

[biz mind your biz]

## 066. Entrepreneur's Survival Guide

### The forbidding road: legal issues facing the entrepreneur.

BY DANIEL M. MAHONEY

It has never been easy to be an entrepreneur. These days, however, the obstacles littering the road to riches seem overly forbidding. Pile on the significant legal issues that must be addressed by the entrepreneur and the path to prosperity can appear bleak. Here are a few tips to help you traverse the sometimes long and winding road of our legal system.

#### Leaving Your Current Employer

Many entrepreneurs have found their business ventures thwarted by a prior employer. Often, the unsuspecting entrepreneur will prepare for a new venture while still employed with another company, or they will leave a company to pursue a related venture. If an employee has signed an agreement with a prior employer that contains either a noncompete, nondisclosure, nonsolicitation, nonmoonlighting, or inventions assignment clause, trouble lurks.

Prior to launching a new company or developing a product that is intended for ownership solely by that company, entrepreneurs should carefully review any agreements they may have signed with a previous or current employer. Stealthy behavior is a recipe for disaster and only temporarily avoids inevitable consequences. The best policy is for the entrepreneur to be forthright with an employer about plans for a new venture. This will set in motion a positive dialogue for an amicable resolution.

#### Forming the Business

Once the entrepreneur assesses the viability of the new business model and decides to proceed, selection of a business entity appropriate for operations is the next step. A range of tax, accounting, structural, corporate governance, and certain personal considerations will drive this selection process.

While an entrepreneur is free to operate as a sole proprietorship or general partnership, the entrepreneur will be personally liable for the debts of the business. Fortunately, there are alternative structures—C-corporation, S-corporation, limited partnership, and limited liability company (LLC)—that offer enhanced liability protection. Additionally, these structures offer a range of attributes that are beneficial or detrimental to the entrepreneur depending upon their specific set of circumstances.

Tax treatment is a significant consideration for many entrepreneurs. The LLC, S-corporation, and limited partnership are “pass-through” entities. That is, the profits and losses generated by the operations pass directly through to the entrepreneur, being subject to taxation only at this level. In contrast, the C-corporation is subject to double taxation in that the profits are taxed first at the corporate level and then again once they are distributed to the entrepreneur.

In addition to its favorable tax attributes, the LLC provides the most flexibility with respect to allocation of profits and losses, capitalization and corporate governance. Accordingly, the LLC has been gaining popularity as the entity of choice. In fact, an entrepreneur may wonder why the alternative structures should be considered.

If the business will be grown “organically” through profits or acquisitions, the LLC is the preferable structure. If, on the other hand, the entrepreneur expects to seek venture capital as a means of financing growth through development, hiring of engineers or significant marketing, the LLC poses significant hurdles and the traditional C-corporation remains the entity of choice.

Regardless of the business structure chosen, the entrepreneur is forewarned to respect corporate formalities by maintaining corporate records and minutes, holding an annual stockholders meeting, and taking care not to mix personal and corporate property. The absence of

these measures could lead to a “piercing of the corporate veil,” depriving the entrepreneur of protection against liability.



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## Raising Money

To grow operations, many entrepreneurs find that they must seek venture capital. This typically involves the sale of company stock. There are only two ways to offer company stock for sale without violating the securities laws—register the transaction with the Securities and Exchange Commission or seek an exemption.

For a startup with limited funds, the enormous cost and time involved with registration makes that option impractical if not impossible. The most popular exemption available to the entrepreneur is a “Reg D offering,” referring to Regulation D (Rules 501-508) of the Securities Act of 1933. To comply with Regulation D, the entrepreneur should limit sales of stock to “accredited” investors where the sale proceeds exceed \$1 million. An accredited investor is an officer or director of the start-up, and/or a person with a net worth of \$1 million, and/or a person who makes at least \$200,000

per year individually or \$300,000 with a spouse. The securities laws require the company to provide detailed disclosure information, including audited financials, to anyone who is not an accredited investor.

## FORMING THE BUSINESS

Pick the right one for your biz.

**C-corporation:** subject to double taxation, the one to choose if you plan on seeking VC money

**S-corporation:** profits and losses generated by operations pass directly through to the entrepreneur


**Limited Partnership:** tax-friendly, profits and losses go directly to the entrepreneur, only taxed once

**Limited Liability Company (LLC):** provides the most flexibility with respect to allocation of profits and losses and capitalization

## Protecting Proprietary Assets

The value of many companies is contained in proprietary customer lists, technology and ideas. To preserve this value, an entrepreneur is well advised to properly protect all intellectual property. This will involve a multifaceted approach using a trade secret policy and a combination of trademark, copyright and patent protection.

A trade secret protection program is easy and relatively inexpensive to implement. First, the availability of the proprietary property must be limited. Second, the entrepreneur must employ reasonable efforts to maintain its secrecy. This second step will require adopting a formal policy, educating the workforce, and using nondisclosure agreements when trade secrets are disclosed. An attorney can assist in establishing and implementing a trade secret protection program but it is ultimately the entrepreneur's responsibility to maintain its integrity.

Bringing an idea to market can be a monumental task, intensified by the appearance of unforeseen problems. However, the entrepreneur who approaches these challenges armed with the knowledge of what lies ahead has the ability to defeat disaster and significantly improve their chances of success. 

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