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PROTECTING YOUR COMPANY

Every business faces a number of different risks and needs to think about how to protect itself. The goal of this article is to provide an overview of the risks and some of the ways a company can protect itself.

1. Taxes. Failure to be up to date with your tax obligations is the simplest way to risk having the IRS or the DRS close your business. Your first responsibility is to pay the withholding taxes due with respect to your employees. The next most important item is to pay taxes on your income. If your company is taxable this means the company level taxes. If your company is a pass-through entity, this means the quarterly estimated tax payments due for each of the owners. No matter what the nature of your business, it is critical that you find a competent accountant with experience in advising businesses like yours. They can help teach you about keeping your books appropriately, keeping your personal expenses and funds separate from your business and about how to save for and file your taxes.

2. Lack of clear direction may lead to foundering and stagnation. Every business should have a comprehensive business plan which should coherently outline the planned business, intended markets, strategy, and technology, with appropriate and credible revenue, profit and expense projections produced either by the principal, or by an experienced accountant or other consultant. The business plan is a working document which needs to be reviewed and revised regularly so that it reflects the business owner's changing business goals. To the extent that your business needs financing the investment marketplace will closely scrutinize these projections in evaluating the long-term viability of the company.

3. Failure to form a business entity (a corporation or limited liability company) puts all of your personal assets at risk to being confiscated or attached to satisfy the claims of your business' creditors. Businesses are operating in entities in order to protect the separate personal assets of the business owners from the risks of the business. Without forming an entity, your business' creditors will be able to take your personal assets to satisfy their claims against your company. Most new ventures today are being organized as limited liability companies. This provides a very favorable and flexible structure for tax and capitalization. A limited liability

company can be easily and cost-effectively converted to a corporation if that is needed or if the company grows and seriously plans to register its stock with one of the exchanges, and go public. However, operating as a limited liability company avoids taxation of the entity and provides tax advantages in the event of a strategic acquisition. Further, as opposed to an S-corporation, a limited liability company can have an extremely flexible capital structure. However, there are certain tax advantages to forming a C-corporation and treating oneself as a W-2 employee. This creates a discipline for tax withholding for the new entrepreneur who is not comfortable with saving revenue and filing quarterly estimated tax returns. If your company grows and takes on employees to whom you want to provide incentives, limited liability companies can create incentive compensation structures which mimic corporate structures (options, restricted equity, phantom equity), as well as unique highly-flexible compensation structures using incentive units with provisions providing for participation in net profits from operations, and/or in proceeds from capital transactions.

4. <u>Setting up conflict resolution with your partners</u>. It is critical that you set up the structure for resolving any conflicts which arise with your partners when you set up your company, or, at the latest, long before you end up in conflict. This is most critical if there is an even number of partners, shareholders or members, and, consequently the risk of a deadlock on any critical issues. First of all, the formative documents should provide the structure for making decisions. Generally, shareholders elect the directors of a corporation. Directors set policy and make major decisions (obtaining major financing, buying another business, shifting focus of the business, etc.) and engage the executive officers (President, Secretary and Treasurer). The executive officers run the company and engage all of the other employees. LLCs should mirror this structure with members electing managers as the LLC counterpart to corporate directors. Managers should function like directors and engage executive officers who will run the company. In non-public closely-held corporations, the shareholders, directors and executive officers will generally be the same folks. In a corporation, the bylaws and/or a shareholders' agreement should define how the company will be operated. In an LLC or partnership, the Operating Agreement or Partnership Agreement should cover this. This will include defining how managers or general partners will be elected and how they will take actions. This includes what vote is needed for what types of actions. A simple majority is all that should be required for mundane matters, but a supermajority (2/3s or 3/4s or unanimous vote) may be required in order to sell the company, buy out a member or partner, undertake major financing, or change the focus of the company. If there is a great risk of a deadlock (if there is an even number of owners or managers), I ask my clients to choose someone in advance whom they all respect to whom they can turn to cast the deciding vote in the event of a deadlock. This person will serve as a mediator and/or arbitrator as needed. I ask my clients to commit to making this a binding process. If they cannot choose

someone in advance, I ask them to commit to the normal procedures of the American Arbitration Association.

5. <u>Setting up and funding buy-sell arrangements with your partners (co-owners).</u> It is important to protect your business interests from the undesirable consequences which may arise if a business partner or co-owner dies or becomes disabled or stops producing or attempts to sell his interest to someone you don't want as a partner. You should have an agreement with your co-owner(s) about when and to whom you each can transfer your interests in your company. This would be a shareholders' agreement for a corporation, or part of the operating agreement for an LLC. These agreements should cover when and to whom transfers may be made and when and to whom they may not be made as well as how they will be valued (or appraised) and how (when, cash or notes and over what time period) that value will be paid. I often include rights of first refusal to co-owners or to the company with respect to transfers to outsiders. I usually allow for transfers made for estate planning purposes and provide for a purchase in the event of a partners death. These arrangements should be funded by insurance held by the various owners or by the company.

6. <u>Insurance</u>. Your business should be covered by appropriate insurance including general liability policies and types of insurance specific to your business. If you have employees you must have unemployment compensation coverage. If you are a professional you need professional liability or malpractice insurance. It is also prudent to carry disability coverage (payable to the individual owner) and business expense coverage (payable to the business).

7. <u>Employment Procedures</u>. Your business should have an employee handbook outlining the company's policies with respect to vacation, sick days, personal days, medical and other insurance coverage, and other benefits. It should also cover use of company property including computers, printers, copiers, fax machines and phones and the right of the business to review or oversee each employee's use of this equipment. The company should have a clear policy for testing job applicants, doing background checks on potential employees and testing of employees. Depending upon the business this may include testing for drug usage. You may also give new hires appropriate skills and attitudes tests which may be obtained from various services. It may be wise to get the advice of a labor and employment attorney or a human resources professional on some of these issues.

8. <u>Conflict of Interest Policy</u>. Your business should adopt and administer a conflict of interest policy. This helps to make sure that corporate or company opportunities stay in the company and are not taken elsewhere without company approval.

9. <u>Whistleblower Policy</u>. I highly recommend that you adopt a Whistleblower Policy. The purpose of such a policy is to empower your employees to report anything which

might hurt the company to the appropriate party. It gives your employees a way around an abusive superior to report abuse which might harm the company. These policies are aimed at inappropriate financial transactions, inappropriate sexual harassment, inappropriate use of company facilities, etc.

10. Protecting Your Intellectual Property. There are four basic types of protection: patent, trademark, copyright and trade secrets. How you go about protecting your company's intellectual property this will depend upon the nature of that intellectual property and your business. If your business is dependant upon novel technology or processes, you need to find a good patent attorney who can help you apply for and obtain one or more patents protecting your technology and/or processes. You should interview several patent attorneys to find one who really has expertise in the type of technology which your business utilizes. There are experts in biotechnology, pharmaceuticals, software, electronic hardware, mechanical devices, etc. Finding one who will really understand what is unique about your product/technology will be critical to the process.

If your company is dependant upon computer software products it is unadvisable to rely on any of the forms of registration to protect the critical software used in your products or services. Software is generally protected using copyright, which only protects substantially the exact code which is registered. Because of the nature of software, a good programmer may be able to write software with similar functionality using entirely different code. Consequently, the best protection for a software-based business is trade secret. You need to protect the source code for your product or device or service rigorously. This means giving your customers only the level of access which they need. They should not get access to your source code. Your license agreements for the use of your product should include obligations that forbid the customer from reverse engineering the code.

If a key part of your business is the name of a product or service or a tagline attached to either, you should consider protecting your use of them through trademark registration. Generally this registration is not available until the name or tagline has been used, although a preliminary filing can be made on intention, but your rights will not be protected until there has been actual use in commerce. Generally, if you have a great idea for a concept like this, it is critical to protect it before you tell anyone about or they may use it themselves.

Finally, your written materials may be protected by copyright registration. The U.S. copyright office website at http://www.copyright.gov/ is one of the most user-friendly of the intellectual property government offices/website. Filings are relatively simple and inexpensive. If you are working on a screenplay for a TV show or film you should register the script as soon as possible. This will add a bit of protection to your negotiations with

producers for financing. However, this should not be your sole protection.

11. <u>Non-compete & Confidentiality Agreements</u>. Non-Disclosure Agreements (NDAs) and Non-Compete Agreements are the next level of protection for your business' confidential intellection property (after patent, trademark, and copyright registration). It is one of the way in which you can help protect trade secrets. Principals, employees, consultants, potential investors and strategic partners should all be asked to sign a confidentiality or non-disclosure agreement (NDA) covering non-public information concerning your business. Principals and new hires should be interviewed to determine whether they are constrained by non-competition agreements with prior employers or business partners. You will not want your partner's or new employee's prior employer or partner to have a claim against your business. A release must be obtained with respect to potential conflicts.

If a potential investor does not agree to do so, a business judgment must be made concerning whether the potential investor may be trusted without an executed NDA. You may get around this with a letter of intent which incorporates some of the same principals. Personal knowledge and the reputation of the individual or company is the key to this decision.

12. <u>Clearly written agreements may help you avoid unnecessary litigation and controversy</u>. It would be nice to operate in a world in which we could absolutely do business on a handshake. However, the complexity of the transactions we often enter into and the likelihood that each side will remember the details differently argues in favor of detailed definitive agreements for your transactions. If you have repetitive types of deals you're your customers you should ask your attorney to draft a good form of agreement. If you work with purchase orders, have your attorney draft terms and conditions favorable to you which can be printed on the back of your purchase orders. It is good to focus on the details of when title passes, when payment(s) must be made, who will indemnify whom for negligence, gross negligence and/or malfeasance, and how controversies will be resolved. I recommend mandatory mediation and/or arbitration provisions and jurisdiction in the Connecticut federal and state courts especially where the other party is at a distance.