

Welcome To Startups!

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- Start Part I



About Joe Barich

- University of Illinois ECE grad 94 BS, 96 MS
 - Took Engineering Law as an undergrad
- About 20 years as a Patent Attorney
 - 15 Years at large, IP-specialty firm
 - Founded Barich IP Law Group
 - *Illinois Rising Star* on the *Super Lawyers* list
 - Patent Buddy® List of Top Patent Prosecutors (top 2%)
- Adjunct Professor, U of I College of Law
 - Teach Patent Prosecution, founded IP Clinic
- Visiting Lecturer in College of Engineering
 - Teach Engineering Law, Startups
- Notre Dame Executive MBA, Guest Lecturer on IP
- U. of Wisconsin, Masters of Engineering Management
 Teach Engineering Law

Class Mechanics

- Syllabus
- 14 class meetings
 - 5 min "half time" around halfway through
- Office Hours
 - After class or by phone
 - Answers may be shared with the class
- Recommended reading
 - Coursepack available at IUB
 - Materials at <u>www.joebarich.com</u>



Other Class Matters

- Taking notes by hand is recommended
 - Many studies confirm taking written notes results in higher grades
 - The Coursepack has been specifically designed to allow you to take notes by hand
- Electronic Device Usage Policy
 - No Audio, Photographic, or Video Recording allowed
 - Don't distract others by texting, IM-ing or taking a call go in the hall if needed
 - Don't browse distracting sites



- Three Exams, 5 Quizzes and Group Projects Grade
- Three Exams Each Exam is 20% of grade
 - 60 questions T/F and multi-choice
- Five quizzes Total quiz score is 20% of grade
 - 20 questions T/F and multi-choice
- Group Projects Grade Total score is 20% of grade
- All Quiz and Exam questions reviewed in class
 - Objective is LEARNING, not just grading
 - Discuss/identify imperfect questions and give credit
 - Check grades on COMPASS



More about quizzes

- Quizzes are not announced (attendance motivator)
- Take top 4/5 quizzes, 5th is extra credit -max 100%
- Example 1 Took 4/5 Quizzes and got 85% on all. Pts from
 4 Quizzes = 340/400. You get 85% for your quiz score.
- Example 2 Took 5/5 Quizzes, got 85% on each one. Pts. from 4 Quizzes = 340/400. Add in 85 points from 5th quiz, so total quiz points would become 425/400, but cap at 400/400 for total quiz score of 100%
- Example 3 Took 5/5 Quizzes, got 60% on each one. Pts. from 4 Quizzes = 240/400. Add in 60 points from 5th quiz, so total quiz points become 300/400 = 75%.



- Group Project Grade 20% of total course grade
 - Students will be divided into teams to form a hypothetical startup and will then be presented with real world scenarios to resolve
 - Teams will then give a 10-15 min presentation on their solution (Powerpoint preferred) at an evening meeting
 - Three Group Projects 4% of grade each
 - Incorporation and Funding Project
 - Contracts Project
 - Intellectual Property Project
 - Team is graded as a whole
 - Peer Evaluation 8% of grade



• Individual assessment of a team member's contributions

- Exam Timing Finish a section's material, then have Exam the next Thursday evening or in class
- Project presentations are previous Thursday
 - Project 1 Sept 20, 7 pm Room TBA
 - Exam 1 Sept 27, 7 pm Room TBA
 - Project 2 Oct 25, 7 pm Room TBA
 - Exam 2 Nov 1, 7 pm Room TBA
 - Project 3 Nov 29, 7 pm Room TBA
 - Exam 3 In class, Dec 6



- Combined Exam, Quiz, and Project score
 - -100-95 = A
 - -95-90 = A-
 - -90-85 = B+
 - -85-80 = B
 - -80-75 = B-
 - -75-70 = C+
 - -70-65 = C
 - -65-60 = C-
 - Less than 60 = D
 - Less than 50 = F



Overview - 1

- Goals of the Class
 - How to use legal tools to construct and run your startup
 - Greater understanding of your legal options
 - Highlight legal pitfalls in practice
 - Practical emphasis
- This class does not make you a lawyer
- This class does not represent legal advice about any real-world situation
- No attorney-client relationship



Overview - 2

- Three Main Sections
 - Basics and Forming a Business
 - Contracts
 - Intellectual Property
- Exam and project for each section



Law/Business Interfaces

- Legal aspects appear in all facets of your business
- What can you do with legal tools?
- Create things
 - Create Company
 - Create IP rights
- Make your agreements enforceable
 - Contracts
- Safeguard corporate assets
 - Preserve ownership of stock and trade secrets
 - Preserve money
- Legal tools provide control and oversight



Law and the Entrepreneur

- Practically, as a startup, your company will always be short on money
 - Difference between what you may be legally entitled to and what your startup can afford
 - Trying to get the maximum return for your \$
 - Trying to give away as little equity as possible
 - Trying to avoid legal entanglements
 - Everything that comes in is reinvested to increase the growth curve
- Law can help you grow
 - Exclusive right to make and sell product with patent
- Or, it can be destructive
 - Get involved in a patent lawsuit, it may bankrupt your company
- Cash flow is often key for startups. Use legal tools to protect your cashflow

Helping Engineers Approach Law

- Issue: Law in general seems uncertain/erratic/ unpredictable/unscientific to an engineer
 - Visualize outcomes as a probability curve rather than a yes/no answer
 - Think of it as an analog system rather than a binary digital system – when is an analog bit 1 or o?
 - Many legal "Rules" are outcome probability influencers, not absolutes
 - Interestingly, presenting something as an absolute to an evaluator may increase its influence on the evaluator
 - Legal "machine" is very complex with many situationally dependent inputs and biases
 - Continually adapting/evolving "operating system"
 that is "updated" with new laws and case decisions

So You Want to Start A Business

- Philosophical Concept vs. Legal Existence
 - Legal concepts/entity created by state legislature and each state sets its own rules
- Three main types
 - Sole Proprietorship
 - Partnerships
 - Corporations
- Primary concerns
 - Separation of personal and corporate assets
 - Limitation of liability



Ease of investment and utility

Sole Proprietorship - 1

- Only one "proprietor" just an individual owner
 - Partnership has two or more "proprietors"
- Owner has liability for all debts of "company"
 - Unlimited liability
- Owner directly owns all assets of company
 - Can't give someone shares of the company in exchange for money
- The default entity if you start engaging in business activities without establishing another legal entity



Sole Proprietorship - 2

- Simplest and cheapest form to establish
 - No corporate formalities
 - No separate tax return for the business
- No double taxation
 - Some corporations may have to pay taxes on earnings before distributing them to shareholders and the shareholders typically have to pay taxes on dividends received
- Bottom line Startups usually move away from sole proprietorship quickly due to the potential for unlimited liability and inability to accept investment



Partnerships

- Historically the first form of business entity other than sole proprietorship
 - Defined by state law and states differ
 - However Uniform Partnership Act (UPA) adopted by many states – or Revised UPA
- Several main types of Partnership
 - General partnership
 - Limited Partnership (discussed later)
 - Limited Liability Partnership (discussed later)



General Partnership -1

- Similar to sole proprietorship, but with two proprietors
- The Partnership Agreement is key
 - If the partnership agreement is silent with regard to a certain aspect, the default partnership rules adopted by the state (typically UPA) are applied
 - CAUTION: If you are working with anyone and you have not incorporated, you may be considered to be in a partnership – and you probably don't want to be.



General Partnership -2

- Partnership default terms
 - All partners have unlimited liability for debts and judgments
 - Unlimited liability is highly undesirable
 - Profits shared equally (by number)
 - May not be desirable
 - Each partner is an agent of the partnership, so each partner can bind all others on behalf of the partnership
 - May not be desirable for all partners to have this authority
 - Partnership terminates on the death or withdrawal of any of the partners



• Inconvenient if anyone leaves

General Partnership -3

- All partners have an equal right to participate in management and control
 - Disagreements decided by majority of partners
- New partners can only be brought in with the consent of all partners



General Partnership Drawbacks

- Still have unlimited liability
- Difficult to take on new partners
- Control issues with all partners being able to bind partnership
- Increased cost and complexity
 - Partnership Agreement
 - Typically separate tax return
- Question: who owns/controls IP developed for the partnership



Partnership By Default

- You probably don't want to be a general partnership
- But! Many startups fall into a general partnership structure without even knowing it
- UPA SECTION 202. FORMATION OF PARTNERSHIP.
 - "...[T]he association of two or more persons to carry on as coowners a business for profit forms a partnership, whether or not the persons intend to form a partnership."
- "A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:
 - of a debt by installments or otherwise;
 - for services as an independent contractor or of wages or other compensation to an employee;
 - of rent (or several other typically non-applicable things)

Situational Hypotheticals

- You have the idea for an awesome internet service and ask your two classmates to help you work on it. You are vague with regard to the structure of your arrangement, but there are e-mails wherein you mention that "we can all three make a lot of money" on the internet service.
- You work together to create an application and get it online and running.
- Situation 1 Your classmates appear one day and mention that they are tired of working on the service and have sold it to EvilCorp for \$10,000 (an extremely low price) here's your \$3,333.
- Situation 2 Classmate #2 is a programming specialist and after the work is done, he asserts that he owns the entire internet service.
- Situation 3 Classmate #3 files a patent application with regard to the internet service and does not list you or Classmate #2 as inventors.



Clarifying a Partnership

- Many times student entrepreneurs mistakenly feel that being vague about their arrangement is somehow to their benefit
 - Typically not often leads to expensive complications
 - Recurring principles this semester are clarity and documentation
- How can you clarify the relationship?
 - Awareness of partnership default condition
 - Classmates could be clarified as independent contractors
 - Clarify parameters of partnership agreement Examples
 - All IP is property of partnership
 - All decisions must be unanimous agreement of partners
 - Only you can bind partnership/make deals
 - Percentage ownership/profit of partners



Corporation - 1

- Historically, general partnerships provided a vehicle for investors to work together, but had several undesirable aspects (most especially unlimited liability)
- Reaction Petition legislature to create a new type of business entity that limits liability to the capital contributed to the entity rather than the personal assets of the shareholders
 - Stimulates investment because investors get limited liability
 - Corporation is a true separate legal entity/"person"
 - Corporation acts through its agents such as CEO and officers
 - Articles of Incorporation and Bylaws replace Partnership Agreement



Corporation - 2

- Owners are not necessarily operators
 - Owners are "shareholders"
 - Operators are corporate officers
- Shareholders elect a board of directors
- Board of directors appoints corporate officers
 - May only appoint C-level in some cases
- Legislative creation of states and subject to that specific state's provisions
 - State provisions may benefit one of the three typical key interests: Shareholders, Management, Employees
 - Illinois corporation is different from a Delaware corporation
 - Delaware law is the most friendly to Management
 - About half the Fortune 500 are Delaware corporations



Corporation - 3

- Articles of Incorporation are typically standardized by state
- Bylaws are the specific operating rules for the company
 - Amazing flexibility with regard to internal structure of corporation
 - Number of directors, percentage ownership needed for certain actions, different classes of stock, etc.
 - However, for startups, stick with simple, standard rules
 - The articles and bylaws for corporation are usually prepared by an attorney



Types of corporations

- Three types of corporations
 - C-corp
 - S-corp
 - Limited Liability Company (LLC)



C-corp

- "Regular" corporation is C-corp
 - Name comes from IRS taxation section
 - No limitation on number of shareholders, foreign or domestic
 - All distributions are taxed as dividends
 - Can issue stock
 - Can issue stock options
 - Required if corporation is to be publically traded
 - Extensive record-keeping requirements and corporate formalities must be observed
 - Double taxation Taxation of corporate profits and then tax dividends when distributed
 - A C-corp is likely your destiny if your startup makes it to the big time



"Closely-held" company

- Not all c-corps are publically traded
- A "closely held" company does not offer its shares to the public
 - Could be any type of company, just not offering shares to public
 - Also called "privately-held company"
- There are several large corporations that are closely held
 - Cargill (110B)
 - Koch Industries (98B)
 - Mars, Inc. (27B)
 - HCA (Hospital Corporation of America) (27B)
 - Ernst & Young (25B)



S-Corp

- More recent form of corporation
 - "I really like the liability limitation of a c-corp, but I don't like the double taxation – I want to have flow-through tax treatment like a partnership!"
 - "OK, but we are going to limit your shareholders to a maximum of 100 US residents."
 - S-corp name comes from IRS taxation section
 - Maximum 100 US resident shareholders people/trusts only
 - No taxation at corporate level
 - No stock options, can't be publically traded
 - Still have record-keeping requirements and corporate formalities must be observed
 - OK for a time (cheaper, simpler), but a C-corp is likely your
 destiny if your startup makes it to the big time

Pro/Cons of an S-Corp

- Pros
 - Pass-through treatment of losses allows investors to deduct them
 - Still have most other advantages of a c-corp
- Cons
 - Limitations on investors
 - Note: Most VCs are corporations, which can't invest in S-corps
- Note can convert from c-corp to s-corp and vice versa, but may incur tax liability and accounting expense
- Bottom Line typically only suitable in a pre-investment startup phase



Limited Liability Company (LLC)

- Relatively recent legislative creation most states passed laws allowing the creation of LLCs by 1996
- "I like the flow-though tax treatment of the S-corp, but I want to let non-US residents and corporations invest and more than 100. I also don't like having to comply with corporate formalities."
- "OK, we will let anyone invest and minimize the corporate formalities, but still only C-corps can offer shares to the public or offer stock options."
- Corporate formalities often become just filing a one-page form each year and paying the fee
- Increased flexibility with regard to investment as compared to scorps, and cheaper that s- or c-corps due to reduced corporate formalities
 - Can convert from LLC to c-corp and vice versa, but may incur
 tax liability and accounting expense

What's Not to Like?

- So what's not to like about LLCs?
- Sometimes corporate formalities are desired by investors
 - Often better transparency, accountability, and investor participation with c-corps
- Want to be able to offer stock options
- Investors want company to be able to go public, but an LLC can't do that
- More established legal track record for c-corps than LLCs, which are treated as partnerships rather than corporations in some contexts



To LLC or not to LLC?

- There have been large LLCs:
 - AOL when owned by Time Warner from 2001 to 2008
 - BMW's U.S. subsidiary, BMW of North America, LLC
 - Chrysler the auto industry bailout, with a majority stake held by Fiat S.p.A.
- If you are looking for a cheap, uncomplicated step up from an unintentional partnership, LLCs can be helpful
- However, as you grow, you will likely be transitioning to a c-corp
- If you are growing quickly or want to be able to offer stock options, then you can start out as a c-corp



Comparison

	C-Corp	S-Corp	LLC
Limited Liability	Yes	Yes	Yes
Double Taxation	Yes	No	No
Max Number of Shareholders	None	100	None
Non-US resident ownership	Yes	No	Yes
Ownership by businesses	Yes	No	Yes
Publically traded	Yes	No	No
Stock Options	Yes	No	No
Corporate Formalities	Yes	Yes	Minimal



Limited Partnership - 1

- Go back in time to when your choices were only between General Partnership and c-corp
 - "Unlimited liability for partners doesn't work for me, but I like the simplicity and lesser expense of a partnership"
 - "OK, divide partners into "limited partners" and "general partner" – only general partner has unlimited liability, and it can be a corporation"
- It was reasoned that the essence of a partnership as opposed to a corporation was that someone had to have unlimited liability but states were OK with that liability being encapsulated in a separate (typically small) corporation



Limited Partnership – 2

- LPs have limited liability no management authority (as LPs, but could also be officers of the GP) and only liable on debts incurred by the partnership to the extent of their registered investment
- The GP pays the LPs a return on their registered investment (similar to a corporate dividend), as set forth in the partnership agreement
- GP remains liable, but may be a corporation
- Lesser corporate formalities
- LPs typically can't bind the partnership
- Some investment groups operate as LPs, but with the advent of LLCs, the LP is a very rare choice for an entity
 - Bottom line For your startup, an LLC would likely
 be a better choice than an LP

Limited Liability Partnership

- Similar to LPs, but no GP and all LPs have limited liability
 - Vary widely from state to state
 - Use may be limited in some states to professionals (such as lawyers and accountants)
 - In some states, negligence claims are limited, but not debts or contract liability
 - Typically not a good entity choice for your startup



Other Entities

- States can legislatively create any form of business entity that they want
 - Broad latitude in making rules for entity
 - The newer or more arcane the entity, the more likely the rules will vary from state to state
- Limited Liability Limited Partnership (LLLP)
 - Offered by 10 states
- Note You probably want to keep it as simple as possible with regard to your startup so as to not scare off potential investors



Maintaining Limited Liability -1

- You went out of your way to establish a c-corp or LLC to limit your liability, so be sure to maintain your liability limitation
- "Piercing the corporate veil"
 - One of the most litigated issues
 - If something has gone wrong with the company, investors are going to do whatever they can to come after your personal assets
 - Standard for veil piercing differs from state to state



Maintaining Limited Liability -2

- Factors for courts to consider are you cheating?
 - Absence or inaccuracy of corporate records
 - Concealment or misrepresentation of members
 - Failure to maintain arm's length relationships with related entities
 - Failure to observe corporate formalities in terms of behavior and documentation
 - Failure to pay dividends
 - Intermingling of assets of the corporation and of the shareholder
 - Manipulation of assets or liabilities to concentrate the assets or liabilities
 - Non-functioning corporate officers and/or directors
 - Significant undercapitalization of the business entity (capitalization requirements vary based on industry, location, and specific company circumstances)
 - Siphoning of corporate funds by the dominant shareholder
 - Treatment by an individual of the assets of corporation as his/her own

Was the corporation being used as a "façade" for dominant shareholder personal dealings - alter ego theory

Maintaining Limited Liability -3

- Don't comingle entity funds with personal funds
- Observe corporate formalities
- Be honest
- Generally treat your corporation like a separate corporation, not your personal pocketbook
- Don't try to hide or manipulate assets
- LLCs have lesser requirements for formalities, so it is less likely that formalities would fail to be followed, but other areas are vulnerable



Summary

- Avoid the unlimited liability of a sole proprietorship or general partnership
 - Be carful not to accidentally fall into a GP
- Look to a C-corp or an LLC
 - Lean toward LLC to preserve cash/keep it simple and early in development
 - Lean toward C-corp if you are aggressive or want to offer stock options



Next Time

- The practicalities of forming your corporation
 - Choosing a corporate name
 - How a state corporation registry works
 - Bylaws and Operating Agreement Examples

