THE 7 SECRET KEYS TO STARTUP SUCCESS

WHAT YOU NEED TO KNOW TO WIN

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Thirty-Year Business Consultant, Serial Entrepreneur, Corporate Attorney, Investor, and Inventor

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Foreword by
US Senator Byron Dorgan (ret.)

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To Marilee, my amazing wife, and my rock for over fifty great years. A wonderful friend, mother, and grandmother. Simply the best!

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FOREWORD

Much of the economic success the United States enjoys has come from the innovative work of entrepreneurs from Henry Ford to Bill Gates. And our continued success will come from the new and exciting entrepreneurs and innovative companies that will keep us competitive in this rapidly changing world.

Serving as a US senator, I had the opportunity to know many men and women who dreamed of starting their own business. I watched some succeed and build large, profitable businesses, and saw some fail. And I wondered, *what was the difference*? It seemed to me it was having the knowledge you needed to build the business. That is exactly what this book is about.

I also understood the connection between private sector businesses risking their capital to create jobs, building products, and providing services and the public sector establishing the rules to help guide those businesses. I know the public and private sectors must work as partners to continue building the American economic engine and our standard of living. Businesses also need help understanding the tools they need to succeed.

This book provides those tools. While most business executives have expertise in some areas, it takes much more to grow a successful company. They need to create a team, understand marketing, hire personnel, and raise capital—all while re-engineering their product. And they face a barrage of basic questions such as:

- How to divide equity among partners?
- How to compensate workers; and
- How to raise capital within the SEC's rules?

That's where this book comes in. This is not your uncle's or aunt's business book. *The 7 Secret Keys to Startup Success* makes a unique contribution. It breaks the mold by providing more of the essential, practical, legal, and business information that growing businesses need to succeed.

It covers the basics like incorporating and raising money. Then it shows you step-by-step what, when, and how to do each task. It's like having a seasoned lawyer and business consultant by your side all the way from concept to commercialization and beyond.

As many as eight-out-of-ten new companies fail in the first year. So it's amazing that so little attention has been paid to *why* companies fail. David Muchow has worked with hundreds of startups and other companies over decades and unlocked the major reasons for these failures. These include mistakes that CEOs don't even know they're making, like giving away too much equity and not putting agreements in writing. So, this book also tells you what *not* to do as well as what *to do*. In short, it helps you to avoid what David calls "Startup Suicide."

It also contains new, useful information you won't get in business school, law school, or anywhere else; and is packed with charts, model legal forms, and other information, such as how to calculate rate of return and reduce legal fees.

At the policy level, it discusses the need for a national dialogue to better support new businesses. It's a call to action so they can go from a concept to commercialization in months, not years.

The 7 Secret Keys to Startup Success covers more ground than other books because the author has worked in every area of business development, from the shop floor to being an inventor, a serial CEO, attorney, and teaching law, business, and entrepreneurship at Georgetown University.

Finally, business books should be fun to read. So, at the end of each chapter there are fictional stories inspired by actual cases, illustrating the principles in the chapter. These involve the adventures of Professor Scooter Magee, a business expert who travels around fixing failing companies.

I enjoyed this trailblazing book that's packed with the critical business and legal information you need to succeed—and is lots of fun as well!

—US Senator Byron Dorgan (ret.)

Sen. Byron Dorgan (ret.), served in the US House and Senate for three decades. He is a New York Times *bestselling author of five books, has been a visiting professor at Georgetown University, and is a senior policy advisor at a premier Washington, DC law firm.*

PREFACE

When I was a law student at Georgetown, my favorite professor was Sam Dash who taught criminal law. He had a mastery of the subject matter and had lived it as the district attorney in Philadelphia and senate chief Watergate counsel in President Nixon's impeachment hearings. His exciting stories vividly illustrated legal principles and kept us riveted. When teaching Law, Business, and Entrepreneurship at Georgetown, I found the same thing. Students were eager to learn but they particularly liked the stories about the characters and cases I'd encountered over decades of law practice and business.

The result is a new kind of startup book. The one book you need to succeed that's also fun to read!

- **It has more of what you really need to know to succeed.** Most startup books cover the same topics—build a team, create a business plan, etc. *The 7 Secret Keys to Startup Success* covers those basic topics and guides you step-by-step through the startup process. But it breaks the mold by providing so much more.
- **Practical advice in more key startup areas**. It gives you more of the practical keys to success in every area—from marketing and finance to protecting your intellectual property, cryptocurrency, and managing startup chaos.

- **Legal and business advice**. It provides legal as well as business tips, tricks, and advice to keep you from violating the many complex laws in hiring, fundraising, and other areas. You'll gain practical advice from my years as a corporate lawyer and federal prosecutor.
- **Prevents "Startup Suicide™."** Most startups fail in the first year. This book shows you not just *what to do*, but also *what not to do* so you can to avoid the big mistakes that lead to Startup Suicide.
- **Information you can't get anywhere else.** You'll gain real-life legal and business insights and advice not available anywhere else, from my working with hundreds of startups and major companies for over thirty years.
- **Charts, model forms, and more**. *The 7 Secret Keys to Startup Success* is packed with charts, tables, and model forms to get you up and running faster.
- **The first startup book that's fun to read.** It's filled with interesting legal cases and business lessons involving figures like Ivanka Trump, Oprah, and others that illustrate key things you need to know. Then, after each chapter there is a fun short story, inspired by real cases, which drives home *The 7 Secret Keys to Startup Success*.
- **Building a national entrepreneurship eco-system (NESS) to support entrepreneurs.** Finally, with a call to action, we discuss how to create a new national support system for entrepreneurs that can help them go from a concept to commercialization in ninety days.

Your feedback is always welcome! Contact me at info@davidmuchowauthor.com.

ABOUT THE AUTHOR

David J. Muchow is managing partner, Muchowlaw. He is a thirty-year business expert, serial entrepreneur, corporate lawyer, and inventor who has advised hundreds of businesses from startup to exit. Dave is an adjunct professor of Law, Business, and Entrepreneurship at the Walsh School of Foreign Service, Georgetown University. He serves on various tech, energy, and non-profit boards, has helped turn ideas into publicly traded companies, and was a founder and officer of a one billion dollar publicly traded mutual fund. Earlier, he served on Capitol Hill, and with the National Security Council staff, the Office of Management and Budget, and as a prosecutor and special assistant to the assistant attorney general, U.S. Department of Justice, where he received the US Attorney General's Special Achievement Award and was chairman of the Federal Advisory Committee on False Identification. He has served with various law firms, been a lobbyist and foreign agent, general counsel and director of international programs for the American Gas Association, and was a founder and CEO of SkyBuilt Power, which built the world's first rapidly deployable solar/wind power stations for the CIA and military; and an associate producer with Fab Films for the PBS film, *When My Times Comes*. Dave is a frequent speaker and consultant on law, business, and entrepreneurship, and author/co-editor of numerous publications including the seven-volume treatise, *Energy Law and Transactions*, *Regulation of the Gas Industry*, and *The*

Energy Handbook. He attended Georgetown University, (BSFS '66), Cornell Law, and Georgetown University Law Center (JD '71). Dave and his wife Marilee live in Arlington, Virginia, where they enjoy spending time with their children Heather and Scott and three grandchildren, Zoe, Zadie, and Lily.

LIST OF CHARACTERS

Finally, a startup book that's fun to read! Business books should be fun to read as well as instructive. *At the end of each chapter, there are fun examples/stories, inspired by real events, which demonstrate the principles in each chapter using the adventures of Professor Scooter Magee, the Startup Expert.*

Scooter helps startups prevent "Startup Suicide" and achieve success while fighting the CIA and others. Think: Professor Indiana Jones in Raiders of the Lost Ark *meets* Bar Rescue *or* Silicon Valley*! Enjoy Scooter's adventures and his practical startup lessons!*

Scooter Magee and Family

Scooter Magee. Professor at Georgetown University, the "Startup Expert"

Megan Magee. Scooter's wife

Zoe, Zadie, and Lily. Their grandchildren

Sammy. Scooter and Megan's dog

The Montevideos

Sr. Vincent Montevideo. Chairman, Zapata, SA

Scarlett Montevideo. Vincent's daughter and fashion heiress

CIA

Chuck "Bulldog" McCatchum. Chief, Threat Analysis Directorate

Johnson. Bulldog's assistant.
Souk Kaep. Technician, Siam Reap, Cambodia Station
Chan. Kaep's Assistant
Dr. Heinrich Johansson. Chief Scientist, Project Tailgate
Derek Martin. Lab Researcher, Project Tailgate
Jason Kingston. Agent
Sarah. Experimental dog
Frank Early. Night Detail Officer, Project Tailgate

FBI

Jackson Tapper. Division Chief, Washington Field Office
JW McKinney. Special Agent, Washington Field Office

Other Clients

Fred Delaney. Air conditioner inventor
Natalya, Toni, and Karen Fusser. Feuding sisters who own restaurant
Baraz Azad. COVID PPE entrepreneur
Susan Glover. COO, Aeris Gloves
Sally Martin. Salmonella poisoning victim

Others

Kelly. Server at Cowboy Cafe
Jorani. Woman selling birds at Angkor Wat
Cold Fingers (CF) Gelato. Russian mob figure and spy camera client
Crunch Hym. Cold Finger's partner
John Martin. In salmonella lawsuit
Caroline. Woman at the Animal Welfare League
Bud Lawrence. Scooter's former boss
Jacob Abner. Cryptocurrency founder
Sally Ann McKay. Scooter's high school friend
Bobby Joe. Toni's boyfriend
Boris "Nuts" Spassky. Cold Finger's creditor
Kathy Burt. Scooter's friend
Jacob Spassky. Boris Spassky's son
H. Bosley Jenkins III. Investor on Queen Mary 2

Chapter 1

PLAN FOR SUCCESS

If you don't know where you are going, you'll end up someplace else.

—Yogi Berra

THE 7 SECRET KEYS TO STARTUP SUCCESS

The 7 Secret Keys to Startup Success are the seven key areas of operation in which startups must make smarter decisions to avoid failure and achieve success. They are:

- Plan For Success
- Manage Your Startup's Risks
- Lock Up Your Intellectual Property
- Be Smarter About Personnel Management
- How to Shake the Money Tree … Legally
- The Smarter Roadmap to Marketing and Sales
- Use "Management Zen" to Reduce Startup Chaos

Each of these keys is a chapter in this book. Each chapter then details the specific steps to be taken and not taken. Other keys could be added but based on my experience in working with hundreds of startups and larger companies over many years these are the most important ones for startups.

I've seen many startup successes and failures. Unfortunately, many of the lessons aren't taught in B-schools, found in books, or used. That's why I call them "secret" keys. Nevertheless, they're critically important. They include things you may only learn by making costly mistakes or when it's already too late, like how to save money on legal fees, how to raise money without violating SEC rules, protecting your intellectual property, and how to fire your partners without getting sued.

PREVENTING "STARTUP SUICIDE"

For startups, knowing what *not to do*—the dangerous mistakes that startups often make—can be as important as knowing what *to do*. Think about learning to ski in the winter. The first things an instructor tells you are things *not to do*: "Don't fall forward, and don't put your skis pointing downhill or you'll go there." Startups with no prior experience are easy prey for big mistakes that lead to "Startup Suicide™." Most startups fail. Sometimes the founders never understand what really happened. But they gave away too much equity, failed to get insurance, didn't write down their oral agreements, and stumbled into a downward cycle of failure—sometimes topped off with a devastating lawsuit. This book shows how to avoid these common mistakes and increase your odds of success.

THE PRACTICAL BUSINESS AND LEGAL THINGS YOU NEED TO KNOW TO WIN

Think of this book as your expert business consultant and lawyer to guide you step-by-step on the road to success. While it has the basics found in other startup books, such as how to raise money and prepare a business plan, we won't spend much time on the well-plowed ground of other books. Rather, the focus is on the many critical, practical things you need to know to survive and succeed that you won't find anywhere else.

Many business books deal with general information on management or "motivation." That's fine, but I've never had a client ask about motivation. Entrepreneurs are some of the most highly motivated people on the planet. Rather, they ask me about practical things like, "Should I incorporate in Delaware? How can I cut my legal fees and when do I need a non-disclosure agreement?"

FINALLY, A STARTUP BOOK THAT'S FUN TO READ!

Let's face it, many business books are boring—they read like encyclopedias. Startups are innovative—so startup books should be innovative, too, and not just useful but also fun to read. So there are interesting cases and stories throughout the book. Then at the end of each chapter there's a fun example and story to illustrate the lessons in the chapter. The stories are inspired by real cases and revolve around Professor Scooter Magee, the "Startup Expert." Scooter travels around in his old Austin Healey and fixes broken startups. Along the way he fights off the CIA and deals with a wide variety of characters and inventors. Think Harrison Ford in *Raiders of the Lost Ark* meets *Silicon Valley* or *Bar Rescue*. You can skip the stories if you want but try a few.

Important Legal Caveats: While this book discusses some general legal and financial principals, it can't provide legal or financial advice to you. The appendices contain parts of contracts and other documents, but don't use those as-is. The laws and facts are different in each jurisdiction. So, on any legal and financial matters, be sure to seek advice from your attorney and financial advisor. Finally, any relationship between real people and events is purely coincidental.

YOUR BASIC STARTUP PLAN: STEP-BY-STEP

Building a startup is like running through the jungle in the dark. You could end up as someone's dinner. You need to be very careful or you'll be committing "Startup Suicide."

The other day I was reviewing a contract for a client that had some very dangerous language buried in a boring heading called "Section 44, Assignment Clause." An assignment is a transfer of the rights and benefits in a contract from one party to another. But this language wasn't even assignment language. It made the founder personally liable for everything under the contract, including all of the founder's personal assets: "Assignment … The Parties signing as officers of entities also agree that by their signatures, they shall also bind themselves personally to the terms set forth in this Agreement." (emphasis added)

In addition to having a lawyer review your contracts, try to avoid being personally liable in any business matter unless you're doing something like getting a bank loan. Banks often require personal guarantees for startup loans. I once talked with a US senator whose family owned a string of banks and even his own banks required him to personally guarantee his loans. Except in the case of loans, if it's a commercial deal, just the company and not you should assume liability. So, as you create your new venture, be careful!

Most startups begin with an idea. Maybe you've seen something that doesn't work and you have a better idea. Or someone asks you to join their startup. But there are lots of challenging steps to get from an idea to commercialization. Before you know it, you'll be drinking from a firehose with everything coming at you at once—legal problems, partner issues, vendor agreements, raising money, marketing problems with your product or service, and more. So, you'll really need a plan to stay focused. Otherwise, you'll be held hostage by fighting the crisis of the moment and never reach your goals.

You can think of the major steps in a company's life in three stages:

- Stage 1 is "Beachhead." This is where you organize the company and personnel and take steps to protect it, like hiring a lawyer to draft non-disclosure, non-compete agreements. and locking up your intellectual property.
- Stage 2 is "Operations." This includes managing and growing the company.
- Stage 3 is "Exit," where you cash out.

While many of the 7 Secret Keys apply to any stage in a business, because this is a startup book, it's focused on the startup stage, Stage 1, Beachhead. This first chapter will give you a high-level overview of the startup process. Then, the following chapters will go deeper into many of the most critical areas discussed. The steps listed below can be done in a different order or in parallel, but make sure you at least consider doing all of them.

Illustration 1

BASIC STARTUP STEPS, 0-60

- ✓ **Develop a Plan.**
- ✓ **Get a Partner With Money.**
- ✓ **Build a Balanced Core Team.**
- ✓ **Form a Business Entity.**
- ✓ **Use Non-Disclosure (NDA) and Non-Compete Agreements.**
- ✓ **Protect Your Intellectual property (IP).**
- ✓ **Get Personnel Documents In Place.**
- ✓ **Choose The Best Way To Compensate Employees.**
- ✓ **Create a Board Of Directors, Board of Advisors.**
- ✓ **Extensive Market Research – Define What "It" Is.**
- ✓ **Design a Minimum Viable Product, Field Test it.**

Note: These are the Earliest Startup Steps Before Marketing and Sales. Many steps can be done in parallel or different order.

WHAT IS YOUR BUSINESS?

Peter Drucker, the renowned business expert, has said that there are just two questions to ask regarding business success. First, "What business will you be in?" and "How's business?"[1] Sometimes start-ups only think about building and selling their product or service—I'll often use the term "product" to include "service" as well. But there is a whole spectrum of things you could do with your product, from just licensing the use of it by others to sales and maintenance.

And maybe it's not a product at all, just a leased service or a Software as a Service (SaaS) in which software is licensed on a subscription basis and hosted from a central server.

Select Your Slice of the Pie

If your invention is patentable and has some real market value—a patent lawyer and others can help you determine that—you could simply license the intellectual property, such as a patent or copyright from your invention and hand off everything else to others, such as the manufacturing, marketing, distribution, sales, etc. If that worked, you could collect a royalty and sit on your yacht. This would save a lot of headaches. Do you really want to worry about running a factory and Occupational Safety and Health Administration (OSHA) regulations? You could also finance the sale of the products and make money from the financing fees, or you could consider offering a maintenance agreement to provide another source of income. This is the frosting on the sales cake. Here's how maintenance plans work. You create a spread sheet and drop in the labor and parts costs and the failure rates for the equipment. Then you price the maintenance plan so that—given a typical failure rate of the product—you've still got enough money to cover it, plus a 25–50 percent profit on it. You can even get an insurance policy behind that to protect yourself from a big failure. Maintenance plans can be an excellent source of income.

Exit Strategy

What do you want to do and by when? Would you like to grow the company and raise its value? Do you like running a company? Or would you like to get sales up and running, add value, and then cash out with a greater profit after some time, say, three-to-five years?

So, think about these different options, which will help focus on the best options for you as you take the following first startup steps.

FIND PARTNERS FOR EARLY FUNDING

Let's get real. As James Hunt, managing partner of the MITA Group, a private equity fund, once told me, "The number one reason companies fail is that they run out of money." Sure, that's obvious, so obvious that it's often overlooked. But it's also very true. So, your first job is to make sure that never happens. Running a business is a bumpy ride. A partner or other source of money like a big line of credit or high net worth investors provides the shock absorbers you need to survive the ride. Even Thomas Edison, one of the world's most successful investors, continuously had to raise money for his many projects. There are an unlimited number of ways to run out of money, which we'll discuss, but it comes down to always having enough money to stay in business. One solution that's obvious but frequently overlooked is to get one or more partners or investors as soon as possible who have enough money to support you when your cash flow hasn't started or is inadequate.

I learned this lesson in 2005. I was a founder and CEO of SkyBuilt Power, a startup company that produced the first rapidly deployable solar and wind power systems for the military and intelligence community. These plug-and-play units in freight containers provided power with no fuel and minimal maintenance to remote areas for the Iraq war effort and Homeland Security. In-Q-Tel, the CIA's venture capital firm, provided SkyBuilt with critical financial support and our first sales. In-Q-Tel's mission is to identify and support startups with transformational technologies that can be used by the military and intelligence agencies. The name came from "intel" for intelligence and "Q" because CIA Director George Tenet liked "Q," the crusty quartermaster and research director in the early James Bond movies.

Building these cutting-edge systems required hundreds of thousands of dollars to solve complex engineering challenges. Fortunately, my good friends and SkyBuilt board members, Bill Buck, Ken Schweers, S. Kinnie Smith, and Bob Hahne, were kind enough to invest and lend money essential to launching the company and maintaining cash flow, while Scott Sklar provided expertise on solar systems. We never could have gotten off the ground and kept going without their critical financial and other support. Make sure you focus on having enough financial backing to keep going. One common metric is to raise enough funding to last twelve to eighteen months.

Then you'll be freer to concentrate on developing the product and getting to profitability.

SELECT AN EXPERIENCED LAWYER TO AVOID RAZOR BLADES IN THE SOUP

Be sure to get a lawyer right away. Your lawyer will help you with typical startup matters, including creating the company and putting personnel agreements in place. Having a good lawyer right off the bat will help you avoid big mistakes that can kill your company. Your lawyer should be able to use experience to see the razor blades in the soup that can cripple a startup. Look for a lawyer who's experienced in startups as well as a broad range of business matters. When hiring a lawyer, consider using smaller or mid-size firms. Bigger firms frequently have higher overheads. Most of the startup work is routine, so you don't need the highest paid, specialized attorneys to do it. Your lawyer should review all contracts until they become routine, to protect you from making bad deals. Contract language can be very tricky and often just a few words you don't understand can leave you with a costly mistake or a deal that's too hard to get out of if it goes bad.

TIP: NEVER SIGN A CONTRACT WITHOUT HAVING A LAWYER LOOK AT IT, UNLESS IT'S FAMILIAR AND YOU FULLY UNDERTAND IT. CONTRACTS ARE LIKE WARS: EASY TO GET INTO AND HARD TO ESCAPE.

BUILD A SOLID CORE TEAM

Be Humble, Ask for Help, and Listen

Understand that you need help. As the startup's CEO, you're probably good at some things, even amazingly good. But that doesn't mean you are good at all things. And the job of CEO is like drinking out of a firehose. You'll need to work on more than one thing at a time while maintaining a reasonable balance in managing all parts of the company, from product development to marketing, legal, fundraising, and personnel. If you don't put a well-qualified team together to help, you'll be overwhelmed and unable to focus on the bigger issues that are more important and strategic.

Every entrepreneur usually has a strong suit that's also a weakness. For example, software entrepreneur gurus just can't stop trying to improve their software. There's always one more feature to add and some code to tweak. It's the fun part for them. We all like to spend more time on the things we enjoy doing and understand. To make it worse, entrepreneurs tend to be creative folks, so for them, creative activities are a lot more fun than the routine, boring tasks like paperwork, legal contracts, and petty personnel issues. But you can't let any of those balls drop or the company will go down with them. This goes double for personnel matters. One of the biggest reasons that startups fail in the first year is personnel issues. People need attention. They want to feel like a part of the company; and when they don't they quit, and you not only have to spend time and money getting someone else, but sometimes they get so mad that they find a lawyer and sue you. It's extremely difficult to raise money from investors when you're a defendant in a lawsuit (See chapter 4 for more personnel tips).

How do you keep on top of all the things your company needs at once? I'll get back to that later (See chapter 7 for some answers to this problem).

No Sycophants

Another big reason to create a solid, core team is to keep you balanced and allow you to thrash out options and ideas before running off in the wrong direction. Pick your core team carefully. A startup can be all consuming and you may be spending more time with your team than with your significant others. You don't want any sycophants. Get talented people dedicated to the company who will feel comfortable arguing with you. Their ideas can help you get to a better result.

Who Should Be on Your Core Team?

The core team must be people that you trust and have the skills and experience you need, perhaps five people or so. In a typical startup you might have the sparkplug—the CEO, who has produced the ideas for the company—a technical expert like a chief technology officer (CTO), a chief financial officer (CFO) or treasurer, and a marketing person. Other duties like developing software and building a web page can be outsourced, which will save overhead.

SELECT THE RIGHT BUSINESS ENTITY AND STATE FOR REGISTRATION

Having a company in place rather than doing everything personally in your name makes you look more professional and ready to do business. It also provides liability protection. In case there's a lawsuit or claim against the company, you want the company, not you personally, to absorb the liability. If things get really bad, the company—instead of you—can file for bankruptcy.

Company Formation Steps

Here's a high-level view of the basic company formation steps. They will vary by state and local rules. In creating a company, your attorney will walk you through the different types of entities, like a sole proprietorship, partnership, limited liability company (LLC), a corporation (called a Corp. or C Corp. or simply a corporation), S corporation (S corp), and benefit corporation, and whether the company should be "for profit" or "non-profit" (also called "not-for-profit"). Each of these entities has its pros and cons, including different tax impacts on you and any other equity owners in the company and on the company itself.

In What State Should I Form My Company?

You should discuss with your lawyer in which state your entity should be registered. States vary in their efficiency, registration fees, tax policies, shareholder protections, and privacy provisions. For example, Delaware is a popular state for startups. It offers flexibility in structuring your company. Only one person needs to be a director and officers don't need to be residents. Directors' names don't need to be required on formation documents, and there's no state income tax. Its Court of Chancery has expertise in the most complex corporate legal matters. Because over half of the Fortune 500 companies are registered there, it has additional prestige. However, other states have many of those features. For example, Nevada, Florida, Wyoming, South Dakota, and others have no state income tax.

However, if you register in any state but aren't a resident, then you need a third party in that state to act as your "resident agent" to receive service of process in case of a lawsuit or to handle any other legal matters for your company in that state. That registered agent service costs money. And you'll also need to be registered in the state in which you are actually running the business. That means that you have to pay twice and need to comply with both states' reporting requirements. Because of this, I often recommend incorporating in the state in which you live and do business to keep things simple and inexpensive. You can always register in a different state later. For example, some major investors might want to have you registered in Delaware or another state where they're located.

Types of Business Entities

Here are just a few of the more popular business entities and some key features for you to consider.

Sole Proprietorship

A sole proprietorship is what you have when you're engaged in business but haven't formed a separate legal entity. It's the default position. The advantage is that you don't need to do as much to start your business and you could get a trade name. It might be a fit for a very low risk business that you want to explore. The downside is that your personal and business matters are totally intermingled. If your business is sued, you're personally liable as well! Your business liabilities become your personal liabilities. It also appears to potential investors and customers that you're engaged in something more like a hobby rather than a "real" business. So, they are hesitant to invest in or provide business loans to sole proprietorships.

Partnerships

A partnership is a simple business form for two or more people. There are various kinds.

General Partnership (GP)

A general partnership can be formed in most states simply by signing a partnership agreement. You do not even need to register as a business entity with the state. Profits, losses, and liabilities flow directly through to the owners' personal income for tax purposes. Each partner can bind the partnership unless otherwise specified in the partnership agreement. That leaves the door open for potential liability.

Limited Partnership (LP)

LPs often have one general partner who has unlimited liability and controls the business, while the other partner(s) have limited liability. The limited liability partners may have various degrees of control over the company as described in a partnership agreement. Profits and losses flow through to the partners' personal income tax, and the general partner pays self-employment taxes.[2]

Limited Liability Partnership (LLP)

LLPs are like general partnerships (GPs) but provide limited liability to all the partners; and absent unusual situations, partners are not responsible for the actions of other partners.[3]

Limited Liability Company (LLC)

Often, startups choose an LLC as their first entity. All the income and expenses from an LLC flow directly through to the equity holders and their personal income tax returns. Because startups often lose money at first, those losses can reduce your taxable income. The entity itself is a "pass through entity" for income and expense purposes and is not separately taxed.

Another advantage of LLCs is that they can be less expensive to form and simpler to operate and maintain. For example, there typically is a flat state annual registration fee of fifty to a hundred dollars from the state in which you operate the LLC, regardless of how many members there are. With a corporation, however, fees tend to be higher and are frequently based on the number of shares, which can make your annual registration fees much more expensive. For example, in Virginia, an LLC's annual registration fee is fifty dollars, but for a corporation with 270,000 or more authorized shares (even if the shares were just "authorized" and not "issued" yet), it would be $1,700.[4]

In LLCs, the equity holders are called "members" and the equity share is called a "membership interest." This contrasts with corporations where the equity holders are called "shareholders" or "stockholders." In practice, however, people often refer to members of LLCs as stockholders or shareholders as well.

C Corp

A C corp is also very popular. It is a separate legal entity from its owners and can be taxed, have its own profits and losses, and be separately legally liable. It is more expensive to set up and requires more record keeping and reporting than LLCs.

One advantage is that C corps can have "qualified stock option plans" with "incentive stock options." This provides more favorable tax treatment for the recipients because the profits they make when the options are exercised are taxed at the capital gains rate which typically is lower than the ordinary income tax rate. Because LLCs don't have "stock," just "membership interests," they can't have stock options. LLCs can, however, issue equity in the form of membership interests to employees and officers and others as an incentive or provide "warrants," which operate in a similar manner to stock options.

On the minus side with a C corp, there is double taxation. First, the corporation is taxed on its earnings. Then, if it distributes its earnings in the form of dividends to shareholders, those earnings become taxable income to the shareholders. In order to "go public" and be listed on a public stock exchange, you must be a C corp.

As with other entities, if you sell your shares after holding them for at least a year, the difference between the acquisition price (called the "basis") and the sale price creates a "capital gain" (if the sale price is higher than your acquisition price) or a "capital loss" for tax purposes (if the shares are sold for less than the basis or acquisition price). If they are sold in less than a year, the gain or loss is treated as "ordinary income."

S-Corp

An S-Corp or S Corporation is not a different legal structure; rather it's an Internal Revenue Service (IRS) tax election that allows more favorable tax treatment for an entity. For example, a single-member LLC is taxed by the IRS as a sole proprietorship by default. This means that the LLC pays a Federal Insurance Contributions Act (FICA) self-employment tax on all income one earns from the business, plus personal income tax based on your personal tax rate. Like a corporation, an S corp has a separate life so if a stockholder leaves the company the S corp continues in existence.

On the other hand, if the LLC files with the IRS and receives S-Corp tax treatment, it can reduce taxes. Here's how that could work. You can pay yourself a salary which has to be "reasonable compensation," similar to what a typical employee would make for your job. Then you would only pay one-half of the usual payroll tax amount, plus a Federal Unemployment Tax Act (FUTA) unemployment tax and personal income taxes on your salary. The business would pay the other one-half of the payroll taxes which can be written off as a tax deduction. Profits would not be subject to payroll taxes.[5] Another advantage is that an S-Corp can have stock options.

The downside is that the IRS places restrictions on S-Corps. For example, you will need to pay yourself a paycheck, deduct payroll taxes, and file quarterly estimated returns. Also, to qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation;
- Have only certain types of shareholders (They may be individuals, certain trusts, and estates but may not be partnerships, corporations, or non-resident alien shareholders);
- Have no more than one hundred shareholders;
- Have only one class of stock; and
- Not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations).

So, if you're not going to have income for some time, the additional steps to create an S Corp might not be worth it because there won't be any tax savings. You can always convert to an S Corp in the future. Tax laws change, so be sure to consult your tax advisor before selecting an entity and its tax treatment.

Benefit Corporation (B corp)

A benefit corporation, also called a "public benefit corporation" or "B corp," is a for-profit entity that requires the company to have a positive impact on society, workers, the community, and the environment in addition to its usual business activities. Startups might choose to create a benefit corporation because it fits with their corporate goals to provide societal benefits. In some states, a C corporation may change to a benefit corporation just by changing its bylaws, while in others it may have to file with the state to change its name. In a benefit corporation, directors must consider the public benefits in addition to profits and the company publishes annual benefit reports. These reports typically have twelve or so third-party standards to be followed to satisfy state reporting standards, but third-party certification of compliance to those standards is not required.[6]

Close Corporation

A close corporation (or "closely held corporation") is a less formal corporation, used by a small group of shareholders, usually not more than thirty-five. It can be run by the members without a board of directors and without an annual meeting, but it cannot be publicly traded. The shareholders are treated like a general partnership, but if they run the company they keep their limited liability and assume the fiduciary duties of a fiduciary and may be held liable for violation of those duties.[7]

Nonprofit Corporation

A nonprofit corporation is a corporation that has received a tax exemption from the IRS. Nonprofits must perform work that benefits society such as educational, religious, literary, charity, scientific, or trade association work. Their rules of operation are set by the IRS and are more restrictive than those of for-profit corporations.

For example, a nonprofit's lobbying activities may be restricted; they can't distribute profits to members or to political campaigns.

Cooperative

A cooperative ("co-op" or "coop") is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise."[8] Cooperatives are owned by their members, with each member having one vote (unrelated to the value of their holdings) when electing the board of directors. Cooperatives are commonly used in New York City for residential housing, and nationally by electric and gas utility companies, including "rural electric cooperatives."

GET YOUR COMPANY'S PAPERWORK IN ORDER

Pick a Name

To form a legal entity, the first step is to pick a name. You're not naming your first born, so don't go crazy figuring out a name. You can always change it later, although this will take more time and expense the longer you wait to do so because more documents will need changing. And, you'll lose the brand name identity you might have created.

Your products can have different names. For example, your company could be named IBC Corp, but you could name your products anything else.

When you've picked a name, you can do an online search at the appropriate office in your state where you're going to register the company and make sure you're not infringing on someone else's name. The state's registration office might be called the Department of State (New York) or the State Corporation Commission (in Virginia). To be more certain that the name isn't infringing on another name, you can have a more extensive trademark search done by a trademark agent. These are usually non-lawyers specifically trained in such searches. They might charge hundreds of dollars for that.

Tax ID Number

You'll need to get a Tax ID number or "Employee Identification Number" (EIN or FEIN) from the IRS. You will need it when you open a bank account, file your tax return, and for other transactions. You can simply go online to IRS.gov and search for "EIN." It only takes a few minutes. This Federal EIN is used for state tax filings as well.

Bylaws and Operating Agreement

Remember to adopt in writing the basic rules under which the company must operate. They're called bylaws for a corporation and an operating agreement for LLCs. When you enter into agreements with other parties and raise money from investors, they often will want to see them. Not having them or having inferior ones are a signal to others that you don't know how to run your own railroad.

They include such things as:

- the address of the company;
- procedures for annual and special meetings;
- elections and voting requirements;
- quorum requirements;
- creating the board of directors and its procedures;
- election and duties of officers;
- stockholder's rights; and
- indemnification of officers by the company.

Although you can get form bylaws documents from the internet for under fifty dollars, they usually provide very thin coverage for the many situations in which a company can find itself. I think of those three-to-to-five-page documents like wearing summer clothes in the arctic—they're clothes, but sometimes they don't give you adequate protection. So have a lawyer draft them up for you. Lawyers can be expensive but fixing problems from inferior corporate documents can be even more expensive. For an outline of a bylaws document and some typical terms, see Appendix 1.

Authorizing Resolutions

Adopt organizational resolutions, which appoint officers, authorize the opening of financial accounts, appoint a law firm and/or accounting firm, issue equity, and approve all prior actions of the founders, etc. Sometimes these resolutions are called "organizational actions in writing in lieu of a meeting," or something similar. They are the written versions of the resolutions that the company would normally adopt if it held an in-person organizational meeting. Or you can hold an in-person meeting and orally pass the resolutions instead. But then they should be written, signed by an officer, and placed in the minutes of the company. See an example of an organizational action in writing at Appendix 2.

Get a Business License

These are usually not expensive. The state or local governments want to know what kind of a business you have and whether there will be any zoning (how many parking spaces, etc.) or other issues regarding the business.

Zoning

Get a zoning permit, if required by local authorities. This is sometimes included in the business license filing.

Tax Filing

Register with federal, state, and/or local tax authorities.

Open Financial Accounts

Once you have done some of these basics, you can open a checking or other financial accounts. Banks typically require that you bring in your state-issued certificate of incorporation (and some will confirm that online with the issuing state office), bylaws, and resolutions appointing a treasurer.

Create a Legally Compliant Webpage

When you're setting up a webpage, there are a number of things you should consider, including a separate webpage tab for legal notices. Some of these are required and some are optional.

Terms and Conditions

Terms and Conditions are optional and include your company's requirements for use of the website. They provide information on protecting your intellectual property rights to the information on the site, detail prohibited uses of the site, provide consents for the site to use information that the user provides, describe payments of fees, and limit your company's liability while using the site.

Cookies Policy

Cookies are text files that a hosting company places on the user's computer to collect information, provide communication with the user, offer focused advertising, and other services. A cookies policy is not generally required except in special situations, such as if your site engages with European Union (EU) users (see the General Data Protection Regulation section next). A cookies policy discloses what cookies are used, who provides them, how the site places and uses them, and how preferences for them can be changed by the user.

Privacy Policy

A privacy policy describes the company's practices for collecting, using, protecting, and disclosing "personal information" that the user provides to the site, and a policy regarding their use is required by the Federal Trade Commission and state privacy laws. "Personal information" includes an e-mail address, physical address, phone numbers and names, and biometric or other personal identifiers.

General Data Protection Regulation (GDPR)

This is an EU regulation that governs the protection of data and privacy on the web in the European Union and European Economic Area (EEA).[9] You need a website policy regarding these matters when data is transferred in or out of those jurisdictions, such as when a user in the European Union uses a website in the United States.

California Privacy Rights Act

This California law[10] imposes privacy protections on certain companies doing business in California. If your business is located in

California or has substantial transactions there (as defined in the Act) you must include language on your site to comply with the required consumer rights imposed by the Act.

Other Requirements
Other privacy regulations are being added from time to time as well, so be sure to have your attorney check for those on a regular basis.

Other Steps

Set up your letterhead, get business cards if you wish, and you're in business.

USE NON-DISCLOSURE (NDA) AND NON-COMPETE AGREEMENTS

The business world can be a dangerous jungle. People steal ideas and products all the time. Someone once took marketing materials off my website and put it on theirs so that they could sell my products. So, how can you protect your ideas from being stolen but still talk about them to those you need to, like investors and potential customers?

One answer is a non-disclosure agreement or NDA. That requires the parties who sign it not to disclose any confidential or proprietary information about the existence of the NDA, your business dealings, and the products and services being discussed. There are exceptions to non-disclosure agreements, such as instances where the information is already publicly available, cases in which you need to disclose information to your agents or advisors to perform duties for the business, or if a court requires disclosure.

Some investors and others won't sign NDAs. They'll tell you that they don't want to remember what's confidential and what's not and from whom. If they have negotiating power in the transaction, you may have to go along with that. A good NDA also has other provisions such as language preventing the recipient from competing against you (a "non-compete") and a provision that prevents one party from circumventing the other on a deal ("non-circumvention" provision) such as bypassing the agent to take control of the deal. Sometimes they're referred to as "a non-compete, non-disclosure Agreement" (NCNDA). A good NCNDA should have all these provisions: an NDA and non-compete and non-circumvention language. For an example, see Appendix 3.

Another way to protect your proprietary information and data is simply not to disclose them. When raising investment capital or getting a customer, you have to tell the other party something. But you can start by telling *what* your product or service does, but not the all-important secret sauce of *how* it does it. Once you get into more serious discussions, you can reveal more information as required and under an NCNDA. That leads us into how to protect your intellectual property.

PROTECT YOUR INTELLECTUAL PROPERTY

TIP: DON'T BLOG ABOUT YOUR SECRET SAUCE OR YOU MIGHT NOT BE ABLE TO GET A PATENT ON IT!

You may develop valuable intellectual property that you'll want to protect.

Intellectual property includes: "…creations of the mind, such as inventions; literary and artistic works; designs; and symbols, names and images used in commerce."[11]

It can include customer lists, software, trade secrets, patents, inventions, franchises, patents, copyrights, and trademarks. It's sometimes distinguished from other more tangible property such as "real property" (real estate) and "personal property" such as computers or desks.

There are various ways to protect your intellectual property. You could keep the information secret. That creates a trade secret, which is any proprietary, commercially valuable information or data kept secret by not telling anyone (or only disclosing it under the protection of an NDA). You also can file for a copyright, patent, or a trademark. (See chapter 3 for a full discussion of each of these.)

Startups sometimes make a big mistake by publicly disclosing their invention before they patent it. Once it's out in the public, you may not be able to get a patent, even if you're the one that invented it and made it public. This is because you can only get a patent from the U.S. Patent and Trademark office (US PTO) for what is novel (meaning new), non-obvious, and useful. So, (subject to certain exemptions, such as if you file for a patent within one year of any disclosure[12]) if the invention is already public, such as if you blog about it before you file for a patent, it's not "novel" anymore because it's in the public domain and you may be denied a patent.

CREATE PERSONNEL AND OFFERING DOCUMENTS

TIP: YOU'RE VIRTUALLY "MARRIED" TO YOUR STARTUP PARTNERS SO BE SURE TO GET A "PRENUPTIAL" PARTNERS AGREEMENT!

Get Personnel Documents in Place

While the proof is elusive, most startups probably fail in the first year. One of the major reasons is that the partners don't get along. You might end up spending more time with your startup partners than your significant others. You're "married" to them, so you need the business version of a prenuptial agreement. To protect each other and your company, you should have a written agreement with every employee or independent contractor working for the company. This should spell out how the person is compensated, what their duties are, how their engagement with the company can be terminated, what happens if they get equity and then leave the company, etc. (See chapter 4 for more partnership information). One of my clients started a company without any personnel documents in place. Then his partner wanted to leave. A one-year battle followed with lawyers and accountants over how much money that partner was due from past business income and his oral claim of a 30 percent equity stake. We finally got a settlement, but this expensive mess was totally avoidable. Don't let this happen to you.

Have Your Offering Documents Drafted by a Lawyer

Once you start raising money, you'll need to prepare documents that describe the terms of your offering, such as how many shares of equity are being offered and for what price. You may want to limit who can invest to sophisticated investors with plenty of net worth, called "accredited investors."[13] This makes it harder for such investors to claim that you lost their money because they already would have signed a document saying that they are sophisticated investors and understand that they could lose all their money by investing in your new venture.

This is a very dangerous area legally and you should have a lawyer advise you on how to proceed. For example, the U.S. Securities and Exchange Commission (SEC) has rules that govern how you must "issue an offering" and raise money. If you fail to follow those rules, you can be subject to civil and even criminal penalties. In addition, each state has laws (also called "Blue Sky Laws") that regulate how funds can be raised (making "offerings") in their states. For example, you might think that if your uncle in California invests $20,000 in your new company that it's just a "friends and family" investment so you don't have to do anything to comply with federal or state security regulations. But unless there's an exemption, most states require you to register and pay a fee before or shortly after making an equity offering. So, check with your lawyer before raising funds (See chapter 5 for further details).

HIRE AN ACCOUNTANT AND MINIMIZE TAX SUPRISES

Setting Up the Books and Records of the Company

You should engage an accountant early in the startup process. Accountants can help you track your income and expenses and provide valuable financial advice. You also don't want to clutter your desk with random receipts and expenses. Your accountant can help you set up a good bookkeeping system to track all of this. Quick Books is one easy-to-use software program to do that. Once you understand how to use Quick Books or another software accounting program, you can input the information yourself, link it to your bank account, easily print checks, and save money on accountants. When you file your income taxes, the information your accountant needs will already be well organized and ready to input into your company's tax return. That can save you and your accountant time and money.

Your accountant can also help you save money by properly classifying various types of expenditures. Some can be "expensed" like rent or wages, allowing you to deduct those costs annually for tax purposes. Other expenditures may be "capital expenses," such as expenses for computers, office furniture, and software. Those typically are depreciated for tax purposes over time based on their useful life which results in lower annual tax savings.

Prepare a Business Plan

Your team, lawyer, and accountant can help you prepare a business plan. That's a document, usually ten to twenty pages, which describes your company, product, management, marketing plan, and financial matters. There's a lot of work in putting a good business plan together, but it is worth it because it forces you to think about what you're doing in some detail. A key part of the plan is a pro-forma profit and loss statement (P&L). This is a spreadsheet detailing three-to-five years of income, expenses, and profit or losses. It shows investors how the company will be performing, and you can use it to manage the company as well (see Chapter 5). Sure, it starts being out of date the minute you produce it because your business is always changing, but it is the best guide you have for the company's financial plans and will help you track your financial results.

TIP: KEEP THE PAR VALUE OF YOUR COMPANY LOW TO REDUCE TAXES.

Minimizing Taxes

Accountants are also helpful with legal tax avoidance strategies. One tricky area is when you get equity in your company. You need to get good accounting advice early on before accepting any equity to minimize its tax impact.

For example, suppose that you start a company. It has one million shares of equity "authorized." "Authorized" means the maximum number of shares that the company has approved to be issued to shareholders or holds in reserve ("treasury stock"). Once shares are issued to investors, they're called "issued shares."

Now, suppose that you plan to issue yourself a total of four hundred thousand shares of stock in two batches ("tranches") of two hundred thousand shares each. The company sets the share price for the first tranche at ten cents per share. The value of those shares will become taxable income to you when they are issued. Two hundred thousand shares multiplied by ten cents per share equals $20,000 of taxable income to you even if the company doesn't have any income to offset that tax. So, you need to be careful about how many shares you get and what price you set for them. That's why you often see a start-up's share price set low, such as at $0.001 per share. That stated price is called "par" value or "nominal value," which is usually unrelated to the current market value of the company. At $0.001 per share, the taxable income would only be $200 ($0.001 multiplied by $200,000).

Now, suppose that the company does great and shares are now worth a hundred dollars each. You give yourself the second tranche of two hundred thousand more shares. Now you'll be taxed on two million dollars of income (one hundred dollars per share multiplied by two hundred thousand shares). Ouch! But an accountant or tax lawyer can structure this so that you can prepay taxes on the value of the stock when the first tranche was granted, not when the later tranches are received. This is done by filing an "83(b) election" with the U.S. Treasury Department. *But that must be filed within thirty days of when the first stock issuance was granted*.[14]

TIP: TO AVOID GETTING SUED, BE SURE TO NOTIFY EMPLOYEES ABOUT THEIR 83(b) ELECTION OPTION BEFORE GRANTING THEM SHARES.

Of course, if the shares go down in value at the time of the second tranche, then you would have overpaid your taxes on the front end. This shows how useful an accountant can be and how important it is to engage one right away and not make a costly mistake by waiting too long.

To avoid a situation in which an employee gets a tax bill from receiving the company's equity and then argues that the company should have disclosed that, your employee handbook and any employment agreement should contain language disclosing this possibility; and the employee should acknowledge that the employee will consult with an accountant or attorney on the tax implications prior to receiving the equity.

SELECT THE BEST WAYS TO COMPENSATE EMPLOYEES

Salaries

Usually, startups don't have much money for salaries. But there are other forms of compensation that may be helpful. These include paying someone on a commission based on the sales they close, or compensation can be in shares of equity in the company such as by offering stock or stock options.

Stock Options

An "employee stock option" is a right for the employee to purchase a certain number of shares in the company at a certain price (the "exercise price") for a certain period in the future under certain conditions. For example, the company might give you an option to purchase a thousand shares of its stock at a discounted price at any time over the next five years whenever the company hits a defined goal, such as one million dollars in sales. The company also benefits because it is not giving away any equity yet and may never have to, unless the event that triggers the option occurs.

Independent Contractors vs. Employees

Often, it makes sense for companies to use "independent contractors" rather than "employees." This reduces the company's overhead expenses for employee benefits like health insurance and 401(k) savings plan contributions. Independent contractors must pay their own federal payroll taxes under the Federal Insurance Contributions Act ("FICA"). That's 15.3 percent of gross wages. The employer pays nothing. On the other hand, if the worker is an "employee," the company must pay one-half of the 15.3 percent or 7.65 percent, and the employee pays the same amount. There are restrictions, however, on the use of independent contractors, such as when they are working full time or otherwise acting more like employees, so be sure to check with your lawyer on using them to avoid violating the Fair Labor Standards Act, enforced by the U.S. Department of Labor (see Chapter 4 for details).[15]

CREATE A BOARD OF DIRECTORS/BOARD OF ADVISORS

As a startup, you want your company to look professional and to demonstrate to others that you have a team that can do the job. You also want and need advisors to second guess you, help you reach the best decisions, and open the doors to potential customers or suppliers. Too often, CEOs keep charging ahead in the wrong direction unless they have a good team of advisors or a board to keep them on track and give them a dose of reality. Startup CEOs are dogged and often have trouble seeing their own failings. A board provides a good reality check and moral support. Of course, some board members can also drive you crazy but generally having a board is very useful.

A board of directors sets policy for the company, while the management runs the company and executes the board's policies. Sometimes boards try to run the company and control the officers, so you will want to pick your board members carefully. They should be supportive, but not intrusive.

Composition of the Board

Think about creating a board of five to seven persons. It should be an odd number to avoid a tie in voting. You might want to have an experienced lawyer, marketing person, CFO, or accountant and one or more officers, typically the president and CEO. The other seats should be for people who can help you grow the business and open doors to your target markets. For example, when I ran a military contracting company, I invited a retired three-star Air Force general, John Fairfield, and a former assistant secretary of the Army, Mario Fiori, to be on the board. They were very helpful in finding marketing opportunities and dealing with the complex military procurement process.

Sometimes when selling to big companies or the government, the person or business unit that wants your products doesn't have the authorization or money to buy them. I remember one time when I was talking on the phone with a colonel in Iraq at a forward operating base. I could hear the gunfire in the background. He wanted to buy our solar/wind power stations and get rid of diesel power because it was too hard and dangerous to resupply the fuel. The Army found that for every twenty-four fuel convoys in Iraq one soldier was killed with improvised explosive devices (IEDs) on the road. But the colonel didn't have any authority to get the funds. Only the Pentagon did. So, we had to work with both the colonel who wanted the product and the Pentagon folks with authority to free up the money. Having board members who know how to do that definitely helps.

Compensation

Board members of a startup don't expect to be paid. Once the company starts making money, you could compensate directors by giving them stock options based on their attendance at board meetings. For example, if you decide that attending a board meeting remotely is worth $300 of their time and attending in person is worth $500 per meeting plus travel expenses, then you could give them stock options equaling those values for every meeting they attend. Later, when the company is making enough money, you could pay them in cash.

Fiduciary Duty of Directors

Under state law, members of a board of directors have a legal, fiduciary duty to the company and to the shareholders. This includes the duties of utmost good faith, honesty, loyalty to the company, and the duty to exercise due care in the management of corporate affairs. As a result, some people may not want to join your board unless you have directors' and officers' liability insurance (D&O insurance) to protect them from potential lawsuits. You usually can get that for less than $2,000 per year and it also protects you, officers, and other designated persons in the company.

Board of Advisors

You could also create a board of advisors. This typically is an informal arrangement. CEOs use them for informal advice and to help open doors to grow the company. Having well-known advisors on your letterhead or in your marketing materials can enhance the image of the company. And they usually don't have a legal or fiduciary duty to the company or shareholders. They also don't expect to get paid when you're still a startup.

DO EXTENSIVE MARKET RESEARCH—DEFINE WHAT "IT" IS

At the beginning, all you have is a bunch of assumptions, just hypotheses, about your new product (or service or both) and who the customer is. You need to figure out both of those to be successful.

TIP: NEVER SIGN A CONTRACT UNLESS YOU CAN REASONABLY GET OUT OF IT!

Regarding what your product should be, don't start signing expensive design or prototyping contracts too early in the process because your idea will change repeatedly in the early stages. Never sign a contract that doesn't allow you to get out with minimal cost. This is where having a good lawyer when you're starting up can be very useful.

Regarding the customer, for your product to be commercially successful, someone needs to write a check to buy it. But they won't buy it unless they want it, and you don't know yet what they want and how much they'd be willing to pay. Sometimes even the customer doesn't know what it wants. Steve Jobs didn't worry about that when he created the iPhone because it was so innovative. Customers loved it when they saw it even though they never had seen one before or wanted one. But you're not Steve Jobs. So, you need to do your best to find out what the customer wants.

Customer Discovery

You should talk with a hundred or so potential target customers and find out what they want. Yes, a hundred. You'll learn a lot. Your idea and its features and price point will become more realistic. The product may even change from a product to a service such as leasing the product, downloading it on a subscription basis, or leasing it rather than selling it.

Prepare for the Discovery Conversation

Make a list of the questions you need answered before talking with the market research targets. Typically, these are potential customers. For example, if your product is a portable heater, does the customer want lower initial costs for the unit, lower operating costs, a quieter unit, more efficiency, or is the customer happy with what he/she has? How is it going to be used? Is it for constant use or intermittent use? How big are the rooms in which it might be used? Is the market residential, commercial, or military, as well as civilian, domestic, or international? You get the idea.

Mostly Listen

When you meet with potential customers during market discovery, mostly listen; don't talk too much. You're not in selling mode. This is market research. Find out what you don't know and haven't thought of yet. You're trying to get inside the customer's head and understand his/her needs so you can meet them. You might say something like this:

- "I have this idea, but I need your help."
- "Would this be of interest to you?"
- "Does it solve a problem you have?"
- "If not, what is your problem and what would meet your needs?"
- "If I built what we're discussing, would you be interested in buying it?"
- "At what price or terms?"
- "What if I financed this and paid for it up front at no cost to you? You'd save money on day one compared to your electricity bill now. Then you'd just pay me a monthly fee."

What Is the Competition?

Your product needs to be cheaper, faster, better, or in some way superior to make folks want to buy it compared to other, similar products. Often the competition is something as simple as the customer doesn't want the hassle of changing suppliers or learning about something new. Think about how reluctant a customer might be to switch bundled services (TV, cell phone, etc.) from one internet provider to another just to save a few dollars. What is your secret sauce? What's your value added? Is it enough to get buyers to buy? Find out what they pay now. Talk about how much they could save. What would it take for them to switch to your product?

DESIGN A SIMPLE PROTOTYPE, A MINIMUM VIABLE PRODUCT (MVP), AND FIELD TEST IT. Suppose you have an idea for a new widget. First, build a workable product. Forget the bells and whistles. Make it out of cardboard if necessary. Get it out in the field and get operating data. If it's a heater, for instance, get real time data from a data logger (operating times, weather conditions, time of day, wind speed, solar radiation, etc.) and get customer feedback. Eric Ries, in his classic book *The Lean Startup*,[16] describes this minimum viable product (MVP) process in detail. Your goal is to learn what product or service the customer wants. Focus on learning, not perfection. You need to learn as fast as possible before your money runs out. Making mistakes with a design or two is okay and can even be valuable because your customer will tell you whether you have the right design or features before you spend too much time and money going the wrong way. Once you get the results of the field test, you can adjust the prototype design to improve it. Then build the next iteration and repeat the process, as necessary.

When I was developing solar/wind power stations for the CIA, it took many working prototypes and hundreds of changes to get a reliable product. Sometimes we'd make one change that would require many more to keep all the systems in balance. Even after you start selling your product you'll need to keep adding value to it to stay ahead of the evolving competition. Find ways to continually value engineer it to make it faster, stronger, more efficient, less expensive, more reliable … whatever. Build, learn, and revise. Don't stop.

Thomas Edison provided a classic example of how much effort it can take to develop a reliable commercial product. As an inventor, Edison made a thousand unsuccessful attempts at inventing the light bulb. When a reporter asked, “How did it feel to fail a thousand times?” Edison replied, “I didn’t fail a thousand times. The light bulb was an invention with a thousand steps.” Edison, who created more than a thousand inventions and was one of the pioneers of General Electric, succeeded despite being severely hearing impaired and being told by teachers that he was “too stupid to learn anything.” Ironically, he was fired from his first two jobs for being “non-productive.”[17] More recently, James Dyson, the inventor of the Dual Cyclone vacuum cleaner and Pure Cool purifying fan, worked for four years and developed 5,127 prototypes while perfecting his vacuum cleaner.[18]

So be realistic. Developing a safe, cost effective, reliable product can take a lot of time and money. Don’t rush the process or you risk a failed product and commercial rejection when you launch it.

There’s a lot more to consider. For example, how do you market the product and/or service? Through reps that take orders, distributors who warehouse the products, direct sales door-to-door, to manufacturers of tiny houses, or on the internet, etc.? See chapter 6 for further details on those issues.

Business books should be fun to read as well as instructive. *So, at the end of each chapter are fun examples/stories, inspired by real events, which demonstrate the principles in each chapter using the adventures of Professor Scooter Magee, the Startup Expert.*

Scooter helps startups prevent Startup Suicide and achieve success while fighting the CIA and others. Think Professor Indiana Jones in Raiders of the Lost Ark *meets* Bar Rescue *or* Silicon Valley*! So, read on and enjoy Scooter’s adventures and his practical startup legal and business lessons!*

Examples of the Failure to Plan: Fire, Ready, Aim at the Cowboy Café

In this chapter we meet Professor Scooter Magee, startup expert, who helps an inventor save money and demonstrates the value of a good business plan.

It was true. The Forbes *cover story said it. CNN and Fox News even agreed. Georgetown Professor Scooter Magee was a genius in fixing broken startups, turning innovative ideas into fortunes, and making companies millions. He was the "Startup Expert." Until he wasn't. Until something or someone turned his life upside down. Was it the CIA? Scooter had to figure things out and fast. Everything was closing in. Being roadkill was not an option.*

It started off as a good day for Scooter Magee. A day to enjoy. Good for him. But all too soon he would be careening down a slippery slope into hell. And he wouldn't have a clue who or what caused it.

For Scooter, nothing was as much fun as being an entrepreneur. It was a constant roller coaster ride. Success or failure was always just a phone call away. That's why he traveled around in his classic 1962 Austin Healey 3000 convertible helping startups get back on track. After thirty years as a startup lawyer, consultant, and professor, he'd pretty much seen it all. All the stupid things that he and hundreds of other startups had done. His passion was to prevent "Startup Suicides."

One Saturday morning, his friend Fred Delaney, amateur-class tinkerer, called Scooter. Fred was excited and wanted to meet right away for lunch. Scooter figured he'd better show up—Fred was a walking hand grenade who was as likely to blow up his own business as succeed. And Scooter was happy to get out of the house.

Around noon Scooter pulled off Langston Highway into the parking lot next to the tattoo parlor at the Cowboy Café—the last authentic dive bar in Arlington, Virginia. You knew that right away when you opened the door. There was a stuffed head of a steer with big horns sticking out of the wall, with the rest of its lop-sided body painted in awful, faded colors behind it. The air conditioner had been dripping on it for years. And there were signs all over the place, like "Hippies Use Side Doors" and "Beer Speaks. People Mumble." Over the kitchen was another sign, "Many People Have Eaten in This Kitchen and Gone on to Lead Normal, Healthy Lives."[19]

There was an old, dark, sticky atmosphere about the place. But for Scooter, it all added up to a comfortable feeling. *Thank God they'd never improved the place*, Scooter thought. *Like they say, "There are many arguments for doing it but no good reasons."* He'd been going there for years—it was authentic. When you're older, authenticity means a lot.

Scooter walked in the door. Kelly, the young server who had just cut her first country song on TikTok, walked toward him, pushing her long, brown hair behind her ear. "The usual?" That wasn't an ask; it was a confirmation. Whenever Kelly saw him coming in, she quickly poured a Diet Coke and placed his usual order with the cook for a chopped steak, medium-rare, buried in grilled onions and gravy. Scooter didn't experiment with sure things. He had good taste for bad food.

Fred was sitting in the back corner at Scooter's favorite booth, waiting to talk with him and trying to unstick his long-sleeved shirt from a brown glob of dried ketchup. Fred looked rumpled as usual in his wrinkled plaid shirt. He blended in well with the faded picture of three old cowboys on the wall behind him. He could have strutted right out of that picture. Five Miles was with him. Fred had named his dog "Five Miles" so he could say he walked five miles every day. Scooter loved dogs and Five Miles was easy to love. He was a spotted hound dog of questionable parentage with sad but knowing eyes. He didn't just lie on the floor; he turned around a couple of times and then flattened himself, spread eagle, like syrup on a pancake. Five Miles looked up at Scooter with those sad eyes, and when the food arrived Scooter placed a little chopped steak on a spoon, topped it with an onion and some gravy and slipped it to the hound, who gulped it up and then happily pancaked himself asleep.

Soon, Five Miles was snoring, but Fred was very much awake and excited. "Scooter," he said, "I need you to help me raise $300,000.

And quick! More folks are moving to trailers to retire. But the twenty bucks per month for electricity for heating and cooling is killing people on their retirement budgets. I've invented a four-phase air conditioner that goes on the roof and cuts the electric bill to zero!"

"How does it work?" Scooter asked.

"Well, that's still a secret but it captures energy from the electromagnetic fields all around us. us You don't need an electric compressor, which uses most of the electricity in an air conditioner. I've made a prototype that works; and listen to this! I've just signed a contract with a manufacturer to build a thousand units for only $300,000. We'll sell them for $500 each, make $500,000, and clear a profit of $200,000! Can you get me the $300,000? I need it by next Tuesday."

Scooter struggled for words. This was a mistake on so many levels that Scooter didn't know where to start, except he knew the more immediate problem was how to help Fred without hurting his feelings. Fred didn't know it yet, but he was committing "Startup Suicide." This was a classic "Fire, Ready, Aim" mistake. He was building the product first, based on nothing more than assumptions, without really knowing what the product should be, who the customer was, and what the competition was. Even worse, he was blowing $300,000 on one design that was almost certainly the wrong one.

"Please stop!" Scooter said. "Look, the concept could be technically interesting. But you're about to blow $300,000! See if you can get out of the contract."

"Why?" asked Fred, somewhat shocked.

"Lots of reasons. Let me explain. You need a business plan. As Yogi Berra said, 'If you don't know where you're going, you'll end up somewhere else.'"

For the next fifteen minutes, Scooter gave Fred a quick lesson on planning ahead and how to structure his startup's rollout to Ready, Aim, Fire. Instead, poor Fred had "Fired" without being ready or taking aim. The discussion was wide-ranging and included everything from the importance of market research to knowing what the customer wants, to rigorous field testing, safety, certification requirements, and more. All of which needed to be done before mass production.

When they were finishing lunch, Scooter said, "Look, I just dumped a lot of information on you. I'll send you a summary of what we just discussed. In the meantime, just find a way to get out of that contract before it explodes on you and you commit Startup Suicide. One of the biggest challenges for any startup is to minimize the chaos and stay focused on the big picture."

"Thanks for your time, Scooter," said Fred, as they walked out the door. Five miles woke up and looked at Scooter.

"Good dog!" Scooter said as he patted him. Scooter had no idea what his love of dogs was going to do to him in a few days. As for Fred, he looked as beaten down as a rented mule in a hailstorm, but at some level he knew Scooter was right.

Scooter went home and let himself enjoy the moment. He'd saved another lost startup soul. He was at the top of his game.

"I've come a long way from those days as a poor kid," he thought. Last month's article in *Forbes* was the cherry on top. *Forbes* dubbed him the "Startup Expert." He thought things were looking good. But he was wrong. Very wrong.

When Scooter got home, he had a call waiting for him on his voice mail. It sounded like the caller's name was "Fingers" or something. He called back.

11:00 hours, July 4
Threat Analysis Directorate
SCIF 403x, CIA Headquarters, Langley, VA

Chuck "Bulldog" McCatchum, directorate chief, was barking as usual. "Everyone sit down and shut up. You too, Jenkins. Raul, that means you! Forget it's the Fourth of July and listen up. We've got our own fireworks show right here." He threw a picture up on the screen. "We just got this picture inside a jail from our Warsaw link. It was taken by a Cambodian spy locked up in an interrogation facility there. High quality, 2800 xprs and flawless pixels. The problem is he was in solitary confinement, naked, had been strip searched, and locked up for a week. So how was he still able to send a picture to his handlers? If this is a super camera with transmission capabilities, we've got to figure it out and fast, or nothing will ever be secret. In the meantime, get the word out to your contacts at the NSA and FBI to pick up any unusual intel chatter about cameras. We need leads, guys. Don't just sit there. Get out of here and get on it!"

One Week Later, 09:00 hours, July 11
Angkor Wat, Cambodia

Souk Kaep was tired of this. It was the third time this week the CIA's miniature spy camera-microphone had failed at Angkor Wat. It could have been anything—rats, bats, birds, or rain. He guessed rain. That's what you get when you hide a KW-23 super-sensitive camera in a strangler tree trunk during rainy season.

He parked on the west side of the four-hundred-acre Angkor Wat site, the largest temple complex in the world, with over one thousand buildings. It was only 09:00 but already 33 Celsius. Steam from last night's rain was rising off the broken pavement. He walked over the weathered stone bridge across the three-mile-long moat around the temple and dodged the puddles and scurrying rats on the gravel path to the massive four pillar building. There he merged with a noisy Italian tour group to avoid notice (while noticing the cute blonde tour guide in the miniskirt) and climbed the ancient steps to the first level. Souk stopped in the entrance hallway overlooking one of the big courtyards. There it was: the 100-foot strangler fig tree with giant roots crawling up the crumbling sandstone wall. It had totally swallowed the host tree and was holding up the crumbling ancient wall. That was good. There hadn't been any serious wall maintenance there since the year 1150, when Suryavarman II of the Khmer Empire built it.

He waited for the group of noisy tourists to pass. Then he took what looked like a smart phone out of his pocket, pressed three buttons, and watched the meter. Nothing. He shinnied up the tree a meter or two, scaping his leg on the bark, to a fork in the branches, pulled out the old camera, and popped in a new one. Souk called Chan at the safe house on his encoded cell phone.

"Chan, I just put in a new camera, are you getting the data?"

"Give me a minute; I'm in the middle of a soccer game! Can you call back; the score's tied!"

"Look, Chan, look, this is important, are you getting the data?"

"Not yet. Oh ... here it comes. Yeah, looks good, I see you. What'd you do to your pants?"

"I ripped them climbing the stupid tree. Next time you're doing this."

"Hey, stop complaining. Switch places? Sure. I'm double-locked in this stinky old place with no windows and a squeaking fan for twelve hours a day and you're running around outside scoping out the cute blondes."

The new camera started taking 180-degree panoramic pictures and listening to conversations up to thirty meters away. Every four hours it would batch-send the data to the safe house in Siem Reap, six kilometers away, to be recorded and analyzed.

For centuries, Angkor Wat has been a place of intrigue and deals, most recently drug deals, where people from around the world could meet and do what they wanted without being noticed in the crowds of tourists. As Somerset Maugham would have said, it was a "sunny place for shady people," and one of the thousand places around the world the CIA was constantly watching.

More dark clouds were forming as Souk hurried from the temple to avoid the coming rain. Food and souvenir vendors were hustling tourists into their tents on both sides of the path to his car. He stopped to see an old woman in a torn shawl under the drooping tent. He needed to buy a bird in a cage for a Buddhist "merit release."

"Hi Jorani, it's that time again," said Souk, smiling. He looked at the many bird cages hanging from the top of the tent. "I'll take that one over there," he said, pointing to a black metal cage with a small brown bird hopping around in it.

She handed him the cage, they chatted for a while, she took his money, and said "Au Kun" or *thank you*. The bird bounced around as he hurried to his car and got there just as the rain began.

Following ancient Buddhist merit customs, Souk and his family would mentally put the weight of all their cares on that unsuspecting little bird, open the cage door, and let it go. It was just a small prayer offering—one of 500,000 caged birds released every year in