

ASPEN COLLEGE SERIES

# Law for Entrepreneurs and Small Business Owners

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# Robert Sprague



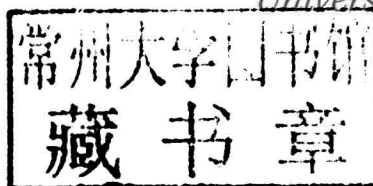
Wolters Kluwer

# Law for Entrepreneurs and Small Business Owners

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**ROBERT SPRAGUE**

*Associate Professor of Legal Studies in Business  
University of Wyoming*



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## Preface

New and small businesses are the economic backbone of the U.S. economy. Not only do small businesses employ the majority of workers, they also account for a disproportionately larger share of new job growth compared to older, larger firms. And in an environment of anemic job growth, underemployment, and career uncertainty, more and more college students are considering starting their own business.

Successful entrepreneurs and small business owners have to know a little bit of everything—management, finance, accounting, human resources, and law. This book is designed to help college students become familiar with the basic legal issues that impact entrepreneurial and small businesses. By understanding these basic issues, entrepreneurs and small business owners will avoid mistakes that can get them into legal hot water, as well as plan ahead to strategically take advantage of laws that can help their business run smoothly and grow.

Almost all “entrepreneurial” ventures start as a small business, though in the classic scenario, they all want to grow into the worldwide leader of their market with tens of thousands of employees and publicly traded stock. But even though a small business may be quite innovative and cutting edge, its owner(s) may wish to remain a relatively small company (though the business may still have millions of dollars in annual revenues). Finally, some people just want to run a small local business that allows them to engage in their community, provide a comfortable living, and give them something to pass on to their children.

This book therefore emphasizes the “small” in business, whether entrepreneurial in nature or not. And it emphasizes “you” as the owner rather than employee.

This book is written primarily for those who are interested in someday starting their own business. It is based on the author’s own experiences as an entrepreneur, small business owner, attorney for small businesses, and instructor of an undergraduate “Business Law for Entrepreneurs” class. The book also includes advanced topics that can be used in an MBA or graduate entrepreneurship course.

Each chapter in the book includes:

- Short videos that introduce key issues.
- Discussions of legal topics and their application to entrepreneurial and small businesses.
- Featured Cases that present courts’ summations and applications of relevant rules of law.

- Critical Thinking Exercises, the majority of which are based on real legal disputes, which ask students to apply the facts in the exercise to the relevant rule of law to decide the outcome.
- Bottom Line summaries of important topics.
- Optional Topics and Optional Critical Thinking Exercises to give instructors the option of further developing some concepts in their courses.
- Advanced Topics that allow instructors, based on the course's needs, to add depth to the course content.
- A list of Key Topics.

Robert Sprague  
January 2015

## *About the Author*

Robert Sprague grew up in a mixed family. His father's side was full of serial entrepreneurs, his mother's side teachers and academic administrators. It is no wonder that he eventually wound up teaching in a college of business.

He is currently an Associate Professor of Legal Studies in Business in the University of Wyoming's College of Business. He earned a Bachelor in Business Administration and Juris Doctorate from the University of Denver and a Master in Business Administration from the University of Southern California.

Prior to joining academia full time, Professor Sprague managed small family businesses, provided legal counseling to small and start-up businesses, started a few of his own businesses, and served as senior management for Silicon Valley-based start-ups.

# *Introduction*

This book is designed to provide college students with an overview of the legal issues facing entrepreneurs and owners of small businesses as they start, operate, and potentially end their businesses. Entrepreneurial start-ups begin as small businesses but are usually viewed as having the potential to become very large businesses—classic examples being Apple, Google, Facebook, and Twitter. Most small businesses are also quite entrepreneurial, but many don't necessarily set their rights on an initial public offering (IPO) and international domination of their particular market.

First, though, listen to Mark Cuban's perspectives on being an entrepreneur, especially during the first 2:15 minutes of this Video Link: Mark Cuban Interview (<http://goo.gl/m2X4ZW>).

There is nothing wrong with starting small and staying small—and here, “small” is a relative term. A “small” business with possibly only one location and a few dozen employees may actually be a multi-million dollar business. At the same time, an entrepreneurial start-up that strives to be the next Facebook may remain a small, marginally profitable enterprise for a number of years. Regardless, most of the legal issues confronting these businesses are very similar, if not identical.

This book is organized in five parts. Part I addresses issues associated with getting a new business started. The first topic explores some of the legal issues associated with the business founders leaving their current employers to start their own business. Covenants not to compete and non-solicitation agreements are covered in this first topic. Additional topics in Part I include selecting a legal form of business, franchising, buying an existing business, raising capital, and unique issues associated with operating an online business. Part II explores intellectual property. Trademarks and trade secrets are covered in detail, compared to patents and copyrights, as almost every business will encounter trademark and trade secret concerns, while patent and copyright issues are usually less prevalent.

Part III of this book addresses employment issues in detail. Once a business begins to grow and thrive it will begin hiring employees. Employment issues confront all businesses (that have employees) from a wide range of situations. Part III begins with an examination of anti-discrimination laws. These laws are covered first because they impact every employment-related decision a business will make—from selecting, to hiring, to managing, to firing. Covering anti-discrimination laws reveals recurring themes throughout Part III, primarily focusing on applying workplace rules and enforcing decisions fairly and consistently.



After covering the various anti-discrimination laws, Part III then turns to initiating the employment relationship. Part III addresses legal issues associated with defining the position, screening candidates, hiring new employees, as well as issues associated with hiring foreign workers.

Part III then turns to managing the employment relationship. It begins with an analysis of the legal doctrine underlying most employment relationships—employment at will. Part III continues with a survey of various workplace laws: the Fair Labor Standards Act; the Family and Medical Leave Act; workers' compensation; workplace safety; unemployment compensation; compensation and benefits, including the Affordable Care Act and COBRA; and the National Labor Relations Act. This portion of Part III also provides an overview of employee arbitration, as well as an overview of employee manual provisions. Part III also examines special employment relationships associated with employer liability based on agency, as well as a discussion of whether workers can be properly classified as independent contractors.

Part III then concludes with a review of legal issues associated with terminating the employment relationship. These issues include whether an employee may be partially protected from termination due to engaging in certain workplace activity (such as reporting suspected discriminatory acts), revisiting covenants not to compete (this time from the employer's perspective), reference letters, and separation agreements.

This book then turns to dealing with customers and suppliers in Part IV. This part is mainly concerned with contract law, derived from common law and the Uniform Commercial Code. Part IV also includes an overview of consumer protection laws, as well as credit and collections. The book concludes in Part V with two ways in which the business may end—either through bankruptcy or through the sale of the business.

Before diving into these various legal issues, it is important to have a basic understanding of how the U.S. legal system works.

## U.S. LEGAL SYSTEM: AN OVERVIEW

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Video Link: History of U.S. Law and What Is the Law? (<http://youtu.be/IOa2KI59RYs>)

Since this book focuses on the *laws* that impact entrepreneurial and small businesses, it is a good idea to have some background knowledge about the U.S. legal system. There are three fundamental sources of law in the United States: constitutional, statutory, and common (or judge-made) law. These three sources of law have parallel counterparts at the state and federal level.

### Constitutional Law

The U.S. Constitution is the supreme law within the United States. No other laws can conflict with the Constitution. The Constitutional Convention ratified the original Constitution in 1787. The Bill of Rights provided the first ten amendments to the Constitution in 1791. Since then, it has been amended 17 additional times (though one amendment was to repeal a previous amendment, prohibition). Amendments to the Constitution may be proposed either by Congress with a two-thirds majority vote in both the House of Representatives and the Senate, or by a constitutional convention

called for by two-thirds of the state legislatures (though none of the 27 amendments so far have been proposed by a constitutional convention). A proposed amendment becomes part of the Constitution as soon as it is ratified by three-fourths of the states.

Of primary interest to U.S. businesses is the so-called Commerce Clause in the Constitution,<sup>1</sup> which grants Congress the power to regulate interstate commerce. This is the overarching authority for federal laws that regulate individual businesses. At a minimum, before a federal law can apply to any business, that business must affect interstate commerce. There is almost no situation in which a business does not affect interstate commerce;<sup>2</sup> so all businesses should consider themselves potentially subject to federal laws. Many federal laws, however, will not trigger unless a business has a certain minimum number of employees, generates a certain level of annual revenue, or engages in a certain type of business.

The U.S. Supreme Court enforces the U.S. Constitution. Except in very limited circumstances, such as a lawsuit between two states, the Supreme Court only considers cases that it agrees to hear. Parties who wish to seek review of a case by the Supreme Court must file a petition for a *writ of certiorari* with the Court. Of the approximately 10,000 petitions received each year (most of them by prisoners claiming their conviction and incarceration violates the Constitution), the Court generally “grants *cert.*” for less than 100 of them. Cases most likely to be heard by the U.S. Supreme Court involve a person or entity claiming to have been denied constitutional protection, a claim that federal or state law violates the Constitution, or when the federal courts have had mixed success in applying a particular federal law.<sup>3</sup>

Each state also has its own constitution, which is the supreme law within the borders of that state. Of course, no state’s constitution can conflict with the U.S. Constitution. Each state also has its own equivalent of a Supreme Court, which will hear challenges to its state’s constitution, as well as cases appealed from the state’s lower courts.

## STATUTORY LAW

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Statutes are laws passed by a congressional body, whether the federal Congress or a state’s legislature. Naturally, federal statutes apply throughout the country, while a state statute only applies within that state’s borders. Federal statutes cannot conflict with the

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1. Art. I, §8 (“The Congress shall have power to . . . regulate commerce with foreign nations, and among the several states. . .”).

2. Even a single-location restaurant in a small town will affect interstate commerce—after all, it is probably buying its food and supplies from a wholesaler who purchases the items from throughout the region, country, or world.

3. A good example of this latter type of case is reflected in how the various federal courts have interpreted the Computer Fraud and Abuse Act (CFAA). The CFAA makes it a federal crime to access a computer without authorization or in a manner that exceeds authorization. Employees have been accused of violating the CFAA after they have accessed and improperly transferred confidential information stored on their employers’ computers to which they had authorized access. Some courts have ruled that improperly transferring the information exceeded authorization, so the employee was found guilty of violating the CFAA. Other courts, however, have ruled that, no, the employee had authorized access to the information regardless of what he ultimately did with it, so no violation occurred. So far, the U.S. Supreme Court has declined to rule on a case that might provide guidance to the courts on their interpretation of the CFAA.

U.S. Constitution. State statutes cannot conflict with the U.S. Constitution, their state's own constitution, or federal statutes. Regulatory agencies, at both the federal and state level, often make their own rules to implement their respective statutes.<sup>4</sup>

## COMMON (JUDGE-MADE) LAW

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Every time a judge issues a decision or writes an opinion, it is law. In most cases, it is binding only on the parties before the court in that particular case, but it may also provide a basis for later judicial decisions. You have probably already encountered the common law in your Business Law or Legal Environment of Business class when you covered contracts—at least those for services and real estate. The four requirements of a valid and enforceable contract (mutual assent, consideration, legality, and capacity) all evolved over centuries through thousands of court decisions. In contrast, in the last century, all of the states passed statutes that address contracts for the sale or lease of goods (in the Uniform Commercial Code, or UCC). Therefore, if a contract involves the sale or lease of goods, the UCC—statutory law—controls. Otherwise, the common law of contracts controls.

A subset of the common law is how judges interpret statutory law. We just saw an example (the CFAA) where different judges apply the law differently in certain situations.

The fact is, reading legal cases is a very important aspect of understanding law. When dealing with common law, the court decision tells what the law is, at least in that court. And when dealing with statutory law, court decisions help us understand how the law will be applied in similar situations. It is therefore very important to be familiar with the process surrounding lawsuits.

## THE ANATOMY OF A LAWSUIT

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A lawsuit is initiated when someone files a complaint. The party filing the complaint is called the “plaintiff,” and the person sued is called the “defendant.”<sup>5</sup> Almost all the cases in this book are “civil,” meaning they involve private parties.<sup>6</sup> This is in contrast to criminal cases, in which the government files a complaint against one or more persons (which could also be a business entity) claiming—alleging—the defendant has violated a law with criminal penalties.

Complaints must be filed in the appropriate court, which is usually generically referred to as a “trial” court.<sup>7</sup> What distinguishes a trial court from other courts (which

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4. For example, the Securities Exchange Act outlaws securities fraud in Section 10(b). The Securities and Exchange Commission (SEC), the regulatory agency charged with enforcing U.S. securities laws, uses its Rule 10b-5 to carry out the statutory mandate to combat securities fraud.

5. In any given case, multiple parties can, and do, file the complaint (plaintiffs), and multiple parties can be, and are, sued (defendants).

6. Though some statutes allow the government to file a civil lawsuit when enforcing a particular law.

7. Many states have courts below the trial court level, such as county courts and small claims courts. In addition, there are other specialized courts that do not handle “normal” trials, such as probate or family courts.

will be discussed shortly) is that the facts of the case are determined at a trial—either by a jury or by the judge sitting as the “fact finder.”<sup>8</sup>

The defendant must answer the complaint—if not, the plaintiff will automatically win with what is known as a “default judgment.” The defendant’s answer will contain denials of claims made in the complaint, and can also include counterclaims against the plaintiff. If the defendant files any counterclaims, the plaintiff must answer them.

Once the complaint, any counterclaims, and all answers have been filed with the court, a process called “discovery” begins. Each party is allowed to request access to any relevant evidence, in the form of documents and witness testimony, in the possession of the other party. Each party will file “interrogatories,” asking the other side for information about the case; answers to interrogatories help a party decide which evidence to ask for during discovery. For small cases, this process may last only a few months and involve only a few hundred documents. For larger, more complex cases, this process can last years and involve millions of documents and records.

## Selecting the Appropriate Court—Jurisdiction

As mentioned above, the vast majority of lawsuits begin in a trial court. Before a case can be heard by a court, and in order for that court’s decision to be binding on the parties, the court must have jurisdiction over both the type of case and parties involved. The plaintiff initially selects the court, as it is the plaintiff who initiates the lawsuit by filing a complaint. Most plaintiffs select a court that is convenient to them. If the defendant lives in the same state or does a significant amount of business in the state where the court is located, jurisdiction should not be an issue.<sup>9</sup> If the defendant does not live in or have significant contacts with the “forum” state (i.e., the state in which the complaint was filed) and does not voluntarily submit to that court’s jurisdiction, the lawsuit will be dismissed. In addition, a plaintiff cannot bring claims based on federal law in a state court.

A federal trial court, called a U.S. District Court, has jurisdiction over federal law claims.<sup>10</sup> In addition, a federal court will have “diversity” jurisdiction even over state law claims if (1) the plaintiff and the defendant are from different states, and (2) the amount in controversy is greater than \$75,000. In this latter situation, the federal court will conduct the trial as if it were the state court that would otherwise have jurisdiction.

## Motion for Summary Judgment and Motion to Dismiss

Once each side has completed discovery, the plaintiff will most likely file a motion for summary judgment and the defendant may also file its own motion for summary judgment (or a motion to dismiss) with the court. The plaintiff’s motion for summary judgment requests that, based on all the facts revealed during discovery, the judge should rule in the plaintiff’s (movant’s) favor. In other words, the plaintiff will claim that considering all the facts discovered, the defendant has no meaningful defense to the

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8. A jury can be requested by either the plaintiff or defendant, but is not required.

9. See Chapter 5, Operating an Online Business, for a discussion and application of personal jurisdiction issues.

10. There are also specialty federal courts that can hear only certain types of issues, such as Bankruptcy Court (for bankruptcy petitions) and Tax Court (for challenges to IRS rulings).

plaintiff's claims; therefore there is no need for a trial and the judge should rule in the plaintiff's favor. Conversely, the defendant, in its motion for summary judgment or motion to dismiss, will claim that considering all the facts discovered, the plaintiff has no real legal claims against the defendant and that the complaint should be dismissed. Fundamentally, the judge is deciding whether the plaintiff's claims are strong enough to be presented before a jury (or fact finding judge) at trial. Any material facts that remain in dispute must be decided by the jury (or fact finding judge) at trial.

Deciding a motion for summary judgment is one of the few instances in which a trial court will issue a written decision, though state trial court decisions are rarely published. In fact, most of the cases used in this book involve a motion for summary judgment or dismissal, through federal district court opinions and federal and state appellate decisions. These cases are important because they provide guidance on how a judge might rule in the future in a factually similar case.

## Appeals

Trial court decisions do not carry much weight beyond the court from which they originate. Of course, they do matter very much for the parties before that court. But two trial judges in the same court building can rule differently on very similar cases. Judges may respect other trial judges' opinions and consider them, but they are not bound by them. We analyze trial court decisions because they often (1) represent what most other courts would decide in similar situations; (2) signal a (new) trend based on evolving law or new technologies; or (3) can be contrasted with a similar case to demonstrate divergent views among the courts.

Either or both parties can appeal the trial court's decision. Not only would the losing party consider appealing, but the winning party sometimes also considers an appeal if it did not achieve all it expected from the trial. Appeals can take place usually at two different stages of the case: (1) upon the judge's motion for summary judgment or dismissal decision; or (2) once the verdict has been rendered. An appeal only questions whether the trial judge applied the law correctly, which often involves whether the judge should have allowed or excluded certain evidence that had an impact on the case. The facts established at trial are never questioned on appeal, though the manner in which those facts were established can be the subject of an appeal. To ensure that a "sore loser" does not appeal just to delay the inevitable, the appealing party usually has to post a bond equivalent to the other party's anticipated costs to defend the appeal. Also, the party appealing a decision is usually referred to as the "appellant" or "petitioner" (regardless of whether it was originally the plaintiff or the defendant), and the other party is usually referred to as the "appellee" or "respondent" (regardless of whether it was originally the plaintiff or the defendant).

Appeals from a federal district court go to the federal Court of Appeals for the circuit in which the district court is located. There are 13 federal circuits spread across the United States. Appeals from a state trial court go to the equivalent Court of Appeals in the state in which the trial court is located. Most appellate courts, state and federal, are broken down into panels of three judges.<sup>11</sup> Once at least two of them agree on a

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11. At the federal level, all the appellate judges in a circuit may decide to consider a case "en banc."

result, they jointly write an opinion; the dissenting judge, if there is one, can write a dissenting opinion.<sup>12</sup> Most federal circuit Court of Appeals decisions are published to provide guidance; however, federal Court of Appeals panel decisions technically only apply to the parties in the case being decided. Just like at the trial level, different panels within the same circuit can reach different conclusions on similar cases. At the state level, however, because there is often only one court of appeals, its decisions are binding on all the lower trial courts. State court of appeals decisions are often published in what are considered “regional” reporters.

The court of appeals, state or federal, can affirm the lower court’s decision, reverse it, or remand it for further proceedings based on the appellate court’s decision.<sup>13</sup> Except when the appeals court affirms the lower court’s decision, the case will return to the trial court—either for potentially an entirely new trial (reversal) or to retry certain aspects of the case (remand). Losing at the appellate level usually serves as a good incentive for the losing party to settle the lawsuit.

While many court decisions are not binding on anyone beyond the parties involved in the case in question, attorneys and law scholars read cases because they provide guidance as to how a different court may rule under similar circumstances. An attorney representing a client before a court may bring an opinion or decision that favors her client to the attention of the court in the hope that the judge will be persuaded by the other opinion’s analysis. If there are other opinions that do not support her client’s position, then she would argue why those opinions are weak or distinguishable and should not be followed.

As noted at the beginning of this discussion, the U.S. Supreme Court and state supreme courts have discretion over whether to hear the vast majority of cases that are presented to them for review. As such, court of appeals decisions often serve as the final analysis within those courts’ jurisdictions.

## KEY TERMS

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Answer

Appeals

Appellate Courts

Commerce Clause

Common Law

Complaint

Constitutional Law

Counterclaims

Defendant

Jurisdiction

Motion for Summary Judgment

Motion to Dismiss

Plaintiff

Statutory Law

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12. A dissenting opinion has no effect on the case, but it may be persuasive to a court sometime in the future.

13. Appellate courts can also affirm in part and reverse in part, as well as modify a lower court’s decision.

## Contents

<i>Preface</i>	xxv
<i>About the Author</i>	xxvii
<i>Introduction</i>	xxix

## Part I: First Steps

<b>CHAPTER 1</b>	<b>LEAVING YOUR EMPLOYER</b>	<b>3</b>
	Introduction	3
	Covenants Not to Compete	4
	Critical Thinking Exercise 1-1	5
	Non-Solicitation Agreements	6
	Featured Case 1-1: <i>Whelan Security Co. v. Kennebrew</i>	7
	Solicitation and Social Media	9
	Critical Thinking Exercise 1-2	9
	Critical Thinking Exercise 1-3	9
	Optional Critical Thinking Exercise	10
	Intellectual Property and the Employment Relationship	11
	Featured Case 1-2: <i>Mattel, Inc. v. MGA Entertainment, Inc.</i>	11
	Featured Case 1-3: <i>Iconix, Inc. v. Tokuda</i>	12
	<i>Key Terms</i>	15
<b>CHAPTER 2</b>	<b>SELECTING THE LEGAL FORM OF BUSINESS</b>	<b>17</b>
	Introduction	17
	Basic Legal Forms of Business	18

Sole Proprietorship	18
Partnership	18
Corporation	21
Limited Liability Company	23
Additional Legal Issues Associated with Operating a Business	25
When Is a Business a Partnership, or Not?	25
Featured Case 2-1: <i>Byker v. Mannes</i>	25
Critical Thinking Exercise 2-1	26
Optional Critical Thinking Exercise	27
The Business Judgment Rule	28
Featured Case 2-2: <i>In re The Walt Disney Company</i>	
<i>Derivative Litigation</i>	28
Special Considerations for Small, Start-Up Businesses	34
Pre-Formation Agreements	34
Featured Case 2-3: <i>Kahn v. Imperial Airport, L.P.</i>	34
Critical Thinking Exercise 2-2	36
Piercing the Corporate Veil	37
Featured Case 2-4: <i>Newport News Holdings Corp. v. Virtual City Vision, Inc.</i>	37
Critical Thinking Exercise 2-3	38
Advanced Critical Thinking Exercise	39
Advanced Topic: Oppression of Minority Owners	39
Getting It Right the First Time	40
Featured Case 2-5: <i>Health and Body Store, LLC v. Justbrand Ltd.</i>	41
Critical Thinking Exercise 2-4	44
Key Terms	45
Legal Forms of Business Overview	46

## CHAPTER 3

<b>“READY-TO-GO” OPTIONS: FRANCHISING AND BUYING AN EXISTING BUSINESS</b>	<b>47</b>
Franchising	47
What Is a Franchise?	48
Featured Case 3-1: <i>Colorado Coffee Bean, LLC v. Peaberry Coffee, Inc.</i>	50
Advantages of Becoming a Franchisee	51
Disadvantages of Franchising	52
Featured Case 3-2: <i>Carlock v. Pillsbury Co.</i>	52



Critical Thinking Exercise 3-1	56
Critical Thinking Exercise 3-2	57
Optional Critical Thinking Exercise	58
Optional Critical Thinking Exercise	59
Buying an Existing Business	60
Featured Case 3-3: <i>Scarlett &amp; Assocs., Inc. v. Briarcliff Center Partners, LLC</i>	61
Critical Thinking Exercise 3-3	64
Optional Critical Thinking Exercise	65
Optional Critical Thinking Exercise	66
<i>Key Terms</i>	66

## CHAPTER 4

## RAISING CAPITAL 67

Introduction	67
The Business Plan	69
Raising Capital Through Investors	70
What Is a Security?	70
Featured Case 4-1: <i>SEC v. W.J. Howey Co.</i>	71
Critical Thinking Exercise 4-1	73
Advanced Critical Thinking Exercise	74
Going Public	75
Smaller Reporting Company	77
Exempt Offerings	77
Section 4(a)(2)	77
Regulation D	78
Regulation A	79
Intrastate Offering Exemption	79
Restricted Securities	80
Crowdfunding	80
Securities Fraud	81
Featured Case 4-2: <i>Matrixx Initiatives, Inc. v. Siracusano</i>	82
Featured Case 4-3: <i>In re Level 3 Communications, Inc. Securities Litigation</i>	84
Critical Thinking Exercise 4-2	86
<i>Key Terms</i>	89