

Wharton Entrepreneurial Programs Business Plan Competition

Fundamental Legal Matters for the Entrepreneur

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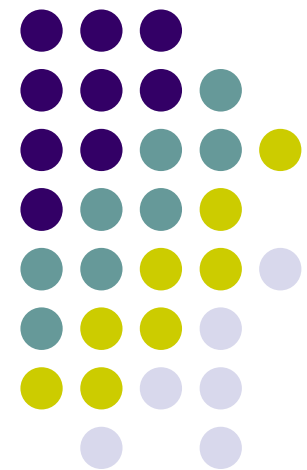
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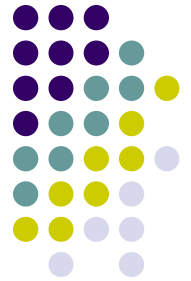
Entrepreneurship Legal Clinic

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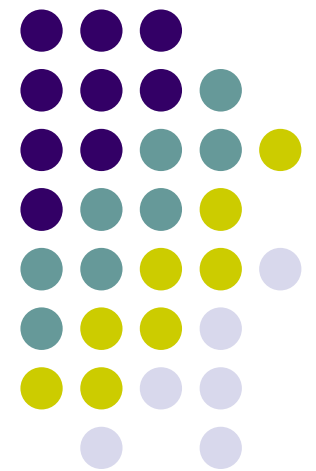


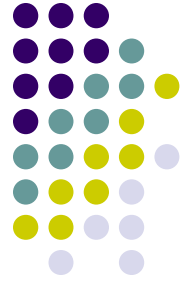
Fundamental Legal Matters for the Entrepreneur



- I. Choice of Entity
- II. Intellectual Property Issues
- III. Questions & Answers

Choice of Entity

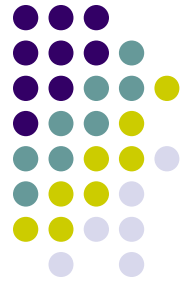




Introduction to Choice of Entity

- Prospective planning is of paramount importance. It is much easier to solve problems before they occur.
- Identify potential problems in two scenarios:
 - Successful business
 - Struggling business

Preliminary Considerations in Forming a Business

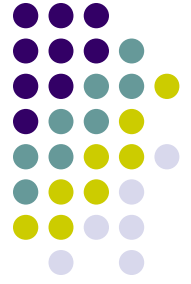


- Short term and long term goals
- Business plan for operating and growth
- Contribution of principals
 - Capital and/or labor
- Division of responsibilities/profits
- Risks and liabilities



What is an “entity”?

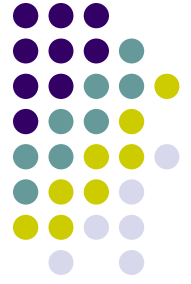
- Legal form that creates a business unit that is separate from its owners and from other firms
- Allows the entity to conduct business in its own name, e.g. contract with others, hold property, sue or be sued
- Usually created through affirmative legal action, e.g. filing certificate of incorporation
- Generally governed by state law



What are the benefits of an entity?

- Limit personal liability for debts or losses of business
- Decrease tax liability
- Increase attractiveness to potential investors
- Transferability of interests
- Build reputation

Limited Liability

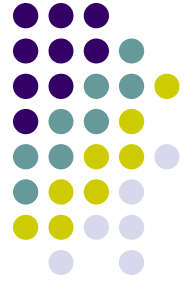


- Without an entity (e.g. sole-proprietorship) or with an unlimited liability entity (e.g. general partnership) the principal is liable for the full amount of any judgment against or debt of the firm, even if this exceeds the principal's capital contribution to the firm
- With a limited liability entity, the principal's liability is limited to his investment in the firm



Limited Liability--Example

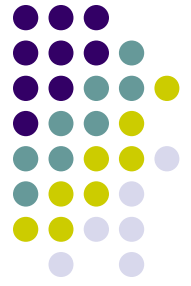
- Principal contributes \$100 to Firm
- Judgment of \$200 against Firm
- With unlimited liability, Principal is personally liable for the full \$200
- With limited liability, Principal's liability cannot exceed his investment in Firm, \$100



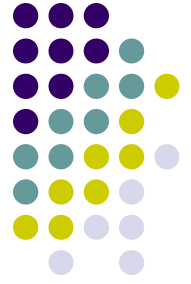
Unlimited Liability

- General partnerships and sole proprietorships have unlimited liability
- Moreover, liability between partners is joint and several, meaning that each partner is liable for the full amount of the debt, even if it exceeds his investment, and even if the other partners pay nothing

General Partnership Liability-- Example



- A, B, and C each contribute \$100 to Partnership (\$300 total in Partnership)
- Judgment against Partnership for \$500
- Judgment Creditor can collect full \$500 from ANY single partner (joint and several liability)
- If Judgment Creditor collects \$500 from A, A must then sue B and C for contribution
- NOTE: General Partnerships can be formed by any joint venture in business, whether or not parties intend to be a general partnership!

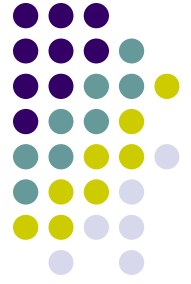


Taxation Issues

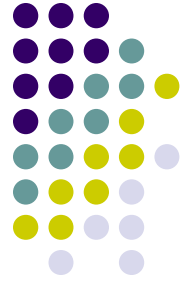
- “Double Taxation”
 - Profits taxed twice: corporate and individual
 - Profits taxed at corporate level as they accrue to corporation
 - Profits taxed again on individual level when distributed to shareholders
- “Flow Through (Pass through) Taxation”
 - Single level taxation: profits taxed only at individual level
 - Profits “flow through” the entity without taxation
 - Profits taxed on individual level when distributed to investors

Issues to Consider

- Liability
 - Limited vs. Unlimited
- Tax advantages
 - Double-taxation vs. Flow-through
- Control issues
 - How will ownership/control be decided if multiple principals?
- Cost and upkeep of entity form
 - Filing fees, bookkeeping, tax returns, etc.
- Exit/Transferability of interests
 - Exit strategy, equity compensation, etc.
- Financing Options
 - Venture capital or other institutional funding
- Ability to go “up the ladder” in entity form



Common Business Entity Forms



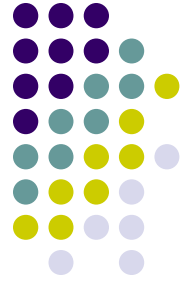
- Sole Proprietorship
- General Partnership
- Limited Partnership
- Limited Liability Company
- C Corporation
- S Corporation

*Entity types are a matter of state law.



Sole Proprietorship

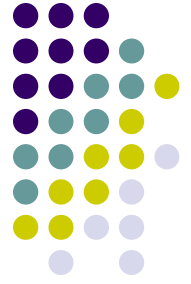
- Description: the one-man-show business
- Formation and Maintenance: fictitious name filing, employer identification number, insurance, local licenses
- Liability: unlimited
- Taxation: single level
- Financing: personal contributions and loans
- Exit/Transferability: sale of assets



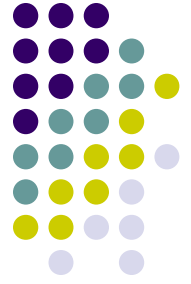
Sole Proprietorship

- Good For
 - Individual owners who want control and do not want to spend a lot of time setting up and maintaining the entity.
- Not Good For
 - Businesses with multiple owners; or where liability, financing options, or continuity of the business are concerns.

General Partnership

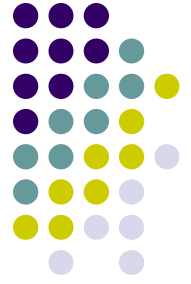


- Description: All partners share responsibilities and benefits of ownership.
- Formation and Maintenance: same as Sole Proprietorship; a general partnership is formed by actions, but should have a Partnership Agreement; most people do not intend to form one
- Liability: unlimited, joint and several
- Taxation: single level, partnership allocates profits and losses among the partners
- Financing: partner contributions and outside debt
- Exit/Transferability: need consent of all partners to transfer partnership interests (unless Partnership Agreement states otherwise)



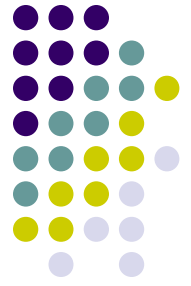
General Partnership

- Good For
 - A group of like-minded owners who want an entity that is easy to set up and maintain.
- Not Good For
 - Businesses where sharing control, liability, or continuity are concerns.



Limited Partnership

- Description: One or more general partners manage the business; limited partners have limited decision-making power.
- Formation and Maintenance: Need at least one general partner; Certificate of Limited Partnership; Partnership Agreement recommended; Sole Proprietorship requirements
- Liability: unlimited, joint and several for general partners; limited for limited partners
- Taxation: single level, partnership allocates profits and losses among the partners
- Financing: partner contributions and outside debt
- Exit/Transferability: transferability provided for in Partnership Agreement



Limited Partnership

- Good For
 - Partnerships where some partners want to be passive investors.
- Not Good For
 - Businesses where the investors want to have some management control or to have easy transferability of their interest in the business.



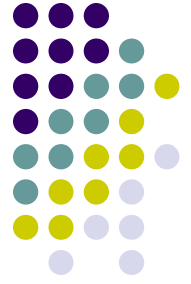
Limited Liability Company

- Description: Flexible entity form for a variety of ownership structures.
- Formation and Maintenance: file Certificate of Organization; create Operating Agreement.
- Liability: limited
- Taxation: single level, option to “check the box”
- Financing: flexible, potentially less attractive to some venture capital funds
- Exit/Transferability: flexible; transferability can be provided for in Operating Agreement

Limited Liability Company

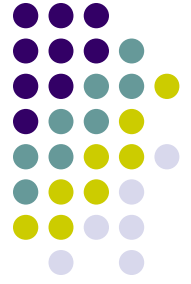


- Good For
 - Businesses that want the limited liability and ease of transferability of a corporation, but the tax treatment of a partnership.
- Not Good For
 - Businesses seeking funding from sources that want to avoid pass through taxation or larger organizations.



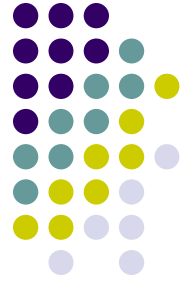
C Corporation

- Description: Centrally managed business owned by shareholders.
- Formation and Maintenance: file Articles of Incorporation; form Board of Directors; adopt Bylaws; hold regular board meeting and adhere to corporate formalities.
- Liability: limited
- Taxation: double taxation
- Financing: flexible and numerous options
- Exit/Transferability: flexible and numerous options; transfer of shares governed by state and federal law



C Corporation

- Good For
 - Businesses that want the most financing and exit options.
- Not Good For
 - Businesses that do not want to spend time on corporate formalities or that want to avoid double taxation.



S Corporation

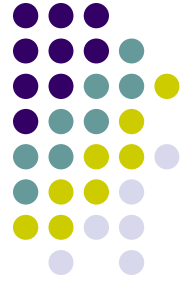
- Description: Corporation with pass through taxation.
- Formation and Maintenance: same as C Corp., and must also adhere to IRS restrictions on shareholders.
- Liability: limited
- Taxation: single level; profits and losses must be allocated according to ownership
- Financing: limited by shareholder restrictions
- Exit/Transferability: limited by shareholder restrictions



S Corporation

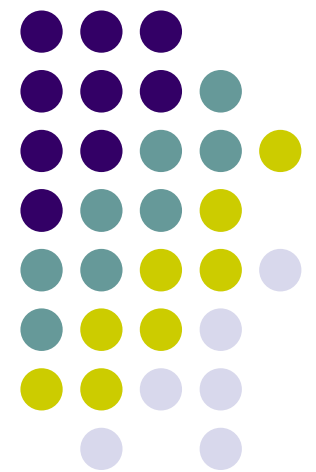
- Good For
 - Smaller businesses that want pass through taxation.
- Not Good For
 - Businesses that want to raise capital widely or that do not want to spend time on corporate formalities.

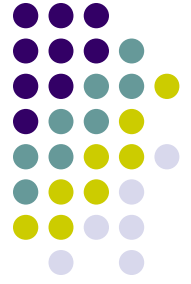
Choice of Entity Internet Resources



- The following resources may be helpful in analyzing choice of entity matters:
 - www.paopen4business.state.pa.us
 - www.phila.gov/business/index.html
 - www.irs.gov/businesses/small/index.html
- Ultimately, applicable law and charter documents govern each entity.

Intellectual Property (IP)





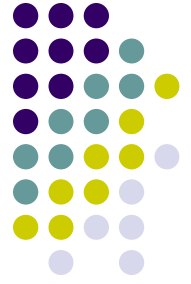
Introduction to IP

- IP encompasses creations of the mind
 - Inventions
 - Software
 - Formulas
 - Business processes
 - Words and symbols that identify goods and services
- Owning IP means having exclusive, enforceable rights to the intellectual creation
 - The rights can be licensed and sold

IP in Your Business



- Identify IP
 - Trademark
 - Copyright
 - Trade Secret
 - Patent
- Formulate ways to protect IP
- Enforce IP protections
 - Within the business – educate and monitor employees
 - In the market – take affirmative steps, such as sending cease and desist letters and branding



What is a Trademark?

- A *trademark* identifies and distinguishes one company's products from those made or sold by others.
- Many things qualify as a trademark.



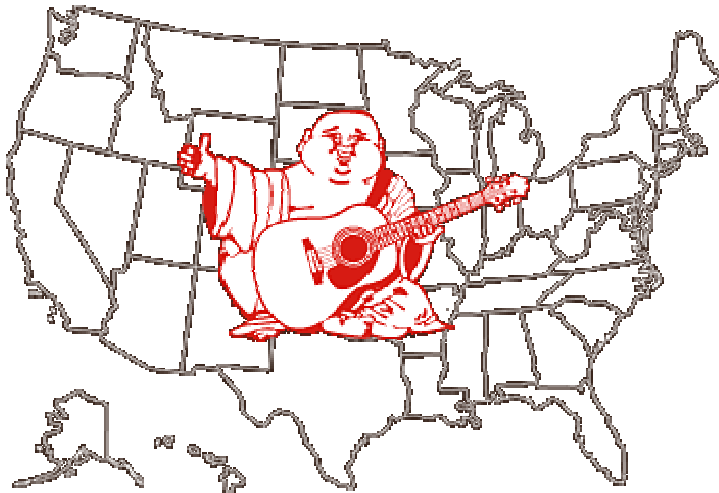
What is a Trademark?



Nike “swoosh,”



AT&T “globe,”

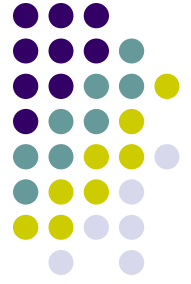


True Religion “buddha”



What is a Trademark?

- Broad interpretation of trademark is made by courts
- Owens Corning was granted a trademark on the color pink. Similarly, the cartoon character of the Pink Panther is used by Owens Corning as the mascot of its insulation division.



Trademark Protection

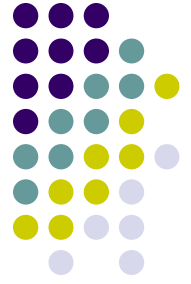
- Although simply using the mark can establish rights to a trademark in the United States under common law, registration with United States Patent and Trademark Office (USPTO) offers crucial benefits.
- Trademark registration lasts for 10 years, but can be renewed indefinitely.
- Must police use! Note that “escalator,” “yo-yo,” “aspirin,” and “cornflakes” were all once trademarks.

Trademark Establishment

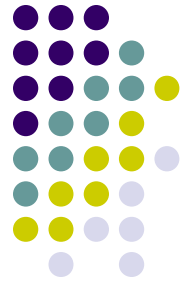


- In order to establish a trademark, the mark must be distinctive and uniquely serve to identify source of product or service.
- Next, perform a trademark search to ensure that no one has already established rights to this or a confusingly similar mark.
- You can search for registered marks via USPTO.gov.
- You can search Google/internet generally for marks too.

Trademark Infringement



- Trademark infringement is proved if, among other things, a likelihood that the allegedly infringing mark could create confusion in the minds of consumers.
- Protect your mark from *dilution*. Tarnishment of your reputation and blurring, decreased distinctiveness, will dilute the value of your mark.



Trademark Infringement

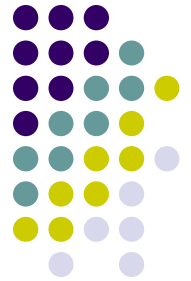
- The Anticybersquatting Consumer Protection Act of 1999 makes it illegal to register or use a domain name with bad-faith intent to profit.
- If a proposed domain name is identical or confusingly similar to a distinctive mark or dilutive of a famous mark, seek advice prior to registration.
- Ex. Virtual Works, Inc. registers domain name vw.net in 1996.



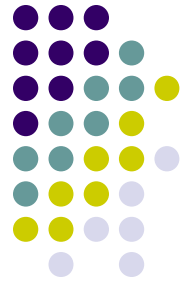
What is a Copyright?

- Copyright gives the owner of an original work of authorship the exclusive right to obtain certain economic benefits from the work.
- Exclusive Rights to:
 1. Reproduction
 2. Derivation
 3. Distribution
 4. Public Performance
 5. Public Display

What is a Copyright?



- As technology progresses, Copyright Law has morphed from protecting published art, music and literature, to also protecting computer software and digital distribution.



Copyright Protection

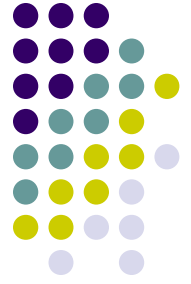
- Critical to those companies operating in Internet, Software, Publishing, Journalism, Entertainment and Music.
- Crucial for Artists, Writers, Musicians, Photographers and Architects.
- Essential for companies distributing devices that are capable of infringing use by others.
- Necessary for all companies operating a website.



Copyright Protection

- Along with providing many forms of creative work with protection, copyrights can also be used to protect work based on another work.
- *Derivative work*, work based on another work, such as adaptations, modifications, and translations may also be protected.
- Although facts are not copyrightable, databases that employ *originality* and *creativity* in presenting the information are protected.
- Similarly, copyright cannot be used to protect an idea or function performance.

Copyright Protection Exceptions



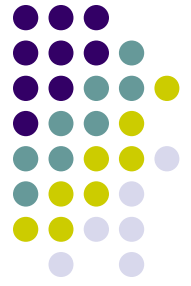
- The doctrine of *fair use* permits others to make limited use of copyrighted materials for certain purposes.
- Criticism, comment, news, scholarship and research can be defined as fair use if the following four factors are deemed consistent with facts to be transformative and value adding:
 1. Purpose and Character
 2. Nature of work
 3. Amount & Substantiality
 4. Effect on market and value
- Subjective Examples include SCOTUS decision that 2 Live Crew parody of “Pretty Woman” was fair use while *Wind Done Gone* was not fair use of *Gone with the Wind*.

Copyright Establishment



- To be eligible for copyright, the following three basic requirements of the work must be met:
 1. Fixed in a tangible medium (e.g., written or recorded)
 2. Original (i.e., created by author)
 3. Creative (i.e., minimally unique)

Copyright Infringement

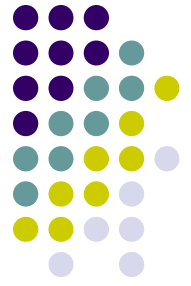


- Although no action is required to obtain copyright protection, as it arises from original authorship fixed in tangible medium, it is advisable to reinforce protection by displaying notice (e.g., ©)
- To pursue infringement, register with the Copyright Office and sue for either actual or statutory damages.
- Actual damages: sky is the limit
- Statutory damages up to \$30k (ordinary) or \$150k (willful).



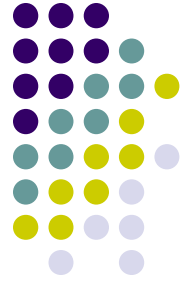
What is a Trade Secret?

- Formula, pattern, compilation, device, idea, or method that:
 - Provides a competitive advantage
 - Derives value, actual or potential, from its confidentiality
 - Is treated in a way that is reasonably expected to maintain confidentiality of the trade secret
- If the information is published or otherwise available to the public, it is no longer a trade secret.



Trade Secret Protection

- State and common law applies, but not federal law
- Enter into Non-Disclosure and Non-Competition Agreements
- Advise parties who possess or have access to trade secrets
- No protection from “reverse engineering”
- Failing to expend reasonable efforts to protect the trade secret could result in loss of protection, even when information was obtained illegally
- Example: Coca-Cola restricting access to formula



Trade Secret Protection

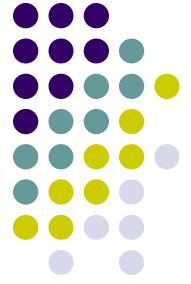
- Mark information “CONFIDENTIAL”
- Limit access to information per need to know basis
- Lock information in file cabinets
- Use password protection
- Establish Internet and Intranet security



What is a Patent?

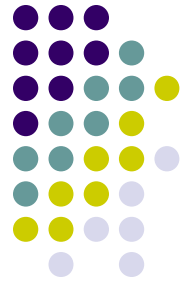
- A limited monopoly given in exchange for public disclosure of the invention
- Created only by the U.S. Patent Office
- Grants owner exclusive right to make, use, license, or sell the invention until expiration
 - 20 years from application filing, which includes the 1-3 years waiting to get approval
- Upon expiration of the patent, the public is free to make, use and sell the invention

What qualifies as a patent?



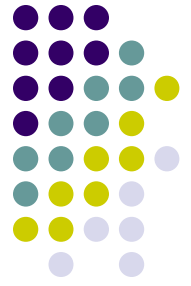
- A process, machine, article of manufacture, composition of matter, an improvement of an invention that is:
 - Useful
 - Novel
 - Nonobvious

Patent Application Process



- Examination process is 1 to 3 years, and a minimum cost of \$5,000
- In the meantime, file a Provisional Patent Application (\$80 or \$160 for large companies)
- The USPTO strongly advises applicants to contact patent lawyers

Trade Secret and Patent Comparison



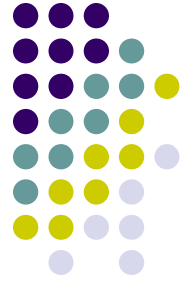
Trade Secret

- Protected by common law and state statutes
- Confidential
- Indefinite protection, as long as information remains secret and useful
- No registration required

Patent

- Protected by Federal law only
- Disclosed to the public
- Protection for 20 years from filing date
- Requires registration, a time-consuming and expensive process

Intellectual Property Internet Resources



- U.S. Copyright Office – www.copyright.gov
- U.S. Patent & Trademark Office – www.uspto.gov
- Nolo Press – www.nolo.com
- Small Business Administration – www.sba.gov/starting_business/startup/ideas.html
- Small Business Development Center – <http://sbdcnet.utsa.edu/SBIC/copyright.htm>
- Invention 101 (Free Online Course) - www.inventionconvention.com/ncio/inventing101/index.html