can easily convert into other types of business entities when the time is right. If you are in the idea or development stage, they may be just what you need. Once you outgrow those early stages you should probably consider a more formal business entity.

Limited liability companies are often a good choice for new companies looking to move past the idea stage and validate their idea, engage in their business, hire employees, and even raise capital in the growth stage. Despite the numerous articles and blogs that declare “Your startup should not be an LLC” or give you “12 reasons for a startup not to be an LLC” these “experts” and bloggers don’t seem to have a very nuanced understanding of the situation; it isn’t static, and your choice isn’t final. There are costs associated with converting your business from one type of entity to another, but there are some compelling reasons to consider an LLC to be the best option at some stage, and it is up to you to determine when each type of entity is best suited to your needs.

LLCs require formal creation with the SCC and come with default rules under state law that govern how the business operates. Virtually all of these rules can be changed in your business’ operating agreement. The operating agreement is essentially a contract between the owners of the LLC, who are called members; it allows them to set their own rules for decision-making authority, distributions of profits/losses, the sale of the business, how the business handles taxes, and the admission of new members. Unlike partnerships, however, LLCs don’t need more than one member. Single-member LLCs operate just like any other LLC, but they only have one owner. There is also no upper limit on the number of members your LLC can have, so if you want to make every one of your employees an owner, you can. Corporations, partnerships, and other LLCs can be members of an LLC.

LLCs can sell equity to investors, or create employee option pools. LLCs also allow you to create different classes of members, such as voting and non-voting members. You can add additional owners without giving up your right to control the company. There are also very few “corporate formalities” required to maintain an LLC, so while you do need to keep good records, you don’t have to have meetings, take minutes, and file numerous reports with the SCC. You pay your taxes and an annual fee to the state ($50 in Virginia) and that’s it.

LLCs are not always the preferred entity for investors, however. While early stage investors are often comfortable with convertible notes, straight debt investments or receiving profit interests in an LLC, institutional investors and VCs, and even many angel investors, tend to prefer receiving their equity in the form of preferred shares in a corporation. Even though LLCs can offer you the same customizable membership interests that corporations can provide, it can be very costly to create a complex and varied array of membership classes, driving up your costs and making LLCs a less attractive option at that point.

If you are not planning to seek money from those types of investors you may never need your business to become anything other than an LLC; even if you are, you still may not need to convert. Fortunately, if the need does arise, converting your business from an LLC to a corporation is fairly simple, and can be accomplished relatively quickly and without a great deal of expense. This allows you to take advantage of the flexibility of the LLC before incurring the administrative burden of a corporation. Timing, as they say, is everything; and an LLC may be a great option during your earlier stages and a less attractive option later on.

Corporations are the most structured, most legislated, and most rigid type of business entity. That may seem like a bad thing, but when we say "rigid" that also means "stable, uniform, and well understood." And business partners, joint venturers, and potential investors like those words. Eventually, that consideration alone may outweigh any others, and converting your business to a corporation will be your best option.

Corporations are still customizable, but there is less leeway in what can be changed. Corporations use a variety of documents to govern how the business operates; articles of incorporation, bylaws, and shareholder agreements are the most common and allow you to authorize employee option pools, create classes of preferred stock, determine what authority the officers have, and decide what actions require shareholder approval.

One of the common critiques of corporations is the dreaded "double-taxation" issue. While it is true that most corporations' profits get taxed twice, once at the corporate level and again when they are paid out to shareholders, this really isn't something an early stage company needs to worry about. Even once your business is revenue positive, you aren't likely to be paying out profits while you are still growing the business. So keep this issue in mind for later, and discuss it with your accountants, but don't let it scare you away from forming a corporation when the time is right. Also, subchapter S corporations, **S-Corps**, are still corporations, but they have filled out an additional form for the IRS that allows them to be taxed like a partnership and avoid the double-taxation issue.

The newest addition to the family of business entities is the **benefit corporation.** In most respects a benefit corporation functions just like any other corporation, but with one main difference; the purpose of the corporation is not simply to make profit, but to provide a public good. Most corporations have the legal duty to maximize profits for the shareholders. This is their primary purpose. Benefit corporations, however, are not primarily directed to make a profit for the shareholders, although that is still permitted, and even encouraged. Benefit corporations exist to provide a public benefit or to donate a certain portion of their profit to a specific charity. In Virginia, and remember that each state has its own requirements, the public benefit can be a material, positive impact on society or the environment, beyond the interest of the shareholders. Benefit corporations have additional filing requirements, such as including a benefit report in its annual filings that includes a narrative description of the ways the corporation pursued the general public good and any circumstances that interfered with the creation of the general or specific benefits the company attempted to create.

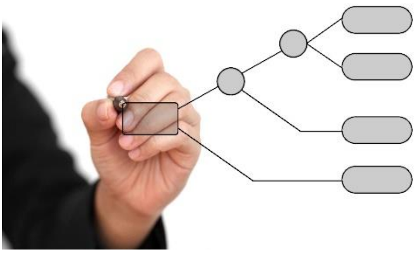
While they may not be ideally suited for most new businesses, benefit corporations can be very attractive to social entrepreneurs who want to make an impact in their communities by providing goods or services to those in need, promote the arts and sciences, or help other business entities with a public benefit find funding. Benefit corporations are also not necessarily pariahs with investors, a growing number of whom are making socially responsible investments.

Corporations are also a bit more unwieldy than LLCs or partnerships. To make changes to the corporate documents the shareholders need to approve the new versions. Making changes to corporate documents may not be too difficult when you and your co-founders are the only shareholders, but once you start adding in additional shareholders, whether they are employees or investors, you need to get more and more people together to authorize the changes. This isn't an insurmountable challenge, but it is an administrative hurdle.

The real drawback of corporations of all varieties is that you must adhere to more corporate formalities than the other types of business entities. As your business grows this will become less of a drawback, but the additional requirements consume valuable managerial resources which may be stretched thin in an early stage company. Corporations are required to keep corporate minutes from the shareholder meetings, to pay an annual fee that can vary by a few thousand dollars per year in different states, and file annual reports with the SCC. Failing to follow these requirements can result in the corporation being terminated by the SCC and the loss of the personal liability protection otherwise afforded to owners and directors. If you are diligent about meeting these requirements the corporate formalities are not much of a drawback; but you need to make sure that things do not slip through the cracks as you get busier with other aspects of your business.

Selecting And Forming The “Right” Type Of Business

The most appropriate business entity for your venture is not always obvious, but when you look at your situation and consider the different characteristics of the options it shouldn’t be too hard to determine which one is the best choice for your business at any given stage. Your choice is not irrevocable, so don’t worry if your circumstances are going to change somewhere down the line.



What are your immediate, short term, and long term goals? Based on your growth plan, what will you need the business to be able to do for you? This will help you determine which type of business entity is best suited to help you meet your goals. Find the best solution for where you are now, and where you will be in a few months or a year. Think about what type of entity you are now or have been, and, if necessary, document your transition or conversion from one type of business entity to another.

When you form any type of business, whether it is a partnership, an LLC, or a corporation, it is extremely important to make sure that your organizational documents specify the rules that govern the operation of your business. If you do not, you will be governed by the default rules of the laws in your state of incorporation. This is one of those areas where a little work up front can avoid serious problems down the line. Track down any previous partners, members, or co-owners now and make sure they have been properly dealt with, and that they don’t have lingering claims to your business, and your future profits, that can reappear once you have put in years of hard work. And remember, some form of due diligence is going to crop up right before you reach the finish line. Make sure you can account for each step of your business’ evolution.

You probably don’t want to spend a lot of time with lawyers drawing up new formation documents, operating agreements, and other corporate documents every six months, but the type of business you form initially does not have to be the type of business entity you intend to become several years later. Balancing the costs with the benefits of the various types of business entities is a business analysis you will have to make, but it will be well worth your time if it helps you avoid operating a business entity that is not well-suited to your situation.

Intellectual Property

Intellectual property is a rapidly expanding area of business that governs intangible assets and the rights relating to certain types of goods. Intellectual property is woven into a wide array of business activities, from R&D to advertising, and from graphic design to lead capturing. Over the past several decades the importance of intellectual property has drastically increased; so has its value. Forty years ago intellectual property accounted for roughly 17% of the total value of the companies trading on the S&P 500. By 2015 that figure had skyrocketed, and IP makes up more than 80% of the value of companies trading on the S&P 500. IP not only represents the majority of the value of established companies, but is probably THE value of your new venture.

Intellectual property is divided into four categories of protection: copyrights, patents, trademarks, and trade secrets. These categories are distinct bodies of law, although there is some overlap when it comes to the types of intangible assets they cover. The same process could be protected by either a patent or a trade secret, and a logo could be both copyrighted and protected by trademark law. It gets even more complicated when a product has features that are protected by a patent, other features that are copyrighted, and other elements which serve as trademarks, and still others that require trade secrets to manufacture.

Understanding the basics is a good first step to navigating the legal landscape of intellectual property law. You need to know what rights you have, what they allow you to do or prevent others from doing, and where your rights end. It is also of paramount importance to ensure that you know, and can show your future investors, who created, invented, authored, and owns each item of your business' intellectual property.

There are four basic considerations every founder and start-up should keep in mind regarding intellectual property: how do you create it, who owns it, how do you protect it, and what do you get by having it. There is also the additional consideration of making sure you don't infringe on someone else's rights. Unfortunately, the laws governing how each type of IP is created, transferred, protected, or infringed are not uniform. Each of the four types have different requirements and different considerations, that you need to be aware of.

Trade Secrets

In nearly every instance the first thing you create on your entrepreneurial journey is a trade secret. It's your idea, your knowhow, and your process that will become your business, product, or service, and what will give you an advantage in the marketplace. But trade secrets are often overlooked and under-appreciated. When asked if a company has protected its IP many founders who haven't filed for a patent will automatically answer "no" without realizing that not all protection requires formal means such as registration and working with attorneys to receive protection. In 2012 it was estimated that trade secrets outnumbered patents by roughly two to one. Virtually everything you may want to eventually patent is a trade secret while it is still being developed. Almost all businesses have some type of trade secrets, and if they follow certain steps these secrets are protected.

A trade secret can be any information, literally any information, that is not generally known, which provides economic value because it is not generally known or cannot be easily discovered by others, and is the subject of reasonable efforts to maintain its secrecy. So, now let's break that definition down into something more concrete.

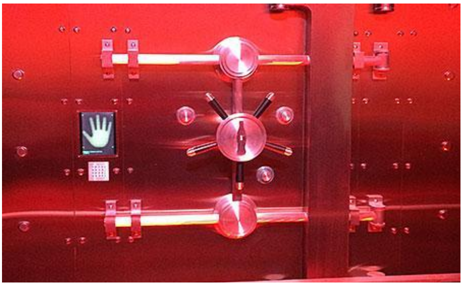
Trade secret creation: In order for something to be considered a trade secret it must meet the following four requirements:

1. Economic value: First, the trade secret needs to be something that is of economic value to its owner. Generally, this is not hard to show since the point for having a secret in a business is typically for economic purposes (keeping your office coffee budget secret wouldn't qualify). This could be as simple as a list of your customers or suppliers, but it could be a list of step-by-step instructions for a vast, complex process needed for creating a product or a particular analytical method your business uses to outperform its competitors.

Valuable information can include knowing how to do something, and even how not to do something. As long as the information provides some economic value to your business, either by increasing efficiency or giving you a competitive advantage, it will probably meet this requirement.

2. Not generally known: The second requirement is that the secret has to be, well, a secret. Basically, it cannot be something that is generally known by people or businesses in your industry. It doesn't have to be a complete secret; if someone else knows the same information that does not mean it is not a secret, but if too many business or individuals outside of your company have the same information it ceases to be a secret. This means the company must be extremely careful about disclosures of this information, and should have confidentiality agreements signed whenever possible. Disclosure does not destroy secrecy automatically, even if you don't have a confidentiality agreement in place, so long as it is to a limited extent and a substantial element of secrecy still exists. However, it is always better to stay on the safe side by using confidentiality agreements.

3. Reasonable efforts are made to protect it: The third requirement is that the company must make reasonable efforts to keep the information a secret. This is determined by weighing the costs of increasing efforts against the value of the trade secret. These reasonable efforts need to be more than just a plan or a directive not to tell anyone the secret formula; the company needs to truly implement the plan. Even if the secret has not become generally known, if steps are not taken to keep it that way you may not have trade secret protection for the information. You don't need to keep the single copy of the information locked in a vault, like Coca Cola does with its secret formula (seriously, they have a bank vault with the formula for Coke locked inside), but you do have to take steps to keep it a secret. Ensuring people who are not authorized to access the information cannot do so and that any time you disclose the information to someone they know it is protected and that they are not permitted to disclose it. It also means not leaving a copy of your business method or invention schematics at Starbucks, or on top of a pile of papers in a co-working space.



Copyright Coca Cola Company

4. Not easily discovered: The last requirement is that the trade secret is not "readily ascertainable by proper means." If the information can be easily discovered by someone else, without stealing the information from you, it probably won't receive protection as a trade secret. In addition, reverse-engineering a product is generally considered proper means of discovery. Independent invention is always considered proper means because your secret was never taken. It doesn't work that way for patents, but trade secrets don't afford quite the same level of protection.

Once these four requirements have been met a trade secret has been created, and legal protection will automatically apply without any further action on your part.

Who owns the trade secret: Put simply, trade secrets are owned by whoever creates them. With one important twist. If you acquire the information by improper means, either by stealing it, or from someone you know wasn't authorized to give it to you, you can't turn around and claim that you have a right to that information just because it satisfies the four requirements for trade secret creation. You have probably heard of "work for hire" agreements, and know that they give employers rights to certain IP created by employees. Work for hire agreements do not, and I'm going to repeat that, do not apply to trade secrets. Work for hire is a concept that applies to copyrights, and we'll look at that area a little later on. If your employees come up with the information they may own the information unless they were employed specifically to create or develop new information or processes. That is not a given, however, and the company may actually be deemed the owner of the secret developed by the employee; but don't take that risk. Use an invention/IP assignment provision in your employment contracts to ensure that your business has the rights to the information created by your employees.

If your business comes up with a secret formula, and another business, completely independently, comes up with the same information, you both own it. And you both own it independently of the other. And if one of you decided to give your valuable knowledge to the world, or unintentionally discloses it to an entire convention center full of people in your industry, the information would cease to be a secret. For everyone.

Trade secrets can be licensed to other people or businesses, but those people and businesses do not own the secret. They are using your IP with your permission. And, if you have a properly drafted contract, they owe you a duty to keep it secret. But we'll get to that in a moment. Trade secrets can also be assigned, or transferred, in their entirety to another business (or to you by your employees with the IP assignment clause we mentioned). Trade secrets can even be shared with others, without any restrictions at all, and still remain a trade secret. But, if too many other players in your industry end up with the information, or if it becomes generally known, it will cease to be protected.

How to protect trade secrets: Protecting your trade secrets is largely a matter of contracts, but also of policy and procedure. Almost every time you disclose your trade secret to a third party you should have a written agreement that makes them aware of the nature of the information, and that creates a duty to protect that information. This is not always going to be an option, however. Investors are notoriously unwilling to sign non-disclosure agreements that could prohibit them from working with other businesses with similar ideas. In those instances, you are going to have to use your best judgment on when, and how much, to disclose. With just about anyone else, get it in writing.

You also need an internal policy, that you actually follow, to protect your trade secrets. Remember the "reasonable efforts to protect" requirement from the portion of this section dealing with creating a trade secret? The exact same requirement applies to keeping it a trade secret. This is because the test comes into play whenever you seek to enforce your rights against someone. If you used to treat the information like Top Secret data, but haven't for the past few months, it will probably not be considered a trade secret (although that will depend in part on just when the information was taken from you). So you need an internal policy that limits access to the information and makes it clear to those with access that they are obligated to keep the secret a secret. If you ever need to enforce your rights it will really help to have all of this in writing. It will help more to have it in a written document signed by the person you are seeking to enforce your rights against.

What trade secret protection gives you: Trade secret protection allows you to do just that, protect your trade secrets. You may wonder "But we already talked about what we have to do to protect a trade secret, is that it?" Good question. No, that's not it. Taking all of the required steps to keep your information secret does provide value simply by taking care of the data, but getting legal protection gives you more. It protects you against misappropriation, essentially theft, of your proprietary information. The law allows you to recapture information that was taken without authorization, and may even allow you to prevent a competitor from competing with you by barring them from the market. You may also be able to force whoever it was that actually stole your information, and anyone who knowingly accepted the stolen secrets, to pay your damages, your legal costs, and, in some cases, to pay punitive damages.

If someone else acquires your secret information they are not necessarily at fault, or liable for any damages. Trade secrets only protect against misappropriation, which essentially means that someone used improper means to acquire the information. If someone hacks into your office network or cracks into the safe where your Secret Formula is stored that would be misappropriation. Paying an employee to divulge the secret would also be improper. Picking up a sheet of paper that details the Secret Formula that you left on the table at Starbucks? Not improper.

Trade secrets can also be licensed to other businesses without losing the protection you have gained. If you have a certain batch of proprietary information, or a secret process, you can give another business the right to use that information, impose on them the obligation to protect it, and use that license agreement as an additional revenue stream. License agreements need to be very well tailored, however; something you find on Google is probably not good enough. But, a properly structured license agreement can preserve your rights while allowing your business to share its trade secrets with a specific business or group in order to maximize the value of the information.

So remember, just because you haven't patented your idea (or maybe it isn't something you can patent), copyrighted it, or used another method to protect your business' valuable information it doesn't mean that you don't have protection. Your trade secrets may be your company's greatest asset, but you do need to take some steps to keep the secret in order to maintain the protection provided by law.

Trademarks

Any word, name, phrase, symbol, logo or device used to identify and distinguish a business's goods or services from those of another business can serve as a trademark.

In some instances the shape or overall look and feel of the product, or the product packaging, can also serve as a trademark. Trademarks serve to indicate the source of the product – even if the exact source is unknown. For a new company just starting out, your name and the recognition that goes along with it will be one of your most valuable assets. Your company logo, your tagline, slogan or virtually anything you use repeatedly in your advertising may qualify as a trademark.

Trademarks are a little tricky however, because they are a bit more nebulous than people think. They give the owner the exclusive right to use the mark, or similar marks, in connection with a certain type of product or service, and in connection with products and services that are closely related to your product or service. You can see how this ends up getting a little confusing, but there are two important goals you should keep in mind; you want to have a mark that you actually have the rights to use so that you can build your business' brand, and you really want to avoid infringing someone else's trademark. We'll actually deal with the second of those two goals first, because that can cause you a lot more trouble than the first.

Trademark infringement: Imitation may be the highest form of flattery, but it may also be trademark infringement. Trademark protection covers more than an exact duplicate of a name or image, but it also covers somewhat less than that as well. Since trademarks are only trademarks for certain goods or services, they are not universally applied. In

McDonald's nemesis, McDowell's burgers: home of the Big Mick. Coming to America (c) Paramount Pictures, 1988 other words, an airline, an insurance company, and a faucet manufacturer can all use the name “Delta” for their companies, without infringing, even though they have nothing to do with each other. On the other hand, trademarks do not work like domain names; if the name you want has been taken you cannot simply change a letter and be off to the races. Trademarks protect substantially similar marks, so changing a letter in a name, a single word in a phrase, or the color of a logo, can be a very bad idea. It is bad enough if you inadvertently end up using someone else’s name (or something very similar to it), but if you know that name is already used, and you use something similar anyway, the penalties can be much harsher.

So how do you avoid making this all-too-common mistake? Do your research. And, as self-serving as this may sound, you should really get a trademark attorney to do the research, because he will be able to do a more thorough job than you can. Do a trademark search and clearance early, preferably before you fall in love with your name, logo or slogan, certainly before you start investing in any sort of advertising, and to avoid being on the wrong end of some lawyer’s nastygram, before you start to use the mark in commerce. You don’t want to have to change a name you have spent time and money promoting, or that your customers will recognize, but you certainly don’t want to be dragged into court.

It isn’t always possible to be completely safe from someone else’s trademark claims, mostly because “similar” and “related” are gray areas that are open to interpretation. But, if you are prudent, you should be able to avoid the worst consequences even if someone comes out of the woodwork to object to your name or logo.

Creating a trademark: Names and logos are not actually trademarks until they are used as trademarks in commerce, and they cannot become trademarks unless they are distinctive.

Use: Trademarks can be registered with the state, or better yet, with the United States Patent and Trademark Office, but they cannot exist without use in commerce. This is a pretty simple and straightforward standard: was the mark used in connection with a transaction providing a product or service to a third party? If so, you have use in commerce, and you acquire trademark rights to the mark. For federal protection, the use must be in interstate commerce, but that is an extremely broad term that covers many local transactions as well. The “third party” in the use requirement must be a real third party, however, and the sale has to be a real sale. You can’t simply ship a t-shirt with your company name on it to your aunt in Wisconsin and call that “use in commerce.” Sell one of your company’s products or subscriptions to one random stranger and you have satisfied the use requirement. It’s a simple, but very important step.

Distinctiveness: In order to serve the function of a trademark a mark must be recognizable as an indication of origin; it must be distinctive. That means it must be something that a consumer will automatically understand is a brand name, rather than a descriptive or generic term for the product itself, or some feature of the service. Generic terms are never capable of serving as a trademark, but descriptive terms can, eventually, acquire distinctiveness. This process can take up to five years, and what new business has time for that? By using terms that are not directly related to the product, or names without any meaning whatsoever, you can gain trademark protection as soon as you use the mark.

Who owns the trademark: Trademarks are owned by the business or individual who makes the product or provides the service with which the mark is associated. Sometimes the artwork of a logo may also be subject to copyright protection, and you will need to secure those rights from the artist who created it, but otherwise your name, logo, slogan, or any other type of mark will belong to your company without the need for any further action. Trademarks can be licensed to other businesses, but if they use your mark you need to make sure that the product or service they offer in connection with your mark is the same type of product you make and that it is of the same quality.

Protecting your mark: Protecting your trademark means ensuring that others are not using the same name, logo, or slogan or a similar name, logo, or slogan, for products or services that are related to yours. It seems simple, but if you want to maintain a trademark you need to ensure that the mark remains an indication of the source of your product, and does not get diluted by applying it to products from unrelated manufacturers or service providers. One of the best ways to protect your mark is to subscribe to a trademark monitoring service. These services can alert you if anyone else attempts to register a similar mark for a related product, and even do more comprehensive searches to find out if someone is using the mark without trying to register it. If you do find someone else using your business' name you need to enforce your rights against them; and that means engaging your legal counsel to deal with the situation.

Benefits of registration: You don't need to register your mark to have the protection of the law, but it sure does help. If your mark is not registered you have the exclusive right to use it, but only in the areas of the country where you actually operate. If someone else starts using the same name in another region they will likely be able to prevent you from expanding your sales to that area without coming up with a new name or logo. Registering your mark with the U.S. Patent and Trademark Office provides a range of benefits, including extending your exclusive rights nationwide. Registration also gives you more legal remedies you can use to deal with infringers, including increased damages and the ability to recover your attorney's fees.

Registration costs: Registration shouldn't cost you too much. While some local firms will charge thousands of dollars for their registration services, there is no need to overpay for the registration. The registration fees themselves range from $225 to $375 per mark for each category of goods or services you claim. Legal fees from a reputable law firm should be less than $1000. Since the odds of successfully registering your mark increase dramatically with the assistance of experienced attorneys, the risk versus the reward should help you decide whether to file your own trademark application or to seek legal counsel. Whether you decide to register your mark yourself or to hire an attorney, if you want to protect your brand and the goodwill that you establish between yourself and your customers, you will want to strongly consider registering your trademarks.

Benefits of trademark protection: The direct benefit of having trademark protection for your business' name, logo, or slogan is that you can prevent other businesses from using a similar name for a similar product or service. Practically speaking, it allows you to force other business who have already started using a similar mark to stop using it. In some cases, the law allows you to recover the value of any lost sales, and can impose punitive damages on willful infringers. The indirect benefit is that you can safely invest in building your brand and investing in marketing without worrying about someone else free-riding off your investment or forcing YOU to stop using THEIR mark.

Trademarks are the embodiment of your company and its reputation. You should make sure that you select marks that you can rightfully claim as you own before you invest in building your brand or doing any sort of advertising. Once you have your mark selected, protect it with a well-tailored federal registration, and defend it against potential infringers in order to protect your brand.

Copyrights

Just like trade secrets and trademarks, copyrights are another type of intellectual property that exists even without formal registration. Copyright law protects creative expression, and it does so as soon as you have written, recorded, typed, or photographed it. Works of authorship include the following categories:

- Literary works
- Musical works, including any accompanying works
- Dramatic works, including any accompanying music
- Pantomimes and choreographic works
- Pictorial, graphic and sculptural works
- Motion pictures and other audiovisual works
- Sound recordings
- Architectural works

How copyrights are created: The only two requirements to have a copyright are originality and fixation. There are also some distinctions between things that, while original and fixed, are not capable of being copyrighted. We'll quickly go through the two required elements, and then get into the somewhat trickier parts.

Originality: Originality is a low standard to meet; if you created it, it is yours. Usually. Copyright requires individualized and subjective decisions of the author for something to be considered creative. Facts, data, and statistics cannot be considered original even if it took effort and labor to come up with them. Compilations of facts organized in a creative way (such as Rick Steve's *Europe Through the Back Door*) may become copyrightable but the copyright protection only applies to the creative organization or selection, and never to the underlying facts themselves.

Fixation: For a work to be considered fixed it must be stable for a certain period of time, and the fixation must be authorized by the author. To be sufficiently durable it must either be stable or last long enough to permit it to be perceived, reproduced, or otherwise communicated for a period of time. Echoes don't count, but a sand castle built at low tide probably would; if you are talking about something in between, call a copyright attorney.

The method of fixation doesn't really matter; it can be almost anything from a marble sculpture to film, even a computer's RAM, and everything in between. Lastly, it must become fixed by, or under the authority of, the author. That simply means that the author must be the one to record, or authorize someone else to record, their performance, for example. An unauthorized fixation may not give anyone any rights, and may even infringe on the author's copyright if the work was already protected. It's the difference between a singer recording their own concert performance (the singer owns the copyright in the recording) and a bootleg copy someone in the audience makes on their phone (an unauthorized recording that no one owns, but may infringe on the artist's copyright to the song itself).

Ideas vs. expressions: Just as facts cannot be protected by copyrights, ideas cannot be copyrighted either. Even if they are very creative ideas they cannot be monopolized by the author. However, original expression of an idea is copyrightable. Sometimes it can be quite difficult to determine where the line will be drawn between idea and expression, and, in fact, the protection of an author's expression extends somewhat further than the literal words on the page. The rationale for this theory is that if a copyright was limited to the exact text plagiarists would escape by making small, inconsequential variations.

Alongside the issue of ideas being separate from the expression there is the "merger doctrine." The merger doctrine essentially states that when ideas merge with expression there is no copyright. If the only way to convey the idea is with a particular expression (e.g. a fillable form may be original expression but is necessary for the use of the idea behind a particular system of bookkeeping) then the two are inseparable. If that happens, the merger doctrine applies and the expression is not protected by copyright. Generally, if there are practical, real-world applications for the thing trying to be copyrighted, the merger doctrine will step in.

Useful articles: If something is truly practical, the appropriate IP protection is a patent rather than a copyright. The "useful article doctrine" divides the worlds of patents and copyrights. Items that are strictly useful fall within the realm of patents, while artistic creations belong in the world of copyright law. For example, a "useful article" is an article that has an intrinsic utilitarian function that is not merely to portray the appearance of the article or to convey information. Useful articles can be pictorial, graphic and sculptural works that are capable of receiving copyright protection only if the features are capable of existing independently of the useful aspects of the article. This applies when copyrighted work has both a practical, functional aspect and an expressive aspect. It ensures that the copyright's protection is limited to the

The artistic aspects of Disney's Mickey Mouse Phone are protected by copyright, but the functional aspects of the phone itself are not.

expressive aspect and does not cover the practical, functional aspect. This isn't always a straightforward analysis. Depending on jurisdiction, courts apply a few different tests to determine if the work falls under the useful article doctrine.

One test looks to see what was in the creator's mind throughout the design process. Were the expressive elements significantly influenced by functional considerations? If so, there will be no copyright protection for those elements. Another test focuses on the form of the work and looks at a reasonable person standard. Does the article evoke a concept separate from its physical function? If it does not then the creative elements are not distinct from the functional ones, and there is copyright. And still a third test focuses on whether the expressive aspects of the work make it function better. Does the expressive part of the article make the article function? If so, there will be no copyright.

Who owns the copyright: Normally whoever creates the creative work is the author, and the owner, of the work. If you work with another person to create something that becomes a joint work, the two of you are co-authors with equal rights to the work. The software you and your co-founder created before you formed your LLC is a joint work, owned equally by the two of you. In certain circumstances, however, that isn't quite as clear cut. If your employee creates something for you that is within the scope of his employment your company is actually considered the author of the work, and will own all of the rights to it; this is called a "work for hire." If you hire an independent contractor or outside service provider to create something for you their work product may be considered a work for hire, if, and only if, there is a signed agreement stating that it is a work for hire.

This is a very, very common mistake that businesses make, and it can cost you if you aren't careful. In addition, only certain types of work are even eligible to be considered work for hire when it comes to non-employees, so be very careful before relying on a "work for hire agreement" to secure your rights to a project. The most common "work for hire" that simply is not a work for hire is software; unless it meets one of the specific requirements of the copyright statute software is not considered a work for hire, and your "work for hire contract" will not make you the owner of the program. If you fail to have an effective copyright transfer agreement your independent contractor is going to be the author AND the owner of the software he or she develops, or the promotional video they create. In the case of software, you might be liable for copyright infringement if you create version 2.0 of the operating system the programming contractors created for you. Your business is going to pay for it, make sure your business owns it.

Copyrights can be sold, transferred, or licensed to someone other than the author, who is the initial owner of the work. But, and this is an important thing to remember, any agreement to transfer ownership of a copyright must be in writing. Any verbal agreement to transfer ownership in a copyrighted work is unenforceable. So, if you want to buy someone else's copyright, get it in writing.

Protecting your copyright: Copyrights do not need to be registered, and you don't need to put a copyright notice on anything you create. But doing so is a very good idea. Copyrights can be registered very easily, and very cheaply, and once they are registered you have a legal document that is proof of your ownership for the duration of the copyright: for individual authors that means for a period of 70 years after their death, and for businesses that means 120 years. That's probably a bit longer than you will need to protect the work, but that's what you'll get when you register. In addition, putting a copyright notice on your image or document will help you protect your rights by making everyone else aware of your claim.

Unlike a trade secret or even a trademark, you cannot lose your copyright if you don't protect it. It may be harder to prove that you own it if you don't stop people from taking it, especially if you don't register it, but you don't lose your rights altogether simply because you don't enforce them.

Infringement and liability: If you copy a copyrighted work without permission, you have infringed on the rights of the owner. But is that the only way to infringe? No, copyrights convey a bundle of rights, not just the right to prevent copying. Copyrights give the owner the exclusive right to reproduce a work, to make derivative works based on the copyrighted work (a prequel to Harry Potter, for instance), to distribute copies, to perform their music or theatrical work in public, to display their work publicly, or to broadcast their music. If you do any of these to works belonging to someone else without obtaining the necessary permission or license, you may have infringed on their rights as a copyright owner.

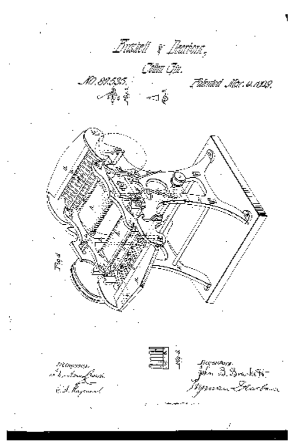
Fair use: The quicksand of the copyright world is "fair use." Almost everyone has heard of it, and almost nobody understands how it works. Relying on fair use can be the quickest way to find yourself on the wrong side of a copyright infringement claim. If you want to use something, or a portion of something, that someone else created and you intend to rely on fair use remember this one simple guideline: DON'T DO IT. If you don't get the proper assistance and analysis ahead of time you may be in need of expert legal defense counsel afterwards. Avoid the problem, and do not rely on fair use, because the odds are it won't apply.

The public domain: Any creative work that has either been protected by a copyright that has expired (it takes more than seventy years for a copyright to expire on its own), or that has been granted to the public by the author/owner of the work, is considered in the public domain. These works can be freely used, copied, distributed and modified by anyone. Doing so may give you rights to your new, creative additions, but will not allow you to claim rights to the original. Where most of the trouble comes from is people and businesses assuming that something is in the public domain when in fact it is not. Simply posting a picture online does not invalidate the author's rights. So be very, very careful when you use any pictures or literature that you think is in the public domain.

Attribution: Another very common mistake businesses make with copyrights is confusing plagiarism for copyright infringement. When you take a picture, video, or written material that belongs to someone else, repost it on your site, or print a hard copy of it, and say "We don't own this, Joe Smith does" this may be all you need to avoid plagiarism charges in school. What you're really saying is "We admit we're infringing on a copyright, and Joe Smith's attorney knows that now." Don't confuse plagiarism and copyright infringement. If you don't have permission you have two good options, get permission from the author, or simply don't recycle their work.

What copyright protection allows you to do: Copyright law gives you an entire bundle of rights, each of which can be used to prevent someone else (or even everyone else) from doing something. The net result is that you can prevent unauthorized copying of your creative work. The practical result is that when someone does copy your photographs, artwork or written work without permission you can force them to stop, and to pay damages. If you register your copyright you may be awarded fixed, statutory damages that are designed to discourage plagiarists and infringers from taking and using that which does not belong to them.

Patents



Patents cover new, useful inventions. The trick is determining what is new, and what counts as an "invention." Anyone who invents or discovers any new and useful process, machine, or item, or any new and useful improvement of one, may obtain a patent. Patents are the ideal method of protection when something is practical or able to be discovered through independent invention because it will still provide protection whereas copyrights and trade secrets would not. The two types of patents are process patents, which cover just what you think they cover, processes and methods, and product patents, which cover actual physical things. Product patents are further divided between utility patents, which protect the way a thing is used or operates, and design patents which protect the way the item looks (the shape of a Coca Cola bottle, for instance). The overall look and feel of the object may also be protected under trademark law as "trade dress."

How patents are created: A word of caution before we get into the requirements. There are many patents out there which were granted after the inventor drafted his own patent application. There are many more applications which get stuck somewhere along the way because someone who may be an expert engineer tried to file a patent application that was just too complicated. You really should consider retaining, or at the very least consulting, a qualified patent attorney to assist you.

Patents are the only form of IP that actually requires you to register them. Before you apply for a patent you may well have trade secret protection for your invention, but it is not going to be protected by patent law until you actually receive a patent. Certain things simply cannot be patented. Laws of nature, abstract ideas, and natural phenomena are never patentable. For everything else, there are five threshold requirements that must be met in order to receive patent protection:

1) Is the invention patentable subject matter?
2) Is the invention useful?
3) Has the inventor properly disclosed the invention?
4) Is the invention new?
5) Is the invention non-obvious?

Patentable subject matter: In general, "anything under the sun that is made by man" can be patented. As stated above, laws of nature, abstract ideas, and natural phenomena are not patentable. For example, a living organism that could be found in nature is not patentable, and nobody has a patent on $E=MC^2$. This means that patents work pretty well for actual, physical objects. For methods, processes and procedures, however, it becomes much more difficult to determine where patent law will apply. Rather than try to explain a very complex area of law (that is almost constantly in flux) we're going to punt this one, and suggest that if you are considering patent protection for a business method, a process or procedure, or computer software, you really need to speak with a patent attorney. Do not rely on what other entrepreneurs tell you about their experience with process or business method patents, because the law has changed dramatically in the past two years. They may have a very good understanding of what the rules were, but that may not help you understand what the rules are now.

Usefulness: Usefulness is a very easy standard to meet; all that is required is that the invention have a specific use or benefit in its currently available form. Just about the only way to fail this to satisfy this requirement is to speculate that the invention might be useful, eventually. If you don't know what the invention does yet, you haven't finished your research, and it is not ready to be patented. Regarding the research and testing process for some products, the usefulness of the research is usually discovered during the testing phase, not the discovery phase. The law wants to make sure that patent rights are not granted too soon so that research continues and the true value is found.

Proper disclosure: Disclosure has to do with the actual "specification" given to the patent office. The specification must contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise and exact terms as to enable any person skilled in the art to make and use the same. There are two main requirements for disclosure: 1) enablement requirement and 2) written description. Patents are exclusive rights to an invention which are granted in exchange for teaching the world what you discovered. The enablement requirement, as mentioned above, requires a person skilled in the art to make and use the invention based on your description.

The written description needs to include one or more claims specifically pointing out and distinctly claiming the subject matter which the applicant regards as her invention. There must be a correlation between what the claims state and what the description states at the time of filing. The written description part of the disclosure ensures that the inventor cannot amend a claim to include material not described in the original specification. It also ensures the inventor was in possession of the claimed invention when the application was filed.

Novelty: A novel invention is one that is both new and filed in a timely manner. Novelty is concerned with whether the invention is actually a new invention, and has not already been available to the public. If the invention is already known to exist, it is not novel. Timely filing requires that the patent application be filed soon after being invented. Even if the invention is new, the inventor will be unable to get a patent if she waited too long to file for a patent.

Non-obvious: This one is rather strange. When seeking a patent, the patent examiner considers whether the invention would have been obvious to others. If it was, no patent for you. Just how do they determine this? By inventing a hypothetical person with average skills and extraordinary knowledge of existing devices or process and trying to determine whether such a person would have thought of the invention you thought of. If you think that sounds like a strange way to determine whether an invention is worth of patent protection you're probably right. This is perhaps the most imprecise part of the patent process.

Business methods: A common question from founders is "can I patent our business method?" Unfortunately, unless you invent a time machine and go back a few years, no, probably not. Business method patents were all the rage a few years ago. Every start-up company under the sun had a new process or method for doing business that they were getting patented. Well, those days are over. The U.S. Supreme Court changed the rules, and now you really need something more concrete than a method of doing business. So, how you go about your business isn't really something you can patent anymore (absent extremely unusual circumstances), and patents are once again mostly for "things," but that is why trade secrets were invented. But, don't just give up on your dreams of a business method patent all together. The law is constantly changing, and if you speak with a patent attorney she will be able to tell you where things stand at that moment.

Patent ownership: Patents are owned by the applicant who files for protection. But not just anyone has the right to file an application. Only the inventor can file the application, unless someone else has acquired the rights to the invention. If you have an employee who is hired to design something for you, your business will own the patent, but the employee is still considered the actual inventor. If you hire people who aren't specifically hired to develop or invent something your business may not be considered the owner of their invention without an invention assignment provision in their employment agreement. If you invented something before you started your business, and want that invention to be an asset of the business (your investors certainly will want that to be the case) you'll need an invention assignment agreement between you and your company. The same holds true for the rest of your team. If they didn't invent it on the job, as part of their job, you're going to want a solid invention/IP assignment agreement in place.

Defending a patent: Like copyrights, once you obtain a patent registration it is yours for the duration of the patent (20 years from the date of filing). You can enforce your patent against anyone who, without your permission, makes your invention, or another invention that uses the entirety of your invention. You can stop business from importing infringing products, and you can stop people from using unlicensed products that embody your patent, or something made with your patented process.

What does a patent allow you to do: Patents allow you to prevent anyone from making your invention, importing an infringing product, or using your process without your permission. It also allows you to safely license your invention to others. When you have a patent you can grant someone else permission to make what you invented, and for many patent holders that can be a very valuable source of revenue. If it is a non-exclusive license you can still make the invention yourself, or even license it to other manufacturers as well. An exclusive license would allow another business to be the only business who could make your patented product; although these agreements should be carefully tailored to ensure that they actually produce and sell the product, otherwise you may not get any benefit from giving away your rights.

General IP Concerns

Intellectual property will be, or perhaps already is, your most valuable asset at some stage in your business' life cycle. It is imperative that you understand what type of category of intellectual property you are dealing with, how each type of IP is created, and how you maintain it. Ensuring that you can properly document your rights to the IP will be a vital part of your eventual due diligence, and will help you enforce your rights if another business or individual misappropriates your trade secrets, mimics your trademarks, infringes on your copyright, or violates your patent.

Many areas of IP law may seem fairly intuitive, and other areas require attention to particular details that may not be obvious. If you are dealing with someone else's IP, or licensing your own, you probably need to consult with an expert every time you do so. If you are setting up an internal policy there is probably no need to talk to your outside counsel for each new hire, simply make sure you have a solid, enforceable invention/IP assignment provision for your employment agreements and drop it in to each contract.

A trademark monitoring service can be really beneficial. For anywhere from a few dollars to a few hundred dollars a year you can have a dedicated monitoring service look for potentially infringing marks. But, beware scams and ineffective services that will attempt to charge you money to do nothing. Working with your corporate counsel to develop a strategy that you can implement yourself will save you money and give you better protection.

Contracts

When we think of contracts we probably have an image of a lengthy legal document with a few "initial here" and "sign here" prompts. But contracts, at their most basic, are simply agreements. They represent an understanding between two parties as to what is going to happen. It could be an employment contract that lays out the duties and responsibilities of an employee and what compensation and benefits will be provided in exchange. Or it could be a verbal agreement that tomorrow morning I'm going to show up and paint your house. Just to be clear, nobody is going to show up and paint your house, so there is no contract here.

Where young businesses often go wrong is when they unintentionally create contractual obligations, and when they enter into contracts without fully understanding all of the terms. A contract with indefinite terms can lead to confusion, mismatched expectations, frustrations, missed deadlines, and cost overruns. Too many times founders who are focused on their business try to write their own contracts and end up relying on forms and documents found on the internet and then trying to customize them to some degree. If you make a mistake, you bear the risk associated with that mistake.

The following, abbreviated true story should serve as an object lesson, and reinforce the importance of the information in this section.

A young company needed a software program to help them continue its rapid growth. They were in a hurry, and on a budget, so they wrote their own contract with a small programming firm that had a good reputation in the community. The total price in the bid was based on a projected total cost from the programmers, who estimated how long it would take them to complete the features the company needed included in the program. The contract itself only included an hourly rate for the programmers. There was no list of features. No delivery date. No cap on the total. And a "work for hire" clause that purported to give the company ownership of the software being developed.

Eight months later, $150,000 over budget (on a $250,000 project), and with an ever shrinking list of deliverables, which had unilaterally been shortened by the programmers, the company realized its mistake. The less efficient the programmers were the more money they got paid. Nothing in the contract required the delivery of specific features. And the work for hire provision was ineffective. All because they didn't know what needed to be included in a contract. An obligation had been created. But it was the obligation to pay the programmers to work on the project. There was little else either party was required to do.

If your business cannot afford to throw away $150,000 you should give careful consideration to the following section, and make sure that you understand your rights, and your obligations, and the obligations of the other party before you create a contract.

Contract formation: To form a contract, there needs to be both mutual assent between the parties and there needs to be some bargained for exchange, referred to as "consideration."

Mutual assent: Mutual assent simply means that both parties need to agree on what is going to happen and give some indication of their intention of that agreement. Essentially, it is when both parties agree to the terms of the contract, but it requires a bit more than simply stating that you have the same desire. In the simplest sense, mutual assent is demonstrated through an offer by one party and an acceptance of that offer by the other. More complicated transactions are going to be the result of negotiations, rather than a simple offer and acceptance, but in the end it all works out to the same thing: "here is our offer" followed by "we accept."

Offer: There must first be an offer before there can be an acceptance. An offer occurs where one party makes a proposal to another party, including the terms of the proposed deal. An offer only becomes definite enough to accept when the proposed terms are fixed, so that once the other party accepts those terms a contract is formed (assuming consideration exists – more on this later). For example, if a programming company proposes to enter into a contract where it will write your software in exchange for a fixed fee this is a valid offer because the terms are definitive. Alternatively, if the programmers proposed to design your software and tell you later how much it costs there would not be an offer because this merely invites you to negotiate more definitive terms with them. If the programmers start working and at some point decide they have worked enough and want to get paid, what are you going to owe him: something, nothing, or anything he demands? The answer is, it depends. And that is never a situation you want to find your business in. In a valid offer the terms should be definite enough so that one party does not have sole discretion over the important terms of the agreement. We should also note that an advertisement will generally not be seen as an offer; it is simply an invitation for prospective customers.

Acceptance: Once an offer has been made, the focus turns to the person to whom the offer has been extended (the offeree). The offeree has the power to either accept the offer, reject it, or counter with another proposal. If the offeree rejects the proposal she may no longer accept the deal, and any subsequent attempt to accept is likely to be viewed as a new offer directed at the original offeror and the whole process goes back to the beginning. An offeree may counter by changing the terms of the offer (i.e. negotiate the terms). The law views a counter as an offer in and of itself, with the ability of acceptance going back to the original offeror. As an offer needs to be accepted to form a contract, the process of acceptance will be viewed more closely. Simply saying "yes" to an offer may be sufficient to accept some offers, but in other cases this will not be enough to demonstrate acceptance. This is because the offeror holds the power to set the manner of acceptance.

However, like the terms of the offer, the manner by which it is accepted must also be definitively stated. If a manner is not specified, then the offeree may accept by any reasonable manner. Acceptance by promise and acceptance by performance are the main ways to accept an offer. Offerors tend to ask for acceptance by promise, where the offeree merely must agree to the exact terms of the offer by promising to perform his end of the bargain through the method of the offeror's choosing – thereby giving notice of their acceptance of the offer. Alternatively, acceptance by performance may be acceptable in some contracts, and is satisfied by simply performing the offeror's desired action – no notice of acceptance is needed because the performance is the acceptance. For example, if you offer John $20 to mow your lawn and he immediately goes outside and starts cutting the grass you're going to owe him the $20 when he finishes. However, if John only mows half the lawn, gets bored, and quits, you won't owe him $20, or even $10 because the acceptance is not effective until the performance is complete.

Consideration: Virtually anything can serve as adequate consideration to form a contract, but what consideration really means is a promise. Both parties to a contract need to agree to be bound to do something. In most cases, it is that one party agrees to provide goods or services, and the other party agrees to pay them a certain amount. The tricky part is that "I agree to pay you" is not the same thing as "I agree to pay you $49.95." Consideration has to be reasonably precise and certain. You can agree to pay someone based on an hourly rate without specifying exactly how many hours of work will be performed, but simply agreeing to pay something is not really sufficient consideration.

As long as these requirements are fulfilled the contract does not necessarily need to be written or appear in a formal document. Some types of contracts must be in writing, but most can be formed verbally. Proving the terms of a verbal contract can be quite tricky if a disagreement arises later on, so it is always best to write down the terms of the deal.

So, where did the company we mentioned earlier go wrong with the programmers? They made an offer: we'll pay you $X per hour to develop our software. The offer was accepted. And a contract was formed. It didn't have more definite conditions on the work to be done or the payment to be made. The company had agreed to pay, and the programmers agreed to program.

Contract law can be very complex, with many rules, exceptions to those rules, and specific requirements for certain types of contracts. A business owner does not need to know all of the nuances of contract law; that's why you rely on your friendly neighborhood lawyers. But it is important to know when the business or owner is legally bound by a contract. To recap, a business owner should look out for:

- Was there an offer with definitive terms?
- Was there acceptance to the terms without changing the terms?
- Did the accepting party use the proper method of acceptance if one is specified?
- Was there consideration?

If all of these are satisfied, then the parties will be bound by contract and will need to perform their respective ends of the bargain.

Breaching a contract*:* It is important to know when a breach of contract may take place both to avoid doing so and to recognize when the other contracting party has done so. While there are a number of ways that a breach may occur, the two most common are an anticipated breach and an actual breach.

An anticipated breach of a contract occurs where one party of the contract expresses that he will not be performing his end of the bargain. It does not matter whether this has been done through their words or their actions, it merely must be clear that they intend not to perform, and it must be clear to the suffering party that the breaching party likely is not to perform. For example, if Joe agrees to sell his car for $100 and deliver it to on Friday, and then either flat out tells the buyer "I've changed my mind and don't intend to sell you the car," or if he sells the car to another buyer before Friday, Joe has committed anticipatory repudiation because he has made it clear that he has no intention of performing his end of the bargain.

An actual breach is much simpler; it only requires that one party fail to perform their obligation under the contract. To use our previous example, if John simply doesn't turn up to deliver the car on Friday as promised, or shows up with a different car, then he has materially breached the contract.

In either case, the remedies available will depend on what was being contracted (goods or services) and the language of the contract itself.

If our unfortunate company had included a definite list of features, a delivery date, and some sort of quality control provision on the contract with the programmers, and the programmers did not deliver the features it agreed to deliver, or missed the delivery date, or delivered a bug-ridden block of code, the programmers would have breached the contract. If they had breached the contract the company would not have had to pay the full price of the contract, and maybe nothing at all, let alone an amount far in excess of the contract price.

Sometimes a contract can be invalidated even once it has formed. Typically, if there was a mistake, a misunderstanding, or a misrepresentation regarding the material terms of the contract there may be grounds to void the agreement. These aren't tools to rely on, but rather things to watch out for; so when you are forming a contract you should do your best to make sure that the contract is understood by both parties and that it does not contain any misrepresentations.

Signing contracts: When you sign a contract you are legally binding someone to do something. Just who that "someone" is depends on how you sign the contract. If you sign you own name, without specifying that you are signing on behalf of your business, then you, personally, are legally bound by that contract. It doesn't matter if you are an LLC or a corporation and you only formed the entity to avoid being personally responsible; if you sign on your own behalf you have just circumvented those liability protections. If you sign a contract "John Doe, CEO" then you, John Doe are going to be bound by the contract.

If, on the other hand, you sign your name on behalf of the business, in your capacity as an agent, partner, officer, director, member or manager then your business is the "someone" who is bound by the contract. You may still be liable for the business' debts in some cases, but signing on behalf of the business as an authorized agent means that the business, not you personally, is one of the parties to the agreement. Signing a contract "Acme Rocket Supplies, BY: John Doe, CEO" binds the rocket supply company, so that John Doe won't be personally liable if the rockets fail to work as advertised.

In some instances, like a commercial lease with a landlord, you may have to sign on behalf of the business, and to personally sign as well. This has the effect of making both you and the business bound by the terms of the contract.

This is one area where form overrides intent. Especially in Virginia, where the laws are very strict regarding the enforcement of contract. So, make sure that you not only know what you are signing, but please be mindful of HOW you are signing.

Be precise: Signing imprecise contracts is not a guaranteed way to cause problems, but it is a risk you cannot afford to take. You need to ensure that when you enter into a contract, whether it is to deliver a product or to engage a service provider, that contract clearly defines what you will give and what you will get. For example, if you hire a group of software developers to create a new program for your business you absolutely, positively must specify what features are to be included, what the delivery date will be, how the scope of the project can be amended, the price, or billing rate, and how that price is impacted by changes to the scope of the project. You also need to ensure that some sort of quality control is included.

The last thing you want is to enter into a contract for a sizable chunk of your business' funds that allows a contractor to unilaterally remove features you deem necessary, or to charge you some uncapped hourly rate that rewards them for being inefficient. And if you think to yourself, "they wouldn't do that" you really need to be a little more cynical. Lastly, whenever you deal with any contractors or service providers, you absolutely need to account for the ownership of the rights to the material being created, and that doesn't mean simply writing "work for hire" into the agreement, because as previously discussed (and contrary to popular opinion) many types of work product are not capable of being classified as works for hire.

The Uniform Commercial Code: The stuff of law school nightmares, the UCC is a set of rules that have been adopted by most states to standardize laws governing commercial transactions. These rules can be incredibly complex, or rather straight-forward. The UCC governs many of the most common activities your business will engage in, ranging from sales and leases of goods to promissory notes, letters of credit, and securities. One item of particular interest is a rule called the Statute of Frauds, an intimidating title for a rule that requires any commercial contract for the sale of goods worth more than $500 to be in writing. This rule also applies to contracts for services, but only if the services will necessarily take longer than 12 months to complete. So while verbal contracts are usually contracts, sometimes they aren't. And you need to know which are which.

A word of warning: When it comes to contracts we know that they can be verbal contracts or written agreements. If the contract is written pay very close attention to everything that is on the page or pages. The law presumes that you read the whole agreement, even if you didn't actually read it. If you agree to a term in the contract by signing at the bottom you cannot then dispute a provision of that contract as "something I didn't agree to." This also holds true for "click-through" contracts; agreements typically found with software but also increasingly common on many forms of electronic media. They typically look something like this "Click here to acknowledge our Terms of Service" and when you click the button to proceed you have entered into a contract, and it is often a contract that severely restricts your rights. Various states have differing approaches to contract law, but here in Virginia you have quite a bit of latitude to enter into contracts, and that can get you into trouble if you end up entering into an unfair contract. So, if you or your attorney didn't write the agreement be very sure that you understand exactly what is included so that you don't end up with an unpleasant surprise later on.

Equity And Securities

Virtually every start-up is going to need funding of some sort. For many, that funding comes in the form of debt instruments like a bank loan or a line of credit. For high growth companies, the funding goal is to sell a portion of your company's equity. You will hear a lot of talk about equity; what you need to remember is that most of the time you deal with equity and investors you are actually dealing with securities. Securities are a form of equity that is held for investment purposes. It is a little more complicated than that, but essentially if the equity does not give the owner the right to manage, not just to vote like a shareholder, but to actually directly manage the operation of the business you're probably dealing with a security. Your membership interest in a member-managed LLC? Not a security, because the membership interest comes with the right to manage the business. Your membership interest in a manager-managed LLC? Security. Stock in your corporation? Security. Even if that stock gets to appoint a director to the board? Yes, still a security.

It can seem confusing, but it isn't all that bad if you keep a few basics in mind.

Securities are very, very heavily regulated. There are state regulations. There are federal regulations. They tell you what you must do, what you can do, and what you must not do. Violating securities laws is very easy to do, and sometimes those violations carry incredibly stiff penalties that include jail time for individual officers, directors, or members who knowingly violate them.

Registered securities: Everyone is familiar with publicly traded shares of stock. These shares are all in companies with publicly disclosed financials, and have generally undergone a great deal of scrutiny before they are freely available for sale. They require registration with the Securities and Exchange Commission, and are subject to numerous laws that are designed to protect investors. Under the federal securities laws, a business is prohibited from offering or selling any type of security unless the offering has been registered with the SEC or an exemption is available. They are not the form of securities your business will be issuing for quite a while, although for many high-growth start-ups and investors an IPO is the goal line. What you will be dealing with for the first few years of your business' existence will be unregistered securities, and private placement transactions.

Private placement: Unregistered securities are sold in private placement transactions. A private placement transaction is any sale of equity or interest in a company that has not been registered with the SEC. This includes common or preferred stock in your corporation, but membership interests in your LLC and even partnership interests can potentially be securities as well, depending on the structure of your business, as all of those convey an ownership interest in the business without necessarily giving the owner the ability to manage the business. Convertible notes and warrants that can be redeemed for equity in your company, either at the discretion of the investor or upon the occurrence of some specific set of circumstances, are also securities, and must comply with the rules, regulations, and laws governing private placement transactions.

Unregistered securities can be difficult, if not virtually impossible, for an investor to resell. This is partly due to the nature of the securities themselves; they relate to companies about which most people know nothing. There are also laws in place that restrict the sale or transfer of unregistered securities. While this can work to the advantage of the private company selling the securities, the real intent is to protect investors from being duped into buying worthless ownership interests in a company. To issue any type of security that has not been registered with the SEC you need to comply with the rules found in the SEC's Regulation D.

Exemptions for private placement transactions: Regulation D includes three SEC rules, 504, 505, and 506, that companies can rely on to sell unregistered securities. Each of these rules have different requirements that you must meet in order to qualify, and to avoid engaging in securities fraud. These rules dictate the value of securities that you are permitted to sell in any 12-month period, and they also limit the investors you are permitted to sell the securities to and how you can advertise the sale or solicit investors.

The determination of what is considered a security is highly fact intensive, and when you get to the point of issuing equity to anyone other than a co-founder or general partner you should probably get some help to make sure you know what is required. Relying on what others have done in your situation may be a great way to go, but it could also lead you onto some dangerous ground. Entrepreneurs may embrace risk, but ask yourself how much you are willing to risk rather than get some advice and guidance.

General securities considerations: Companies not only run into trouble by failing to abide by securities laws when it comes to investors, but are constantly finding new and exciting ways of making unforced errors when it comes to equity.

Authorized shares: If your business is a corporation you need to have a certain number of authorized shares listed in your articles of incorporation. Some companies think “why not aim high?” and issue 1,000,000 shares in their new venture. Everyone likes owning large numbers of things, and having one third of a million is a lot more fun than owning 30 shares out of 100. Some states, including Virginia, charge you an annual fee that is based on the number of shares you have authorized. Not how many you actually have issued, but how many you can issue. This fee can be several thousand dollars per year higher than if you authorize a small number of shares. There is also a fee to register your company based on the number of authorized shares: 25,000 or fewer shares and you pay the minimum registration fee. However, the annual fee doesn’t work off the same schedule, and the minimum annual fee is for companies with 5,000 or fewer shares. So, be wary of anyone who suggests you go with 25,000 to save money; that advice will cost you money every year.

The number of authorized shares you have is a cap. You cannot issue more shares than that number. All too often companies fail to keep track of that number and end up issuing more shares, or options that would convert into shares, than they are authorized to issue. If you do that you are selling someone something you cannot actually sell them because the shares don’t actually exist. That’s fraud. However, it is very, very easy to change the number of shares you have authorized. You can amend the company’s articles of incorporation and simply drop a bigger number in the new version you file. Have 5,000 authorized shares, 4,900 of which are issued and outstanding, and want to give your key employees 500 shares? Simply authorize any number large enough to accommodate your issuance. You probably don’t want to do this every few weeks or months, so plan ahead.

Keep an accurate cap table: You don’t need an MBA to keep track of your business’ capitalization in your early stage, although when you have several different classes of stock, convertible notes, warrants, and debt instruments all outstanding and want to know who owns what you’re going to want someone who really understands these things to figure it out. It doesn’t matter if you have two co-founders in a partnership, or an LLC, or if you have formed a corporation, created an employee stock option pool, and have a couple convertible notes already; you need to have a cap table that accurately reflects the capitalization of your business. Document every single change. Keep a running tally (and make sure you never have people owning more than 100% of the business), and grow that simple document as you grow your company. You don’t have to do anything fancy, but if you like playing with numbers and hypotheticals you can have a lot of fun with a simple spreadsheet cap table. Give your financial guru a copy. Give your attorney a copy. Keep them updated on any changes. It will simplify your life tremendously, and help you avoid some really troublesome problems, when you get to the due diligence stage.

Employee equity: Who doesn't love paying employees with equity rather than actual dollars? It seems like a win-win. And it can be. But it can be somewhat tricky, and there are some potential unintended consequences. There is also an unfortunate tendency to give out more equity than you should, to be penny wise and pound foolish, as it were. This, like so much else, is a business consideration rather than a legal one, but there are a few legal issues involved with employee equity. There are tax implications to employee equity, either direct grants or options, and you will need to speak with a tax attorney or a good CPA to understand the best approach for your particular situation.

When you grant equity to your employees they may be considered owners, rather than employees, which can impact benefit plans. They are also getting equity which may be an unregistered security, so you'll need to make sure you know what is required and what restrictions apply. Like with any other sort of equity grant, you need to be aware of how much your business has issued, and how much it is authorized to issue. You may wonder why we keep repeating some variation of this idea, but the sad truth is far too many businesses simply don't keep track of it and end up giving out more than they can. There is also the question of timing and vesting schedules (at what point are the shares or membership units irrevocable?) of equity grants. So it's not quite as straight forward as "let's give them equity and pay them less."

Miscellaneous Mistakes

While the topics we've covered so far address many of the most mistakes made by entrepreneurs we wanted to include a brief overview of a few additional areas that tend to cause problems for founders and early-stage companies.

Employees vs interns: Interns. You may think you have one, or two, or several. Odds are, what you have are unpaid employees, and that's illegal. Interns are not a source of free labor. Wage hour regulations, workers' compensation laws, welfare benefits, and employee tax laws could all be violated if you have an "intern" who isn't actually an intern. It may seem like a good idea to get a college student to come work for you, learn a few things along the way, and not get paid. But that's an incredibly dangerous approach that can cause long-term liability for your business, and for you personally. Interns must receive training that is similar to the training which they would receive in an educational institution. On the job training does not qualify. The purpose of an internship is to benefit the intern, not the business. If you use a student to help with marketing, handle your social media, do clerical work, or just about any other task you can think of, that student is probably an employee, not an intern. And you MUST pay them. Unless the student is part of an academic program that placed the intern with you for a period of time, and there are specific requirements that must be met and reported back to the academic program, you probably don't actually have an intern, you have an employee. Treat them like an employee.

Employees vs independent contractors: Just like interns, independent contractors tend to be somewhat misunderstood. There are definitely benefits to having an independent contractor, who is responsible for their own employment taxes, rather than an employee. The tax benefit tends to be the primary motivating factor when a business classifies someone who is not a bona fide third party as an independent contractor. But, just like with interns, calling someone an independent contractor doesn't make it so. Whether or not someone is considered an independent contractor depends on what aspect of law you are applying. If it is tax law, the IRS has a list of requirements that must be met in order for someone to be considered a contractor rather than an employee. If it is copyright law (remember that independent contractors are usually considered the author of any creative work) the courts will apply a test that varies based on the jurisdiction.

In general, if you control the schedule or direct the work of a worker he is an employee. If she works out of your office, on your equipment, she is an employee. If you control how she is paid rather than receive an invoice for her service, she is probably an employee. And the least important factor, what do you call them. If you don't pay their employment taxes, but treat them like employees, the IRS will probably find you violated the law. However, court will probably find that not only did you violate the law, that you cannot then rely on the law when it comes to something like a copyright. It can be a lose-lose situation. So, don't try to cheat the IRS by calling employees contractors.

Fictitious names: If you use any name other than the full name of your business and an indication of what type of business entity it is you need to file for a fictitious name. Your new company can call itself Acme Corporation if that is its actual name, but it can't call itself Acme, or Acme Rockets without registering a fictitious name with the SCC. If it does, however, it could call itself anything at all and do business as NASA, at least as far as the SCC is concerned. You do still have to worry about trademark infringement with fictitious names, but you will need one if you want to use anything other than the complete and accurate name of your business as it is registered with the state.

Foreign corporation registrations: You actually need to register your business in each and every state in which you do business. Each state will have different criteria for determining what constitutes doing business in that state, so you will have to make sure that you are complying with each state's laws. If you are considered to be doing business in that state, you have to register with that state's corporation commission or secretary of state. You don't have to incorporate there; you've already done that in your home state, but you do have to let the state know you are there, provide the name and address of a local registered agent, file annual reports there, and pay whatever fees that state assesses.

Local business licenses: Not only do you need to register your business in each state you do business in, you may need to have a city or county business license in each locality where you operate. Each state will have different rules, and even within a state counties and cities may not all have the same requirements. So don't forget to check with your local governmental bodies to make sure you are in compliance.

Securing a domain name: Your business' name does not guarantee you rights to the corresponding domain name. Registering your business' trademark does not guarantee you rights to the corresponding domain name. While you may be able to use your business' name and trademark to force someone to hand over their domain name registration that is not always a simple process, and it's rarely cheap. Cybersquatting is illegal, but unfortunately it is the cornerstone of many online businesses that register domain names and attempt to sell them to businesses. Don’t let them force you to pay more than you need to pay, or hire legal counsel to assist you fight them for it, when registering your own domain name is simple, fast, and cheap.

Fixing a problem rather than avoiding it: Many problems can be fixed after they arise. Sometimes it is incredibly simple to do so. Quite often, it is much more expensive and time consuming to fix a problem rather than to avoid it. Consider the legal landscape carefully. Think about your situation and what you are hoping to accomplish. And then make sure you get some good, preventative guidance. Do what you do best, and let someone else do what they do better. You may find that you save money, have less stress, and encounter fewer problems. When you get around to dealing with investors and start the due diligence process, you will be in a much better position if you work with a guide who can help you navigate the legal landscape your business crosses than if you try to explore that landscape on your own.

Tax law: Once again, we’re going to shy away from advice on this topic, at least as far as the law goes. When it comes to your business’ tax issues you have no better resource than a qualified tax professional. Find a tax attorney or a licensed CPA who can help you understand the tax implications of your choice of business entity, your conversion from one entity to another, your obligations to employees, and all of those other facets of operating a business that end up involving taxes. The IRS doesn’t mess about, and you shouldn’t either. Your business’ accountant or tax attorney can be an invaluable resource, and can help save you money by showing you how to maximize the value of your company’s structure and transactions.

Navigating the Legal Landscape, Safely.

The first step in avoiding trouble is knowing that it exists. Otherwise, while you may avoid it through sheer luck, you may be treading on dangerous ground without any idea that it is about to fall out from under you. We hope that this guide has provided you with some valuable information that can help you spot some of the troublesome issues and to avoid many of the most common mistakes. You probably don't take health care advice from your auto mechanic, or car safety tips from your doctor. Don't rely on non-lawyers for expertise about legal issues. Get information from a reliable source, and use the laws to protect your business rather than wander into the wilderness that is the legal landscape without a guide and end up a cautionary tale for others who will draw good judgment from your experience.

Best of luck with your business and your entrepreneurial journey!

Appendix

SAMPLE DUE DILLIGENCE REQUEST LIST

A.	**Corporate Documents and Records**	
	1.	Articles or certificate of formation, as amended to date.
	2.	Operating agreement, as amended to date.
	3.	Minutes of meetings of members, managers and/or board of directors and all material committees (board and non-board), plus organizational minutes.
	4.	Evidence of the Company's good standing in the jurisdiction of its formation and all jurisdictions in which the Company is qualified to conduct business as a foreign company.
	5.	A list of all jurisdictions in which the Company is qualified to conduct business as a foreign company and copies of all registrations and qualifications to do business as a foreign company.
	6.	A list of, and all of the foregoing documents for, any subsidiaries of the Company and for any other entities in which the Company holds an equity interest.
	7.	Copies of documents relating to partnership, joint venture or other affiliations of the Company.
	8.	If the Company or a substantial portion of its assets was acquired in a prior transaction, all documentation related to the acquisition, including any acquisition agreement and all documentation related to the financing of the acquisition.
	9.	All other material agreements and documentation to which the Company or its subsidiaries is or was a party, relating to any business combination or any material acquisition or disposition of assets outside of the ordinary course of business.

B.	**Securities**	
	1.	Equity ownership records, including any membership interest or unit ledger.
	2.	Schedules setting forth the Company's equity structure, including membership interests and if applicable, the number and type of units of membership interests issued and outstanding, the names of members and the percentage interest of each member, including outstanding profits interests, options or warrants with dates of expiration and exercise prices thereof and terms of any vesting.
	3.	Copies of buy-sell, voting trust or other agreements relating to the purchase of the Company's equity.
	4.	Copies of irrevocable proxies, preemptive rights, member agreements, redemption/repurchase agreements or any other agreements affecting member rights.
	5.	Copies of all equity certificates, warrants, options, debentures, calls, commitments and any other outstanding securities, including copies of any equity incentive, profits interest, option or other plans adopted by the Company.
	6.	Permits, qualifications, or notices relating to the Company's securities that have been filed with any governmental agencies.
	7.	Copies of agreements, offering circulars, private placement memoranda, disclosure letters and similar documents relating to sales or proposed sales of the Company's equity securities, copies of correspondence with investors or potential investors, and copies of any written proposals for the acquisition of the Company's securities.

C.	**General Business Matters**	
	1.	Information describing the Company's business, including (i) sales and marketing arrangements, (ii) customer base, (iii) pricing and credit policies, (iv) competition and (v) business reputation.
	2.	List of any assumed, fictitious or other business names which the Company has used to conduct business within the last two years.
	3.	List of all jurisdictions in which the Company transacts business or is planning to transact business in the near future, including locations where the Company maintains inventories, owns or leases real property, or has employees, and a list of addresses for all sales or service offices open at anytime since the Company's formation.
	4.	Reports to management for the last two years by:
		(i) independent public accountants, including all letters and opinions accompanying financial statements, letters issued during the past three years regarding control systems, methods of accounting, etc., including any changes in such systems or methods;
		(ii) internal auditors;
		(iii) appraisers relating to valuation of the Company's assets and business; and
		(iv) other consultants or outside experts, including without limitation environmental experts and management consultants, hired with respect to business operations.
	5.	Copies of the Company's financial statements (audited, if available) for the past two years.
	6.	List of all current and former managers, directors and officers of the Company during the last two years.

C.	**General Business Matters**	
	7.	Information regarding bank and credit arrangements, including:
		(i) list of all banks where seller maintains accounts, credit lines, loan agreements and safe deposit boxes;
		(ii) list of persons authorized to transact business on behalf of the Company with banks or other financial institutions; and
	8.	Copies of documents of title for major assets and equipment purchase agreements together with a schedule setting for the location of major assets.
	9.	Copies of all documents purporting to create liens, mortgages, security interests, pledges, charges or other encumbrances on real or personal property in favor or against the assets of the Company or its subsidiaries and copies of all financing statements filed with respect to the above.
	10.	Schedule of insurance policy coverage setting forth the name of the insurer, type of insurance, amount of coverage, deductibles, named insureds, whether any litigation has been tendered to and accepted by insurance companies in defense of the Company, and title insurance policies, together with copies of all such policies.
	11.	Copies of product and/or service warranties.
	12.	Copies of correspondence with lenders (including loan commitments) for the last three years including all compliance reports submitted by the Company, its subsidiaries or its independent public accountants, and computations demonstrating compliance with covenants in existing financing documents.
	13.	Copies of any other documents or information which, in the judgment of the Company, are significant with respect to its or its subsidiaries' business or operations or the contemplated transaction.

C.	General Business Matters	
	14.	Copies of the Company’s agreements with customers, wholesalers, distributors, manufacturers, vendors, and suppliers (i.e., distribution, dealer, or resale agreements, franchise agreements, purchase orders, sales acknowledgments, invoices, warranty disclaimers, etc.).
	15.	List of the Company’s (i) suppliers, (ii) customers, (iii) distributors, and (iv) manufacturers during the last two years.
	16.	The most recent purchase orders from the Company’s five largest customers.
	17.	Financials through July 31, 2016.
	18.	A report detailing the Company’s sales pipeline

D.	Employee Documents and Information	
	1.	Copies of all existing or anticipated employee and officer benefit plans, option plans, profit sharing plans, bonus plans, pension plans, retirement plans, multiemployer plans, employment agreements, noncompetition agreements, consulting agreements, employee manuals and any other written company policies relating to employees.
	2.	Copies of the Company’s written policies relating to employee grievances, terminations, leaves of absence, vacation, long-term disability or severance (including descriptions of these policies where the Company does not maintain written policies).
	3.	Copies of all other agreements with any employee, officer, consultant or agent, and a written description of employment terms and benefits where employment is pursuant to oral agreements.
	4.	An organizational chart of the Company’s management.

D.	Employee Documents and Information	
	5.	List of all current employees showing name, title, job grade, manager or supervisor, salary, benefits accrued/eligibility and date of hire.
	6.	Timekeeping and payroll records.

E.	Technology	
	1.	Copies or descriptions of the Company’s established policies (whether written or oral) regarding trade secrets and other proprietary rights and actions taken to protect the Company’s trade secrets or other proprietary rights.
	2.	Copies of confidentiality and secrecy agreements.
	3.	Identification of materials, works, etc. which the Company seeks to protect by copyright, patent or other means.
	4.	Copies of all agreements relating to the license or other use of the Company’s patents, copyrights or other intellectual properties, including research and development agreements, manufacturing licenses and distribution and marketing agreements.
	5.	List of all patents, trademarks, service marks, copyrights, and domain names, including pending applications for registration, with descriptive titles, registration numbers, jurisdiction and effective and expiration dates, as applicable. In the case of unregistered trademarks and service marks, a list of such unregistered marks together with date of first use and jurisdictions where such marks are used.
	6.	Copies of all agreements relating to the license or other use by the Company of third parties’ intellectual property.
	7.	All documentation relating to any conflicts, interferences, third-party suits, patent oppositions, internal memos and external

E.	Technology	
		reports on possible infringement of rights of third parties or of the Company’s rights by third parties.
	8.	Copies of all disclosures to patent counsel for patent prosecution.

F.	Taxes	
	1.	Copies of tax returns for the last two closed years and all open years together with copies of any notices of delinquencies, underpayment, etc. applicable governmental agencies.
	2.	Copies of reports of auditors or other applicable governmental agencies and related materials, including claims for refunds, investigations, audits or disputes for any fiscal year not barred by the applicable statute of limitations.
	3.	Copies of agreements extending time or waiving applicable statutes of limitation regarding the assessment or payment of taxes.
	4.	Description of the Company’s net operating losses, if any.
	5.	List of persons who prepare the Company’s tax returns and list of persons with powers of attorney.

G.	Litigation and Claims	
	1.	Description of all present or threatened litigation, administrative proceedings, governmental investigations or inquiries, arbitration or claims affecting the Company or its subsidiaries.
	2.	Copies of all letters from the Company’s attorneys to the Company’s independent public accountants in the past three years regarding litigation in which the Company or any of its subsidiaries is, was or may be involved.

G.	Litigation and Claims	
	3.	All pending, threatened, closed or completed litigation, arbitration, mediation, administrative or other proceedings involving the Company, any subsidiary or any joint venture involving the Company or any subsidiary, any officer or director (including parties, remedies sought and nature of action) for each of the past five (5) years, including any claim or action brought by or on behalf of an employee and involving EEOC, OSHA, federal, state, or local labor or employment regulations (provide copies).
	4.	Copies of all consent and other decrees, judgments, orders and settlement agreements and other agreements to which the Company or any of its subsidiaries is a party or is bound.

H.	Government Regulation and Licensing	
	1.	Copies of reports filed and significant correspondence with any state or federal regulatory agencies during the past three years. All material in the files of the Company or its subsidiaries regarding possible environmental pollution, including correspondence with all governmental agencies, and internal and external consultant reports regarding the same.
	2.	Copies of all permits, licenses, governmental clearances, etc. necessary for the conduct of the Company's business.
	3.	Copies of real property deeds, zoning permits and property tax information.
	4.	Description and location of any equipment tanks, drums or other containers that may contain petroleum products, chemicals and/or hazardous materials or wastes ("Hazardous Substances") and spills, leaks or other releases of Hazardous Substances which have occurred on the Company's property.
	5.	Copies of title records for the Company's real property.

I.	**Material Contracts** Copies of all material contracts, agreements and commitments relating to:	
	1.	Leases of real property and leases of any substantial amount of personal property to which the Company or any of its subsidiaries is a party, either as lessor or lessee;
	2.	Agreements relating to current or future debt (including reimbursement) obligations for borrowed money, including agreements to acquire any such debt obligation of others or for a leasing transaction of a type required to be capitalized;
	3.	Agreements regarding obligations or liabilities as guarantor, surety, co-signer, endorser, co-maker, indemnitor or otherwise in respect of the obligation of any other person or entity;
	4.	Agreements by which the Company or any of its subsidiaries is subject to any obligation or requirement to provide, or under which the Company or any of its subsidiaries is currently providing, funds to or making any investment (in the form of a loan, capital contribution or otherwise) in any person or entity;
	5.	Advertising, marketing or similar agreements and any agreement or commitment relating to the payment of a commission;
	6.	Conditional sales agreements; standard purchase order and sales acknowledgment terms and conditions; and service agreements;
	7.	Agreements which limit the freedom of the Company, any of its subsidiaries or "key" employees to engage in any line of business or to compete with any other person;
	8.	Agreements with governmental agencies or any other contract which would be adversely affected by, or for which any filing or other notification to any governmental agency would be required because of a change in ownership;
	9.	Purchase or lease agreements or commitments which require the Company to make any future capital expenditure or commitment for property or equipment;

I.	**Material Contracts**	
	10.	Agreements, contracts, commitments or loans to which any of the officers or directors or any affiliate or associate (or former affiliates or associates) is a party;
	11.	Contracts, commitments or agreements with any officer, employee, consultant or agent that contains any severance or termination pay liabilities or obligations including “golden parachute” agreements;
	12.	Description of any “soft” contracts - (i.e., oral understandings, customary practices that may establish rights, remedies or defenses to certain obligations/claims to which the Company is a party); and
	13.	Copies of any other contracts which are material to the operation of the Company’s business or which may have a material effect on the Company’s assets or properties or the contemplated transaction.

A Founder’s Guide to Navigating the Legal Landscape