COOPER LAW LLC

Isaiah D. Cooper
Admitted in NY & CT

79 Bedford Avenue
Hamden, CT 06517
Tel: (203) 497-9969
Fax: (203) 721-6101
http://www.cooperlaw.net

START-UP COMPANIES: BUSINESS AND LEGAL NEEDS

Depending upon the nature of the business contemplated, a start-up venture must structure its business for successful operation in a manner that (i) is likely to attract capital (if needed); (ii) provides a tax-advantaged structure for operations; and (iii) provides the opportunity for either long-term operation, a sale of the company, or an eventual initial public offering ("IPO"). The following is a list of business and legal issues that should be addressed in order for the venture to achieve its business objectives. These issues are typical in the world of start-ups and require varying amounts of legal assistance which must be planned for in the start-up's budget. The issues are raised in the following comments and suggestions.

1. Business Plan. A start-up venture needs a comprehensive business plan which should coherently outline the planned business, markets, strategy, technology and management team, with appropriate and credible revenue, profit and expense projections produced either by the founders, an accountant or by an experienced consultant or investment banker. This is particularly crucial for software or internet-based companies. The investment marketplace will closely scrutinize these projections in evaluating the long-term viability of the company. An entrepreneur planning a new business should seek assistance in preparing a business plan which outlines all of the major issues they are likely to face. There are many sources for this help including both online resources and consultants who specialize in working with start-ups.

2. Accountant. In setting up your company you should consult with an accountant and/or a bookkeeper to make sure you are keeping good accounting records. If the venture financing objectives include the seeking of capital and ultimately a private sale or an IPO, the company will need to make sure it has an accounting firm on board that has credibility in the marketplace. If the company is organized as an LLC (and taxed as a partnership), you must also choose an accountant who understands and is familiar with the rules for LLCs and partnership taxation. Engagement of an excellent accounting firm to perform audits and tax accounting improves the credibility of the company's financials and projections in the investment marketplace, and will make it easier to obtain bank or equity financing when needed.

3. Choice of Entity. We recommend that new start-up ventures organize 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-

© 2011 Isaiah D. Cooper, Cooper Law LLC

Under the professional rules of conduct that govern the practice of law, this document may be considered as informational material. It should not be construed, or relied upon, as professional advice in a legal context.

effectively converted to a corporation when (and if) the company plans to 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 (and confidential) capital structure. 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 profit participation and capital event participation features.

4. Capitalization. Prior to seeking equity financing (the sale of the entity's securities in order to raise capital) all of the founders must agree on their relative interests in the new venture and figure out how much capital they need in order to operate, to develop and market their service, product or technology, and what percentage of the company they are willing to provide to investors in exchange for the investment of their funds. The better and more realistic the founders financing planning and projections are, both respect to expenses and expected revenue, the better they will be able evaluate what percentage of the company the funds they intend to raise should represent. The founders should keep track of their business expenses made before forming their entity and should record the value which they each contribute in exchange for their interests in the company. Such contributions may include cash and property, including intellectual property such as the business name, the concept, specially developed software or technology, patents, patent applications, trademarks, trademark applications, copyrights, copyrights and the associated protected property. A limited liability company operating agreement must be drafted to reflect the founders' respective roles in controlling the company, setting compensation and providing procedures in the event of death, disability, or non-performance of any founder or member. Units may be reserved for investors, new employees and consultants (depending upon the business's plans). The percentage provided to investors will often be determined by negotiation, but entrepreneurs should begin with terms and expectations that set the stage for those negotiations. The further the entrepreneurs can progress in developing the business, getting it operational and developing some revenue before seeking outside funding, the smaller the interest which will need to be given to investors.

5. Non-compete & Confidentiality Agreements. Founders and new hires should determine whether they are constrained by non-competition agreements with prior employers or business partners. The entrepreneur will not want such parties to have a claim against the new venture with respect to the type of business planned. A release must be obtained with respect to any such agreements which are in effect and which have bearing on the business which is contemplated.

Potential investors, strategic partners, employees and consultants should all be asked to sign a confidentiality or non-disclosure agreement (NDA) covering non-public information concerning the new venture's business. Be sure that a potential employee or consultant is not constrained by an existing non-compete before hiring or you may be inviting a lawsuit from the

© 2011 Isaiah D. Cooper, Cooper Law LLC
Under the professional rules of conduct that govern the practice of law, this document may be considered as informational material. It should not be construed, or relied upon, as professional advice in a legal context.

prior employer. 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. Personal knowledge and the reputation or references of the individual or investment or venture capital company is the key to this decision.

6. **Intellectual Property.** The entity's trademarks, trade names, proprietary processes, programs and inventions should be registered with the U.S. Patent & Trademark Office. This may include applications for trademark registration, patents and/or copyrights. Although software may be protected by copyright, software companies should generally protect their source code as a trade secret, and only provide their object code to their customers pursuant to a well written license agreement which creates consequences for reverse engineering the software. Prior to going live with a website, an "intent to use" trademark application should be filed with respect to the critical company or product name, and amended as the trademark is used commercially or as the site is brought live. Initially the founders (or the new entity) must acquire any domain names which they intend to use. The availability of domain names and the existence of similar names in registered trademarks should be considered before naming your company or your product.

7. **Barriers to Entry.** It can be very helpful if the venture can establish barriers to entry in its marketplace. Barriers to entry can be established through (i) the creation of proprietary technology and processes (which are properly protected by patent, trademark and/or copyright registrations), (ii) the creation of solid and loyal relationships with its leading accounts (this will require the identification of industry market leaders); (iii) the establishment of a viable distribution network (again hopefully characterized by exclusive relationships), and/or (iv) the establishment of a topnotch and difficult to replicate team to run the company.

8. **Board of Managers.** The "Board of Managers" is the limited liability company equivalent of a corporate board of directors. The board set establishes the direction, goals and policy for the company, approves major transactions, and engages the executive officers who will run the company. In small closely-held companies, the owners (members for LLCs), managers (directors for a corporation) and executive officers will generally be the same people. The investment marketplace puts a premium on the presence of well-known industry leaders on a board of directors or managers and discounts for the absence of the same. For this reason, the directors or managers of the company should consider recruiting additional industry experts to serve as independent “managers” of the company. The independent “managers” may also serve as the compensation committee for founders who are employees. The independent managers should be from banking, finance, or specific business backgrounds which relate to the company’s business. The founders should develop a list of potential candidates. The company may need to plan to pay managers for their expenses and/or time in attending meetings. The company’s operating agreement should allow for telephonic meetings.

9. **Incentive Compensation.** In order to attract high quality personnel in

© 2011 Isaiah D. Cooper, Cooper Law LLC
Under the professional rules of conduct that govern the practice of law, this document may be considered as informational material. It should not be construed, or relied upon, as professional advice in a legal context.

the early stages when companies are often short on cash, a start up company might want to adopt an incentive compensation system for employees, managers, executives and consultants. This will allow the company to conserve limited cash and still attract top-level people. The company can issue either options to acquire membership units, or "incentive units" (membership units having either or both "profit participation" or "capital appreciation" features). Incentive units are similar to restricted stock but provide greater flexibility in structure.

10. Advisory Board. The start-up might also want to have an "advisory board" which would be distinguished from the Board of Managers. The advisory board might include investors or experts in the company's particular area. Advisors would not be fiduciaries and need not be involved in the day-to-day operation of the business. The involvement of the board of advisors could be helpful to the extent the advisors provide practical advice, and/or the use of their names in establishing the company in their industry. However, members of an advisory board should also be checked for conflicts and be subject to an NDA.

11. Disclosure Documents. In order to raise capital by soliciting investments in the venture in a private placement of securities (membership interests or units in the company) the company will need disclosure documents that comply with state and federal securities laws, a securities purchase agreement, and an investor questionnaire (in order obtain the information needed for filing with the SEC and state securities administrators). Though extensive, substantial and full disclosure concerning the business and the risks of the investment is required *with respect to individual investors who are not "accredited investors,"* generally, such disclosure should be used with all potential investors, including "accredited investors." Various documents must be filed with the SEC and with the state securities administrators for each state where an investor resides. The states generally require some level of filing fee in addition to the filing of informational documents and forms.

Each of the items above impacts a new company's budget and need for legal advice. A start-up's legal needs should be met in segmented steps as the importance of each layer of legal protection is added at the appropriate point in your company's development, with full consideration of your budgeting constraints. Cooper Law LLC is prepared to provide cost-effective and practical legal assistance to new companies at each stage of the venture's development. Additional commercial and operational issues will arise as your new company commences operations.

© 2011 Isaiah D. Cooper, Cooper Law LLC
Under the professional rules of conduct that govern the practice of law, this document may be considered as informational material. It should not be construed, or relied upon, as professional advice in a legal context.