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SOME KEY THINGS ENTREPRENEURS NEED TO KNOW ABOUT THE LAW AND LAWYERS

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ABSTRACT

New business formation is a powerful economic engine that creates jobs. Diverse legal issues are encountered as a start-up entity approaches formation, initial capitalization and fundraising, arrangements with employees and independent contractors, and relationships with other third parties. The endeavors of a typical start-up in the United States will likely implicate many of the following areas of law: intellectual property; business organizations; tax laws; employment and labor laws; securities regulation; contracts and licensing agreements; commercial sales; debtor-creditor relations; real estate law; health and safety laws/codes; permits and licenses; environmental protection; industry specific regulatory laws and approval processes; tort/personal injury, products liability, and insurance laws; antitrust and other unfair competition laws; import/export laws;

immigration laws; laws related to the internet, privacy and e-commerce; and possibly many other federal, state and/or local laws, and, for many businesses these days, international laws. Company founders need to develop familiarity with the effects of such laws and need to access qualified legal talent to address legal issues in the planning and implementation of their venture. This article is designed to provide entrepreneurs with an overview of several areas of law that commonly arise in for-profit start-up ventures and offer them some important tips on working with lawyers.

Keywords: accounting, angel investor, business organizations, copyright, corporate finance, corporate governance, entrepreneurship, intellectual property, lawyers, leadership, legal issues, National Venture Capital Association (NVCA), patents, securities law, start-up, trademark, venture capital,

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I. OVERVIEW

Stanford business school professor Edward P. Lazear observes that "The entrepreneur is the single most important player in a modern economy."[1] Bruce R. Barringer and R. Duane Ireland state that "An entrepreneur assembles and then integrates all the resources needed – the money, the people, the business model, the strategy, and the risk-bearing ability – to transform the invention into a viable business."[2] In addition, "entrepreneurship" has been defined as "the process by which individuals pursue opportunities without regard to resources they currently control."[3] Lazear has defined an "entrepreneur" as "someone who responds affirmatively to the question 'I am among those who initially established the business.' Such individuals, even if they leave the business early, are usually responsible for the conception of the basic product, hiring the initial team, and obtaining at least some early financing."[4]

A business, regulatory and tax environment conducive to the creation and growth of new businesses is the key to job growth. Small businesses are responsible for creation of 60 to 80 percent of net new employment since the mid-1990s.[5] The U.S. Small

[1] Edward P. Lazear, *Entrepreneurship*, IZA Discussion Paper No. 760 2 (2003), *available at* http://ssrn.com/abstract=333802.

[2] BRUCE R. BARRINGER & R. DUANE IRELAND, ENTREPRENEURSHIP: SUCCESSFULLY LAUNCHING NEW VENTURES 5 (2d ed. 2008), *citing* P. Sharma & J.J. Chrisman, *Toward a Reconciliation of the Definitional Issues in the Field of Corporate Entrepreneurship*, 23 ENTREPRENEURSHIP THEORY & PRACTICE 11 (1999).

[3] *Id.* at 6, *citing* H.H. Stevenson & J.C. Jarillo, *A Paradigm for Entrepreneurship: Entrepreneurial Management*, 11 STRATEGIC MGMT. J. 17 (1990).

[4] Edward P. Lazear, *Entrepreneurship*, IZA Discussion Paper No. 760 2 (2003), *available at* http://ssrn.com/abstract=333802.

[5] Vivek Wadhwa, Raj Aggarwal, Krisztina Holly & Alex Salkever, *Making of A Successful Entrepreneur: Anatomy of an Entrepreneur Part II* 4 (2009). Kauffman Foundation Small Research Projects Research Paper No. 2. *available at* http://ssrn.com/abstract=1507384.

Business Administration "found that net job creation in the immediate years following the 1990-1991 and 2001 recessions stemmed from employment generated by small firms with fewer than 500 employees."[6] Thus, all in our society have a vested interest in the nurturing and formation of new businesses. It is through this business formation process that jobs at all levels are created.[7]

Every entrepreneur must find talent to perform the numerous functional areas required for their enterprise to operate and thrive. Depending on the nature of the business, these functional areas and related core skills necessary for any business to become successful will likely include: a visionary, driven to succeed; an operations manager (or "field marshal"); finance; accounting; legal; marketing; information technology and social media; and industry specific expertise (e.g., petroleum engineer skills for an oil and gas company, software engineering for a software company, or medical training and expertise for a medical device company).

Every enterprise requires legal advice to successfully navigate the maze of regulatory and business problems. Professor Robert C. Bird even goes so far as to suggest that strategic legal resources can be employed as "sources of sustainable competitive advantage."[8] Our purpose in writing this paper is to highlight some of the

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[6] Vivek Wadhwa, Raj Aggarwal, Krisztina Holly & Alex Salkever, *Making of A Successful Entrepreneur: Anatomy of an Entrepreneur Part II* 4 (2009). Kauffman Foundation Small Research Projects Research Paper No. 2. *available at* http://ssrn.com/abstract=1507384, *citing* U.S. Small Business Administration, Office of Advocacy, *The Small Business Economy*, Washington (2009).

[7] *See* Ana Campoy, *Policy, Geography Boost Texas Job Growth*, WALL ST. J., Aug. 22, 2011, at A4.

[8] *See* Robert C. Bird, *Can Law Be a Source of Sustainable Competitive Advantage?,* 1 (2007), *available at* http://ssrn.com/abstract=985704. *See also* Robert C. Bird & David Orozco, *Finding the Right Corporate Legal Strategy*, MITSLOAN MGMT. REV. (Sept. 16, 2014), *available at* http://sloanreview.mit.edu/article/finding-the-right-corporate-legal-strategy/ (last viewed Sept. 29, 2015).

more common and significant issues entrepreneurs need to know about regarding laws and working with lawyers. Typically, start-up ventures in the United States may implicate many diverse areas of law. Our intent is not to present an exhaustive and lengthy study, but rather a short and useful discussion that is of practical value to an entrepreneur looking to get an initial introduction to the role of laws and lawyers in planning and launching a start-up venture. We hope this will inspire the entrepreneur to then dig deeper into books and other resources that engage in more in-depth treatment of various legal issues in the context of enterprise planning.[9]

First, we present below an initial overview of commonly encountered start-up legal issues and considerations involved in finding the right lawyer(s) to help deal with them. Second, the strategic importance of information technology, social media, and intellectual property is explored. Third, choices of entity considerations are discussed. Fourth, laws pertaining to raising early-stage capital are addressed. Fifth, we examine sources of early-stage capital. Sixth, is a discussion of creditor rights and bankruptcy considerations. Seventh, we focus on legal issues raised by the employer-employee relationship. Next, we briefly discuss the importance of risk awareness and risk management. We then offer a few concluding thoughts regarding the efficient use of lawyers and the importance of an entrepreneur developing familiarity with legal issues and engaging legal counsel to address them as part of the planning and implementation of the business venture.

[9] *See, e.g.*, Constance E. Bagley and Craig E. Dauchy, THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW, (4th Ed., Cengage Learning 2011); Dwight Drake: BUSINESS PLANNING :CLOSELY-HELD ENTERPRISES, (3rd Ed., West 2011). *See also* the annotated bibliography of law and entrepreneurship publications on the Ewing Marion Kauffman Foundation's Entrepreneurship Law (hereinafter, "EshipLaw") website at http://www.entrepreneurship.org/Entrepreneurship-Law/Topic-Overviews/Law-Scholarship-Overview.aspx (last visited Sept. 24, 2015).

II. START-UP LEGAL ISSUES AND FINDING THE RIGHT LAWYER

All of us owe much to those individuals who (against the odds) risk their finite time and personal net worth in the attempt to create a successful business. To survive, all successful entrepreneurs of necessity have become skillful at optimizing efficiency at every opportunity. Entrepreneurs also need to deal with what may often seem to them an endless maze of laws and regulations, some of them presenting hurdles, and others opportunities. This requires that they become educated on spotting areas of law they will encounter and engaging qualified legal counsel to guide them—which, given the many specialty areas of law that now exist, may well and often does mean hiring more than one lawyer.

The Start-Up and Legal Considerations

A typical start-up venture in the United States will likely implicate many of the following areas of law: intellectual property; business organizations; tax laws; employment and labor laws; securities regulation; contracts and licensing agreements; commercial sales; debtor-creditor relations; real estate law; health and safety laws/codes; permits and licenses; environmental protection; industry specific regulatory laws and approval processes; tort/personal injury, products liability, insurance laws; antitrust and other unfair competition laws; import/export laws; immigration laws; laws related to the internet, privacy, e-commerce, and consumer protection laws; and possibly many other federal, state and/or local laws, and, for many businesses these days, international laws.

At the most basic level, all successful start-ups have the same fundamental requirements, regardless of specific industry. Building the foundation for any successful enterprise is analogous to constructing a structurally sound foundation for your house.

Careful preparation before work begins is essential. You can always go back and try to repair a faulty foundation after you've attempted to place a structure on top; but, such an effort will likely prove costly, disruptive and a waste of limited management team resources. A core set of skills is necessary for any business to become successful. Legal talent, either "in house" or outside the enterprise is required.

When to Engage a Lawyer

How does an entrepreneur know if and when he or she needs to engage a lawyer? This can be a very challenging question. Can the entrepreneur really afford to pay for legal advice before his or her business plan has reached a level of feasibility to justify that expense? At the same time, are there risks in waiting too long? The answer to the second question is most certainly "yes." Not getting legal advice can cause a multitude of mistakes that can prove costly, and perhaps disastrous. For example, an entrepreneur might accidentally make disclosures that erode or preclude the ability to protect intellectual property; create ownership rights in other people or entities that the entrepreneur did not consider "partners;" cause unintended adverse tax consequences; or violate securities regulation laws in ways that lead to civil or criminal liability and inhibit the ability to raise capital going forward.

There is no simple answer as to exactly when to hire one or more lawyers to help avoid these or other legal problems. Common mistakes we've seen entrepreneurs make do allow us to suggest some scenarios that should trigger the need to get legal counsel. These include: (1) when any significant prospect of creating intellectual property arises; (2) whenever considering working with anyone else who might argue they have "a piece of the deal;" (3) whenever thinking about borrowing any money from anyone for the venture or issuing or committing to issue anyone an ownership interest or option to acquire an ownership interest; and (4) when hiring any service provider, and especially one who may be an employee. Those are certainly not the only times when an entrepreneur needs legal advice, but they are indicative of some of the more commonly arising situations in which such advice is of critical importance.

Finding the Right Legal Talent

How likely is it that one lawyer is truly well versed in all of the areas of law potentially affecting a venture? Lawyers come with various degrees of relevant experience and training. The study of law requires both graduate study to earn a law degree and specific experience gained as a result of legal practice in the relevant areas of law (communications, employment law, entertainment, intellectual property, international business, oil and gas, tax, and securities law are all examples of areas that can require significant time for a lawyer to gain facility). For the first-time entrepreneur, a host of diverse legal issues will present themselves in areas such as entity choice and formation, initial capitalization and fundraising, taxation, employment law, contracts, and intellectual property considerations. Luppino observes:

> [F]or a lawyer to be viewed by his or her client as an effective counselor, the client must first recognize and appreciate the value of having a good lawyer on the client's team, and then decide that the lawyer in question is indeed a good one. Both of these assessments may require overcoming some stereotypes and determining what really counts and what the skill level, integrity and commitment of a particular lawyer really are.[10]

[10] Anthony J. Luppino, *Can Do: Training Lawyers to be Effective Counselors to Entrepreneurs – Report to the Ewing Marion Kauffman Foundation,* 6 (2008), *available at* http://ssrn.com/abstract=1157065.

Finding the right lawyer is somewhat like the search to find an appropriate surgeon. Just as you wouldn't want a foot specialist operating on your brain, it's usually not a good idea to approach a "generalist" lawyer who specializes in family or criminal law to handle complex tax or securities law matters. Luppino cautions that:

> Soon, the entrepreneur will recognize that chances are his or her lawyer will not be an expert in all of the areas of law that may touch a business venture. So, a lawyer who is a 'networker' may be desirable (or essential). The entrepreneur will also quickly be made aware that many of the laws to be addressed will restrict or preclude avenues that were—before the lawyers were brought in—viewed as viable paths toward success. In other words, the entrepreneur's lawyers may often have to be messengers of bad news, and accordingly appear to be masters of 'no, you can't do that'—which is why many consumers of business law services are quite naturally inclined to hope to find… 'can do' lawyers.[11]

Therefore, the goal of entrepreneurial lawyer identification and recruitment is to find those knowledgeable lawyers who "have also developed significant business savvy and creativity, and who use their training in seeing all sides of an argument to become extremely valuable sounding boards for their clients, sometimes participating in the design and engineering, and often at least quarterbacking, the negotiation of their key transactions."[12]

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[11] *Id.* at 7. *See also* Bagley & Dauchy, *supra* note 9, at Ch. 3 ("Selecting and Working with an Attorney").

[12] Luppino, *supra* note 10, at 8, *citing* Ronald Gilson, *Value Creations by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239 (1984) (contending that lawyers add value as 'transaction cost engineers' and 'reputational intermediaries'). *See also* Ronald J. Gilson & Robert H. Mnookin, *Foreword: Business Lawyers and Value Creation for Clients*, 74 OR. L. REV. 1 (1995); Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J. L. BUS. & FIN. 486 (2007); Anthony J. Luppino, *The Value of Lawyers as Members of Entrepreneurial Teams*, Ch. 12 in HANDBOOK ON LAW, INNOVATION AND GROWTH (Robert Litan, ed., 2011); Robert C. Bird, *The Many Futures of Legal Strategy*, 47 AM. BUS. L.J. 575 (2010); Constance E. Bagley, *What's Law Got to Do With It?,* 47 AM. BUS. L.J. 587 (2010); George J. Siedel & Helena Haapio, *Using Protective Law for Competitive Advantage*, 47 AM. BUS. L.J. 641 (2010); Larry A. DiMatteo, *Strategic Contracting: Contract Law as a Source of Competitive Advantage*, 47 AM. BUS. L.J. 727 (2010).

Lawyers and Fees

What kinds of fees do lawyers typically charge? Are they negotiable? It is fairly common for business lawyers to use an hourly rate approach to fees for services related to organizing a business. The rates can vary greatly from lawyer to lawyer depending on a number of market conditions and levels of training and experience. Moreover, the bill is of course not based solely on the hourly rate; rather, it is based on that rate multiplied by the number of hours billed on the engagement. The client, especially if a first-time entrepreneur, is not in a particularly good position to estimate how many hours will actually be involved, thus making budgeting for legal expense a difficult and uncertain proposition. It is possible to ask for discounted rates, and to get a plan that will involve having attorneys at lower hourly rates perform services they can perform well and efficiently, bringing in more senior lawyers (with higher hourly rates) on only an "as needed" basis.

What about a fixed fee for a discrete piece of transactional work (such as forming a corporation or limited liability company), or an hourly rate fee but with a dollar amount maximum/cap? Fixed fees can be a matter of negotiation and do make budgeting easier. However, the entrepreneur should consider what might be in the head of the lawyer who has already (on an hourly basis equivalent) hit the max on the matter in terms of the dollar amount of time that can be billed to the client under the arrangement and has to decide how to prioritize his/her work on the matter with other clients' work (which may be on the clock at hourly rates). The lawyer is of course subject to discipline under rules of attorney conduct and potential liability for malpractice should he or she neglect or otherwise fail to fulfill obligations to the client; but questions of prioritization in the context of having multiple clients may make it difficult to draw clear lines of enforcement of the attorney's duties in this type of situation.

How about an entrepreneur with limited cash at the early stage of a venture proposing to pay a lawyer with an equity interest in the venture in lieu of as cash fee? Despite the risk of conflicts of interest inherent in that type of arrangement, it is possible for a lawyer to ethically accept that kind of deal if done properly and in the right circumstances.[13] The entrepreneur should of course consider whether that may be penny wise and pound foolish—might that equity interest turn out to be much more generous to the lawyer than the entrepreneur contemplated?[14] In addition, issuing equity for services is within the ambit of the securities laws discussed later in this paper as an issue to be considered when issuing investment units for services, money or other property.

Is an entrepreneur better off hiring a big law firm or a solo, small or medium-sized law firm? Again, no easy answer to this. A large firm with multiple departments (intellectual property, tax, business law, employment law, etc.) can offer the advantage of relatively one-stop-shopping to cover a diverse set of legal needs. But a solo, small, or medium law firm may have less overhead, more affordable fees, and a good network to bring in outside "specialists"[15] when needed. There is simply no perfect answer. The

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[13] *See* ABA Formal Opinion 00-418 (July 7, 2000). *See also,* Poonam Puri, *Taking Stock of Taking Stock,* 87 CORNELL L. REV. 99 (2001).

[14] *See, e.g.,* Passante v. McWilliam *et al.*, 53 Cal. App. 4th 1240 (Cal. App. 1997) (3% of stock promised to lawyer for "rookie baseball card company" turned out to be worth approximately $33 million; jury found for lawyer in suit to enforce that deal, but trial court and appellate court overturned that and held that the company did not have to make good on what was found to be just an unenforceable "moral" promise to make a gift to the attorney on the particular facts of that case).

[15] We mean here "specialists" in the sense of substantial experience in particularly challenging areas of law. Lawyers are generally subject to restrictions as to when and how they may hold themselves out as specialists in a formal sense. *See, e.g.,* ABA MRPC &.4(d) (" A lawyer shall not state or imply that a lawyer is certified as a specialist in a particular field of law, unless: (1) the lawyer has been certified as a specialist by an organization that has been approved by an

good news is that the entrepreneur can interview lawyers and negotiate a tailored deal if the entrepreneur is willing to take the time to do that, preferably with some recommendations by trusted mentors who have "been around the block" as consumers of legal services.

Can one lawyer represent multiple owners in forming a business entity for the venture? The American Bar Association's Model Rules of Professional Conduct say "yes" in limited circumstances.[16] That approach may be cost efficient, but the entrepreneurs involved still might think twice before going that route; there is a lot to be said for having your own lawyer focused on your individual interests.

Do any lawyers help start-up entrepreneurs on a *pro bono* (i.e., no charge) basis? In view of the key role entrepreneurship plays in job creation and economic growth it is not surprising that there are indeed some avenues for start-up entrepreneurs, especially entrepreneurs of limited financial means, to obtain some *pro bono* legal services in launching their ventures. For example, several U.S. law schools have clinics that assist entrepreneurs in their communities, [17] and the U.S. Patent & Trademark Office has been

appropriate state authority or that has been accredited by the American Bar Association; and (2) the name of the certifying organization is clearly identified in the communication.").

[16] *See* ABA MRPC 1.7, Comment [28] ("Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.").

[17] *See* the state-by-state list of such law school clinics on the EshipLaw website at http://www.entrepreneurship.org/Entrepreneurship-Law/Topic-Introductions/Transactional-Clinics-Introduction.aspx (last visited Sept. 24, 2015).

promoting the creation of *pro bono* initiatives by intellectual property lawyers to assist inventors.[18] Entrepreneurs should consider those and other options for free legal assistance they may find if they do some research and explore possibilities with organizations supporting entrepreneurship and innovation in their regions.

III. INFORMATION TECHNOLOGY AND INTELLECTUAL PROPERTY

Information Technology and Social Media

Social media, the technological development that represents a global cultural sea change within recent years, dictates a must-have functional skill for almost every contemporary enterprise.[19] Marketing channels have changed dramatically during the

[18] *See* United States Patent and Trademark Office, U.S. Dept. of Congress, Pro Bono (Free Legal Representation), *available at* http://www.uspto.gov/inventors/proseprobono/. (last visited Sept. 24, 2015).

[19] *See generally* Michael Trusov, Randolph E. Bucklin & Koen H. Pauwels, *Effects of Word-of-Mouth Versus Traditional Marketing: Findings from an Internet Social Networking Site,* 73 J. MARKETING 90 (2009), *available at* http://ssrn.com/abstract=1129351; Anindya Ghose & Panagiotis G. Ipeirotis, *Estimating the Helpfulness and Economic Impact of Product Reviews: Mining Text and Reviewer Characteristics*, IEEE TRANS. KNOWLEDGE & DATA ENGINEERING (2011), *available at* http://ssrn.com/abstract=1261751; Frank T. Piller, Alexander Vossen & Christoph Ihl, *From Social Media to Social Product Development: The Impact of Social Media on Co-Creation of Innovation*, 65 DIE UNTERNEHMUNG (2012), *available at* http://ssrn.com/abstract=1975523; Donna L. Hoffman & Thomas P. Novak, Why Do People Use Social Media? Empirical Findings and a New Theoretical Framework for Social Media Goal Pursuit, (unpublished paper) (2012), *available at* http://ssrn.com/abstract=1989586; Jeongha Oh, Anjan Susarla & Yong Tan, Examining the Diffusion of User-Generated Content in Online Social Networks, (unpublished paper) (2008), *available at* http://ssrn.com/abstract=1182631; Rebecca Walker Naylor, Cait Poynor Lamberton & Patricia M. West, *Beyond the 'Like' Button: The Impact of Mere Virtual Presence on Brand Evaluations and Purchase Intentions in Social Media Settings,* 76 J. MARKETING 105 (2012), *available at* http://ssrn.com/abstract=2078586; David Broom, Margaret McCann, Michael C. Bromby & Alexis Barlow, Return on Investment: What Literature Exists on the Use of Social Media and ROI?, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1926900; Pradeep Racherla & Robert Allen King, What We Know and Don't Know About Online Word-Of-Mouth: A Systematic Review and Synthesis of the Literature (unpublished paper) (2012), *available at* http://ssrn.com/abstract=2187040; Donna L. Hoffman & Thomas P. Novak, Online Experience in Social Media: Two Paths to Feeling Close and Connected (unpublished paper) (2013), *available at* http://ssrn.com/abstract=1990005; David F. Larcker, Sarah M. Larcker & Brian Tayan, Monitoring Risks Before They Go Viral: Is it Time for the Board to Embrace Social Media?, Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-25 (2012), *available at* http://ssrn.com/abstract=2035072; Victor A. Barger & Lauren Labrecque, *An Integrated Marketing Communications Perspective on Social Media Metrics*, INT'L J. INTEGRATED MARKETING COMM. (Spring 2013), *available at* http://ssrn.com/abstract=2280132; Paul M.

Leonardi, Marleen Huysman & Charles Steinfield, *Enterprise Social Media: Definition, History, and Prospects for the Study of Social Technologies in Organizations*, 19 J. COMP.-MEDIATED COMM. 1 (2013), *available at* http://ssrn.com/abstract=2283960; Manish Parihar, Social Media: The Final Frontier in Customer Experience Management, *in* Epoch Strategies for Marketing, Family Business and Entrepreneurship, (unpublished paper) (2012), *available at* http://ssrn.com/abstract=1982325; Anjana Susarla, Yong Tan & Jeongha Oh, Influentials, Imitables or Susceptibles? Virality and Word-of-Mouth Conversations in Online Social Networks, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=1984690; Daniel E. O'Leary, Developing Trust and Relationships in the Supply Chain Using Social Media, (unpublished paper) (2012), *available at* http://ssrn.com/abstract=2115202; Dharmesh Motwani, Devendra Shrimali & Khushbu Agarwal, Customer's Attitude Towards Social Media Marketing, 3 J. BUS. MGMT. & SOC. SCI. RES. (2014), *available at* http://ssrn.com/abstract=2438187; Bin Gu & Qiang Ye, *First Step in Social Media - Measuring the Influence of Online Management Responses on Customer Satisfaction*, 23 PRODUCTIONS & OPERATIONS MGMT. (2011), *available at* http://ssrn.com/abstract=2111716; Liangfei Qiu, Qian Tang & Andrew B. Whinston, Two Formulas for Success in Social Media: Social Learning and Network Effects, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2177077; Birud Sindhav, *Co-Creation of Value: Creating New Products Through Social Media*, 2 INT'L J. MGMT. RES. (2011), *available at* http://ssrn.com/abstract=2397832; Vidisha Sharma & Vijayakumar Bharathi, Social Media for Start-Ups - An Effective Marketing Tool, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2333262; Raghuram Iyengar, Sangman Han & Sunil Gupta, Do Friends Influence Purchases in a Social Network?, Harvard Business School Marketing Unit Working Paper No. 09-123 (2009), *available at* http://ssrn.com/abstract=1392172; William McGeveran, *Disclosure, Endorsement, and Identity in Social Marketing*, 2009 U. ILL. L. REV. 1105 (2009), *available at* http://ssrn.com/abstract=1334406; Lina M. Gomez & Ricardo Chalmeta, The Importance of Corporate Social Responsibility Communication in the Age of Social Media, 16th International Public Relations Research Conference, Miami, March 6-10, 2013, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2290793; Lian Fen Lee, Amy P. Hutton & Susan Shu, *The Role of Social Media in the Capital Market: Evidence from Consumer Product Recalls*, 53 J. ACCT. RES. (2015), *available at* http://ssrn.com/abstract=2557212; Jinwei Cao, Kamile Asli Basoglu, Hong Sheng & Paul Benjamin Lowry, A Systematic Review of Social Networking Research in Information Systems, Communications of the Association for Information Systems, (unpublished paper) (2014), *available at* http://ssrn.com/abstract=2525108.

past decade.[20] The opportunities and pitfalls of such new technologies as Facebook,[21] Google,[22] GPS or location-based mobile services,[23] IM,[24] LinkedIn,[25] mobile internet,[26]

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[20] *See generally* Urs Gasser, Sandra Cortesi, Momin Malik & Ashley Lee, Youth and Digital Media: From Credibility to Information Quality, Berkman Center Research Publication No. 2012-1 (Feb. 16, 2012), *available at* http://ssrn.com/abstract=2005272; Yubo Chen, Scott Fay & Qi Wang, The Role of Marketing in Social Media: How Online Consumer Reviews Evolve, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1710357 Utpal M. Dholakia, What Makes Groupon Promotions Profitable for Businesses?, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1790414; Jeffrey W. Treem & Paul M. Leonardi, *Social Media Use in Organizations: Exploring the Affordances of Visibility, Editability, Persistence, and Association*, 36 COMM. YEARBOOK 143 (2012), *available at* http://ssrn.com/abstract=2129853; David A. Schweidel, Wendy W. Moe & Chris Boudreaux, Social Media Intelligence: Measuring Brand Sentiment from Online Conversations, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1874892; Hiroshi Onishi & Puneet Manchanda, Marketing Activity, Blogging and Sales, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1487183; Anindya Ghose, Panagiotis G. Ipeirotis & Beibei Li, Designing Ranking Systems for Hotels on Travel Search Engines by Mining User-Generated and Crowd-Sourced Content, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1856558; Igor Pustylnick, Advertising in Social Networks, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1976893 Gerald C. Kane, Maryam Alavi, Giuseppe (Joe) Labianca & Steve Borgatti, *What's Different About Social Media Networks? A Framework and Research Agenda*, 38 MIS Q. 257 (2014), *available at* http://ssrn.com/abstract=2239249; Samuel P. Fraiberger & Arun Sundararajan, Peer-to-Peer Rental Markets in the Sharing Economy, (unpublished paper) (2015), NYU Stern School of Business Research Paper, *available at* http://ssrn.com/abstract=2574337; Benedikt Jahn, Werner H. Kunz & Anton Meyer, The Role of Social Media for Luxury-Brands – Motives for Consumer Engagement and Opportunities for Businesses, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2307106; Ellen P. Goodman, *Peer Promotions and False Advertising Law*, 58 S.C. L. REV. 683 (2007), *available at* http://ssrn.com/abstract=1009304; Benjamin Lawrence, Susan Fournier & Frederic F. Brunel, *When Companies Don't Make the Ad: A Multimethod Inquiry Into the Differential Effectiveness of Consumer-Generated Advertising*, 42 J. ADVERTISING 292 (2013); José van Dijck & Thomas Poell, *Understanding Social Media Logic*, 1 MEDIA & COMM. 2 (2013), *available at* http://ssrn.com/abstract=2309065; Bellarmine A. Ezumah, Generation Y and Online Advertising: Perceptions and Preferences of Social Media Networking Sites, (unpublished paper) (2012), *available at* http://ssrn.com/abstract=2256434; Xitong Li & Lynn Wu, Herding and Social Media Word-of-Mouth: Evidence from Groupon, (unpublished paper) (2014), *available at* http://ssrn.com/abstract=2264411; Robert Peaslee & Stephanie Miles, 'Where Buzz is Born': South-by-Southwest, Blogging, and Media Conduction, Presented at Association for Educators in Journalism and Mass Communication Ann. Conf., Aug. 9-12, 2012 (unpublished paper, 2011) (on file with authors).

[21] *See generally* Dokyun Lee, Kartik Hosanagar & Harikesh Nair, The Effect of Social Media Marketing Content on Consumer Engagement: Evidence from Facebook, (unpublished paper) (2014), *available at* http://ssrn.com/abstract=2290802; Jörg Claussen, Tobias Kretschmer & Philip Mayrhofer, *The Effects of Rewarding User Engagement – The Case of Facebook Apps*, 24 INFO. SYSTEMS RES. 186 (2013), *available at* http://ssrn.com/abstract=1599458; Sharad Borle, Utpal M. Dholakia, Siddharth S. Singh & Emily Durham, The Impact of Facebook Fan Page Participation on Customer Behavior: An Empirical Investigation, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2555994; M. Laeeq Khan & Jan Boehmer, Small Business Use of Facebook for Marketing: The Case of a Family Owned Mediterranean Restaurant, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2579508; Catherine Tucker, Social Advertising, (unpublished paper) (2012), *available at* http://ssrn.com/abstract=1975897; Jonah A.

paid search,[27] streaming media,[28] and Twitter[29] need to be understood and utilized. For most enterprises in this environment, if a company's management and marketing strategy

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22 *See generally* Florence Thépot, *Market Power in Online Search and Social-Networking: A Matter of Two-Sided Markets*, 36 W. COMP. 195 (2013), *available at* http://ssrn.com/abstract=2307009.

23 *See generally* Zhuping Liu, Jason A. Duan & Frenkel Ter Hofstede, Marketing Spillovers of Location-Based Mobile Services, (unpublished paper) (2014), *available at* http://ssrn.com/abstract=2578335; Matthew W. Wilson, *Location-Based Services, Conspicuous Mobility, and the Location-Aware Future*, 43 GEOFORUM 1266 (2012), *available at* http://ssrn.com/abstract=2181053; Dirk Grunwald, Aaron Beach, Kevin Bauer, Qin Lv & Douglas Sicker, The Risks and Regulation of Location, TPRC 2010 (unpublished paper) (2010), *available at* http://ssrn.com/abstract=1989200; Bart Lariviere, Herm Joosten, Edward Malthouse, Marcel Van Birgelen, Pelin Aksoy, Werner H. Kunz & Ming-Hui Huang, Value Fusion: The Blending of Consumer and Firm Value in the Distinct Context of Mobile Technologies and Social Media, (unpublished paper) (2013), *available at* http://ssrn.com/abstract=2307058.

24 *See generally* Jeffrey Bellin, *Facebook, Twitter, and the Uncertain Future of Present Sense Impressions*, 160 U. PA. L. REV. 331 (2012), *available at* http://ssrn.com/abstract=1792786.

25 Rajiv Garg & Rahul Telang, To Be or Not To Be Linked on LinkedIn: Job Search Using Online Social Networks, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1813532.

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27 *See generally* Anindya Ghose, Panagiotis G. Ipeirotis & Beibei *Li, Examining the Impact of Ranking on Consumer Behavior and Search Engine Revenue,* 1 MGMT. SCI. (2014), *available at* http://ssrn.com/abstract=2264354.

28 *See generally* Olufunmilayo Arewa, *Youtube, UGC, and Digital Music: Competing Business and Cultural Models in the Internet Age,* 104 NW. U. L. REV. 431 (2010), *available at* http://ssrn.com/abstract=1892329.

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is not focused on social media, some very powerful marketing channels are being overlooked.[30]

Few enterprise operational areas present as much inherent risk or prove as difficult to govern as Information Technology ("IT").[31] Even in mature companies, seasoned corporate directors are asking "How can I be expected to govern something I know so little about?"[32] Trautman and Altenbaumer-Price have observed that for almost

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at http://ssrn.com/abstract=2137479; Shiyang Gong, Juanjuan Zhang, Ping Zhao & Xuping Jiang, Tweets and Sales, (unpublished paper) (2014), *available at* http://ssrn.com/abstract=2461370; Richard E. Custin, Kathleen Britton & Sharon Yarak, *A Tweet on Social Media for Your Business*, CALIF. BUS. PRACT. (Apr. 2014), *available at* http://ssrn.com/abstract=2374247; Juliet M. Moringiello, Notice, Assent, and Form in a 140 Character World, SW. L. REV. (forthcoming), *available at* http://ssrn.com/abstract=2491249; Svetlana Rybalko & Trent Seltzer, *Corporate Communications in 140 Characters or Less: How Fortune 500 Companies Engage Stakeholders Using Twitter?* 36 PUB. REL. REV. 336 (2010); Christoph Riedl, Felix Köbler, Suparna Goswami & Helmut Krcmar, *Tweeting to Feel Connected: A Model for Social Connectedness in Online Social Networks*, 29 INT'L J. HUMAN-COMPUTER INTERACTION 670 (2013).

[30] *See generally* Derek Slater, Urs Gasser, Meg Smith, Derek E. Bambauer, John G. Palfrey, Content and Control: Assessing the Impact of Policy Choices on Potential Online Business Models in the Music and Film Industries, Berkman Publication Series Paper No. 2005-01 (2005), *available at* http://ssrn.com/abstract=654602; Anindita Chakravarty, Yong Liu & Tridib Mazumdar, *The Differential Effects of Online Word-of-Mouth and Critics' Reviews on Pre-Release Movie Evaluation*, 24 J. INTERACTIVE MKTING. 185 (2010), *available at* http://ssrn.com/abstract=1949821; Terry Daugherty & Ernest Hoffman, *eWOM and the Importance of Capturing Consumer Attention within Social Media*, 20 J. MKTNG. COMM. 82 (2014), *available at* http://ssrn.com/abstract=2567567; Yichuan Wang & M. Nick Hajli, *Co-Creation in Branding Through Social Commerce: The Role of Social Support, Relationship Quality and Privacy Concerns*, PROCEEDINGS OF TWENTIETH AMERICAS CONFERENCE ON INFORMATION SYSTEMS, Savannah, Ga. (2014), *available at* http://ssrn.com/abstract=2449127.

[31] *See generally* Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 JOHN MARSHALL J. OF COMP. & INFOR. LAW, 313 (2011), *available at* http://www.ssrn.com/abstract=1947283; Lawrence J. Trautman, Jason Triche & James C. Wetherbe, *Corporate Information Governance Under Fire,* 8 J. STRATEGIC & INT'L STUD. 105 (2013), *available at* http://ssrn.com/abstract=2314119; Lawrence J. Trautman, *Managing Cyberthreat*, 31 SANTA CLARA HIGH TECH. L.J. __ (2015), *available at* http://ssrn.com/abstract=2534119; Lawrence J. Trautman, Cybersecurity: What About U.S. Policy?, (forthcoming), *available at* http://ssrn.com/abstract=2548561; Nancy J. King & V.T. Raja, *What Do They Really Know About Me in the Cloud? A Comparative Law Perspective on Protecting Privacy and Security of Sensitive Consumer Data*, 50 AM. BUS. L.J. 413 (2013).

[32] *See* Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 JOHN MARSHALL J. OF COMP. & INFOR. LAW, 313 (2011), *citing* Peter Weill and Jeanne W. Ross depict Information Technology as one of the "six key assets for any enterprise" (the others being human, physical, financial, intellectual property and relationships). *See* PETER WEILL & JEANNE W. ROSS, IT GOVERNANCE: HOW TOP PERFORMERS MANAGE IT DECISIONS RIGHTS FOR SUPERIOR RESULTS 6 (Harv. Bus. Sch. Press) 2 (2004). Peter Weill, Director of the Center for Information Systems Research ("CISR") and Senior Research Scientist at the Massachusetts Institute of Technology's Sloan School of Management led research

every enterprise "IT is fundamental to support, sustain, and grow the business. Yet, in a recent survey of 5,500 business leaders worldwide, '58 percent of executives polled said they have lost sensitive personal information, and for nearly 60 percent of those who have had a breach, it was not an isolated event.'"[33] Moreover:

> During recent years, IT risk has demonstrated the potential to cause catastrophic losses to the enterprise balance sheet, reputation, and even threaten its very existence . . . examples of the effects of an IT failure include: loss of sensitive customer private information; loss of sensitive product or financial data of the corporation; virus attacks by hackers on the company's computer systems and those of its customers or vendors; business interruption losses due to IT downtime; as well as theft and use of client credit card or other sensitive data.[34]

Each start-up possesses different levels of Information Technology experience and skills. For example, while an early-stage software or new social media company may be inundated with engineering and IT talent, expertise and understanding, an agricultural, fast food or oil and gas start-up may have few IT resources and little IT experience among its management team. These days, almost every start-up has a website, regardless of industry or mission. For those entrepreneurs engaged in any form of e-commerce, a tremendous amount of often unanticipated risk exposure may result. Elsewhere, one of your authors has presented relevant annual report risk disclosures from eBay (parent of PayPal), along

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during 2001-2003 which studied 256 enterprises in Europe, Asia Pacific and the Americas. During the same general time period parallel studies were conducted by Jeanne Ross and Cynthia Beath (University of Texas).

[33] Trautman & Altenbaumer-Price *supra* note 31 at 326 *citing* Accenture Report, *How Global Organizations Approach the Challenge of Protecting Personal Data*, at 15 (2010) (available at http://www.accenture.com/NR/rdonlyres/836A71D2-4E7E-4E42-A778-4D8A40596296/0/Accenture_Data_privacy_reportLD.pdf).

[34] Trautman & Altenbaumer-Price *supra* note 31 at 326 *citing* USI Insurance Services, *Cyber Liability / Security and Privacy Insurance* (2009) (on file with the authors). *See also* Bagley & Dauchy, supra note 9, at 516 and in Ch. 14 ("Intellectual Property and Cyberlaw") generally.

with other eBay and PayPal documents to illustrate perceived legal risks in a major e-commerce enterprise engaged in receiving payments.[35]

Value of Intellectual Property

While intellectual property ("IP") considerations may not be mission-critical for all start-ups, for many, IP protection will be essential.[36] For many technology or pharmaceutical enterprises, their IP portfolios constitute their most significant assets.[37] Examples of valuable intellectual property "intangible assets" include: advertising;[38]

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[35] *See* Lawrence J. Trautman, E-Commerce and Electronic Payment System Risks: Lessons From PayPal, 16 U.C. DAVIS BUS. L.J. (forthcoming), *available at* http://ssrn.com/abstract=2314119.

[36] *See generally* Roger D. Blair & Thomas F. Cotter, An Economic Analysis of Seller and User Liability in Intellectual Property Law (1999), *available at* http://ssrn.com/abstract=146235; As resources for entrepreneurs to get some IP background, we particularly like the following links: The various "IP Basics" subsections posted by Prof. Emeritus Thomas G. Field, Jr. on the University of New Hampshire School of Law website at http://law.unh.edu/franklin-pierce-ip-center/studying-ip-at-unh-law/ip-basics , and the following governmental links: http://www.uspto.gov/inventors/index.jsp (U.S. Patent & Trademark Office); http://www.uspto.gov/inventors/iac/index.jsp (U.S. Patent & Trademark Office); http://www.uspto.gov/faq/patents.jsp (U.S. Patent & Trademark Office); http://www.uspto.gov/faq/trademarks.jsp (U.S. Patent & Trademark Office); and http://www.copyright.gov/ (U.S. Copyright Office) (all last visited Sept. 24, 2015). *See also* Sapna Kumar, *Regulating Digital Trade*, FLA. L. REV. (forthcoming), *available at* http://ssrn.com/abstract=2586740; Yoni Pruzansky & Liad Wagman, *Intellectual Property Protection and Firm Innovation*, (March 2015), *available at* http://ssrn.com/abstract=2583524; Mark A. Lemley, *Ex Ante Versus Ex Post Justifications for Intellectual Property*, 71 U. CHI. L. REV. 129 (2004), *available at* http://ssrn.com/abstract=494424; Wen Wen, Marco Ceccagnoli & Chris Forman, *Opening Up IP Strategy: Implications for Open Source Software Entry By Start-Up Firms*, MGMT. SCI. (forthcoming).

[37] *See generally* Ed Silverman, *Battling FDA to Fend Off Generic Rivals*, WALL ST. J., Apr. 17, 2015 at B2 (observing that Abilify generated sales of $4.9 billion during 2014, but faces the loss of patent protection next week).

[38] *See* Lisa P. Ramsey, *Intellectual Property Rights in Advertising*, 12 MICH. TELECOMM. & TECH. L. REV. 189 (2006), *available at* http://ssrn.com/abstract=969037.

brand identity;[39] celebrity endorsements; copyrights;[40] creative content; designs;[41] domain names;[42] fragrance;[43] logos; patents;[44] servicemarks and trademarks;[45] trade

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[39] *See generally* Deven R. Desai, Ioannis Lianos & Spencer Weber Waller, Brands, Competition Law and IP (Cambridge University Press (forthcoming 2015), *available at* http://ssrn.com/abstract=2584509; Julie Manning Magid, Anthony D. Cox & Dena S. Cox, *Quantifying Brand Image: Empirical Evidence of Trademark Dilution*, 43 AM. BUS L.J. 1 (2006); Interbrand, *2014 Best Global Brands*, *available at* http://bestglobalbrands.com/2014/ranking/ (providing a list of the world's top 100 brands) (last viewed Sept. 24, 2015).

[40] *See generally* Michael A. Carrier, *Copyright and Innovation: The Untold Story*, 2012 WIS. L. REV. 891, *available at* http://ssrn.com/abstract=2099876; Robert Brauneis, *Copyright and the World's Most Popular Song*, 56 J. COPYRIGHT SOC'Y U.S.A. 335 (2009), *available at* http://ssrn.com/abstract=1111624; Lawrence B. Solum, *The Future of Copyright*, 83 TEX. L. REV. 1137 (2005), *available at* http://ssrn.com/abstract=698306; Julie E. Cohen, *Creativity and Culture in Copyright Theory*, 40 UC DAVIS L. REV. 1151 (2007), *available at* http://ssrn.com/abstract=929527; John G. Palfrey, Urs Gasser, Miriam Simun, & Rosalie Barnes, Youth, Creativity, and Copyright in the Digital Age, Berkman Center Research Publication No. 2009-05, *available at* http://ssrn.com/abstract=1552415; Oren Bracha, *Standing Copyright Law on its Head? The Googlization of Everything and the Many Faces of Property*, 85 TEX. L. REV. 1799 (2007), *available at* http://ssrn.com/abstract=931426; Joseph Fishman, *Creating Around Copyright*, 128 HARV. L. REV. 1333 (2015), *available at* http://ssrn.com/abstract=2465590; Daniel J. Gervais, *Transmissions of Music on the Internet: an Analysis of the Copyright Laws of Canada, France, Germany, Japan, the United Kingdom, and the United States*, 34 VAND. J. TRANSNAT'L L. 1363 (2001), *available at* http://ssrn.com/abstract=733763; Peter C. DiCola, *Money From Music: Survey Evidence on Musicians' Revenue and Lessons About Copyright Incentives,* 55 ARIZ. L. REV. 1 (2013); Jessica Litman, *Sharing and Stealing*, 27 HASTINGS COMM. & ENT. L.J. 1 (2004), *available at* http://ssrn.com/abstract=621261; William M. Landes & Richard A. Posner, *Indefinitely Renewable Copyright*, 70 U. CHI. L. REV. 471 (2003); Brad A. Greenberg, *Copyright Trolls and the Common Law*, 100 IOWA L. REV. BULL. 77 (2015).

[41] Kevin V. Tu, *Counterfeit Fashion: The Interplay between Copyright and Trademark Law in Original Fashion Designs and Designer Knockoffs*, 18 TEX. INTELL. PROP. L.J. 419 (2010), *available at* http://ssrn.com/abstract=1681053; Lisa J. Hedrick, *Tearing Fashion Design Protection Apart at the Seams*, 65 WASH. & LEE L. REV. 215 (2008), *available at* http://ssrn.com/abstract=1127190; Randal C. Picker, *Of Pirates and Puffy Shirts: A Comment on the Piracy Paradox: Innovation and Intellectual Property in Fashion Design*, VA. L. REV. IN BRIEF (2007), *available at* http://ssrn.com/abstract=959727; Kal Raustiala & Christopher Jon Sprigman, *The Piracy Paradox: Innovation and Intellectual Property in Fashion Design,* 92 VA. L. REV. 1687 (2006).

[42] *See generally* Andrew Sellars, The In Rem Forfeiture of Copyright-Infringing Domain Names (May 8, 2011), *available at* http://ssrn.com/abstract=1835604; Jeffrey M. Samuels & Linda B. Samuels, *Internet Domain Names: The Uniform Dispute Resolution Policy,* 40 AM. BUS. L.J. 885 (2003).

[43] Thomas G. Field, *Copyright Protection for Perfumes*, 45 IDEA: J. L. & TECH. 19 (2004), *available at* http://ssrn.com/abstract=573881.

[44] *See generally* Daniel Cahoy, *Breaking Patents,* 32 MICH. J. INT'L L. 461 (2011); Gideon Parchomovsky & Alex Stein, *Originality,* 95 VA. L. REV. 1505 (2009), *available at* http://ssrn.com/abstract=1361911; Tammy W. Cowart, Roger Lirely & Sherry Avery, *Two Methodologies for Predicting Patent Litigation Outcomes: Logistic Regression Versus Classification Trees*, 51 AM. BUS. L.J. 843 (2014); Lynda J. Oswald, *Simplifying Multiactor Patent Infringement Cases Through Proper Application of Common Law Doctrine,* 51 AM. BUS. L.J. 1 (2014); Nathaniel Grow, *Joint Patent Infringement Following Akamai*, 51 AM. BUS. L.J. 71 (2014); Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?,* 83 TEX. L.

names; and trade secrets (such as business practices, customer information, and marketing plans).[46]

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[45] *See generally* Stephanie M. Greene, *Sorting Out 'Fair Use' and 'Likelihood of Confusion' in Trademark Law*, 43 AM. BUS. L.J. 43 (2006), *available at* http://ssrn.com/abstract=1491345.

[46] *See generally* Mark A. Lemley, *The Surprising Virtues of Treating Trade Secrets as IP Rights*, 61 STAN. L. REV. 311 (2008), *available at* http://ssrn.com/abstract=1155167; Richard A. Epstein, Trade Secrets as Private Property: Their Constitutional Protection, U Chicago Law & Economics, Olin Working Paper No. 190, (June 2003), *available at* http://ssrn.com/abstract=421340; Michael Risch, *Why Do We Have Trade Secrets?*, 11 MARQ. INTELL. PROP. L. REV. 1 (2007), *available at* http://ssrn.com/abstract=885778; Jacob Loshin, *Secrets Revealed: How Magicians Protect Intellectual Property without Law* (2007), *available at* http://ssrn.com/abstract=1005564; Brian J. Love & Christopher B. Seaman, *Best Mode Trade Secrets*, 15 YALE J. L. & TECH. 1, (2012), *available at* http://ssrn.com/abstract=2056115; Tom C. W. Lin, *Executive Trade Secrets*, 87 NOTRE DAME L. REV. 911 (2012), *available at* http://ssrn.com/abstract=2047462; Josh Lerner, Using Litigation to Understand Trade Secrets: A Preliminary Exploration (2006), *available at* http://ssrn.com/abstract=922520; Gillian L. L. Lester & Eric L. Talley, Trade Secrets and Mutual Investments (2000), USC Law School, Olin Research Paper No. 00-15; Georgetown Law and Economics Research Paper No. 246406, *available at* http://ssrn.com/abstract=246406 (customer lists); Elizabeth A. Rowe, *When Trade Secrets Become Shackles: Fairness and The Inevitable Disclosure Doctrine*, 7 TULANE J. TECH. & INTELL. PROP. 167 (2005), *available at* http://ssrn.com/abstract=1144196; Marisa Anne Pagnattaro, *'The Google Challenge': Enforcement of Noncompete and Trade Secret Agreements for Employees Working in China*, 44 AM. BUS. L.J. 603 (2007), *available at* http://ssrn.com/abstract=1565040; Marisa Anne Pagnattaro, *Protecting Trade Secrets in China: Update on Employee Disclosures and the Limitations of the Law*, 45 AM. BUS. L.J. 399 (2008), *available at* http://ssrn.com/abstract=1565063; Robert C. Bird, Defending Intellectual Property Rights in the BRIC Economies (2005), *available at* http://ssrn.com/abstract=807844; Henry E. Smith, *Intellectual Property as Property: Delineating Entitlements in Information*, 116 YALE L.J. 1742 (2007), *available at* http://ssrn.com/abstract=1000520; John R. Allison & Lianlian Lin, *The Evolution of Chinese Attitudes Toward Property Rights in Invention and Discovery*, 20 U. PA. J. INT'L ECON. L. 735 (1999), *available at* http://ssrn.com/abstract=222539; Daniel Cahoy & Robert Bird, *The Emerging BRIC Economies: Lessons from Intellectual Property Negotiation and Enforcement*, 5 NW. J. TECH. & INT'L PROP. 400 (2007); Jordan M. Blanke, *Vincent van Gogh, "Sweat of the Brow," and Database Protection*, 39 AM. BUS. L.J. 645 (2002); Kurt M. Saunders, *Can You Keep a (Trade) Secret? - The Pennsylvania Uniform Trade Secrets Act*, 75 PA. B. ASS'N. Q. 139 (2004), *available at* http://ssrn.com/abstract=563056; Robert G. Bone, *Trade Secrecy, Innovation, and the*

Article 1, section 8 of the Constitution of the United States provides that "Congress shall have power… to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."[47] Professors Peter Menell and Suzanne Scotchmer describe the two principal objectives of intellectual property law as: (1) promoting innovation and aesthetic creativity; and (2) protecting the integrity of the commercial IP marketplace.[48] As Professor Mark A. Lemley observes, "IP laws are deliberate government interventions in the market to try to shape how people participate in that market, encouraging new

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Requirement of Reasonable Secrecy Precautions, *in* THE LAW AND THEORY OF TRADE SECRECY: A HANDBOOK OF CONTEMPORARY RESEARCH, (Rochelle C. Dreyfuss & Katherine J. Strandberg, eds., Edward Elgar Press, 2010), http://ssrn.com/abstract=1467723; Sandy Klasa, Hernan Ortiz-Molina, Matthew A. Serfling, Shweta Srinivasan, Protection of Trade Secrets and Capital Structure Decisions (unpublished manuscript, 2014), *available at* http://ssrn.com/abstract=2439216.

[47] U.S. CONST. art. I, § 8. *But see* Lewis Hyde, Frames from the Framers: How America's Revolutionaries Imagined Intellectual Property (Dec. 2005), *available at* http://ssrn.com/abstract=870073. (Observing that copyright and patent were understood by the Founders to be monopolies; and unchecked monopolies were understood as social evils. Also, that IP should ultimately be an intangible equivalent of tangible res publicae, like roads, bridges, or harbors). *See also* Adam Mossoff, *Who Cares What Thomas Jefferson Thought About Patents? Reevaluating the Patent 'Privilege' in Historical Context.* 92 CORNELL L. REV. 953 (2007), *available at* http://ssrn.com/abstract=892062; Lawrence B. Solum, *Congress's Power to Promote the Progress of Science: Eldred V. Ashcroft*, 36 Loy. L.A. L. Rev. 1 (2002), *available at* http://ssrn.com/abstract=337182.

[48] See generally Peter S. Menell & Suzanne Scotchmer, *Intellectual Property,* In HANDBOOK OF LAW AND ECONOMICS, A. Mitchell Polinsky and Steven Shavell, Forthcoming; UC Berkeley Public Law Research Paper No. 741724, *available at* http://ssrn.com/abstract=741424. *See also* Robert E. Litan, Yochai Benkler, Henry N. Butler, John Henry Clippinger, Robert Cook-Deegan, Robert D. Cooter, Aaron S. Edlin, Nicole Stelle Garnett, Ronald J. Gilson, Oliver R. Goodenough, Gillian K. Hadfield, Mark A. Lemley, Frank Partnoy, George L. Priest, Larry E. Ribstein, Charles F. Sabel, Peter H. Schuck, Hal S. Scott, Robert E. Scott, Alex Stein, Victoria Stodden, John E. Tyler, Alan D. Viard, Benjamin Wittes, Rules for Growth: Promoting Innovation and Growth Through Legal Reform, (2011), Yale Law & Economics Research Paper No. 426; Stanford Law and Economics Olin Working Paper No. 410; UC Berkeley Public Law Research Paper No. 1757982, *available at* http://ssrn.com/abstract=1757982; Robert E. Thomas, *Vanquishing Copyright Pirates and Patent Trolls: The Divergent Evolution of Copyright and Patent Laws,* 43 AM. BUS. L.J. 689 (2006).

creation by rewarding it with above-market returns and discouraging imitation by imposing damages or even barring it altogether."[49]

Advances in information technology raise new IP issues.[50] For example, Professor Jack M. Balkin states, "The most important decisions affecting the future of freedom of speech will not occur in constitutional law; they will be decisions about technological design, legislative and administrative regulations, the formation of new business models, and the collective activities of end-users."[51] Entrepreneurs may find it

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[49] *See* Mark A. Lemley, IP and Other Regulations, (Apr. 2, 2015), *available at* http://ssrn.com/abstract=2589278, *citing* Mark A. Lemley, *Taking the Regulatory Nature of IP Seriously,* 92 TEX. L. REV. 107 (2014). *See also* Mark A. Lemley, *The Regulatory Turn in IP,* 36 HARV. J. L. & PUB. POL'Y 109 (2013); Daniel Cahoy, *Changing the Rules in the Middle of the Game: How the Prospective Application of Judicial Determinations Related to Intellectual Property can Promote Economic Efficiency,* 41 AM. BUS. L.J. 1 (2003); Jonathan Zittrain, *Internet Points of Control,* B.C. L. REV. (forthcoming), *available at* http://ssrn.com/abstract=388860.

[50] Jonathan Zittrain, A History of Online Gatekeeping, 19 HARV. J.L. & TECH. 253 (2006), *available at* http://ssrn.com/abstract=905862; Urs Gasser, iTunes: How Copyright, Contract, and Technology Shape the Business of Digital Media - A Case Study (June 2004), Berkman Center for Internet & Society at Harvard Law School Research Publication No. 2004-07, *available at* http://ssrn.com/abstract=556802; Deven R. Desai, & Gerard N. Magliocca, *Patents, Meet Napster: 3D Printing and the Digitization of Things*, 102 GEO. L.J. 1691 (2014), *available at* http://ssrn.com/abstract=2338067; Jonathan Zittrain, *Normative Principles for Evaluating Free and Proprietary Software*, 71 U. CHI. L. REV. 265 (2004), *available at* http://ssrn.com/abstract=529862; Andrea M. Matwyshyn, *Technoconsen(t)sus,* 85 WASH. U. L. REV. 529 (2007), *available at* http://ssrn.com/abstract=904075; Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law,* 75 TEX. L. REV. 989 (1997), *available at* http://ssrn.com/abstract=1274199; F. Scott Kieff & Troy A. Paredes, The Basics Matter: At the Periphery of Intellectual Property, Stanford Law and Economics Olin Working Paper No. 275 (2004), *available at* http://ssrn.com/abstract=501142; Derek Slater, Urs Gasser, Meg Smith, Derek E. Bambauer, & John G. Palfrey, Content and Control: Assessing the Impact of Policy Choices on Potential Online Business Models in the Music and Film Industries, Berkman Publication Series Paper No. 2005-01, *available at* http://ssrn.com/abstract=654602; Deborah S. Tussey, *Music at the Edge of Chaos: A Complex Systems Perspective on File Sharing*, LOY. U. CHI. L.J. (2005), *available at* http://ssrn.com/abstract=850244; Stephanie Greene, *Reconciling Napster With The SONY Decision and Recent Amendments to Copyright Law*, 39 AM. BUS. L.J. 57 (2001); Peter K. Yu, *From Pirates to Partners (Episode II): Protecting Intellectual Property in Post-WTO China,* 55 AM. U. L. REV. 901 (2006).

[51] *See generally* Jack M. Balkin, *The Future of Free Expression in a Digital Age*, 36 PEPP. L. REV. (2009), *available at* http://ssrn.com/abstract=1335055. *See also* Jonathan Zittrain, *The Generative Internet,* 119 HARV. L. REV. 1974 (2006); Siva Vaidhyanathan, *Open Source as Culture-Culture as Open Source*, OPEN SOURCE ANNUAL 2005, Clemens Brandt, ed., Berlin: Technische U. (2005), *available at* http://ssrn.com/abstract=713044; Richard N. Langlois, Technological Standards, Innovation, and Essential Facilities: Toward a Schumpeterian Post-Chicago Approach, *available at* http://ssrn.com/abstract=204069; Bernard Reddy & David S.

advisable to require nondisclosure agreements before making disclosures about key intellectual property assets for purposes of financing, key employee recruitment, business combinations or acquisitions, or other similar purposes.[52] The three primary forms of intellectual property protection are copyright, patent, and trademark.

Copyright

The U.S. Copyright office defines copyright as "a form of protection grounded in the U.S. Constitution and granted by law for original works of authorship fixed in a tangible medium of expression. Copyright covers both published and unpublished works."[53] The law of copyright "protects original works of authorship including literary, dramatic, musical, and artistic works, such as poetry, novels, movies, songs, computer software, and architecture. Copyright does not protect facts, ideas, systems, or methods of operation, although it may protect the way these things are expressed."[54] Copyright differs from a trademark or patent in that:

> Copyright protects original works of authorship, while a patent protects inventions or discoveries. Ideas and discoveries are not protected by the copyright law, although the way in which they are expressed may be. A trademark protects words, phrases, symbols, or designs identifying the source of the goods or services of one party and distinguishing them from those of others.[55]

Evans, Government Preferences for Promoting Open-Source Software: A Solution in Search of a Problem (May 21, 2002), *available at* http://ssrn.com/abstract=313202.

[52] *See generally* Stephen M. McJohn, *Top Tens in 2012: Patent, Trademark, Copyright and Trade Secret Cases*, 11 NW. J. TECH. & INTELL. PROP. 173 (2013), *available at* http://ssrn.com/abstract=2186675 (observing that nondisclosure agreements were held to provide less protection for claimed trade secrets than some precedent would suggest).

[53] *See* Copyright in General, Frequently Asked Questions, U.S. Copyright Office, *available at* http://copyright.gov/help/faq/faq-general.html#what (last visited May 31, 2015).

[54] *Id.*

[55] *Id. See also* Kevin J. Hickey, *Reframing Similarity Analysis in Copyright*, 93 WASH. U. L. REV. (2015).

Copyright protection is afforded "the moment it is created and fixed in a tangible form that it is perceptible either directly or with the aid of a machine or device… You will have to register, however, if you wish to bring a lawsuit for infringement of a U.S. work."[56] In addition, "Registered works may be eligible for statutory damages and attorney's fees in successful litigation. Finally, if registration occurs within five years of publication, it is considered *prima facie* evidence in a court of law."[57] The position of Register of Copyrights and the U.S. Copyright Office was "created by Congress in 1897 as a separate department of the Library of Congress."[58]

<u>Patent</u>

The Leahy-Smith America Invents Act (AIA),[59] signed into law by President Barack Obama on September 16, 2011, "represents the most significant reform of the Patent Act since 1952… [intended to] give a boost to American companies and inventors who have suffered costly delays and unnecessary litigation, and let them focus instead on innovation and job creation."[60] The AIA is intended to help entrepreneurs, inventors and small business owners by immediately offering:

1. a fast track option for patent processing within 12 months;
2. reducing the current patent backlog;
3. reducing litigation;

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[56] *See* Copyright in General, Frequently Asked Questions, U.S. Copyright Office, *available at* http://copyright.gov/help/faq/faq-general.html#what (last visited Sept. 24, 2015).
[57] *Id.*
[58] *See* Overview of the Copyright Office, U.S. Copyright Office, *available at* http://copyright.gov/about/) (last visited Sept. 24, 2015).
[59] Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011) (codified in scattered sections of 35 U.S.C. 2012), *available at* http://www.gpo.gov/fdsys/pkg/PLAW-112publ29/pdf/PLAW-112publ29.pdf. (Last viewed Sept. 24, 2015).
[60] Press Release, The White House, *President Obama Signs America Invents Act, Overhauling the Patent System to Stimulate Economic Growth, and Announces New Steps to Help Entrepreneurs Create Jobs*, (Sept. 16, 2011), *available at* https://www.whitehouse.gov/the-press-office/2011/09/16/president-obama-signs-america-invents-act-overhauling-patent-system-stim. (Last viewed Sept. 24, 2015).

4. increasing patent quality; and
5. increasing the ability of American inventors to protect their IP abroad.[61]

Observing that "obtaining patent protection is vital for [many] startup companies,"[62] Professor Patricia E. Campbell warns that certain provisions of the AIA "potentially [make] it more difficult for them to obtain patents and [cast] doubt on the validity of any patents they may receive."[63] Most significantly, the AIA provides that the Unites States changed, effective March 16, 2013, from a first-to-invent system to a first-to-file regime.[64] Other significant challenges to inventors include, "the expanded definition of prior art and the uncertainty surrounding 'disclosures' and the multitude of new opportunities for third parties to challenge the issuance and validity of patents."[65]

The role of the United States Patent and Trademark Office (USPTO), an agency of the U.S. Department of Commerce, "is to grant patents for the protection of inventions and to register trademarks."[66] The patent confers "'the right to exclude others from making, using, offering for sale, or selling' the invention in the United States or

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[61] *Id.*
[62] *See generally* Patricia E. Campbell, *Coping With the America Invents Act: Patent Challenges for Startup Companies,* 8.2 OHIO ST. ENTREP. BUS. L.J. 355 (2013). *See* Mark A. Lemley & Dan L. Burk, *Policy Levers in Patent Law,* 89 VA. L. REV. 1575 (2003) (suggesting that economic policy and industry-specific variation should be considered when applying patent rules to specific cases).
[63] *Id.*, *citing* Virginia Bridges, *Patent Laws Change Saturday, Affecting Small Business Inventors,* NEWS OBSERVER (Mar. 11, 2013), *available at* http://www.newsobserver.com/2013/03/11/2742358/inventors-should-move-quickly.html; Gary Lauder, *New Patent Law Means Trouble for Tech Entrepreneurs,* FORBES (Sept. 20, 2011, 4:04 PM), http://www.forbes.com/sites/ciocentral/2011/09/20/new-patent-law-means-trouble-for-tech-entrepreneurs/.
[64] Leahy-Smith America Invents Act § 3.
[65] *See* Campbell, *supra* note 62 at 356. *See also* Robin Feldman, *Patent Demands & Startup Companies: The View From The Venture Capital Community,* 16 YALE J.L. & TECH. 236 (2014) (discussing patent monetization).
[66] U.S. Patent & Trademark Office, General Information Concerning Patents 2 (Oct. 2014), *available at* http://www.uspto.gov/patents-getting-started/general-information-concerning-patents (last visited Sept. 24, 2015).

'importing' the invention into the United States."[67] Of significance, the actual right "granted is not the right to make, use, offer for sale, sell or import, but the right to exclude others from making, using, offering for sale, selling or importing the invention."[68] The USPTO describes the three types of patents as

> 1) **Utility patents** may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or composition of matter, or any new and useful improvement thereof;
> 2) **Design patents** may be granted to anyone who invents a new, original, and ornamental design for an article of manufacture; and
> 3) **Plant patents** may be granted to anyone who invents or discovers and asexually reproduces any distinct and new variety of plant.[69]

Of course obtaining a patent and enforcing it are two different things. The time and expense of both initial patent prosecution and subsequent litigating of claims of patent infringement can be quite large. Accordingly, an entrepreneur should discuss with qualified patent counsel a cost-benefit analysis of both the initial patenting costs and potential enforcement costs, taking into account other possible approaches (such as, for example, reliance on trade secrets).[70]

Patent Agents and Attorneys

Intellectual property practice is a uniquely specialized area of the law. The USPTO warns that application preparation "for patent and the conducting of the proceedings in the [USPTO] to obtain the patent is an undertaking requiring the knowledge of patent law and rules and Office practice and procedures, as well as

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[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *See, e.g.*, David L. Bodde, THE INTENTIONAL ENTREPRENEUR: BRINGING TECHNOLOGY AND ENGINEERING TO THE REAL NEW ECONOMY (M.E. Sharpe 2004) at Chapter 8; Thomas G. Field, Jr., *IP Basics: Seeking Cost-Effective Patents*, *available at* http://law.unh.edu/franklin-pierce-ip-center/studying-ip-at-unh-law/ip-basics/cost-effective-patents/ (last visited Sept. 24, 2015).

knowledge of the scientific or technical matters involved in the particular invention."[71]

Moreover:

> Inventors may prepare their own applications and file them in the USPTO and conduct the proceedings themselves, but unless they are familiar with these matters or study them in detail, they may get into considerable difficulty. While a patent may be obtained in many cases by persons not skilled in this work, there would be no assurance that the patent obtained would adequately protect the particular invention.
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> Most inventors employ the services of registered patent attorneys or patent agents. The law gives the USPTO the power to make rules and regulations governing conduct and the recognition of patent attorneys and agents to practice before the USPTO. Persons who are not recognized by the USPTO for this practice are not permitted by law to represent inventors before the USPTO. The USPTO maintains a register of attorneys and agents. To be admitted to this register, a person must comply with the regulations prescribed by the Office, which require a showing that the person is of good moral character and of good repute and that he or she has the legal, scientific, and technical qualifications necessary to render applicants for patents a valuable service. Certain of these qualifications must be demonstrated by the passing of an examination. Those admitted to the examination must have a college degree in engineering or physical science or the equivalent of such a degree.
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> The USPTO registers both attorneys at law and persons who are not attorneys at law. The former persons are now referred to as "patent attorneys," and the latter persons are referred to as "patent agents." Both patent attorneys and patent agents are permitted to prepare an application for a patent and conduct the prosecution in the USPTO. Patent agents, however, cannot conduct patent litigation in the courts or perform various services that the local jurisdiction considers as practicing law. For example, a patent agent could not draw up a contract relating to a patent, such as an assignment or a license, if the state in which he or she resides considers drafting contracts as practicing law…
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> The USPTO cannot recommend any particular attorney or agent, or aid in the selection of an attorney or agent, as by stating, in response to inquiry that a named patent attorney, agent, or firm, is "reliable" or "capable." The USPTO maintains a directory of registered patent attorneys and agents at *http://des.uspto.gov/OEDCI*...
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> In employing a patent attorney or agent, the inventor executes a power of attorney, which is filed in the USPTO and made of record in the application file. When a registered attorney or agent has been appointed, the Office does not communicate with the inventor directly but conducts

[71]U.S. Patent & Trademark Office, General Information Concerning Patents 2 (Oct. 2014), *available at* http://www.uspto.gov/patents-getting-started/general-information-concerning-patents (last visited Sept. 24, 2015).

the correspondence with the attorney or agent since he or she is acting for the inventor thereafter although the inventor is free to contact the USPTO concerning the status of his or her application. The inventor may remove the attorney or agent by revoking the power of attorney.[72]

Trademark

The USPTO describes a trademark as "a word, name, symbol, or device that is used in trade with goods to indicate the source of the goods and to distinguish them from the goods of others."[73] Closely related, "a servicemark is the same as a trademark except that it identifies and distinguishes the source of a service rather than a product. The terms 'trademark' and 'mark' are commonly used to refer to both trademarks and servicemarks."[74] The purpose of a trademark is to identify for consumers the source of the product and perhaps provide some additional information about the product itself based on prior experiences or reputation.[75]

Professor Jasmine Abdel-khalik observes that there are various types of trademarks, including word marks, slogans, logos, "color, sound, and trade dress," which can include both the packaging and sometimes even the design of the product.[76] However, just because something can be a trademark does not mean that it will be one. There are a variety of limitations and prohibitions that can prevent a symbol from functioning like a trademark,[77] and consulting with an attorney can help steer a

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72 *Id.*
73 *Id.* at 3.
74 *Id.*
75 See J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition §§2:3, 2:5 (4th ed., 2015).
76 Email from Jasmine C. Abdel-khalik, Associate Professor of Law at the UMKC School of law (May 27, 2015, on file with authors) [hereinafter Abdel-khalik]. See, e.g., McCarthy, supra note 75, at §§7:9, 7:19, 7:24, 7:26, 7:33,7:39,7:54, 7:106 – 7:108.
77 See, e.g., McCarthy, *supra* note 75, at §§ 7:63, 12:1, 13:1, 14:1, 15:2, 19:75 (to name a few: functionality, genericness, personal names, geographic terms, terms that need secondary meaning, and statutory bars to federal registration).

business through these limitations and prohibitions. In addition, there can be complications a business has not considered. For example, although logos are a type of trademark, they can also "have [tricky] copyright implications if you hire someone to create / design it."[78]

Unlike patent, a trademark or servicemark is created as soon as it is used to sell a product, goods or services, but a business can apply for a federal registration (as long as there is prior use or a bona fide intent to use the mark for the identified goods and/or services) and receive some additional benefits.[79] Because of the ease in creating a trademark, businesses must be particularly careful when choosing marks to avoid infringing the marks owned by others. A trademark-experienced attorney can provide a trademark clearance report to assess the risk that any mark is unavailable based on another's use as well as assist with the registration process.

IV. PRINCIPAL CHOICE OF ENTITY CONSIDERATIONS

Choice of entity analysis can be generally separated into questions of: (1) liability management, (2) agency authority, and (3) capital structure, including tax considerations. Many law school graduates should be familiar with this multi-layered analysis from courses in business associations/organizations and taxation of business enterprises. What is commonly referred to as "choice of entity" essentially consists of three choices: what basic form of entity is wanted?; under what jurisdiction's laws should it be formed?; and what tax classification is desired for it for federal and state tax purposes?[80]

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[78] Abdel-khalik, *supra* note 76.
[79] Abdel-khalik, *supra* note 76; McCarthy, *supra* note 75, at §§ 16:1, 19:1.25.
[80] While many states follow the federal tax classification of a business entity for income tax purposes, some do not—so a state-by-state analysis is needed for a complete picture. *See, e.g.*, C. Andrew Lafond & Jeffrey J. Schrader, *Multistate Tax Considerations for S Corporations*, J.

Corporations and other entity types, such as the limited liability company ("LLC") are generally creatures of state law. A corporation created under the laws of Delaware will be subject to different governance, case law regime, and regulatory schematic than a corporate entity organized under the laws of Florida or Texas. Because choice of entity is legally intensive, the issue should not be undertaken without the guidance of an experienced attorney, preferably one who practices in the jurisdiction where the start-up company will be domiciled and will conduct the bulk of its business. However, in some cases an entrepreneur may find, with advice of qualified counsel, that they want to form their company under the law of a state other than the venture's principal business location. That approach is made possible by (i) the ability to form a company in a state and then register it to do business in the other states in which it will conduct business, and (ii) the "internal affairs" doctrine, which generally allows the law of the entity's formation to govern matters pertaining to the internal relationships among the company and its owners and management, and matters regarding the statutory shielding of certain types of owners from personal liability for company obligations.[81]

Each of the following types of business entity offers its own advantages and disadvantages (and some may not be available in all jurisdictions): sole proprietorship; general partnership; limited liability partnership; limited partnership; limited liability

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ACCT. (Jan. 31, 2011), *available at* http://www.journalofaccountancy.com/issues/2011/feb/20103307.html (last visited Sept. 24, 2015).

[81] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971). *See also* Franklin Gevurtz, BUSINESS PLANNING (5th Ed., Foundation Press 2015), at 101-02; Robert W. Hamilton, Jonathan R. Macey & Douglas K. Moll, THE LAW OF BUSINESS ORGANIZATIONS (12TH Ed. West Academic Publishing 2014) at 156.

limited partnership; limited liability company; certain business trusts (e.g. Real Estate Investment Trust, etc.); and corporation.[82]

Liability Considerations

A primary goal of entity choice is to limit the personal liability of individuals involved in the enterprise. For example, a sole proprietor is personally liable for wrongful acts and contracts entered, as are partners in regular (sometimes called "general") partnerships and general partners in limited partnerships–whereas shareholders of a corporation, limited partners in limited partnerships, all partners in limited liability partnership or limited liability limited partnership, and members of a limited liability company are generally not personally liable for obligations of the entity.[83] However, the "liability shield" generally available to owners in those latter categories are not without exception.

First, particular statutory provisions may impose personal liability on owners for some specific types of obligations.[84] Second, courts have developed the doctrine of

[82] There are a multitude of publications with in-depth discussion of tax and non-tax considerations in making choice of entity determinations. *See, e.g.,* Bagley & Dauchy, *supra* note 9, at Ch. 4 ("Deciding Whether to Incorporate"); Drake, supra note 9, at Ch. 3 ("The Choice of Entity Challenge"); Byron F. Egan, *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code,* 42 TEX. J. BUS. L. 171 (Spring 2007); "*Choice of Entity Alternatives,"* 39 TEX. J. BUS. L. 379 (Winter 2004); and William P. Streng, CHOICE OF ENTITY, Blomberg/BNA Tax Management Portfolio 700-3rd. *See also generally* Stephanie M. Greene, *Improving Internal Governance in Unincorporated Business Entities,* 46 AM. BUS. L.J. v (2009) (sole proprietorship); Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies,* 46 AM. BUS. L.J. 221 (2009); Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243 (2009); Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law,* 46 AM. BUS. L.J. 279 (2009).
[83] *See, e.g.,* Gevurtz, *supra* note 81, at 51-53; Hamilton et al., *supra* note 81, at 3-5, 1115, 1177-1197, and 1199.
[84]*See, e.g.,* Hamilton et al. *supra* note 81, at 255 (possible liability under environmental laws; I.R.S. website at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employment-Taxes-and-the-Trust-Fund-Recovery-Penalty-TFRP (discussing "responsible person" liability for trust fund/payroll taxes) (last visited Sept. 24, 2015).

"piercing the corporate veil" (which has been applied to not just corporations, but also to unincorporated entities, such as limited liability companies) where the facts and circumstances indicate the company was formed or maintained in a flimsy or deceptive manner and one or more of the company owners should be held personally liable for company obligations.[85] Third, even if the company is properly formed and well-maintained in a manner providing owners with a good shield from personally liability, a savvy lender, lessor or other would-be creditor of a company may insist on a personal guarantee from one or more of the owners as a conditions to making the loan, lease or other contract with the company. In addition, entrepreneurs looking to start a company need to understand that even if none of those exceptions applies, they can still be personally liable for their own wrongdoing—in other words the liability shields offered by various types of business entities are designed to relieve an owner from vicarious personal liability for *company* obligations, not for the owner's own direct obligations.

Agency Authority

Entrepreneurs forming a business entity should be concerned with who in the organization may have authority to sign/bind the company to contracts. While a business entity can create "agents" to act for it by agreement, it is also the case that the type of entity formed may *automatically* create agents by statute under the applicable business organizations law. For example, all partners in a regular partnership are typically by statute agents with authority to bind the partnership to contracts in the usual course of

[85] *See generally* Gevurtz, *supra* note 81, at 50; Hamilton et al. *supra* note 81, at 213-57 and 1250-57.

business.[86] Moreover, each partner has "apparent authority" to conduct such ordinary business—meaning that, for example, even if the partners have agreed among themselves that no partner is to commit the partnership to a contract of a certain size or duration without the prior approval of other partners, a partner ignoring that restriction and signing such a contract without such approval on behalf of the partnership may well have bound the partnership to the contract. The third party creditor is generally able to enforce the contract unless either (i) the creditor knew of the approval restriction; or (ii) the contract is of a type outside of the usual course of the partnership's business.[87] If being forced to honor the contract causes damage to the partnership the other partners can sue the "loose cannon" who ignored the approval restriction. But what if that wrongdoer doesn't have enough assets to cover the damages he or she caused by exercising their "apparent authority"?

That kind of agency authority is generally granted by statute to every partner in a regular partnership or limited liability partnership, to every "general partner" in a limited partnership or limited liability limited partnership, to every member in a "member-managed" limited liability company, and to every "manager" in a manager-managed limited liability company.[88] In contrast, state business organizations statutes generally do not grant such agency authority to limited partners, to members of a manager-managed limited liability company who are not designated "managers," or to shareholders in a

[86] *See* Uniform Partnership Act (U.P.A.) (1914) at §9; Revised Uniform Partnership Act (R.U.P.A.) (1997) at §301.
[87] *Id.*
[88] *See, e.g.,* MO. REV. STAT. §§358.090 (2015) (partners in regular partnerships and limited liability partnerships); 359.251.1 (general partners in limited partnerships and limited liability partnerships); and 347.065 (members in member-managed limited liability companies and managers in manager-managed limited liability companies).

corporation. So, once again, it is important for entrepreneurs forming a business entity to get qualified legal counsel to help them take this agency issue into account in the multi-factored choice of entity analysis.

Capital Structure Tax Considerations

In addition to liability and agency considerations, another primary goal of business entity selection will be to settle on a structure that minimizes tax liability, while providing a legal form most conducive to raising needed capital. Relevant considerations will include, but not be limited to (i) anticipated amount of capital needed and likely sources, (ii) number of individuals involved in managing the business, and (iii) number of individuals contributing capital and whether they are natural persons or non-natural persons.

Some investors may actually be motivated to invest in a start-up in anticipation of likely losses to be incurred during the early operating history of the enterprise. In that case, or for other tax reasons,[89] they may be most interested in a "pass-through entity" for tax purposes at least in the early stages of their venture. That means a tax status under which the entity itself does not pay income tax; rather the owners pay tax on their shares of the entity's income, and is allocated their shares of the entity's tax deductions and tax credits.[90] For many businesses that will involve determining whether "partnership" or "S corporation" tax status is desired, as opposed to a "C corporation" in which the

[89] Such as avoiding double taxation (i.e., at both the company and owner level) of earnings, or, if partnership taxation applies having the ability to, subject to certain exceptions make distributions of appreciated property (i.e., property with fair market value in excess of tax basis) on a tax-deferred basis. *See generally* Gevurtz, *supra* note 81, at 58-80; William S. Mckee et al., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (Thomson Reuters 2015) at Chapters 1 and 19.
[90] *See generally* Hamilton et al. *supra* note 81, at 6-14.

corporation pays tax on its taxable income and shareholders generally pay tax on the dividends paid to them.[91] Importantly, not all entities will be eligible for partnership or S corporation tax status, making it, again, important to get qualified legal counsel to explain the options and requirements, as well as the opportunities to change tax status later in the life of the venture (and the tax consequences of such changes).[92]

A detailed comparison of partnership taxation to S corporation taxation is beyond the scope of this article, but a few key points merit mention here. First, the entrepreneur should understand that S corporations pose some pretty substantial capital structure limitations, in that they are limited to having no more than 100 shareholders, to (generally) not having any shareholders who are not human beings legally resident in the U.S. (so generally can't have business entities as owners), and to not having more than one class of stock in terms of distribution rights (so, can't have preferred and common equity).[93] Also, the company founders need to realize that in a pass-through entity (partnership or S corporation) the owners pay tax on their shares of the entity's taxable income *whether or not that have received corresponding distributions*. Further complexities include the effects of company liabilities on the ability of owners to claim tax losses generated by the entity.[94]

In addition, there can be important tax consequences associated with how owners acquire their equity interests in the business entity. For example, partnership taxation has some important differences from S or C corporations when an owner is acquiring equity

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[91] *Id.*
[92] *See, e.g.,* Gevurtz, *supra* note 81, at 58-59, 74-76; Hamilton et al., *supra* note 81, at 6-14; Mckee et al., *supra* note 89, at Ch. 3.06.
[93] I.R.C. §1361.
[94] *See* Gevurtz, *supra* note 81, at 77-78; Mckee et al. *supra* note 89, at Ch. 7.02.

in exchange for a contribution of property with a fair market value in excess of the owner's tax basis in the property, especially when the property has liabilities associated with it.[95] It is critical that the entrepreneur understand the tax implications of such property transfers. Similarly, they need to understand the tax aspects of getting equity in exchange for services or promises associated with services. Many start-up entrepreneurs fall into the trap of not understanding the tax consequences of issuing equity interests in a venture to service providers.[96] Included here is the potential importance of a timely "Section 83(b) election" with respect to non-vested equity issued in connection with the performance of services.[97] Getting qualified tax counsel involved in capital structure planning *before* any offers or promises are made is clearly the best way to go.

V. RAISING CAPITAL IN COMPLIANCE WITH SECURITIES LAWS

A start-up is inherently a legal endeavor. Early dollars invested to obtain solid legal advice and planning are invaluable and can save future resources by reducing the likelihood of costly, time-consuming efforts required to correct oversights and inadvertent mistakes made during the organizational business planning phase. Even worse, a naïve well-meaning (but unlawful) solicitation or sale of securities not in compliance with federal and state securities laws may subject those involved to civil and criminal penalties.[98]

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[95] *See* Gevurtz, *supra* note 81, at 336-37, 341-42, 351-52.
[96] *See* Mckee et al. *supra* note 89, at Ch.5.
[97] I.R.C. Section 83(b).
[98] *See generally*, Linda Chatman Thomsen, International Institute for Securities Market Development, Division of Enforcement, 2005 Program, SEC, *available at* *https://www.sec.gov/about/offices/oia/oia_enforce/overviewenfor.pdf*; *See also* MARC I. STEINBERG, SECURITIES REGULATION (6th Edition 2013).

We will present below issues regarding the definition of a "security" for key federal securities laws purposes and briefly describe equity and debt offerings to set the stage for our discussion of various types of early stage capital. The definition of "security" is quite important because if an offering of securities is to occur then it must either be registered (an expensive and time-consuming process) or demonstrated to be exempt from registration under federal and state securities regulation purposes.[99] Complicating matters, while there is generally substantial overlap in the definitions, some states define "security" somewhat differently than under federal securities law.[100] Again, in navigating all the requirements to avoid costly violations, skilled and experienced legal advice is not a luxury, but a necessity.

What Is an Equity Security?

The term "security" is defined in Section 2(a)(1) of the *Securities Act of 1933* ("Securities Act") and Section 3(a)(10) of the *Securities Exchange Act of 1934* ("Exchange Act").[101] Even though stock is included in the definition of a security, the mere labeling of an investment as "stock" doesn't necessarily mean that it conforms to the definition of "security" for purpose of the Securities Act or Exchange Act. There are

[99] Securities Act of 1933 §5(a). *See also* Mo. Rev. Stat. §409.3-301.1 (2015), §517.07 Fla. Stat. (2015). For general information about state securities laws see http://www.sec.gov/answers/statesecreg.htm (last visited Sept. 24, 2015) and http://www.nasaa.org/ (last visited May 31, 2015). There are many publications addressing the securities regulations context of raising capital from various sources for start-up businesses in the U.S. *See, e.g.*, Bagley & Dauchy, *supra* note 9 at Ch. 7 ("Raising Money and Securities Regulation"); Drake, *supra* note 9, at 135-177.

[100] *See generally* Thomas Lee Hazen, Federal Securities Laws, 6 (3rd Ed. 2011). *See also* Cornell U. L. Sch., Blue Sky Law, *available at* https://www.law.cornell.edu/wex/blue_sky_law (last visited Sept. 24, 2015).

[101] Securities Act of 1933 §2(a)(1), 15 U.S.C. § 77b(a)(1); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. §78c(a)(10). *See generally* Stephen G. Christianson, *Proof of a "Security" under Federal and State Statutes*, 22 AM. JUR. PROOF OF FACTS 3D 485 (Originally published in 1993, updated August 2013).

certain characteristics that are a common feature of stock, those include: (1) the right to receive "dividends contingent upon an apportionment of profits"; (2) negotiable; (3) the ability to be pledged or hypothecated; (4) voting rights in proportion to the number of shares owned and (5) the ability to appreciate in value.[102]

The term investment contract is also included in the definition and is also considered a security.[103] Investment contract is a broad term that has been used to analyze a variety of investment instruments, such as unincorporated entities like partnerships or limited liability companies, to determine whether or not those instruments are securities within the meaning of the Securities Act. The traditional test for an investment contract—the "Howey test"— is: (1) an investment of money; (2) in a "common enterprise"; (3) with an expectation that profits will be derived 'solely' through the efforts of others.[104]

Debt

Securities may come in the form of equity or debt. Notes and other forms of debt, can be considered securities.[105] If a corporation, limited liability company, or other business entity proposes to use debt to raise capital, the registration (or establish exemption) requirements under the Securities Act will apply if the debt instrument

[102] *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).
[103] Securities Act of 1933 §2(a)(1).
[104] *SEC v. W.J. Howey Co*., 328 U.S. 298 (1946) (In the 1946 case, the U.S. Supreme Court shed light on the definition of a "security." In a case that involved land contracts for orange trees, the Court determined that a security included any scheme that involved an "an investment of money in a common enterprise with profits to come solely from the efforts of others." When applied to unincorporated entities, the key issue is often whether profits are to be derived solely from the efforts of the investor or whether the investor passively invests in the business. The determination of whether the investor is passive will depend on the facts and circumstances of each situation). *See also* Miriam R. Albert, *The Howey Test Turns 64: Are Courts Grading This Test on a Curve?,* 2 WM. & MARY BUS. L. REV. 1 (2011).
[105] Securities Act of 1933 §2(a)(1).

constitutes a security.[106] The test, more commonly referred to as the "family resemblance test," takes into consideration four factors: (1) the motivation of the parties; (2) plan of distribution; (3) expectations of the public; and (4) whether or not there is another applicable regulatory scheme that may reduce the risk of the investment.[107] When the investments involve a return of both the principal and interest, the factors that evidence the motivation of the parties and the plan of distribution evidence that the note is a security.[108] Public perception determines whether the third factor is satisfied.[109] The final factor is whether there is another applicable regulatory scheme (such as banking laws under the Gramm Leach Bliley Act or the regulation of employee retirement income under ERISA) that may reduce the risk of the investment.[110]

Again, the initial significance of finding that a security is being offered or sold means that the security will need to be registered on the federal level and also registered under state law in every state where an offer is made or the security is sold, unless particular exemptions from registration apply.[111] Registration is a costly process and subjects the issuer to even more possible liability. In order to avoid registration many issuers will seek an exemption from registration; however, even if an exemption applies, there is still potential issuer liability for securities fraud.[112]

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[106] *Reves v. Ernst & Young*, 494 U.S. 56 (1990).
[107] Id.
[108] Id.
[109] Id.
[110] Id.
[111] *See* note 99 *supra* and accompanying text.
[112] *See*, *e.g.* preamble to the SEC's Regulation D at 17 C.F.R. §230.500(a) ("Regulation D relates to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the Act) (15 U.S.C.77a et seq., as amended). Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws.").

The Reg-D Offering

When the SEC adopted Regulation D ("Reg. D"), it provided a relatively clear and viable path to exempt small and private offerings from the federal registration requirement.[113] Regulation D consists of three different "issuer" exemptions: Rule 504, Rule 505, and Rule 506.[114] While the three exemptions are subject to some common requirements and restrictions, each has some unique limitations to its availability. Reliance on Regulation D alone neither obviates the need to comply with any applicable state laws that relate to the offer or sale of securities nor voids liability under the antifraud laws.[115] While those who appropriately rely on and satisfy the condition of a Reg. D exemption do not have to register their securities, they must provide a notice filing to the SEC on "Form D" within 15 days of the first sale.[116]

Rule 504:

Rule 504 provides an exemption from federal registration for offerings up to $1 million in a twelve month period.[117] This includes all securities sold twelve months before the start of and during the targeted offering period.[118] The issuer must take steps to ensure that the securities acquired are not resold.[119] A Rule 504 offering neither limits the number of purchasers nor requires that purchasers have a certain net worth or possess a certain level

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[113] See 17 C.F.R. § 230.501-508. The rules were adopted in Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11251 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230, 239). Regulation D consists of Rules 501 through 508. Rules 501 through 503 and Rules 507 through 508 are general rules of support for the exemptions found in Rules 504 through 506.
[114] *See e.g.* Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation,* 13 TRANSACTIONS: THE TENNESSEE JOURNAL OF BUSINESS LAW 88 (2011).
[115] 17 C.F.R. §§ 230.500(b) and 17 C.F.R. §§ 230.504(b)(ii).
[116] 17 C.F.R. § 230.503.
[117] 17 C.F.R. § 230.504(b)(2).
[118] 17 C.F.R. § 230.504(b)(2).
[119] 17 C.F.R. § 230.502(d).

of business sophistication.[120] In addition, there are no federal-level disclosure requirements.[121] The issuer is prohibited from generally soliciting or advertising the offering,[122] except those solicitation and resale restrictions do not apply if the issuer, as part of state registration requirements, publicly files and delivers substantive disclosure documents to investors before the sale of securities.[123] Because the securities issued under Rule 504 are not "covered securities" under §18 of the 33 Act, exemption under Rule 504 does not preempt state regulation.[124]

Rule 505:

Rule 505 exempts offerings up to $5 million. Included in this limit is the sale of all securities sold twelve months before and during the offering period.[125] While an issuer may sell to an unlimited number of "accredited" investors, the number of non-accredited investors is limited to 35.[126] Even though the rule does not require non-accredited investors to be financially sophisticated, the issuer must disclose to all non-accredited investors investment information consisting of financial statements, certified by an independent public accountant, and other written information that is material to the offering.[127] General

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[120] 17 C.F.R. § 230.504.
[121] 17 C.F.R § 230.504, 230.502(b)(1) .
[122] 17 C.F.R. §230.504(b)(1) and 230.502(c).
[123] 17 C.F.R. § 230.504(b)(i) and 17 C.F.R. § 504(b)(ii).
[124] 17 C.F.R. § 230.500(b)(1). *See also* Gevurtz, *supra* note 81, at 654-55.
[125] 17 C.F.R. § 230.505(b)(2)(i).
[126] 17 C.F.R. § 230.505(b)(2)(ii). Accredited investors commonly tend to include an individual with an income in excess of $200,000 in each of the past two years or joint income with a spouse in excess of $300,000, (2) an individual with a net worth that exceed $1 million, excluding their primary residence (3) a business entity or trust not formed with the specific purpose of acquiring securities with total assets of $5 million,. There are other criteria which one could meet to be considered an accredited investor, including for example individual who are directors, general partners or "executive officers" of the issuer. *See* 17 C.F.R. § 230.501(a).
[127] 17 C.F.R. § 230.502(b)(2)(B). The issuer is not required to make the Rule 502(b)(2) disclosures to "accredited" investors, but a note under 17 C.F.R. § 230.502(b) suggests that "it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws."

solicitation and general advertising are also prohibited,[128] and the issuer must take steps to prevent any public resale of the securities.[129] If within the last 5 years, the issuer has been involved in any securities law violations, then that issuer is disqualified from the Rule 505 exemption.[130] These provisions also apply to any director, officer or owner with 10% or more of any class of security.[131] This criteria highlights the importance of knowing and understanding the criminal and civil backgrounds of all the parties involved in the venture because it may impact the availability of some exemptions. Similar to Rule 504, state regulation is not preempted by Rule 505 exemption.[132]

Rule 506:

Under Rule 506, there is no limit on the dollar amount of the offering.[133] An unlimited number of accredited investors is permitted, and up to 35 non-accredited investors. In addition, in a Rule 506 offering, each non-accredited investors must (themselves or through a qualified purchaser representative) have sufficient business knowledge so they are capable of evaluating the risks of a potential investment.[134] As with Rule 505, specified disclosures must be made to each non-accredited investor,[135] and the issuer must take steps to ensure the securities acquired are not immediately resold.[136] The offering cannot be integrated with any other offers that are made within six months of the target offering.[137] There are also prohibitions on directors, executive officers, or other

[128] 17 C.F.R. § 230.505(b) and 17 C.F.R. § 230.502(c).
[129] 17 C.F.R. § 230.505(b) and 17 C.F.R. § 230.502(d).
[130] 17 C.F.R. § 230.505(b)(2)(iii) and 17 C.F.R. § 230.262.
[131] *Id.* The SEC recently adopted similar provisions for Rule 506.
[132] 17 C.F.R. § 230.500(b).
[133] 17 C.F.R. § 230.506.
[134] 17 C.F.R. § 230.506(b)(2)(ii) and 17 C.F.R. § 230.501(a).
[135] 17 C.F.R. § 230.506(b)(1) and 230.502(b).
[136] 17 C.F.R. § 230.506(b)(1) and 230.502(d).
[137] 17 C.F.R. § 230.502(a).

participants with 20% or more beneficial ownership who have been convicted of a felony or misdemeanor within the last 10 years in connection with the purchase or sale of a security.[138] There is a ban on general solicitation and general advertising,[139] though the Jumpstart Our Business Startups (JOBS) Act of 2012 and subsequently issued SEC rules lifted the ban for otherwise qualifying Rule 506 offerings in which all purchasers are (or are reasonably believed to) accredited if the issuer takes reasonable steps to verify this fact.[140] While that limited relief from the ban on general solicitation and advertising for Rule 506 offerings with only accredited investors is sometimes referred to as a type of "crowdfunding," it is not the same as the yet-to-be implemented "crowdfunding exemption" for certain offerings up to $1 million discussed below.[141]

Another reason Rule 506 is very important to entrepreneurs who seek to minimize expenses is because it is the only rule under Regulation D that also preempts state substantive securities regulation.[142] Even though the issuer is exempt from blue sky registration requirements, nothing in the rule shields the issuer from subsequent litigation by a state regulatory agency for securities fraud, nor does it exempt the issuer from paying any required fees or making any required notice filings.[143]

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[138] 17 C.F.R. § 230.506(d).
[139] 17 C.F.R. §230.506(b)(1) and 230.502(c).
[140] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013).
[141] *See* notes 190 *infra* and accompanying text.
[142] *See* §18(b)(4)(E) of the Securities Act of 1933. *See also*, Rutherford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 287 (2012).
[143] Some states may continue to impose certain filing obligations. As a result, the issuer may be required to file a copy of its Form D with state regulators.

Other Exemptions from Registration: Regulation A and Intrastate Offerings

The intrastate exemption is reserved for issuers who offer or sell securities only in the state where the issuer is incorporated.[144] There are three basic requirements to qualify for this exemption. The issuer must be incorporated or have its principal place of business in the state where it offers the securities, carry out a significant amount of its business in the target state, and make offers and sales only to residents of that state. Unfortunately, the restriction to a single state impacts any broad-based search for capital because it only takes one offer (even if it does not result in a sale) to nullify the exemption. Even though Section 3(a)(11) provides an exemption from federal regulation, state regulations may still apply.[145]

In addition to the intrastate exemption, there is also Regulation A, for which the SEC recently adopted new rules.[146] Issuers can avoid full registration by conducting a simplified mini-registration process, but the exemption has now been expanded into two tiers.[147] Issuers may raise up to $20 million in a Tier 1 offerings and, with more extensive financial disclosure, up to $50 million in a Tier 2 offering.[148] Under Regulation A, the SEC has evolved its position about solicitation, and allows the issuer to solicit interest in the offering prior to filing any offering statement.[149] State registration is preempted for Tier 2 offerings, but still required for Tier 1 offerings.[150] Prior to the JOBS Act, Regulation A

[144] 15 U.S.C. §3(a)(11).
[145] Id.
[146] Amendments for Small and Additional Issues Exemptions under the Securities Act, Release Number 33-9741 (March 25, 2015).
[147] Id.
[148] Id.
[149] Id.
[150] Id. Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 401(b)(2012).

offerings were rarely used. Some attribute this to the impact of state blue sky laws,[151] while others believe the $5 million offering limit was too low.[152] It remains to be seen whether the new regulations adopted by the SEC on March 25, 2015 will increase the number of Regulation A offerings.

Private Company vs. Public Platform

Few seed-stage enterprises will achieve the success and gain the critical mass necessary to justify the expense of a registered public offering. However, planning for such an eventuality seems prudent, even at the embryo stage. Enterprises with more than 2,000 shareholders of record (or 500 that are not accredited investors) and assets of more than $10 million are subject to the periodic reporting requirements under the Exchange Act.[153] With rare exceptions, all start-ups will begin life as private entities with just a few equity owners, and, if they are successful, usually spend at least a few years in a non-public mode (even if well funded from institutional venture sources).

The benefits of being a publicly traded company include access to securities markets to raise capital and a liquidity event for early-venture investors and key management. Disadvantages of public share ownership include the substantial expenses for legal, accounting, and regulatory compliance, additional corporate governance infrastructure expenses, including expenses associated with board committee oversight and the retention of necessary consultants and more transparency regarding corporate activities. The extra expenses can easily amount to hundreds of thousands of dollars

[151] Campbell Exemptions, *supra* note 142, at 305.
[152] http://financialservices.house.gov/blog/?postid=301209 (last visited Sept. 24, 2015).
[153] Securities Exchange Act of 1934 §12(g), as amended, and 17 C.F.R.240, Rules 12g-1 to 12g5-2.

annually, and disproportionately will be a greater percentage of revenues for smaller enterprises.[154]

<u>Skilled, Experienced Legal and Accounting Advice is a Necessity</u>

We've already seen that raising start-up capital through the issuance of securities is a legally-intensive endeavor. Compliance with federal and state securities laws requires the skillful guidance of a lawyer familiar with this specific area of law. Not every attorney will be well versed in this niche area of practice.

Audited financial statements and guidance with respect to required financial statement disclosures will also require coordination with and retention of a public accounting firm that routinely deals in securities transaction matters. Like attorneys, the public accounting profession is often difficult for non-practitioners to understand. The Public Company Accounting Oversight Board (PCAOB) reports registering 1,600 accounting firms.[155] PCAOB board member Daniel L. Goelzer observed during 2006 that 1,600 "is a far higher number than we originally anticipated, and it reflects the breadth of the public company audit practice in this country. However, in terms of concentration, a very high percentage of the total public company market capitalization is audited by only a handful of firms."[156] Moreover, "a 2004 GAO report found that just four firms audit nearly 99 percent of the revenues of all SEC registered companies."[157] Although an early-stage enterprise may not need to incur the expense of hiring one of the largest

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[154] *See generally* Gevurtz, *supra* note 81, at 562-63; Daniel L. Goelzer, Remarks before the PCAOB Forum on Auditing in the Small Business Environment, Fort Lauderdale, Florida, Feb. 27, 2006.
[155] *See generally* Daniel L. Goelzer, at *Id.*
[156] *Id.*
[157] *Id. See also* Robert A. Prentice, *The Case for Educating Legally-Aware Accountants*, 38 AM. BUS. L.J. 597 (2001).

accounting firms, just as in the case of finding appropriate legal guidance, not every local accounting firm will be experienced or staffed to provide the services you need.

VI. SOURCES OF EARLY STAGE CAPITAL

Perhaps no activity is as legally-intensive as the effort by individuals or an enterprise to raise capital. Professors William R. Kerr and Ramana Nanda observe that "Financing constraints are one of the biggest concerns impacting potential entrepreneurs…"[158] Sources of capital for small companies will vary based on the stage of development (seed stage, early stage before proof of concept, post-break-even, etc.) and the relative attractiveness to investors of the particular industry sector (healthcare, clean energy, biotech/pharmaceuticals, social media, etc.). Different sources will be available based upon these and other criteria. In its most simplified form, these available investors have been separated into the following categories: friends and family; angel investors; traditional commercial banks and other sources of debt or collateralized financing; Small Business Investment Companies; institutional venture sources; investment banks; and franchising. Also discussed are the potential funding opportunities available by crowdfunding efforts.

[158] William R. Kerr & Ramana Nanda, Financing Constraints and Entrepreneurship, 13 Harvard Business School Entrepreneurial Management Working Paper No. 10-013 (2009), *available at* http://ssrn.com/abstract=1447503. *See also* Ramana Nanda & Matthew Rhodes-Kropf, Financing Risk and Innovation, Harvard Business School Entrepreneurial Management Working Paper No. 11-013 (2014), *available at* http://ssrn.com/abstract=1657937.

Friends and Family

Most start-ups are financed initially by the entrepreneur and funds from family and friends. Because of the high risk of failure of any new business, the cost to the enterprise of financing should decrease as the perceived risk of failure decreases. It's at the very beginning, with little more than an idea, unproven concept or partial business plan that any business enterprise is most risky. Since data indicates that well over 90% of all new businesses will fail within five years, many aspiring entrepreneurs will have no choice but to fund their endeavor from personal funds, credit cards and personally secured loans.[159]

"Angel" Investors

An angel investor is typically an affluent individual investor who provides his or her own funds for a start-up. Capital from angel investors fills the gap between funds available from friends and family (usually much less and not more than a few hundred thousand dollars)[160] and institutional venture firms which may have minimal thresholds of $1 to $3 million. During recent years, as increased institutional funds have flowed into venture capital firms, the minimum allocation to any one portfolio company has tended to

[159] Sarah E. Needleman, *Entrepreneurs Hit Up Family, but Paypack is Slow*, WALL ST. J. Nov 24, 2010, at B6. *See also* Samuel Lee & Petra Persson, Financing from Family and Friends (May 1, 2013), IFN Working Paper No. 933; NYU Stern Working Paper FIN-12-007; IFN Working Paper No. 933; ECGI - Finance Working Paper No. 358, *available at* http://ssrn.com/abstract=2086625. *See also* discussion of friends and family early stage funding and advantages and disadvantages of that and other possible sources of funding discussed below in Bagley & Dauchy, *supra* note 9, at 145-157.

[160] *See* Gerard Hoberg, Brent D. Goldfarb, David Kirsch & Alexander J. Triantis, *Does Angel Participation Matter? An Analysis of Early Venture Financing,* 3 n4 (March 24, 2009), Robert H. Smith School Research Paper No. RHS 06-072, *available at* http://ssrn.com/abstract=1024186, *observing* "(The mean investment of $150,375 made by angels in our sample is large relative to the $10,000 average outside equity investment made by individuals as reported by Reynolds (2005). Shane (2008) reports that investments over $200,000 fall in the top one percentile of angel investments).

increase because these firms can't otherwise justify the cost of monitoring and managing an investment that is immaterial to their portfolio's performance.

An entrepreneur may likely find angel funding advantageous in terms of how control must be relinquished for this form of investor participation. In a study of 182 Series A preferred stock fundings, "derived from the electronic records of the [prestigious but] now defunct law firm Brobeck, Phleger & Harrison (Brobeck),"[161] professors Hoberg, Goldfarb, Kirsch and Triantis find that "investor composition is strongly related to control rights, and deals with more angel investors have weaker control rights."[162] Moreover, the Hoberg et al. study confirms the findings of Aghion and Tirole;[163] Cassamatta;[164] and Hellmann 2002,[165] in that the allocation of control rights go "to the party whose marginal contribution to the project is greatest. [Hoberg, et al.] hypothesize that angels and VCs primarily differ on their abilities and disposition to influence firm behavior and investment patience. Consistent with this notion, [Hoberg, et al.] find that angel investors generally obtain weaker control rights than do VCs."[166] The four central findings of the Hoberg, Goldfarb, Kirsch and Triantis study are as follows

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[161] Hoberg, *supra* note 160 at 3.
[162] *Id.* at 1.
[163] P. Aghion & P. Bolton, *An Incomplete Contracts Approach to Financial Contracting,* 59(3) REV. ECON. STUD. 473 (1992).
[164] C. Cassamatta, *Financing and Advising: Optimal Financial Contracts With Venture Capitalists,* 58 J. FIN. 2059 (2003).
[165] Hoberg, *supra* note 160 at 2, *citing* T. Hellman, *A Theory of Strategic Venture Investing,* 64 J. FIN. ECON. 285 (2002), *observing at* 2 n2 (Hellmann and Puri (2000, 2002) document variance in product market strategy and top management team professionalization of VC-backed and non-VC-backed firms. Kaplan and Stromberg (2004) analyze venture capital contracts and find that investor rights vary with the expected and actual investor effort contribution. Dessein (2005) provides an alternative theory of control rights, attributing investor right allocation to signaling. An alternative, and perhaps complementary, explanation is that angels are more patient than VCs (Jovanovic and Szentes 2007). They may relinquish control to mitigate the entrepreneur's risk of premature liquidation especially when projects require longer time horizons (Lacetera 2008)).
[166] Gerard Hoberg, Brent D. Goldfarb, David Kirsch & Alexander J. Triantis, *Does Angel Participation Matter? An Analysis of Early Venture Financing,* 1 (2009), Robert H. Smith School Research Paper No. RHS 06-072, *available at* http://ssrn.com/abstract=1024186.

1. When firms raise smaller amounts of capital, they do so from either angels alone, VCs alone, or from both angels and VCs. In contrast, when larger investments are needed, VC participation is generally necessary, suggesting that matching is constrained.
2. In Series A rounds, angels almost always take preferred shares. Nevertheless, the presence of angels, either investing alone or alongside VCs, is associated with weaker cash flow and control rights…
3. Among smaller deals, angel-only deals have the lowest incidence of failure, and a similar incidence of IPOs and acquisitions…
4. When deals are large, those financed by VCs alone are more successful than those in which angels participate.[167]

Traditional Banking and Collateralized Debt Financing

Because many early stage start-up ventures are either too small or lack sufficient unsecured assets to qualify for traditional bank funding, with some exceptions, most commercial banks are not good candidates for unsecured funding. However, several studies illustrate the role of bank financing for entrepreneurial ventures.[168] The uncertain economic environment following the 2008-2009 capital markets demise has resulted in commercial banks subsequently being slow to approve loan requests, often due to the deteriorating credit worthiness of potential borrowers. The other side of the same coin is that small borrowers have been reluctant to borrow given economic uncertainty.

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[167] *Id.*

[168] *See generally* Andrew Winton & Vijay Yerramilli, *Entrepreneurial Finance: Banks versus Venture Capital,* 88 J. FIN. ECON. 51 (2008), *available at* http://ssrn.com/abstract=952037; Sheryl, Winston Smith, Beg, Borrow, and Deal? Entrepreneurs' Choice of Financing and New Firm Innovation, (unpublished paper) (2011), *available at* http://ssrn.com/abstract=1573685; Linda M. Van De Gucht & Nancy Huyghebaert, The Determinants of Financial Structure: New Insights from Business Start-Ups (2002), K.U. Leuven, Department of Applied Economics, Working Paper No. 0203, *available at* http://ssrn.com/abstract=296841; Andrew Winton & Vijay Yerramilli, A Model of Entrepreneurial Finance (2004), *available at* http://ssrn.com/abstract=566921; Hui Chen, Jianjun Miao & Neng Wang, *Entrepreneurial Finance and Nondiversifiable Risk*, 23 REV. FIN. STUD. 4348 (2010), *available at* http://ssrn.com/abstract=1369293; William R. Kerr & Ramana Nanda, Financing Innovation, Harvard Business School Entrepreneurial Management Working Paper No. 15-034 (2014), *available at* http://ssrn.com/abstract=2519572; Alicia Robb & David T. Robinson, *The Capital Structure Decisions of New Firms*, 28 REV. FIN. STUD. 1768 (2015), *available at* http://ssrn.com/abstract=1345895.

Small Business Administration (SBA)

A wide variety of financial assistance programs for small businesses are offered by the SBA.[169] A detailed discussion of the various SBA programs offered and their availability is beyond the scope of this article. However, some Small Business Administration programs may prove useful as the government "guarantee" often provides sufficient risk reduction to enable commercial banks to fund the small enterprise.

Small Business Investment Companies (SBICs)

Since 1959, Small Business Investment Companies (SBICs) have supplied equity capital, long-term loans and management assistance to qualifying small businesses.[170] The SBIC Program is one of many financial assistance programs available through the U.S. Small Business Administration. The structure of the program is unique in that SBICs are privately owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. Note that the U.S. Small Business Administration does not invest directly into small business through the SBIC Program. In addition, SBIC financing is not appropriate for all types of businesses and financing needs.

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[169] *See* https://www.sba.gov/category/navigation-structure/loans-grants (last visited May 31, 2015). *But see* Mirit Eyal-Cohen, 55 B.C. L. Rev. 719 (2014) (commenting about how current various governmental classifications fail to assess congressional intent and policy considerations to optimize economic growth).

[170] *See* https://www.sba.gov/content/sbic-program-seeking-financing-your-small-business (last visited Sept. 24, 2015).

Institutional Venture Capital (VC) Sources

Like most business phenomenon, the availability of venture capital sources will wax and wane based on various factors and a correlation to the overall economy that may not prove readily apparent to most. Factors that are prominent in aggregate availability of venture capital will include: a rising equity market that has provided investors with both the investible cash and confidence to make additional venture (highly illiquid) investments; actual and perceived likelihood of near term "new cash" from liquidity events (such as a robust initial public offering (IPO) market); the increase or decrease in portfolio allocation to venture capital as an asset class by major institutional investors (such as the California Public Employees Retirement System (CalPERS), Harvard Endowment, Texas State Teachers System, or the like).[171] Institutional venture firms serve as intermediaries for these funds, receiving an allocation from such sources as state employee retirement funds or college endowments and tend to be specialized in their focus and staffing expertise to enhance their investment returns.

Do the top Venture Capital firms provide more than just money to their entrepreneurs? "As has been shown by Sorensen (2004), Kaplan and Schoar (2005), Gompers, Kovner, Lerner and Scharfstein (2006), and Hochberg, Ljungqvist and Lu (2006), companies that are funded by more experienced (top-tier) venture capital firms

[171] Manuel Amador & Augustin Landier, *Entrepreneurial Pressure and Innovation*, AFA 2004 San Diego Meetings, *available at* http://ssrn.com/abstract=436320; Josh Lerner, Boom and Bust in the Venture Capital Industry and the Impact on Innovation, Harvard NOM Working Paper No. 03-13 (2002), *available at* http://ssrn.com/abstract=366041; Thomas Gehrig & Rune Stenbacka, Venture Cycles: Theory and Evidence (February 2003), CESifo Working Paper Series No. 882, *available at* http://ssrn.com/abstract=386762; Ramana Nanda & Matthew Rhodes-Kropf, Investment Cycles and Startup Innovation, Harvard Business School Entrepreneurial Management Working Paper No. 12-032 (2012), *available at* http://ssrn.com/abstract=1950581; Paul A. Gompers, Anna Kovner, Josh Lerner, David S. Scharfstein, Venture Capital Investment Cycles: The Impact of Public Markets, NBER Working Paper No. w11385 (2005), *available at* http://ssrn.com/abstract=731040.

are better able to identify high quality companies and entrepreneurs."[172] The Gompers study suggests that by helping start-ups recruit key management, refine strategy, and make important customer contacts – top-tier venture capital firms contribute considerable value in addition to funding. A survey of 549 successful entrepreneurs found that "Venture capital and private /angel investments play a relatively small role in the startups of first-time entrepreneurs. Only 11 percent received venture capital, and 9 percent received angel financing for their first startups."[173] John F. Coyle and Joseph M. Green report that "around 2005, investors in early-stage technology companies increasingly turned to much simplified versions of traditional convertible preferred stock documents to structure their investments."[174] Before 2005, individual investors "who invested in

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[172] Paul A. Gompers, Anna Kovner, Josh Lerner & David S. Scharfstein, *Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs*, 2 (2006), *available at* http://ssrn.com/abstract=933932, *citing* Morten Sorensen, How Smart is Smart Money? A Two-Sided Matching Model of Venture Capital, (Unpublished paper), U. Chi. (2004); Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital*, 60 J. FIN. 1791(2005); Yael Hochberg, Alexander Ljungqvist, & Yang Lu, *Whom You Know Matters: Venture Capital Networks and Investment Performance*, 62 J. FIN. 251 (2007). *See also* Douglas J. Cumming & Sofia Johan, *Advice and Monitoring in Venture Finance,* 21 FIN. MKTS. & PORTFOLIO MGMT. 3 (2007), *available at* http://ssrn.com/abstract=642122; Tom Elfring & Willem Hulsink, Networks in Entrepreneurship, ERIM Report Series Reference No. ERS-2001-28-STR. (201 6), *available at* http://ssrn.com/abstract=370887; Grant Fleming, Douglas J. Cumming & Jo-Ann Suchard, *Venture Capitalist Value-Added Activities, Fundraising and Drawdowns*, 29 J. BANKING & FIN. 295 (2005), *available at* http://ssrn.com/abstract=466962; Mark J. Garmaise, Informed Investors and the Financing of Entrepreneurial Projects, EFMA 2001 Lugano Meetings (2001), *available at* http://ssrn.com/abstract=263162; Ervin L. Black, F. Greg Burton, David A. Wood & Aaron F. Zimbelman, *Entrerpreneurial Success: Differing Perceptions of Entrepreneurs and Venture Capitalists,* 11 INT'L J. ENTRE. & INNOVATION 189 (2010), *available at* http://ssrn.com/abstract=735563; Arthur G. Korteweg & Morten Sorensen, *Risk and Return Characteristics of Venture Capital-Backed Entrepreneurial Companies*, 23 REV. FIN. STUD. 3738 (2010), *available at* http://ssrn.com/abstract=1108610; Suting Hong, Competition, Syndication, and Entry in the Venture Capital Market, FRB of Philadelphia Working Paper No. 13-49 (2013), *available at* http://ssrn.com/abstract=2379084.

[173] Vivek Wadhwa, Raj Aggarwal, Krisztina Holly & Alex Salkever, *Making of A Successful Entrepreneur: Anatomy of an Entrepreneur Part II* 4, 5 (2009), Kauffman Foundation Small Research Projects Research Paper No. 2, *available at* http://ssrn.com/abstract=1507384.

[174] John F. Coyle and Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 134 (2014). *See also* Jason M. Gordon & David Orozco, *Trust and Control: The Value Effect of Venture Capital Term Sheet Provisions as Risk Allocation Tools,* 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 195 (2015) (discussing how term sheet provisions delineate the

early-stage technology companies would typically invest alongside the founder of the new venture by purchasing shares of common stock. Venture capital funds, which invested more substantial amounts of capital at later stages in a company's development, would typically receive convertible preferred stock."[175]

The New Investment Banking Maze

The failure of Bear Stearns and Lehman Bros. during the 2008-2009 Wall Street melt-down has resulted in a much smaller universe of investment banking firms available to handle the funding needs of smaller enterprises. Major bracket firms such as Goldman Sachs or Credit Suisse may have venture capital units, but are simply not structured to deal with micro cap clients. Because less "public Wall Street" research tends to be available for very small publicly-traded companies, the universe of potential investment banking assistance will be limited to a relatively few firms.

Franchising Strategy

Franchising is recognized as an important form of organization.[176] A franchising strategy can be both a source of financing and a strategy for increased business growth. Most states heavily regulate business franchises and require registration of extensive

subjective risk perceptions of each party to the transaction by allocating control or trusting a party with decision-making rights).

[175] *Id.* at 133.

[176] *See generally* Jonathan Klick, Bruce H. Kobayashi, & Larry E. Ribstein (Deceased), The Effect of Contract Regulation: The Case of Franchising, George Mason Law & Economics Research Paper No. 07-03; 2nd Annual Conference on Empirical Legal Studies Paper; FSU College of Law, Law and Economics Paper No. 07/001 (2006), *available at* http://ssrn.com/abstract=951464; Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 AM. BUS. L.J. 659 (2013); Norman Bishara & Cindy A. Schipani, *A Corporate Governance Perspective on the Franchisor-Franchisee Relationship,* 19 STAN. J.L. BUS. & FIN. 103 (2014), *available at* http://ssrn.com/abstract=2467524.

offering memorandum for the sale of franchise units. Once again, this is a legal practice specialty.

Crowdfunding

The impact of small business growth on job creation and economic expansion continues to grow, but there is a downward trend in the willingness of venture capital firms to invest in seed-stage companies. Non-equity crowdfunding fills in this gap by providing much needed seed funding and spreading the risks broadly across the crowd so that the cost of failure to any one contributor is minimal. Non-equity crowdfunding has proven to be a great way to test out new ideas, finance micro-startups, and weed out bad business ideas at an early stage.[177]

The music and film industry provided the genesis for crowdfunding by soliciting donations from supporters to fund music recording or cinema projects.[178] Artists often

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[177] *See, e.g.*, Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption* 13 U. PA. J. BUS. L. 973 (2013), *available at* http://scholarship.law.upenn.edu/jbl/vol13/iss4/5. *See also* Ethan R. Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1 (2014), *available at* http://ssrn.com/abstract=2088298; Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 29 J. BUS. VENTURING 585 (2013), *available at* http://ssrn.com/abstract=1578175; Ajay Agrawal, Christian Catalini & Avi Goldfarb, The Geography of Crowdfunding. NET Institute Working Paper No. 10-08 (2010), *available at* http://ssrn.com/abstract=1692661; Praveen Kumar, Nisan Langberg & David Zvilichovsky, (Crowd)Funding Innovation (2015), *available at* http://ssrn.com/abstract=2600923; Jordana Viotto, Crowdfunding: A Progress Report (2015), *available at* http://ssrn.com/abstract=2592443; Gerrit K.C. Ahlers, Douglas J. Cumming, Christina Guenther & Denis Schweizer, Signaling in Equity Crowdfunding, 39 ENTRE. THEORY & PRACT. (Forthcoming 2015), *available at* http://ssrn.com/abstract=2564121; Karima Bouaiss & Isabelle Maque, Cartography of Academic Literature on Crowdfunding (2015), *available at* http://ssrn.com/abstract=2573739; Alex Murray, Suresh Kotha & Greg Fisher, Persuading Crowds: Mindset, Learning and Influence Mechanisms in Crowdfunding, Kelley School of Business Research Paper No. 15-27 Campaigns (2015), *available at* http://ssrn.com/abstract=2584583. *See also* David Orozco, *The Use of Legal Crowdsourcing ('Lawsourcing') as a Means to Achieve Legal, Regulatory and Policy Objectives*, 53 AM. BUS. L.J. (2016), *available at* http://ssrn.com/abstract=2520515 (discussing lawsourcing and legal Q&A platforms, government participation forums, and strategic nonmarket practices).

[178] *See generally* Michael A. Carrier, *No, RIAA, It's Not the End of the World for Musicians*, 82 U.M.K.C. L. REV. (2015), *available at* http://ssrn.com/abstract=2602469; Patryk Galuszka &

accept donations over the Internet or pre-sale CDs of music or films with a promise of sending the final product when it becomes available. Early movers in the crowdfunding space include Kickstarter[179] and Indiegogo.[180] Kickstarter, which focuses on creative projects, claims that since 2009 a total of more than $1.96 billion has been pledged to Kickstarter projects; 92,000 projects have been successfully funded by 9.4 million backers.[181]

Contributions received through crowdfunding can be separated into the "gift" category or the "investment" category.[182] Contributions that are considered gifts (donations, reward, or pre-purchases) are given to the fundraising entrepreneurs without any expectation of equity or other participation in future earnings.[183] Contributions considered to be investments are those that have repayment terms and may involve a return.[184] If the contribution can be classified as a security (whether an equity security or debt security) the "offering" involved in such crowdfunding must be registered or an exemption must be found under the rules described above. Under the donation model, contributors donate their money and receive nothing in return for their contribution.[185]

Victor Bystrov, *Crowdfunding: A Case Study of a New Model of Financing Music Production*, 13 J. INTERNET COMM. 233 (2014), *available at* http://ssrn.com/abstract=2523843.

[179] *See* Kickstarter, About Us, *available at* https://www.kickstarter.com/about?ref=nav (last visited Sept. 24, 2015); Venkat Kuppuswamy & Barry L. Bayus, Crowdfunding Creative Ideas: The Dynamics of Project Backers in Kickstarter, UNC Kenan-Flagler Research Paper No. 2013-15 (2014), *available at* http://ssrn.com/abstract=2234765.

[180] Indiegogo, Indiegogo: *An International Crowdfunding Platform to Raise Money, About Us, available at* http://www.indiegogo.com/about/our-story. (last visited Sept. 24, 2015).

[181] *See* Kickstarter Stats, *available at* https://www.kickstarter.com/help/stats?ref=footer (last visited Sept. 24, 2015), and Appendix A to this article (regarding completed Kickstarter Funded Projects).

[182] C. Steven Bradford, Crowdfunding and the Federal Securities Laws (Draft), page 10, Oct. 7, 2011, http://www.sec.gov/info/smallbus/acsec/bradford_crowdfunding.pdf (last visited Sept. 24, 2015).

[183] *Id.* at 14.

[184] *Id.* at 15.

[185] *Id.*

Even though contributors under the reward and the pre-purchase model receive neither interest nor a portion of business earnings, contributors may receive a diverse range of rewards, from small tokens like key chains, to opportunities to pre-purchase items produced by the funded projects.

Contributions classified as gifts are presumably not subject to the securities laws. Even though the donation model involves the investment of money in a common enterprise, it does not satisfy the third element of the *Howey* test because profits are not expected. Contributors know in advance that they will not receive a return of any kind and gratuitous contributions are not securities. Contributors in both the reward and pre-purchase models do expect a return, but to classify as an investment contract under the *Howey* test, the reward must be of a financial nature, "such as capital appreciation or a participation in earnings or even a fixed rate of interest."[186] Accordingly, because the *Howey* Test is not met for those contributions classified as gifts, capital raised through crowdfunding under the reward, pre-purchase or donation models do not fall under the definition of a security and thus, the federal securities laws Act do not apply.

The other basic model — the equity model — clearly involves investments with a return and profit motive.[187] The equity model allows contributors a speculative right to return of capital and to have "an interest in the profits or a return of the business they are helping to fund."[188] Again, whether or not contributions made under these two models can be considered securities is relevant to determine if registration is required or an exemption must be sought.

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[186] *Id.* at 33.
[187] *Id.* at 33.
[188] *Id.* 24.

For the reasons described above,[189] for-profit stock is essentially always a security, and equity interests in unincorporated business entities are tested for "investment contract" (and thus "securities" status) under the *Howey* test. The application of the *Howey* test to investments made under the equity model is fairly straightforward. In the equity model of crowdfunding, all elements of the *Howey* test are extremely likely to be satisfied. There is clearly an investment of money, in a common enterprise, with an expectation of profits arising solely from the managerial efforts of others.

The JOBS Act of 2012, establishes a regulatory foundation to enable small businesses to access new capital using crowdfunding.[190] Title III of the JOBS Act creates an exemption under the U.S. securities laws, allowing investors to raise $1 million in capital through the offer and sale of securities to the public through crowdfunding platforms.[191] These crowdfunding- provisions "include investment restrictions and new compliance requirements for both small businesses seeking to obtain funds through crowdfunding and the portals that will connect entrepreneurs and investors."[192] Congress intended to lower regulatory barriers in order to give small companies and start-ups a larger pool of investors from which to raise capital, but whether that objective has been accomplished remains to be seen. Congress tasked the SEC with adopting rules and regulations to implement the new law, but despite issuing proposed regulations, the SEC has stalled when it comes to adopting final regulations to implement the crowdfunding

[189] Notes 99-111 *supra* and accompanying text.
[190] Pub. L. No. 112-106, 126 Stat. 306 (2012), codified at scattered sections of Chapters 2A and 2B of Title 15, United States Code.
[191] SEC Press Release 2013-227, *SEC Issues Proposal on Crowdfunding* (Oct. 23, 2013), *available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677*.
[192] Hearing Memo, SEC's Crowdfunding Proposal: Will it Work for Small Businesses? House Committee on Small Business Subcommittee on Investigations, Oversight and Regulations, 113th Cong. (Jan. 13, 2014), *available at* http://smallbusiness.house.gov/uploadedfiles/1-16-2014_revised_hearing_memo.pdf.

exemption.[193] Meanwhile, some states have enacted crowdfunding exemptions for certain types of intrastate crowdfunded securities offerings.[194]

VII. CREDITOR'S RIGHTS

If there is one sure thing you can count on in a start-up, it's that things will go wrong. Studies show that about 25 percent of all entrepreneurial start-ups will fail within the first year and that by year five, less than half survive.[195] As discussed more fully above in Section IV ("Principal Choice of Entity Considerations"), a primary goal in selecting the type of entity in which to conduct business concerns the ability to limit the personal liability of individuals involved in the entity. Often, it's when things go wrong that the wisdom of having previously obtained good legal advice is appreciated. Unfortunately, several scenarios may place an entrepreneur in the unfortunate position of needing legal advice regarding debt collection, secured credit and bankruptcy.

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[193] SEC's Crowdfunding Proposal: Will it Work for Small Businesses? Hearing before the House Committee on Small Business Subcommittee on Investigations, Oversight and Regulations, 113th Cong. (2014) (opening statement of Chairman David Schweikert).

[194] Kansas and Georgia were among the first states to adopt an intrastate crowdfunding exemption. Other states including, Alabama, Michigan, and Virginia have followed. *See* "Intrastate Crowdfunding Resource Center" on North American Securities Administrators Association website at http://www.nasaa.org/industry-resources/corporation-finance/instrastate-crowdfunding-resource-center/ and the link thereon to Intrastate Crowdfunding Legislation & Regulation directory at http://www.nasaa.org/industry-resources/corporation-finance/instrastate-crowdfunding-resource-center/intrastate-crowdfunding-directory/ (both last visited Sept. 24, 2015).

[195] Jeffrey Pfeffer, *Evidence-Based Management for Entrepreneurial Environments: Faster and Better Decisions with Less Risk*, Rock Center for Corporate Governance at Stanford University Working Paper No. 75; Stanford University Graduate School of Business Research Paper No. 2051 at 2 (2010), *available at* http://ssrn.com/abstract=1564422, *citing* Scott Shane, *Startup Failure Rates – The Real Numbers,* SMALLBIZTRENDS (Apr. 28, 2008), *available at* http://smallbiztrends.com/2008/04/startup-failure-rates.html. *See also* E. J. Reedy & Robert E. Litan, *Starting Smaller; Staying Smaller: America's Slow Leak in Job Creation*, (2011), at http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2011/07/job_leaks_starting_smaller_study.pdf.

Debt Collection

As an entrepreneur, understanding your rights as a *creditor* will require experienced legal advice.[196] Each business, whether serving consumers or other businesses, will want to make sure that payment is received from its customers, hopefully without prodding. To ensure its written contracts are optimal for achieving payment, an experienced commercial law attorney can advise a company about what the contract should say before execution. In doing so the company will maximize its chances of prevailing if judicial action must be taken for collection. Conversely, a company will want to have its attorney review any written contracts its vendors and supplies present for approval. This is especially recommended for the very one-sided contracts proffered by "predatory" vendors such as those offering credit card services/machines or cash incentives for long-term purchasing agreements (such as gasoline suppliers to convenience stores, for instance, which typically offer cash payments to entice business owners into signing).

Secured Credit

The entrepreneur who seeks a commercial lender will also want to have an attorney explain loan documents and their consequences, especially if the loan terms will require a personal guarantee of the business owner (even if the loan is made in the name of the entity). Often the lender will require some security,[197] which can include: the land and buildings being purchased; inventories; receivables; or even the home of the business

[196] *See generally* Bagley & Dauchy, *supra* note 9, at Ch. 12 (Creditors' Rights and Bankruptcy").
[197] *See generally* Alvin C. Harrell, *2011-2013 Secured Transactions Review*, 68 CONSUMER FIN. L.Q. REP. 157 (2014); Alvin C. Harrell, *The 2010 Amendments to the Uniform Text of Article 9*, 65 CONSUMER FIN. L.Q. REP. 138 (2011).

owner or other personal assets. The borrower will want to fully understand the consequences, and explore alternatives if any are available.

Bankruptcy

Bankruptcy is another topic requiring specialized legal advice and much has been written on the subject.[198] In one scenario, many entrepreneurs find themselves in the position of having to "sign personally" as parties responsible for the repayment of debt obligations if the enterprise should be unable to promptly repay. On the other hand, the entrepreneur may need legal advice regarding the collection of receivables or may need to collect on a note secured by collateral. Depending on the size of legal community in which the entrepreneur finds herself; or, the jurisdiction in which the adverse party resides or has its principal place of business – finding experienced legal representation may or may not prove difficult.

[198] *See generally* Stephen J. Ware, *An Overview of Bankruptcy Law in the United States,* 9 INT'L CORP. RESCUE 320 (2012) (provides an overview of bankruptcy and debtor-creditor law in the United States); Edith S. Hotchkiss, John Kose, Karin S. Thorburn & Robert M. Mooradian, *Bankruptcy and the Resolution of Financial Distress,* (2008), *available at* http:ssrn.com/abstract=1086942; Sergei A. Davydenko & Julian R. Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK,* 63 J. FIN. 565 (2008), *available at* http://ssrn.com/abstract=647861; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy,* 55 STAN. L. REV. 751 (2002) (observing that the vast majority of firms in financial distress never enter bankruptcy); Jean Braucher, *The Challenge to the Bench and Bar Presented by the 2005 Bankruptcy Act: Resistance Need Not be Futile,* U. ILL. L. REV. 93 (2007), *available at* http://ssrn.com/abstract=947930; Stephen A. Hillegeist, Elizabeth K. Keating, Donald P. Cram, & Kyle G. Lundstedt, *Assessing the Probability of Bankruptcy,* 9 REV. ACCT. STUD. 5 (2004); Mike W. Peng, Yasuhiro Yamakawa & Seung-Hyun Lee, *Bankruptcy Laws and Entrepreneur-Friendliness,* ENTREPRENEURSHIP THEORY & PRAC. 517 (May, 2010); Seung-Hyun Lee, Yasuhiro Yamakawa, Mike W. Peng & Jay B. Barney, *How Do Bankruptcy Laws Affect Entrepreneurship Development Around the World?,* 26 J. BUS. VENTURING 505 (2011); Kenneth Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start,* 23 J. L. ECON & ORG. 161 (2007), *available at* http://ssrn.com/abstract=463000; Alvin C. Harrell & Jon Ann Giblin, *A Review of the 2005 Bankruptcy Code Amendments: Impact on Creditors' Operations,* 62 CONSUMER FIN. L.Q. REP. (2008).

As a creditor to someone else's bankruptcy, an entrepreneur will want legal representation in filing a claim, foreclosing on secured property, and otherwise making sure its claim is recognized with proper lien priority in the distribution of any proceeds from the liquidation of the bankrupt's non-exempt assets. The entrepreneur might also want to investigate the possibility that insurance coverage for debtor default in some industries may be available. As a debtor, early assistance from an attorney could mean negotiated forbearance from certain creditors which might avoid bankruptcy. If unavoidable, the business owner may need to choose between a company bankruptcy or a personal bankruptcy if he or she has given a personal guarantee. An experienced bankruptcy attorney will help advise the entrepreneur in any of those events.

VIII. LEGAL ISSUES WITH EMPLOYEES

Entrepreneurs also need to understand that a venture having one or more employees faces a wide array of legal issues and associated compliance obligations flowing from the employer-employee relationship. As a threshold matter a determination must be made as to whether workers are employees or independent contractors. Misclassifying a worker as an independent contractor when in fact the worker is an employee can create a host of problems for the employer—such as, for example, liability for failure to withhold and remit payroll taxes. Unfortunately, proper classification can be difficult because it involves a multi-factored analysis of the facts and circumstances essentially designed to determine if the employer controls the worker in a manner sufficient to result in employee status.[199] Thus, entrepreneurs should seek legal counsel to

[199] *See, e.g.*, Bagley & Dauchy, *supra* note 9, at 198-203; Hamilton, et al. *supra* note 81, at 19-23; and the Internal Revenue Service's discussion of this issue at

help with this analysis, and in unclear situations may want to ask for a governmental determination.[200]

If one or more employees will be hired, various federal and state laws specific to the employer-employee relationship can come into play, including, among others: payroll tax obligations; laws prohibiting discriminatory practices and sexual harassment;[201] fair labor standards and collective bargaining laws; laws relating to pensions and health plans; workplace safety laws; Affordable Care Act requirements; unemployment insurance laws; employer social media policies,[202] issues surrounding immigration and work permit

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http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Self-Employed-or-Employee (last visited Sept. 24, 2015).

[200] *See* I.R.S. Manual 7.50.1 Form SS-8 Procesing, *available at* http://www.irs.gov/irm/part7/irm_07-050-001r.html (last visited Sept. 24, 2015). *But see* IRS Worker Classification Program: Current Procedures Cause Delays and Hardship for Businesses and Workers by Failing to Provide Determinations Timely and Not Affording Independent Review of Adverse Decisions, Most Serious Problems #19, 2013 Annual Rpt. To Cong., *available at http://www.taxpayeradvocate.irs.gov/2013-annual-report/downloads/IRS-WORKER-CLASSIFICATION-PROGRAM-Current-Procedures-Cause-Delays-and-Hardships-for-Businesses-and-Workers.pdf* (last viewed Sept. 24, 2015).

[201] *See generally* Bagley & Dauchy, *supra* note 9, at Ch. 8 ("Marshaling Human Resources"); Drake, supra note 9, at Ch. 15 ("The Enterprise Employees"); Lynn McLain, Recurring Nightmares? Evidence Issues that Keep Coming Back in Employment Cases, (unpublished paper) (2010), *available at* http://ssrn.com/abstract=1652353; Gundars Kaupins & Susan Park, *Legal and Ethical Issues Associated with Employee Use of Social Networks*, 1 ADVANCES BUS. RES. 82 (2010), *available at* http://ssrn.com/abstract=2309702; Megan Whitehill, Note, *Better Safe Than Subjective: The Problematic Intersection of Prehire Social Networking Checks and Title VII Employment Discrimination*, 85 TEMP. L. REV. 229 (2012), *available at* http://ssrn.com/abstract=2158831 (discussing use of social networks in hiring decisions).

[202] *See generally* Robert Sprague, *Invasion of the Social Networks: Blurring the Line between Personal Life and the Employment Relationship,* 50 U. LOUISVILLE L. REV. 1 (2011), *available at* http://ssrn.com/abstract=1773049; Robert Sprague, *Facebook Meets the NLRB: Employee Online Communications and Unfair Labor Practices,* 14 U. PA J. BUS. L. 957 (2012), *available at* http://ssrn.com/abstract=1982717; Robert Sprague & Abigail E. Fournier, *Online Social Media and the End of the Employment-at-Will Doctrine*, 52 WASHBURN L.J. 557 (2013), *available at* http://ssrn.com/abstract=2224093; Christine Neylon O'Brien, *The National Labor Relations Board: Perspectives on Social Media,* 8 CHARLESTON L. REV. 411 (2014), *available at* http://ssrn.com/abstract=2442385; Christine Neylon O'Brien, *The First Facebook Firing Case Under Section 7 of the National Labor Relations Act: Exploring the Limits of Labor Law Protection for Concerted Communication on Social Media*, 45 SUFFOLK U. L. REV. 29 (2011), *available at* http://ssrn.com/abstract=1967637; Christine Neylon O'Brien, *The Top Ten NLRB Cases on Facebook Firings and Employer Social Media Policies*, 92 OR. L. REV. 337 (2013), *available at* http://ssrn.com/abstract=2277900; Willow Jacobson & Shannon Tufts, To Post or Not to Post: Employee Rights and Social Media, APSA 2011 Annual Meeting Paper, *available at* http://ssrn.com/abstract=1900942.

policies for foreign nationals,[203] and workers' compensation obligations.[204] Compliance with many aspects of such employment laws can be a relatively straightforward matter, while other issues involved may be quite complex. Constant technological changes result in new legal issues between employers and employees. As just one example, Professor Jasmine Abdel-khalik points to recent controversies "about who owns LinkedIn accounts of executives when they leave the business… as valuable contacts can travel with someone when s/he leaves. Perhaps companies should consider starting to institute policies about ownership of LinkedIn accounts."[205] A business is well-served to engage

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[203] *See generally* Vivek Wadhwa, AnnaLee Saxenian, Richard B. Freeman & G. Gereffi, America's Loss is the World's Gain: America's New Immigrant Entrepreneurs, Part 4 (unpublished paper) (2009), *available at* http://ssrn.com/abstract=1348616; Vivek Wadhwa, Guillermina Jasso, Ben A. Rissing, G. Gereffi & Richard B. Freeman, *Intellectual Property, the Immigration Backlog, and a Reverse Brain-Drain: America's New Immigrant Entrepreneurs, Part III* (unpublished paper) (2007), *available at* http://ssrn.com/abstract=1008366; Vivek Wadhwa, Ben A. Rissing, AnnaLee Saxenian & G. Gereffi, Education, Entrepreneurship and Immigration: America's New Immigrant Entrepreneurs, Part II (2007), *available at* http://ssrn.com/abstract=991327; Vivek Wadhwa, AnnaLee Saxenian, Ben A. Rissing & G. Gereffi, America's New Immigrant Entrepreneurs: Part I (unpublished paper) (2007), Duke Science, Technology & Innovation Paper No. 23, *available at* http://ssrn.com/abstract=990152; Dane Stangler & Jared Konczal, *Give Me Your Entrepreneurs, Your Innovators: Estimating Employment Impact of a Startup Visa*, Ewing Marion Kauffman Foundation (2013), *available at* http://ssrn.com/abstract=2226454.

[204] *See generally* Gregory M. Duhl & Jaclyn S. Millner, *Social Networking and Workers' Compensation Law at the Crossroads*, 31 PACE L. REV. 1 (2011), *available at* http://ssrn.com/abstract=1675026.

[205] Abdel-khalik, *supra* note 76. See, e.g., Eagle v. Morgan, 2013 U.S. Dist. LEXIS 34220 (E.D. Pa. Mar. 12, 2013) (finding liability on some counts but ordering zero compensatory or punitive damages in a dispute over a former employee's LinkedIn account); Jefferson Audio Visual Sys. v. Gunnar Light, 2013 U.S. Dist. LEXIS 66239 (May 8, 2013 W.D. Ky) (dismissing a misrepresentation claim based on a former employee's failure to update his LinkedIn account to reflect that he was terminated from his job with the employer). *See generally* Hugh McLaughlin, You're Fired: Pack Everything but Your Social Media Passwords, 13 Nw. J. Tech. & Intell. Prop. 87 (2015); Courtney J. Mitchell, Keep Your Friends Close: A Framework for Addressing Rights to Social Media Contacts, 67 VAND. L. REV. 1459 (2014); Zoe Argento, *Whose Social Network Account? A Trade Secret Approach to Allocating Rights*, 19 MICH. TELECOMM. TECH. L. REV. 201 (2013); Steve Anderson, Who Owns a Social Profile? You or Your Company?, LinkedIn (Aug. 7, 2013), https://www.linkedin.com/pulse/20130807115218-5214630-who-owns-a-social-profile-you-or-your-company.

legal counsel well-versed in employment laws compliance planning as part of the overall planning of a business venture.[206]

In addition to the need to engage legal counsel to assist with compliance issues, an entrepreneur should consider hiring a lawyer to advise on the negotiation of employment contracts with key employees. This can be especially true if the contract is to include “restrictive covenants”—such as confidentiality agreements, non-compete agreements and promise to not solicit the venture’s customers or other employees—which can have enforceability issues (which vary from state-to-state).[207] Professors John

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[206] For general information regarding several of the federal laws pertaining to the employer-employee relationship see: Employers Tax Guide at http://www.irs.gov/pub/irs-pdf/p15.pdf (federal payroll tax obligations); U.S. Equal Employment Opportunity Commission “About EEOC” discussion at http://www.eeoc.gov/eeoc/ (employment discrimination claims); EEOC discussion of sexual harassment laws at http://www.eeoc.gov/laws/types/sexual_harassment.cfm: U.S. Department of Labor-Wage and Hour Division webpage regarding compliance with the Fair Labor Standards Act at http://www.dol.gov/whd/flsa/; National Labor Relations Board webpage on Employer/Union Rights and Obligations at http://www.nlrb.gov/rights-we-protect/employerunion-rights-and-obligations; U.S. Department of Labor-Health Plans and Benefits/Employee Retirement Income Security Act-ERISA at http://www.dol.gov/dol/topic/health-plans/erisa.htm; U.S. Department of Labor-Occupational Safety & Health Administration Help for Employers webpage at https://www.osha.gov/employers/index.html and Small Business webpage at https://www.osha.gov/dcsp/smallbusiness/index.html; I.R.S. Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act at http://www.irs.gov/Affordable-Care-Act/Employers/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act; U.S. Small Business Administration webpage on Affordable Care Act obligations of Employers with 50 or More Employees at https://www.sba.gov/content/employers-50-or-more-employees; and U.S. Department of Labor Unemployment Insurance webpage (discuss federal-state collaborations) at http://www.dol.gov/dol/topic/unemployment-insurance/ (all last visited Sept. 24, 2015). State laws on payroll taxes, workers compensation and various other employer obligations can vary from state-to-state, and entrepreneurs will need to consider the laws of all states in which they operate. One useful tool for startup companies and their legal advisors to include in their research into state law obligations to employees and other compliance obligations for operating in a business in particular states is the I.R.S. Starting a Business webpage at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Starting-a-Business, which includes state-by-state links to starting a business on-line resources at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/State-Links-1 (last visited Sept. 24, 2015); Jeffrey Scott Ray, Evolving Human Resource (HR) Management to Cope with Disruptive Innovation Technologies, (unpublished paper) (2012), *available at* http://ssrn.com/abstract=2173815.

[207] *See generally* Kyle B. Sill, *Drafting Effective Noncompete Clauses and Other Restrictive Covenants: Considerations Across the United States*, 14 FLA. COASTAL L. REV. 365 (2013); Margo E. K. Reder & Christine Neylon O'Brien, *Managing the Risk of Trade Secret Loss Due to Job*

F. Coyle and Gregg D. Polsky report that leading Silicon Valley technology companies such as Google and Facebook, "have been buying start-up companies at a brisk pace. In many of these transactions, the buyer has little interest in acquiring the startup's projects or assets. Instead, the buyer's primary motivation is to hire some or all of the startup's software engineers."[208] Referred to as "acqui-hires," this increasingly common strategy allows technology companies to "satisfy their intense demand for engineering talent."[209]

IX. RISK AWARENESS AND MANAGEMENT

With the 2007-2008 global financial crisis, Massey Energy coal mining tragedy, BP Gulf of Mexico oil spill disasters during 2010, and growing epidemic of cybersecurity breaches, business enterprises everywhere have cast renewed focus on the topic of risk management.[210] Many mature companies have created standing committees of the board

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Mobility in an Innovation Economy with the Theory of Inevitable Disclosure, 12 J. HIGH TECH. L. 373 (2012), *available at* http://ssrn.com/abstract=2014051; Peter Swire, *A Theory of Disclosure for Security and Competitive Reasons: Open Source, Proprietary Software, and Government Agencies,* 42 HOUS. L. REV. 1333 (2006), *available at* http://ssrn.com/abstract=842228; Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete,* 74 N.Y.U. L. REV. 575 (1999), *available at* http://ssrn.com/abstract=124508; Jay P. Kesan & Carol M. Hayes, *The Law and Policy of Non-Compete Clauses in the United States and Their Implications, in* COMPARATIVE BUSINESS INNOVATION: A LEGAL BALANCING ACT, (Marilyn Pittard, ed., Edward Elgar Publishing, 2013), *available at* http://ssrn.com/abstract=1948593; Randall S. Thomas, Norman Bishara & Kenneth J. Martin, *An Empirical Analysis of Non-Competition Clauses and Other Restrictive Post-Employment Covenants,* 68 VAND. L. REV. 1 (2015), *available at* http://ssrn.com/abstract=2401781; Marion G. Crain, *Arm's Length Intimacy: Employment as Relationship,* WASH. U. J.L. & POL'Y 163 (2011), *available at* http://ssrn.com/abstract=1940691; Catherine Fisk & Adam Patrick Barry, *Contingent Loyalty and Restricted Exit: Commentary on the Restatement of Employment Law*, 16 EMP. RTS. & EMP. POL'Y J. 1 (2012), *available at* http://ssrn.com/abstract=2060621; Andrea M. Matwyshyn, *Imagining the Intangible*, 34 DEL. J. CORP. L. 965 (2009), *available at* http://ssrn.com/abstract=1473590.

208 John F. Coyle & Gregg D. Polsky, *Acqui-hiring,* 63 DUKE L.J. 281 (2013).

209 *Id.* at 281.

210 *See generally* David F. Larcker, Sarah M. Larcker & Brian Tayan, Lululemon: A Sheer Debacle in Risk Management, Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-41; Stanford University Graduate School of Business Research Paper No. 14-21 (2014), *available at* http://ssrn.com/abstract=2455983; Galina M. Vereshchagina, Hugo A. Hopenhayn, *Risk Taking By Entrepreneurs,* 99 AM. ECON. REV. 1808 (2009), *available at*

to enhance enterprise risk management efforts.[211] While this topic may appear at first glance to be well beyond the purview of early-stage enterprises, it seems that giving systematic thought to "the worse that can happen" may yield rewards and mean the difference between survival and failure. Bribery and corruption laws, such as the Foreign Corrupt Practices Act or U.K. Bribery Act of 2010 may prove to be an expensive trap for the unwary.[212] While these types of issues may seem esoteric and not on the radar screen of most entrepreneurs, unfortunately they may have the ability to consume and destroy both scarce people and financial resources. Accordingly, sources of material risk should be seriously considered. A crisis environment may prove challenging even for those enterprises having strong, experienced management teams and abundant financial resources. Almost all start-ups, tending to have less of everything, will prove to be much more fragile during a crisis.

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http://ssrn.com/abstract=990928; Lawrence J. Trautman, Personal Ethics and the U.S. Financial Collapse of 2008-09, (forthcoming), *available at* http://ssrn.com/abstract=2502124.

[211] *See generally* Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 J. MARSHALL J. COMPUTER & INFO. L. 313 (2011).

[212] *See generally* Lawrence J. Trautman & Kara Altenbaumer-Price, *The Foreign Corrupt Practices Act: Minefield for Directors*, 6 VA. L. & BUS. REV. 145 (2011), *available at* http://ssrn.com/abstract=1930190; Lawrence J. Trautman & Kara Altenbaumer-Price, *Lawyers, Guns & Money − The Bribery Problem and U.K. Bribery Act,* 47 INT'L LAW. 481 (2013), *available at* http://ssrn.com/abstract=2276738; Lawrence J. Trautman & Kara Altenbaumer-Price, *Foreign Corrupt Practices Act: An Update on Enforcement and SEC and DOJ Guidance*, 41 SEC. REG. L.J. 241 (2013), *available at* http://ssrn.com/abstract=2293382; Gideon Mark, *Private FCPA Enforcement*, 49 AM. BUS. L.J. 419 (2012); Philip M. Nichols, *The Business Case for Complying with Bribery Laws*, 49 AM. BUS. L.J. 325 (2012); Norman D. Bishara, *Governance and Corruption Constraints in the Middle-East: Overcoming the Business Ethics Glass Ceiling*, 48 AM. BUS. L.J. 227 (2011); Peter R. Reilly, Incentivizing Corporate America to Eradicate Transnational Bribery Worldwide: Federal Transparency and Voluntary Disclosure Under the Foreign Corrupt Practices Act, __ FLA. L. REV. (2015) (forthcoming), *available at* http://ssrn.com/abstract=2585789; Mike Koehler, *A Foreign Corrupt Practices Act Narrative*, 22 MICH. ST. INT'L L. REV. 961 (2014), *available at* http://ssrn.com/abstract=2428555; Mike Koehler, *Ten Seldom Discussed Foreign Corrupt Practices Act Facts that You Need to Know*, 10 BLOOMBERG BNA WHITE COLLAR CRIME REPORT 347 (May 1, 2015), *available at* http://ssrn.com/abstract=2601840; Virginia G. Maurer & Ralph E. Maurer, *Uncharted Boundaries of the U.S. Foreign Corrupt Practices Act*, 20 J. FIN. CRIME 355 (2013).

X. EFFICIENT USE OF LEGAL COUNSEL

How can an entrepreneur prepare to make efficient use of legal counsel? First, by doing some homework. It makes little sense to pay lawyers charging on an hourly basis to ask you, while "on the clock," questions you could have asked yourself if you did some homework. The more the entrepreneur anticipates the information legal counsel will need before giving advice, the more time and money the entrepreneur can save by assembling that information in preparation for working with such counsel. The entrepreneur should engage legal counsel early-on in the venture planning process. Discovering legal issues after committing to a course of action often causes problems that cannot be easily unwound, and generally end up costing more to address than if the associated legal issues were spotted and dealt with early on.[213]

XI. CONCLUSION

New business formation is the economic engine that creates jobs. To survive, all successful entrepreneurs must become skillful at optimizing efficiency at every opportunity. In the United States, diverse legal issues such as intellectual property identification and protection, entity choice and formation, taxation, initial capitalization and fundraising (through various sources) in compliance with securities laws, debtor-creditor laws, and employment laws will require finding skilled legal talent.

It is critical to economic recovery and growth that entrepreneurs make the effort to become educated on legal issues their startups will encounter. Entrepreneurs must

[213] *See generally* Bagley & Dauchy, *supra* note 9, at 41-48; Thomas C. Brown & Anthony J. Luppino, *How To Be Your Own Lawyer...Without Being a Fool: A Practical Guide for the Entrepreneur Who Wants to Save Time and Money through Informed Self-Help, Preparation and the Efficient Use of Legal Counsel, available online* through http://www.howtobeyourownlawyer.com/about/.

engage "can do" legal counsel to help navigate them through the various laws and regulations involved, because it is through the business formation process and allocation of capital to deserving enterprises that jobs at all levels are created. All of us owe much to those individuals who (against the odds) risk their finite time and personal net worth in the attempt to create a successful business.

APPENDIX A

Completed Kickstarter Funded Projects
(As of April 21, 2015)[214]

Category	Successfully Funded Projects	Less than $1,000 Raised	$1,000 to $9,999 Raised	$10,000 to $19,999 Raised	$20,000 to $99,999 Raised	$100 K to $999,999 Raised	$1 M Raised
All	**83,170**	**9,738**	**49,902**	**11,564**	**9,975**	**1,891**	**100**
Music	19,643	1,897	14,298	2,457	945	45	1
Film & Video	17,398	1,791	10,239	2,719	2,400	245	4
Art	7,263	1,494	4,777	640	329	22	1
Publishing	7,170	1,094	4,600	895	547	34	0
Games	5,327	380	2,048	971	1,427	459	42
Theater	4,724	612	3,516	376	210	10	0
Design	4,538	298	1,563	854	1,390	418	15
Food	3,734	435	1,607	881	768	41	2
Comics	2,717	327	1,669	379	297	44	1
Technology	2,711	178	788	381	845	486	33
Fashion	2,665	277	1,345	475	494	73	1
Photography	2,092	367	1,271	280	166	8	0
Dance	1,675	150	1,342	139	44	0	0
Crafts	947	334	515	57	38	3	0
Journalism	566	104	324	60	75	3	0

[214] Kickstarter. Successfully Funded Projects, *available at* https://www.kickstarter.com/help/stats?ref=footer.