

**“WHAT EVERY BUSINESS SHOULD
KNOW ABOUT KEEPING ITS
CORPORATE HOUSE IN ORDER”**

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Small Business Initiative
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IMPORTANT



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MANAGING YOUR RELATIONSHIPS & COVERING YOUR ASSETS



- Protecting your company's assets in dealings with your employees and other third parties – confidentiality and non-compete agreements.
- Protecting your company by keeping its corporate records in order.
- Protecting your assets in partnership relationships – buying and selling, shareholder agreements and life changing events.



CONFIDENTIALITY & NON-COMPETITON AGREEMENTS



WHAT DO YOU HAVE TO LOSE?

- Loss of Confidential Information
- Loss of Employees
- Loss of Customers



CONFIDENTIALITY & NON-COMPETITION AGREEMENTS



HOW CAN YOU MINIMIZE YOUR EXPOSURE?

- Understand/Identify the Legal Issues
- Limit Dissemination of Confidential Information
- Use Written Agreements Where Feasible
- Be Cautious of the "Trust Me" Approach
- Take Prompt Action to Enforce Your Rights



CONFIDENTIALITY & NON-COMPETITION AGREEMENTS



WHAT REMEDIES DO YOU HAVE?

- Trade Secret Act
- Common Law Torts
- Contractual Remedies
- Intellectual Property Statutes



STATUTORY / COMMON LAW REMEDIES



UNIFORM TRADE SECRETS ACT (“UTSA”)

- Law that protects the misappropriation of confidential information or “Trade Secrets”
- Most states have adopted some version of the UTSA
- Provides a uniform definition of what a trade secret is
- Clarifies, among other things, how a trade secret can be misappropriated and remedies for misappropriation
 - “misappropriation” generally speaking means discovery of information through improper means (*e.g.*, theft, wiretapping or fraud) or a breach of confidentiality



WHAT IS A TRADE SECRET?



- The UTSA defines a trade secret as “information” that derives independent economic value, actual or potential, from not being generally well known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use and which is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.



WHAT IS A TRADE SECRET?



- Formula, drawing, pattern, program, compilation, device, method, technique or processes used in one's business
- Derives independent economic value from not being known to others



FACTORS TO DETERMINE WHETHER SOMETHING IS A TRADE SECRET



- The extent to which the information is known outside of the company's business
- The extent to which it is known by employees and others involved in the company's business
- The extent of measures taken by the company to guard the secrecy of the information
- The value of the information to the business and its competitors
- The amount of effort or money expended by the business in developing the information
- The level of difficulty for others to properly acquire or duplicate the information



EXAMPLES OF TRADE SECRETS



- Indirect rates and multipliers
- Source code for software programs
- Certain types of client or customer lists
- Marketing plans, sales strategies
- Business and financial information
- Bidding policies and procedures
- Price lists



GENERALLY NOT TRADE SECRETS



- General knowledge-information that is known generally in an industry
- Skills and abilities necessary to perform the job
- Publicly available information



RELYING ON TRADE SECRETS STATUTORY OR COMMON LAW PROTECTIONS



Most states will protect a owner's trade secrets from unauthorized disclosure or use by employees or other persons who obtained them in confidence from the owner

Pros

➤ No written agreement

Cons

➤ More difficult to prove

➤ Uncertainty as to what information is considered trade secret

➤ Must use reasonable efforts to keep the information secret

➤ Deterrent effect



COMMON LAW DUTY OF LOYALTY



- Employee has a duty NOT to engage in activities which conflict with an employer's interests (competition)
- Duty not to usurp business opportunities for personal gain
- Can prohibit from competing and diverting business during employment and from soliciting employees and customers for competing business
- Limited protection once the employee is no longer employed



PURPOSE OF AGREEMENTS



➤ Minimize Uncertainty

- Defines rights and duties of disclosing party and recipient
- Use of an agreement reinforces owner's treatment of the information as a trade secret and demonstrates owner's taking reasonable precaution to protect it

➤ Deterrence

➤ Contractual Remedy

➤ Added Litigation Benefits



NONDISCLOSURE AGREEMENTS



- Restraints upon the disclosure of confidential, proprietary and trade secret information by recipient

- Who should sign – anyone who has access to company confidential and proprietary information
 - Employees
 - Consultants
 - Potential Business Partners
 - Potential Customers



NONDISCLOSURE AGREEMENTS PROVISIONS TO INCLUDE



- Definition of Confidential Information
- Exclude Info that is not “Confidential”
 - Already in the Recipient's Possession
 - Available for Public Use without a Breach of the Confidentiality Agreement
 - Obtained from any Other Person having No Obligation of Confidentiality
- Restrict Dissemination on a Need to Know Basis



NONDISCLOSURE AGREEMENTS PROVISIONS TO INCLUDE



- Duty of Care
- Mutual
- Prohibit Disclosure, Copying or Use of Confidential Information
- Protect Written and Oral Proprietary Information
- Return Material
- Remedies – Injunctive Relief
- Laws & Choice of Jurisdiction



NON-COMPETITION RESTRICTIONS



- Attempt to Preserve the employer's business relations and goodwill with customers; prevent employees from working for competitors; taking the employer's secrets, customers, employees ("non-solicitation" or "anti-employee raiding") after the employment relationship ends
- Generally Disfavored by Courts as Against Public Policy
- Must be Narrowly Drafted



NON-COMPETITION RESTRICTIONS



LIMIT TO KEY EMPLOYEES

- The Extent to which the Employee Possesses Confidential Information
- The Extent of Employee's Contacts with the Company's Customers
- Employee's Position and Duties
- The Length of Time the Employee was with the Company



NON-COMPETITION RESTRICTIONS



➤ CONSULTANTS – MAY REQUIRE SPECIAL CONSIDERATIONS

- Cannot control consultants – they are independent contractors
- Secure narrowly tailored non-compete and non-disclosure/non-use covenants
- Limited to use of confidential/trade secret information



NON-COMPETITION RESTRICTIONS



- Courts will apply a 3 Part Test to Determine whether a Covenant not to Compete is Enforceable.
- From the Employer's Standpoint - is the agreement no more restrictive than is necessary to protect the employer in some legitimate business interest?
 - From the Employee's Standpoint - not unduly harsh or oppressive in curtailing the employees legitimate efforts to earn a living
 - Sound Public Policy (free trade, competitive market)



NON-COMPETITION RESTRICTIONS



➤ The burden of whether an agreement is reasonable is on the employer. The employer must have some legitimate interest to protect, for example:

- Trade Secrets (as defined by statute)
- Confidential or Proprietary Information
- “Unique Services”
- Customer Relationships
- Client or Contact Lists
- Goodwill developed by the Employee for the Employer
- Unique Services
- Can't be used to Prevent an Increase in Ordinary Competition



NON-COMPETITION RESTRICTIONS



- How Must a Non-Compete Agreement be drafted to be Reasonable?
- Duration of the Restraint
 - Geographic Scope
 - Extent of the activity being restricted
 - Consider further restricting to customers with whom the employee came in contact with, identified, or learned of, during his/her employment
 - Consider including a statement that a list of customers will be supplied upon request at the termination of the employment relationship



NON-COMPETITION RESTRICTIONS



Which Law Governs?

- Generally courts will follow choice of law placed in the contract (but not always)
 - Make sure chosen state law is favorable
 - If not specified, will be the state in which the employee is providing the majority of the employment related services



NON-COMPETITION RESTRICTIONS



Enforcement

- Failure to promptly enforce could be deemed a “waiver”
- Failure to promptly enforce could trigger other employees to breach
- Failure to consistently enforce

Injunctive Relief



NON-COMPETITION RESTRICTIONS



Severability/Blue Pencil Provision

- Severability
- Blue Pencil Provision
 - Courts will not always “blue pencil” even if the parties agree
 - Don’t draft overboard restrictions in reliance on blue pencil
- Assignment
 - Don’t assume non-compete signed by an employee while there were working for one employer is automatically enforceable by a business that buys the company’s assets



NON-COMPETITION RESTRICTIONS



➤ Hiring an Individual under a Non-Compete, Nondisclosure or Non-Solicitation Agreement

- Enforced against employer
- Tortious interference with contractual relations
- Economic Advantage



NON-COMPETITION RESTRICTIONS



- What should you do to Prevent Litigation?
 - Obtain employee's written agreements with former employers
 - Debrief Employees prior to starting and upon exiting employment with the company
 - Covenants
 - Similar line of business
 - Departing Employees
 - Emphasis on company's policies
 - Inform the new employer in writing of employee's duties
 - Make sure an employee knows they can't take documents with them



CORPORATE AUDIT CONSIDERATIONS



AUDIT CONSIDERATIONS



Corporate Records

- Are the Company's corporate documents in order?
- Does the Company keep an updated record book containing:
 - the Articles of Incorporation
 - the Bylaws
 - meeting minutes
 - stock ledger



AUDIT CONSIDERATIONS



Corporate Records

- These items are required in many states.
- The failure to keep these records accurate and current could lead to numerous problems, including:
 - (i) the ability to obtain financing at a critical time;
 - (ii) concerns by a prospective buyer with the lack of documented corporate history; and/or
 - (iii) the imposition of fines or penalties by state corporation commissions.



AUDIT CONSIDERATIONS



Shareholder and Director Meetings

- Does the Company conduct annual shareholder and director meetings?
- Are all directors and officers appointed regularly and in accordance with the Bylaws?
- Does the Board authorize actions that require director approval, as required by the Bylaws and applicable law?
- Do the Board and the shareholders understand and take advantage of corporate laws allowing for electronic meetings and action by written consent?



AUDIT CONSIDERATIONS



Shareholder and Director Meetings

- The failure to observe these corporate requirements could result in a challenge to the validity of the action taken or legal challenges by the shareholders that Board members have not met their fiduciary obligations.



AUDIT CONSIDERATIONS



Chain of Title of Stock Ownership

- Has the Company issued stock certificates to all stockholders and cancelled all certificates of former stockholders?
- If stock has been transferred from one stockholder to another, is there documentation evidencing the transfer?



AUDIT CONSIDERATIONS



Chain of Title of Stock Ownership

- The Company should have a clear chain of title verifying current ownership and all previous stock transactions since its inception.
- The inability to demonstrate a documented chain of title is likely to raise concerns with a prospective purchaser or a lending institution, and could jeopardize the transaction.



AUDIT CONSIDERATIONS



Issuing New Stock

- Does the Company have enough authorized shares to issue additional stock?
- Is an amendment to the Articles of Incorporation necessary?
- Has the Board approved the issuance of additional stock?
- Is the Company required to give “preemptive rights” to existing stockholders, which grant them the right to maintain their respective percentages of ownership?



AUDIT CONSIDERATIONS



Issuing New Stock

- If stock is issued incorrectly, this can affect the validity of the shares and/or the transaction. A current or former shareholder may have a basis to make an unexpected claim at some future date.



AUDIT CONSIDERATIONS



Stock Bonus Plans

- Does the Company have a stock bonus plan? If so, is it clearly stated; does it fit the Company's needs; and does it provide proper incentives for executive staff?
- Does the Company issue stock options, and if so, are they compliant with applicable laws and regulations?
- Does the Company take advantage of the benefits of stock options?
- Has the Company considered alternatives to issuing stock, such as a phantom stock plan?



AUDIT CONSIDERATIONS



Stock Bonus Plans

- The method by which a company should incentivize its staff will vary from company to company.
- An appropriate stock or other bonus plan should take into account a variety of company-specific factors.
- Whatever method is selected should be fair and clearly stated in a written agreement or plan in order to avoid costly disputes.



AUDIT CONSIDERATIONS



State Registrations

- Is the Company conducting business in any states in which it is not registered?
- Has the company registered to do business in all states where it is conducting business?
- Does the company have a current registered agent in each state in which it is authorized to transact business?



AUDIT CONSIDERATIONS



State Registrations

- Many states impose penalties and fines on companies that are not authorized to do business in the state.
- Also, the failure to register could affect the ability of a company to bring a lawsuit and the failure to have a current registered agent could cause the company to miss important documents from the Secretary of State, including service of complaints and notices to file annual reports.



AUDIT CONSIDERATIONS



Liens and Security Interests

- Does the Company have a clear understanding of what creditor liens exist on its assets?
- Have all security interests in the Company's assets for loans that have been paid off been released?
- Has the Company checked to ensure there are no judgment liens against it?



AUDIT CONSIDERATIONS



Liens and Security Interests

- Security interests and judgment liens can interfere with a corporation's ability to obtain financing and/or sell the business. The Company should have an accurate understanding of the liens and encumbrances that are on record. The Company should also make sure that state records regarding outstanding liens are accurate and current.



AUDIT CONSIDERATIONS



Purchase or Sale of a Business

- Is the Company considering an acquisition of another business or selling some or all of its stock or assets?
- Is the Company familiar with letters of intent and engagement letters for financial advisors?
- Does the Company use a comprehensive due diligence list?
- Is the Company aware of the different legal and business implications of structuring the sale of a business as an asset sale, stock sale or merger?



AUDIT CONSIDERATIONS



Purchase or Sale of a Business

- Many companies make the mistake of proceeding with an acquisition without fully understanding the legal, tax and financial consequences. Some companies also employ tax and legal advisors too late in the process, and consequently, find it difficult to negotiate terms to protect their interests without jeopardizing the entire transaction.
- Legal and tax advice should be sought early in the process. Is the Company aware of the different legal and business implications of structuring the sale of a business as an asset sale, stock sale or merger?



IMPORTANT AGREEMENTS AMONG OWNERS



- Shareholders' (Buy-Sell) Agreements for Corporations
- Operating Agreements for LLCs



OWNER AGREEMENTS



- Can Restrict Transfers of Ownership to Third Parties
- Can Ensure Right to Buy Back Equity Upon Termination, Retirement, Death, etc.
- Provisions for Valuing Stock / Membership Interests



EXIT STRATEGY PROVISIONS



➤ Tag-Along and Drag-Along Rights

➤ Put and Call Rights



DRAG-ALONG RIGHTS



- The Right to Force Other Equity Holders to Sell When (Majority) Owner Ready to Sell to a Third Party
- On Same Terms Offered by Third Party



TAG-ALONG RIGHTS



- The Rights of (Minority) Owners to Have Their Interests Sold Along With Other Equity Holders' Interests
- On Same Terms Offered by Third Party



CALL RIGHTS



- Can Force Other Equity Holders to Sell Their Equity Interests to You

PUT RIGHTS

- Can Force Another Equity Holder or the Company to Buy Your Shares/Interests



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QUESTIONS ?

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