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PROTECTING YOUR BUSINESS

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 business or company can protect itself.

1. Write a Business Plan. 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 projections of revenue, profits and expenses, 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' changing 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.

2. Form a business entity (a corporation or limited liability company) for your business. Failure to form a business entity puts all of your personal assets at risk of being confiscated or attached to satisfy the claims of your business' creditors. Businesses are operated within 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. You may test the waters of a new business venture by operating it briefly as a sole proprietorship. However, once you see some success and determine to continue operating, you should form an entity and contribute the business into it.

Unless your business will need to raise capital, you should probably structure it as either a limited liability company (an LLC) or an S-corporation. An LLC provides a very favorable and flexible structure for tax and capitalization. An LLC may elect to be treated as an S-corporation. An LLC 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. 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 with multiple classes of equity and may issue units of membership units to investors. Such units may provide the

investors with the right preferential distributions of revenue and profits. However, there are certain tax advantages to operating your business as a either a C-corporation or an S-corporation, including the ability to treat owners as W-2 employees and deduct their compensation (as employees) from profits. 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 (incentive stock 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.

3. Taxes. Failure to be up to date with your tax obligations is the simplest way to risk having the IRS or state tax authorities (in Connecticut the Department of Revenue Services) close your business. Your first responsibility is to withhold and pay the withholding taxes with respect to your employees. The next most important item is to pay taxes on your income. If your company is taxable (a C corporation) this means the company level taxes. If your company is a pass-through entity (an LLC, partnership or S-corporation), this means that quarterly estimated tax payments must be made for each of the owners. You must figure out if you need to charge your customers sales tax for your products or services. If so, register for this, charge it and pay the taxes to the appropriate tax authority. In Connecticut, each business is obligated to file annual business property returns with the municipality where they have premises on November 1 for all business property owned as of October 1. You must also pay tax on any real property owned by your business. Some leases pass real property taxes through to the tenant. 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.

4. Setting up conflict resolution with your partners. Many businesses are forced to close because of unresolved conflicts between or among the owners. It is critical that you set up a structure for resolving any conflicts which arise between or among you and your partners when you set up your company, long before you end up in a conflict. This is more 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. For corporations, the shareholders elect the directors and the directors set company policy, 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's day to day operations and engage/hire all of the other needed

employees. LLCs should mirror this structure with members electing managers, the LLC counterpart to corporate directors. Since the LLC statutes don't generally provide a lot of detail about managers and their responsibility and authority, when I form an LLC, the Articles of Organization (or other formative document) provide explicitly that the LLC's managers will have the same authority, rights and responsibilities as are provided to the directors of corporations under the corporate statute. Managers should function like directors, setting company policy, making major decisions, and engaging the executive officers who will run the company. In non-public closely-held companies, the shareholders or members, directors or managers and the executive officers will generally be the same individual(s). 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 directors, 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. However, a supermajority (2/3s or 3/4s or unanimous vote) may be required in order to sell the company, buy out or admit 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 and whom they can trust to cast the deciding vote in the event of a deadlock. This person may serve as a director or as a manager and may function as a mediator and/or arbitrator as needed. I also tell my clients to agree in advance to pay this person's normal rate for the time required for him or her to hear their positions on the matter in conflict. I also 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> An owner's death or disability can destroy your business. It is important to protect your business interests from the undesirable consequences which may arise if a business partner or co-owner dies, becomes disabled, gets divorced, stops producing/working for the company 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 may transfer your interests in your company. This should be in a shareholders' agreement among the shareholders of a corporation, or part of the operating agreement for an LLC. These agreements should cover when and to whom transfers may be made, when and to whom they may not be made, as well as how they will be valued (or appraised) and how that value will be paid (with cash and/or a promissory note providing for installment payment over what time period). 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 partner's death. These arrangements should be funded by insurance held by the various owners or by the company. There should be a provision providing for the company to buy additional insurance on each owner annually as the value of the company expands

6. Insurance. A major claim from an employee or from a creditor might bankrupt your business. Your business should be covered by appropriate insurance including a general liability policy and other types of insurance specific to your business. You should consider obtaining directors and officers insurance or a similar product covering the managers and officers of an LLC. If you have employees you must have unemployment compensation and worker's compensation coverage. If you are a professional (doctor, attorney, architect, accountant, engineer, etc.) you should obtain professional liability or malpractice insurance. It is also prudent to carry disability coverage (payable to the individual owner and/or the business) and business expense coverage (payable to the business). As noted above, some portions of the buy-sell agreement can be funded with life insurance covering the company's owners and/or principal officers.

7. Employment Procedures. Every business should develop procedures for interviewing, testing, and obtaining background checks on potential and actual employees. A business should also have a form of letter for engaging employees which makes clear that the employment is "at-will" and that they may be terminated at any time. This engagement letter should also provide an overview of the company's policies with respect to vacation, sick days, personal days, medical and other insurance coverage, and other benefits. The company should also develop rules covering employee use of company property including computers, e-mail, the company's website, printers, copiers, fax machines and phones and the right of the business to review or oversee each employee's use of this equipment and property. Depending upon the business this may include random testing for drug usage. Appropriate skills and attitudes tests for applicants and new hires may be obtained from various services. You must determine what forms you need each new hire to complete on or before their first day. It may be wise to get the advice of a labor and employment attorney or human resources professional on some of these issues. If your company has more than a few employees you should have an HR professional or labor and employment attorney prepare an employee handbook in which all of these policies are clearly set forth. This should then be given to all employees and to all new hires.

8. Conflict of Interest Policy. 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. If an employee or an owner has an idea which is not directly related to the company's existing business, there should be a procedure for them to present the idea to the board of directors or managers who

will be responsible for determining if the company will pursue developing the idea. If the board determines that the company will pursue the development of the idea, the employee or owner may not take the idea elsewhere. If the board determines that the company will not pursue the development of the idea, the employee or owner may work on the development of the idea independently on his or her own time and with partners outside of the company.

9. Whistleblower Policy. I highly recommend that companies adopt a Whistleblower Policy. The purpose of such a policy is to empower your employees to report any activity which might hurt the company to an appropriate person within the company. Such a policy should provide each employee a way to report an abusive supervisor to an appropriate and responsible party within the company (or in some cases to outside counsel). The policy should cover inappropriate financial transactions, sexual harassment, inappropriate use of company facilities or property, health and safety violations, criminal activity, etc. This policy must provide an alternative person to whom inappropriate activity should be reported if an employee needs to report his or her direct supervisor. Not only should this policy be adopted but it must be treated seriously.

10. Protecting Your Intellectual Property. If intellectual property is critical to your company's business, it is important to register it and protect it. There are four basic types of protection or registration: (i) patent, (ii) trademark, (iii) copyright and (iv) trade secrets. How you go about protecting your company's intellectual property will depend upon the nature of that intellectual property and your business.

Patents. If your business is dependent upon novel technology or processes, you need to find a good patent attorney who can help you determine if your technology is actually novel by reviewing any related patent filings. If patent counsel determines that your technology is novel, s/he can help you apply for and obtain one or more patents protecting your technology and/or processes.

There are three types of patents which may be obtained: (1) utility patents, (2) design patents, and (3) plant (or biological) patents. Utility patents generally cover the functioning of the technology. A design patent will be used to cover the 3-D design of a particular product or device, such as a particular design for a Coca Cola bottle. A plant patent may be provided for the details of a newly discovered species or biological component.

The process of obtaining patent registration for your technology is costly. You should interview several patent attorneys to find one who has significant expertise in the type of technology which your business utilizes. There are patent attorneys who have expertise in biotechnology, pharmaceuticals, software, electronic hardware, mechanical devices, as well as other areas or combinations of areas. Finding one who will really understand what is unique about your product/technology will be critical to the process.

Also, you might initially file/submit a provisional patent application rather than a full utility patent application. In a provisional patent application the claims and description of the technology are generally less detailed than in a full utility patent application. In order to move forward the process of obtaining a patent on the technology, the inventor(s) must file a full utility patent application with respect to the technology within 12 months after the filing of the provisional patent application. During such 12-month period the inventor(s) may be able to raise needed capital in order to help pay for the expense of the process for submitting and defending the full utility patent application.

Software: Patent Copyright or Trade Secret Protection. If your company is dependent upon computer software products which embody and effect a novel process, the process may be protected via patent registration. Otherwise software is generally protected using copyright registration, which only protects substantially the exact code which is registered. You don't need to file (and thereby reveal) ***all*** of the software code in order to obtain copyright registration; Your copyright registration application must include only the first 50 pages and the last 50 pages of the software code, and those pages may be redacted or marked to exclude critical confidential portions of the code.

Because of the nature of software, a good programmer may be able to write software with similar functionality using entirely different code. Consequently, if there is not a possibility of obtaining a patent for the process embodied in the software, the best protection for your software may be to treat it as a trade secret. Generally, the source code is never provided to the user, only the object code. You need to protect the source code for your product or device or service rigorously. Your customers should receive only the level of access which they need to use the software. Your license agreements for the use of your product should include obligations that forbid the customer from reverse engineering the code.

Trademarks. If a key part of your business is the name of a product or service, a logo, or a tagline attached to either a name or a logo, you should consider protecting their use through trademark registration with U.S. Patent and Trademark Office (http://www.uspto.gov/). Trademarks are registered in specific classes for each type of product or services. Generally this registration is not available until the name or tagline has been used commercially, though an application may be filed based on your intention to use the name, logo and/or tagline (or combination). That said, your rights will not be protected until there has been actual use of the name, logo and/or tagline (or combination) 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 it or they may use it themselves.

Copyright Protection. Your written materials and other creative content may be protected by copyright registration. Common law copyright arises whenever an author, artist, musician, filmmaker or other creative person creates a written work, an image, writes or records music,

or a video or film (as well as other forms of work). These inherent rights can be registered with the U.S. copyright office. This registration provides the copyright holder with better rights to use U.S. courts to enforce their copyright in their work and to stop an infringer from using copyrighted work. The U.S. copyright office's website (http://www.copyright.gov/) is 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.

If you are using images for your company's website (or in other marketing materials) make sure that you have either created the images you are using or purchased or licensed them from the creator or copyright holder. Owners of such images which discover unlicensed use of their images will demand payments for their unlicensed use which are many multiples of the normal licensing fees.

Trade Secrets. In additional to some software code, formulas and recipes for certain types of products are best protected as trade secrets. The most obvious example is the formula for Coca Cola® (While the formula is a trade secret, the name of the company/product is a registered trademark.). This approach should be used with recipes and formulas. It may also be used for certain business processes, customer lists and other critical business information. If this approach is used, the trade secret information should be closely protected and only shared with smallest number of key personnel with an absolute need to know the information in order for the business to operate.

11. Non-compete & Confidentiality Agreements. Non-Disclosure Agreements (NDAs) and Non-Compete Agreements are the next level of protection for your business' confidential intellectual property (after patent, trademark, and copyright registration). It is one of the ways in which you can help protect trade secrets. Potential investors, principals, employees, potential employees, consultants and strategic partners should all be asked to sign a confidentiality or non-disclosure agreement (NDA) covering non-public information concerning your business. The NDA should presume that everything which is disclosed is confidential and the recipient should be obligated to maintain its confidentiality. ***There should be no obligation for a disclosing party to mark or label information as confidential.*** If there is such an obligation, eventually the disclosing party will forget to mark something which is being disclosed. Principals and new hires should be interviewed to determine whether they are constrained by non-competition agreements entered into with prior employers or prior 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 if a principal or new hire is bound by a non-competition agreement with a prior employer or with prior business partners.

If a potential investor does not agree to sign an NDA (they rarely agree), 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 investor or of the investment company is the key to this decision.

12. **Clearly written agreements may help you avoid unnecessary litigation and controversy.** 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 not remember the details clearly or will remember them differently argues in favor of detailed definitive agreements for your transactions. If you have repetitive types of deals 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 for recording the mediation or arbitration decision, especially if the other party's offices are in another state.

The key components to agreements include the following: (1) defining the parties (name, type of entity, state of organization, main office address), (2) recitals of key facts or history, (3) define the products or services to be delivered, (4) define the term for the agreement, the time for delivery of the products or services and how the agreement may be terminated, (5) define the consideration for product(s) or service (how much will be paid) and when the consideration will be paid, (6) define the governing law, (7) provide dispute resolution procedures (mediation, arbitration or lawsuits) and how any judgments, arbitration or mediation decisions or awards may be recorded (in what court or courts), (8) provide warranties or representations and warranties or limits on warranties, and (9) general provisions, including assignability of various rights and obligations of each party, amendment of the agreement, procedures for providing notices to each party, exceptions from obligations for force majeure events, governing law, severability of invalid provisions (if any), indemnification (if any), counterpart execution, and signature blocks for each party.