THE BOOK
BY ENTREPRENEURS FOR ENTREPRENEURS

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http//thebookbye4e.com

THE BOOK

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About the Making of this Book and its Authors

I initially thought I would write a book about risk and it took me about a day to figure out that was going to be very boring to me and that instead, I should write a book about something I regularly do. That is representing business owners, their companies, and addressing the myriad of issues they face in everyday life. I wanted to examine the blocking and tackling of business and how to structure it and carry it forward more effectively and profitably. I quickly saw that while I have diverse knowledge of many areas of business, largely from a legal perspective, I was lacking in many other crucial areas and would need to collaborate with those who had domain expertise in the topics that are addressed in the chapters which follow.

It so happens I like people, like meeting them, have to, to run a successful professional practice and as a result I have a very fine network of folks with similar networking styles and personalities but very different experience, expertise and credentials. It was not difficult to form the team that assembled to create this work. Frankly, it was a blast and an honor. I hope to have following editions that permit this book to be an evolving reference source for business people and entrepreneurs. That is after I get some rest.

Thanks to technology and electronic publishing, this work is somewhat unique in that it permits the reader to buy the entire book or specific chapters. If you buy specific chapters the proceeds go mainly to the authors of those chapters. If you buy the book, the proceeds are divided amongst all the authors in varying degrees of ownership. The choice is yours.

Set out in the following pages in alphabetical order, are biographies of the various authors who have collaborated with the editor to make this book a reality. They are the editor’s friends, fellow professionals and partners, clients, current and former, and all are domain experts. They are entrepreneurial in spirit and often in practice. They have met payrolls and wrestled with starting up their own companies. They are dedicated, creative people who quite frankly it is an honor to know and be associated with. Read their biographies to get a flavor of the author of each chapter. Feel free to reach out to them.

I know I speak for all of us when I say it is an honor to represent, advise and assist in the success of fellow entrepreneurs, the wealth creators who make our world a better place and provide employment for our fellow human beings. Be creative, add to our fabric, benefit your fellow citizens and yourself, above all, enjoy the journey.

Joel N. Goldblatt Editor.

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John is a patent and trademark lawyer and partner at the Partridge firm in Chicago, Illinois. John has been handling the intellectual property legal needs of clients for over twenty years. John's experience covers the full gamut of obtaining, protecting, evaluating, enforcing rights relating to intellectual property secured by patents, trademarks, copyrights and trade secrets, both domestically and internationally.

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Editor's Acknowledgements

To my father who inspired me to be involved in and appreciate the power of business in people's lives. To my co-authors who just plain inspire me. To my co-editor Jennifer Foughner and web designer Marlene Franke who did the heavy lifting and helped to keep me moving towards the finish line. To my wife Janice and daughters Ellen and Clare who inspire me to be a better husband, father and human being every day.

Chapter 1 | Leadership and Strategy

Stephen J. "Steve" Luczo

"A leader is best when people barely know he exists, when his work is done, his aim fulfilled, they will say: we did it ourselves." — Lao Tzu

"He who has never learned to obey cannot be a good commander." — Aristotle

"Anyone can hold the helm when the sea is calm." — Publilius Syrus

"Leaders aren't born, they are made." — Vince Lombardi

"Leadership is a potent combination of strategy and character. But if you must be without one, be without strategy." — Norman Schwarzkopf

"Leadership is unlocking people's potential to become better." — Bill Bradley

"As we look ahead into the next century, leaders will be those who empower others." Bill Gates

In speaking, writing, or thinking about "leadership," the question of whether leaders are "born" or "made" seems inescapable. Having been involved in a wide variety of forums discussing leadership, I have thought deeply about the question of "where leadership comes from," and I have discussed at it great length with many of the amazing leaders I have met.

As the quotes above indicate, there are great minds on both sides of this debate; there are also some who think it irrelevant to mention either view. Why does this distinction matter? At its simplest, if leaders are born (not made), then exercises such as "leadership training" (and even this chapter) are futile. However, if one believes that leaders are *made* and that leadership qualities can be *trained*, then discussions around leadership attributes and methods to acquire these attributes are worthy of our attention.

I conclude that the answer to this question is not "either/or," but rather "and." Marcus Aurelius captured the essence of the problem in observing that "we are too much accustomed to attribute a single cause that which is a cause of several, and the majority of controversies come from that." When I was younger, I believed strongly in one answer: that the "natural born leader" theory was a myth. In America we are trained to believe

that hard work determines fate and character; as the youngest of three sons born into a middle class (at best) home, it was perhaps natural to believe anyone could be a leader. In that belief, I had a shot.
Despite my beliefs, I grappled with the reality that some individuals seemed "different" or "more exceptional" than others, although my definition of "exceptional" differed from that of the traditional standard-bearers. The measure by which I made this determination had little to do with "accepted" measures of excellence such as grades, money, athletic ability, or attractiveness; instead, I began to see "natural-born leaders" as individuals with innate abilities to empathize with others, assimilate disparate pieces of information, and motivate teams and individuals to take positive action. As I have gotten older, I have reflected on these types of people and realized that regardless of their paths in life, they all seem to turn into leaders. However, under the right conditions, even people who otherwise wouldn't be categorized as "leaders" can develop and sustain leadership capability. For those blessed with that certain fabric of character that allows others to trust them with the honor of being a leader, this chapter will be interesting as they think about which elements seem to resonate. And for those who want to become leaders, perhaps the framework below will point to areas where, with practice and attention, a greater leader can develop.

As a precursor to discussing what makes a leader, we must first define "leadership." While speaking on this topic at Creighton University I offered the following definition:

> "Leadership is behavior from an individual that **motivates** others to **accomplish something extraordinary** and to take ownership of the outcome."

Here, the critical elements of leadership are captured by the bolded words.

- A leader **motivates**, he or she does not "order" or "command" action.
- Leadership is defined by **extraordinary accomplishment**. Intent and desire are important, but great leadership has to encompass effectiveness of achieving an important goal.
- Leaders create environments and processes that allow the implementers to **take ownership of the successful outcome**, but conversely, the **leader must take full ownership for lack of execution**.

The model I use to frame effective leadership uses the word "leadership" to convey the message. We begin with "L.E.A.D.," which describes four primary elements of great leadership: learn, empower, adapt, and delegate.

"Learn" is the first and most important word in this model. A leader must be open-minded to new ideas. The skill of recalling previous experiences, determining their relevance to a new situation, and then testing one's hypothesis and adjusting as necessary is a critical skill that can be developed. Learning and listening (discussed later in this chapter) are highly positively correlated. Once you accept that you are not the absolutely expert on any subject, you are more open to continued learning, and thereby more likely to acquire new information that can be used to develop a successful plan.

“Empower” was one of the foundational words in the Bill Gates quote included at the start of this chapter. It is the ability to grant others the freedom to implement a plan that accomplishes a goal. Most great leaders are defined by consistent success; this consistency is oftentimes the result of the leverage created by empowerment.

“Adapt” reflects the reality that all plans are developed against an assumed plan that never turns out completely as expected. A leader must be in touch with what is happening on the ground and be willing to adapt the plan to reflect new and changing conditions. Many military historians would define Julius Caesar as the greatest general of all time. In addition to a multitude of skills, Caesar was probably best known for his ability to “adapt.” As described by Tacitus, Caesar displayed “prudence in counsel, courage in the field, calm presence of mind in the midst of danger, and an amazing dexterity in sudden and unforeseen emergencies.” An effective leader creates a support system that allows the team to adapt by giving subordinates the authority to self-organize in order to infuse dynamic reality into a static plan.

“Delegate” is the necessary complement to adaptation. A leader must be clear about delegating what types of decisions may be made by different levels of the organization. This is oftentimes a function of the variance to plan, or the impact that a decision might have on the overall objective or on the probability of successful outcome.

In order to do these four things effectively, a leader must clearly communicate goals and metrics. The following questions (at a minimum) must be answered prior to beginning any project:

- What are we trying achieve?
- Why is it important?
- What resources do we have? What resources do we need?
- How are we collectively going to solve the problem?
- What role does each of us play?
- How should we react to changing circumstances?
- What is the process and latitude around decision-making?
- What are our specific measures of success?

Once these ideas are framed, the process must include a consistent “review and reward” system so that the team is reinforced for positive actions and progress. Entire books have been written about the pros and cons of various reward systems, but the common conclusion is that rewards and recognition are important; we tend not to do enough of it in the business environment (and maybe too much of it in the grade school sports environment!).

Finally, we must honor the effort and the result. Too often in business, as soon as we achieve our goal, we hurry to anticipate and plan our next set of objectives. We must learn to create space to allow team members to reflect on their accomplishments and understand their worth before moving on. When we fail to do so, we trivialize the objective and undermine our own leadership. Above all, people want to do things that really matter.

The second part of the "leadership" framework is "E. R.," which stands for "earn respect." "Earn" implies work. You have to invest yourself in a fully committed way to be a great leader. This commitment is evidenced in whether or not people believe that you are invested in the plan, and whether you are authentic in your belief. It takes hard work and good work to earn anything, and it takes especially hard work to earn another's respect.

"Respect" is at the fulcrum of the word and the model. It is the essential element. Above all else, the team must respect a leader to be successful consistently. The key to earning respect is to show respect. As my good friend Ronnie Lott says, "in order to get respect, you have to get respect." The point is, respect commands respect, and to give respect is essentially to trust another implicitly. Trust is among the strongest forms of interpersonal connection.

I believe that respect is earned when you exhibit a consistent code of conduct over time. As team members learn that a leader will not waiver from "good conduct" in the event of stress or challenge, the leader gains the trust of the team. "Good" may sometimes be subjective, but not when it comes to some basic human benchmarks like honesty, dignity, honor, fairness, loyalty, compassion, or kindness. Al Shugart, a highly accomplished business leader, used to tell people: "just be nice." This was also reflective of his "keep it simple" approach to life, which was one of his key success factors as a leader.

While simple, Al's honesty and kindness was legendary; it resulted in people doing extraordinary things for Al with just the shake of a hand. In an era of 100-page contracts for fundraising, Al received venture funding with a one-paragraph note that essentially said that he would work hard and never waste the investor's money. Interestedly, Seagate only had two sources of venture capital when it was founded, and up until the last few years, the return on that venture investment was the highest IRR among all technology investments in Silicon Valley. A $500,000 investment returned over $100M within a year.

In order to maintain a consistent code of conduct, one must possess self-respect and virtue. Someone who is not self-aware enough to accept who he is and appreciate what motivates him is likely to behave in an inconsistent manner. The concept of "virtue," a critical idea that is unfortunately rarely discussed in our modern world, bears repeating. Among the great Greek and Roman leaders, virtue was typically the foundational behavior to which all in society aspired. Today, people think of this word as somewhat prudish, but it encompasses a set of values and behaviors that evoke goodness, morality, dignity, and decency. Most importantly, it commands respect.

The final four letters in the leadership model ("S.H.I.P.") stand for solicit, honest, input, and peers. One can think of this as "solicit honest input from your peers." Whether broken down into the individual words or taken as a whole thought the message is the same. Create an environment where all team members are confident that they can contribute to the plan and the process and share ownership of the accomplishment.

"Solicit" means to seek something actively. A great leader has to show interest and a willingness to connect with those he or she leads. Poor leaders are aloof and exclusive, which intimidates subordinates. If a leader wants accurate information about process and progress, then openness to feedback is essential. Reaching out proactively creates an open environment for communication.

"Honesty" is among the most important characteristics of excellent leadership. Like respect, if you wish for clear and honest input, then you must conduct yourself in an honest way, both with respect to your personal code of ethics and to the information that you provide the team. Oftentimes this issue gets discussed at length in situations where only limited information can be provided to team members. In those situations, it is much more effective to identify clearly the information that cannot be shared, as opposed to providing inaccurate or deceptive information. If you have established respect, as discussed above, your team will trust the need for selective disclosure.

"Input" means that prior to determining a plan of action, a good leader leverages the team's perspective to formulate strategy and tactics. While initial goals and objectives may not have this full degree of input, it is always helpful to consolidate ideas around the plan of execution. While strategy and goals can cascade down, information flow up the chain of command is essential for success. As Stan McChrystal explains, "effective organizational leadership requires context down and requirements up." To the extent that the team has a "shared consciousness" of the goals and the tactics, changes and roadblocks are likely to be addressed more positively and proactively.

"Peers" reflects the somewhat obvious point that leadership requires a team. Leaders have to be comfortable assuming command while recognizing that the team is an entity in itself. While there are different roles and ranks of authority within the team, the entire entity is a peer group of sorts. In order to solicit honest input from your peers, you have to be able to *listen*. This was difficult for me in my younger years, but when I was named CEO at Seagate, I made a concerted effort to address this inability to listen to others by telling myself to listen with the same mental focus I possess when I speak. "Listen as if I am speaking" became the mind trick I would use to force myself to shut up and really focus on what someone was trying to tell me. I would further advance this effort by searching ideas opposed my own and forcing myself to take the position of supporting those arguments versus instinctively rejecting them, much like debate training that teaches one to argue both sides of an argument to the fullest.

As I became more successful in listening and trying to use the information I gained to solve the problem at hand, I gained the confidence necessary to consider different points of view. This confidence had the amplifying effect of also instilling confidence in myself. As I recognized that I was more open to the input of others, I gained a greater confidence that the resulting conclusion was likely to be more accurate. So it was the confidence in myself that allowed me to be a better listener. Stated another way, when I meet people who are incapable of listening to an alternative view, or those who find it difficult not to be the ones talking, I now understand that much of this behavior is driven fundamentally by insecurity. This insecurity is masked by actions that are touted as “bravado,” “boldness,” or “decisiveness,” but this behavior limits dialogue, input, and data acquisition, all of which results in a sub-optimal solution.

At its core, to solicit honest input, one must be considerate enough to respect that others’ ideas may be in direct opposition to one’s own. While a leader does not have to agree with all input received, he or she will be more successful in an environment that is open to debate and consideration of all ideas. When team members recognize that their views have been addressed and analyzed, the chances of acceptance of whatever is decided increase exponentially.

All of what I’ve described here can be learned. With practice and encouragement, many people can become great leaders. So why aren’t there more great leaders?

I think the answer is that in addition to these characteristics, there is always a bit of ”magic” in great leaders that inspires others to follow in hopes of doing great things. I think this “magic” is what causes, or confuses, the great debate of whether leaders are “made” or “born.” Clearly, leadership is more than a set of attributes—there are people with many leadership attributes who don’t “lead,” and there are others who are able to lead without possessing all of the necessary attributes—and although the “magic” is hard to define, we know it when we see it. I define it as a certain energy that combines courage, integrity, and passion. The formula is different for different people, and likely different for different situations.

Importantly, I think that the “magic” is in all of us. It’s just a matter of what *unleashes* the magic. For some, it is always on the surface, ready to be applied to any situation, and for others, it is inside, but can emerge in certain situations.

I asked 10 great leaders for one word or phrase to describe the most important element of a great leader (i.e., the one ingredient that makes “leadership magic”). The leaders I asked included His Holiness the Dalai Lama, Bill Gates, Alan Mulally, Meg Whitman, Bill Bradley, Maria Klave, Thomas Stafford, Joe Montana, Stan McChrystal, and Marcus Allen.

“Courage” was the word used most often by these leaders, and integrity, humility, empathy, and honesty were themes that appeared often in their comments. The ability to empower those being led was also consistent across all responses. For me, a great leader has to be happy, humble, honest, and hard working. My single-word answer to describe these four “H’s” is “virtue,” which I hope becomes more relevant in our world and in our vocabulary in the future. To the extent that “virtue” doesn’t resonate with today’s readers, I would say that a great leader has to have integrity and the ability to communicate passionately and respectfully.

In summary, I believe that a great leader has to be genuine and personally happy and at peace. This quote captures the essence of my approach:

> *“The happiness of your life depends on the quality of your thoughts, therefore guard accordingly, and take care that you entertain no notions unsuitable to virtue and reasonable nature.” —Marcus Aurelius*

Chapter 2 | Leadership and Management

Michael Shapiro

Very early in the formulation of any new business, strategy, or phase of development of an enterprise, those in charge of the business or project must have a clear grasp of the differences between leadership and management. Those in charge must understand the implications of these two key business concepts, as success or failure will surely follow based upon how effectively these concepts are deployed and managed.

Defining Leadership and Management

The difference between leadership and management can be summed up as follows:

> *When Noah heard the weather forecast, he ordered the building of the ark: that was* ***leadership****.*
> *When he looked around and said, "make sure the elephants don't see what the rabbits are up to": that was* ***management****.*

Leadership is setting a new direction or vision for a group. A leader spearheads that new direction. *Management* controls or directs people and resources in a group according to principles or values that have already been established by a leader.

The difference between leadership and management can also be illustrated by considering what happens when you have one without the other:

- **Leadership without management** sets a direction or vision that others follow without considering fully how the new goal will be accomplished. Others then have to fumble to follow the trail that is left behind, picking up the pieces and making it work (i.e., the general who leads a charge into battle without looking back to see if the troops are following him).

- **Management without leadership** controls resources to maintain the status quo or ensure things happen according to already-established plans (i.e., a referee manages a sports game, but does not usually provide "leadership" because there is no new change, no new direction—the referee is controlling resources to ensure that the laws of the game are followed and status quo is maintained).

- **Leadership combined with management** both sets a new direction and manages the resources to follow it (i.e., a newly elected president or prime minister who assists in drafting legislation and meets with the legislature to obtain consensus as required to pass it).

Furthermore, *managers* have subordinates. Managers have a position of authority vested in them by the company, and their subordinates work for them. *Leaders*, however, have followers. Leaders do not have subordinates, at least not when they are truly leading.

Management is planning and organizing projects and operations, allocating resources to minimize costs and maximize benefits, directing practices and procedures, establishing controls to measure the effectiveness and efficiencies, and motivating subordinates. Management is concerned with present activities and the immediate results of those activities.

Leadership is more abstract when considered separately from management. Leadership is guiding a person or group toward the best results. It is having the ability to determine and articulate visions and goals. Leadership is on par with management, but takes on precedence for strategic management and long-term success.

Leadership also establishes guiding or core principles that establish where the organization wants to head. In the words of Peter Drucker and Warren Bennis, “leadership is doing the right things; management is doing things right.” In other words, *leadership*—doing the right things—means deciding the best course of action to take. Where do we want to be in the end? What should we be doing to get to where we want to go?

The act of *management* follows the act of *leadership*. Once the best course or direction has been decided, management—doing things right—picks up the ball, looks at the objectives established by leadership, and determines the best way to get there. According to current thinking, managers are principally administrators; they write business plans, set budgets, and monitor progress. Leaders, on the other hand, get organizations and people to change. That's true, but I propose a more useful distinction between management and leadership: management is a *function* that must be exercised in any business, while leadership is a *relationship* between leaders and followers that can energize an organization.

Leading Effectively

My belief is that no matter the size of your company, as the leader, you must provide the company with:

- Vision—where are we going?
- Mission—how will we get there?
- Core Values or standards of the company—rules we live by, or the way we do things when no one is looking

In his famous TED talk, Simon Sinek describes the “WHY” as being the critical differentiator of successful businesses. *Why* do we exist to do what we do (rather than *what* we do or *how* we do it)? Take Apple, for example. It’s not *what* they do (make consumer electronics) or *how* they do it (efficient production and appealing design), but instead *why* they do it: to challenge the status quo by making beautifully engineered, easy-to-use, ground breaking products.

A leader’s responsibility is to inspire, influence, motivate, and develop people. You create a vision, mission, and values, but you must inspire the rest of the company to “drink the Kool-Aid.” A leader achieves this at

least in part by modeling the core values of the company. People buy into a leader before they buy into a service or product. As Bill Bradley says, “leadership is unlocking people’s potential to become better.”
Good business leaders provide direction. They cut through the weeds and show us the optimal path and plan. As a leader, *you* are the face of the company, not your logo or brand identity. Employees, clients, vendors, and competitors view your leadership actions and the company’s identity as one and the same.

Leadership often requires a high degree of emotional intelligence (i.e., the ability to know yourself and the effect you have on others). Daniel Goleman identifies six distinct leadership styles. Most leaders have a default style and some have developed other styles based on the situation.

1. **The coercive style.** The “do what I say” approach is really effective in a turnaround situation or crisis. However, in most other situations, coercive leadership inhibits the organization’s flexibility and dampens employees’ motivation.

2. **The authoritative style**. An authoritative leader takes a “come with me” approach: she states the overall goal but gives people the freedom to choose their own means of achieving it. This style works especially well when a business is adrift, but it’s less effective when the leader is working with a team of experts who are more experienced than he is.

3. **The affiliative style.** The hallmark of an affiliative leader is a “people come first” attitude. This style is particularly useful for building team harmony or increasing morale, but its heavy emphasis on praise can allow poor performance to go uncorrected. Also, affiliative leaders rarely offer advice, which can leave employees confused and directionless.

4. **The democratic style**. This style’s impact on organizational climate is not as high as you might imagine. By giving workers a voice in decisions, democratic leaders build organizational flexibility and responsibility and help generate fresh ideas, but sometimes the price is endless meetings and employees who feel leaderless.

5. **The pacesetting style**. A leader who sets high performance standards and embodies them has a very positive impact on employees who are self-motivated and highly competent, but lesser employees tend to feel overwhelmed by such a leader’s demands for excellence and to resent his tendency to take over a situation.

6. **The coaching style**. This style focuses more on personal development than on immediate work-related tasks. It works well when employees are already aware of their weaknesses and want to improve, but not when they are resistant or unable to change.

Finally, remember that leadership does not equate to authority. The title only gets you so far; it's your ability to influence others to believe in your vision, support your mission, and follow your plan that makes a truly great and effective leader.

For a helpful list of initial questions to ask to assist in developing vision, mission, and core values for any new business or new business initiative, see **Chapter 3: Starting a Business** (page 63). Keeping these issues in mind helps to separate successful business enterprises from mediocre or failed attempts.

Chapter 3 | Starting a Business

Michael Shapiro

Starting a business is a lot like developing a campaign – it occurs on many fronts at the same time. Some things will take place concurrently, and others consecutively. First and foremost, one needs to articulate a value proposition – what does the business do, how and for whom does it exist, and what key resources does it need?

In "The One Page Business Plan," Jim Horan offers a simple framework to begin thinking about a business. It's not a full-blown business plan, but instead offers a structured way to begin developing a business concept.

The process focuses on five sections:

1. **Vision** – Describe the business idea in a way that captures your passion.
    - What products or services do you plan to offer?
    - Where will you do business – local/regional/national/international/online?
    - Who are your customers?
    - When will you be operational?
    - Why are you starting this business?
    - How will I fund the start-up or acquisition of the business?

2. **Mission** – Describe the purpose for which the product or service exists.
    - What is your product or service and what differentiates it from the competition?
    - Who are your ideal clients or customers?
    - Why will people buy your product or service? What value does this provide?
    - What unique benefits does your product provide?
    - What passions are you trying to satisfy by building this business?

3. **Objectives** – clarify what you are trying to accomplish in specific, measurable goals. These should be **S.M.A.R.T**. goals (specific, measurable, attainable, relevant, and timely):
    - Specific – Clear and unambiguous (profit, sales, employees, products, etc.)
    - Measurable – Must be quantifiable and metrics-oriented
    - Attainable – Must be within the realm of possibility, even if it's a stretch
    - Relevant – Must be a goal that matters
    - Timely – Must have a time component, such as a specific deadline for launch of a product

4. **Strategies** – these are concepts such as:

- Direction – What industry practices will you follow?
- Philosophy – What is the basis for your business relative to your competition?
- Values – What values will define your business both externally and internally?
- Methodologies – What specific methods will you use to focus on building your business?

5. **Plans** – these are the specific actions the business must take to achieve the objectives.
    - Eight to ten specific activities that will enable you to achieve your goals.
    - These steps should be within the first six months – often the first three.
    - Once achieved, replace with new plans.

What follows is a detailed overview of the (often concurrent) steps that every entrepreneur must take when starting a business.

Figuring out why you want to start a business

People often go the entrepreneurial route because they either have a Great Idea that fulfills a market need faster, better, or cheaper than its competition or because they are making the Great Escape from a "traditional" 9-5 job.

If it's an idea, don't be married to it – test the market first. If it gets traction, great! If not, knowing when to modify or abandon the idea is critical. Many people hang on too long; there's a fine line between perseverance and stubbornness. Sometimes, a pivot in thinking is required. Other times, you may have to realize that your Great Idea could not get traction. Furthermore, execution is key; great ideas are a dime a dozen. It's the ability to develop a business idea, create proof of concept, and execute on a plan that separates successful entrepreneurs from creative thinkers.

Many entrepreneurs find success with the lean start-up method, which is a newer approach to starting a company outlined in *The Lean Startup – How Today's Entrepreneurs Use Continuous Innovation To Create Radically Successful Businesses* by Eric Ries. Rather than spend a lot of time planning and building a product or service and then releasing it to the public, the lean startup method advocates creating a basic prototype or concept, releasing it to a small test group, and then incorporating constructive feedback into the next iteration of the product or idea. This process reduces the development time significantly while providing a proof of concept early on.

Creating your Business Plan

Doing a business plan provides a roadmap for the launch of a business. The format of your plan should be determined by the audience for your plan. Ask yourself:

1. Who is your audience?

- Self
- Friends and family investors
- Angel investors
- SBA / Bank loan
- Potential partners and employees

2. What kind of plan do you need? Some formats include *traditional* (Figure 1), *one-page* (Figure 1), and *lean canvas* (Figure 2).

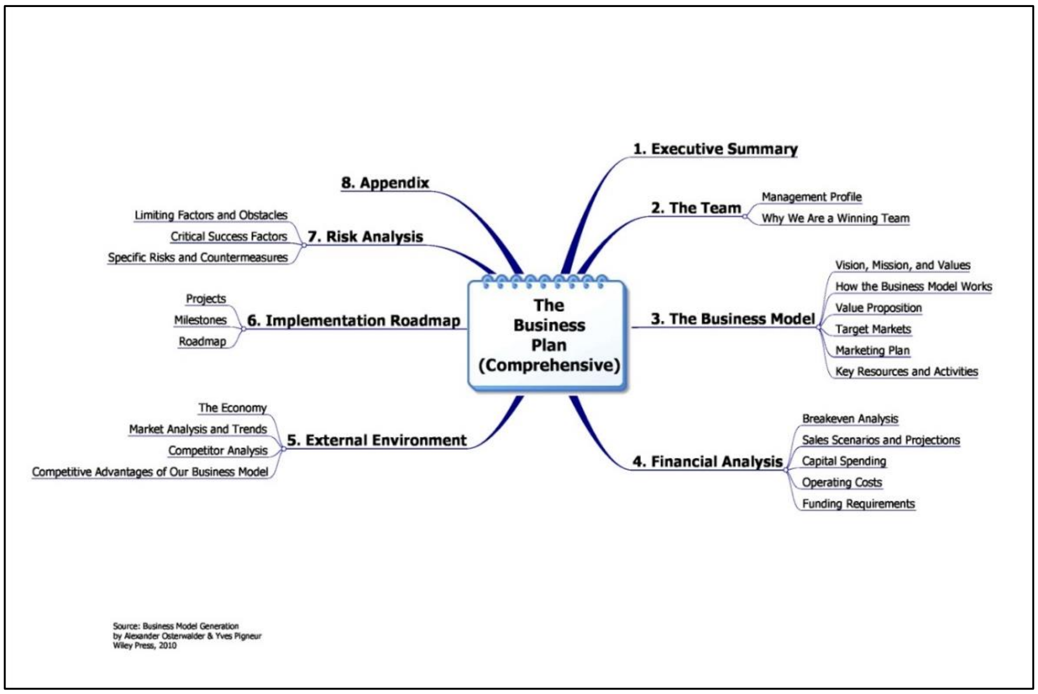

Figure 1

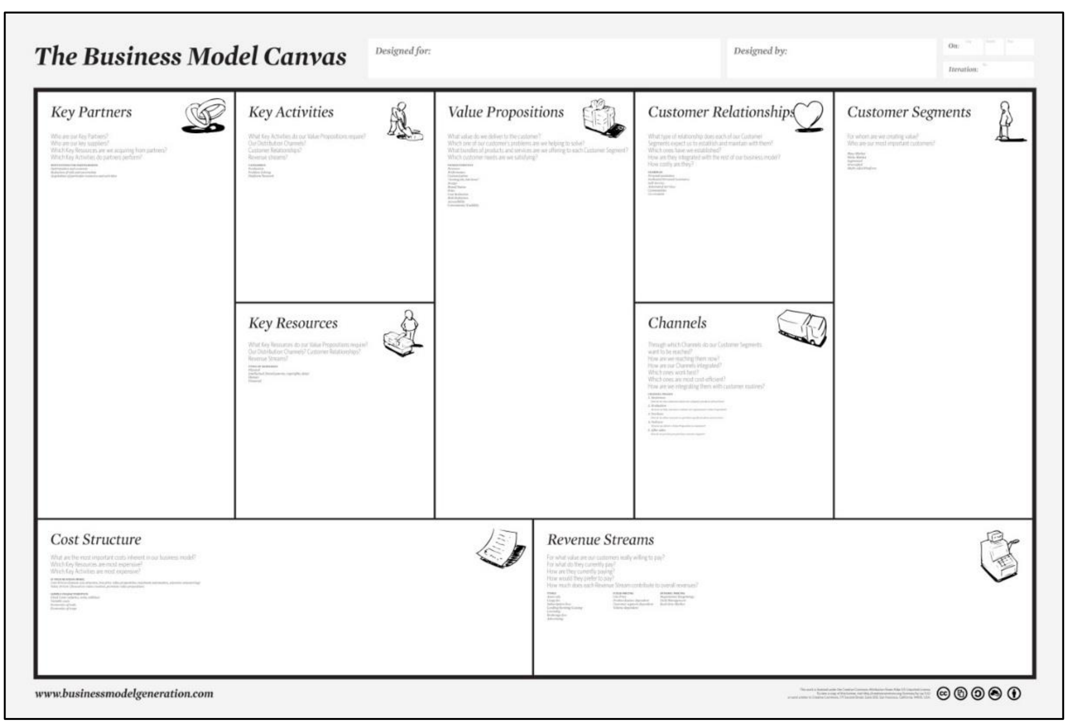

Figure 2

3. How detailed should the plan be? There should be enough detail to demonstrate that you have thought about all aspects of the business. Sections of the plan should include:
    - Business Description
    - Market Strategy
    - Competitive Analysis
    - Design & Development Plan
    - Operations and Management Plan
    - Financials

The business plan will remain a work in progress. It should be updated regularly with actual vs. projected data. Over time, the plan will evolve into a strategic plan. (For more on business planning, see **Chapter 4: Business Planning and Analysis**, page 72.)

Identifying sources of funding for your business – every business needs start-up funding. Where does it come from? There are a number of sources, such as:

- The Bootstrap approach, which involves starting with a minimal investment and then funding the business through the revenue it generates.
- Personal savings, 401k funds, or cash advances from a credit line or home mortgage.
- Loans from friends and family (either a personal loan or loan to the business).
- Angel investments: angel investors are interested in providing small start-up funds in exchange for an equity stake in the business. They usually do not have an active role in the business.
- Crowdfunding sites such as Kickstarter.com may also provide funds for a business idea that is compelling to a wide variety of people.

Along with knowing where the money will come from, it's important to know how much money you will need. This will include start-up costs as well as operating capital until the business becomes cash flow positive.
Do financial projections by the month for first year and quarterly for years two and three. Try to imagine every expense or purchase you will need to make. Also, **be very conservative in your projections**. Entrepreneurs typically underestimate costs and overestimate revenues.

Determining an exit strategy – In his book *The E-Myth Revisited*, Michael Gerber suggests that one should begin building a business with an exit strategy in mind because where you want a business to end up has a direct impact on how it is grown. Three options he identifies are:

1. **Build to grow**, where the goal is to grow the business as large as possible. The idea may be to provide a legacy business for future generations or simply to take a business through the five stages of the business lifecycle[1]:

[1] "The Five Stages of Business Growth," Neil Churchill and Virginia Lewis, Harvard Business Review, June 1983

- **Stage 1 – Existence**: the business's main concerns are obtaining customers and delivering the product or service.
- **Stage 2 – Survival**: the business has demonstrated that it is a workable business entity. It has enough customers and satisfies them sufficiently to keep them. The key problem shifts from mere existence to the relationship between revenue and expenses (i.e., focus shifts to funding growth).
- **Stage 3 – Success/Growth**: the decision facing the owners is whether to exploit the company's accomplishments and expand or keep the company stable and profitable, providing a base for alternative owner activities.
- **Stage 4 – Take-off**: the key concern is how to grow rapidly and how to finance that growth.
- **Stage 5 – Resource Maturity**: the greatest concerns of a company at this stage are, first, to consolidate and control the financial gains brought on by rapid growth and, second to retain the advantages of small size including flexibility of response and the entrepreneurial spirit.

2. **Build to sell**, where the goal is to grow the business as quickly as possible through the development of scalable, replicable processes that take the founder out of the center of the business. This goal creates an entity with value that may then operate and succeed without the direct involvement of the founder. It has value beyond the founder's direct involvement.

3. **Build to run**, where the goal is to provide a business that relies on the direct involvement of the founder in key activities such as business development and / or production of the product or service.

Seeking out professional advisors – after establishing your reasons for starting a business and laying out your business plan, you will need to identify your core team of professional advisors. When starting a business, there are several areas where one needs advice from a professional.

1. **Legal** – Some issues your legal counsel will address are:
    - Entity formation – what type - LLC / LLP / S-Corp / C-Corp / Sole proprietorship – each type has unique properties that relate to tax implications and personal asset protection through a "corporate veil." There are other aspects that will apply to one form or another.
    - Business registrations with Fed and State – FEIN / state / local registration.
    - Name search for both entity and web domain availability. You should do both in the beginning. You don't want to name a business only to discover that there are no available domain names.
    - If there are partners (also addressed in the Chapter 6 entitled "Forms of Entities to use When Starting a Business" on page 89), there needs to be a Partnership or Operating Agreement that specifies such things as:
        - Capital invested
        - Roles and responsibilities

- Equity distribution
- Exit or dissolution process
- If there is Intellectual property, one should consider legal protection of:
    - Copyrights
    - Trademarks
    - Patents
    - "Secret sauce recipe"

2. **Accounting –** some issues your financial counsel will address are:
    - The tax implications of the legal entity for you as well as the business.
    - Making estimated tax payments to avoid penalties and a large, unexpected tax bill at the end of the year
    - How will the business interact with your personal taxes?

3. **Payroll** – even if you are the only employee, you need to deal with how you will be paid or pay employees.
    - How to do payroll? This task is one of the first things to outsource.
    - How and when to make payments to FICA, FUTA, withholding, and State Unemployment Compensation.
    - What accounting/bookkeeping system to use: QuickBooks is usually the best choice, but it's important to get advice on set-up and use of the system.
    - You must also know what Federal, State, and City compliance reporting is required.

4. **Insurance** – there are various types of insurance to consider. These include:
    - **Property and casualty coverage** – this insurance protects against property losses to your business, home or car and/or against legal liability that may result from injury or damage to the property of others. This type of insurance can protect a person or a business with an interest in the insured physical property against losses.
    - **Umbrella liability** – Designed to give you an extra layer of security, business umbrella liability insurance provides supplementary coverage for costs associated with lawsuits, legal fees and settlements. Additionally, business umbrella liability insurance can cover bodily injury and personal property claims that are not covered by your other liability policies (such as property, auto and workers compensation).
    - **Errors and omissions** – This type of insurance covers your company or you individually, in the event that a client holds you responsible for a service you provided, or failed to provide, that did not have the expected or promised results.
    - **Bonding insurance** – Often called simply "bonding," Bonding Insurance is a way of insuring against loss caused by a lack of competence or by fraud or dishonesty. People who carry this

type of insurance are referred to as being "bonded." People who work for companies that require after-hours access, such as cleaning services, or those who work for companies that deal with large quantities of cash, like armored-car services, might need to be bonded.

- **Directors' and Officers' liability** – This type of insurance protects past, present and future directors and officers of for-profit or nonprofit companies from damages resulting from alleged or actual wrongful acts they may have committed in their positions. The policy provides protection in the event of any actual or alleged error, misstatement, omission, misleading statement, or breach of duty. In addition, some policies extend the same coverage to employees. Directors and officers liability insurance is needed when a board of directors is assembled. Investors usually require that you have directors and officer's liability insurance as part of the conditions for funding your company.
- **Workers' Compensation** – Workers' compensation is a form of insurance providing wage replacement and medical benefits to employees injured in the course of employment in exchange for mandatory relinquishment of the employee's right to sue his or her employer for the tort of negligence. The tradeoff between assured, limited coverage and lack of recourse outside the worker compensation system is known as "the compensation bargain."

Establishing business-specific bank accounts – if you have a business, then you must have a business bank account. Choose a bank that is convenient for you. There are both benefits and liabilities to using the same bank for your personal and business accounts.

- On the plus side, you already have a relationship. It's also easy to transfer funds between accounts.
- On the negative side, if your business defaults on a loan, the bank may attach your personal account for collections.
- It's essential to have a separate bank account for the business to avoid comingling of personal funds. Should you ever be audited by the IRS, a comingled account would be a major problem. Some businesses also have separate operating and payroll accounts.
- You may also want a line of credit with the bank to fund growth gaps or capital acquisitions.
- An SBA loan is another type of funding done through a bank. Not every bank does SBA loans.

Structuring your partnerships – starting a business is simple when it's just you; you wear all the hats and are responsible for everything. If you have partners, however, it's a different story. You'll have to consider issues such as:

1. **Role differentiation** – who does what is determined by three factors:
    - **Role determination** (i.e., overlapping roles vs. a division of labor; egalitarian vs. hierarchical decision making)
    - **Relationships** – are your partners friends and family, acquaintances, or former co-workers? These distinctions will have a bearing on

- **Rewards** (i.e., equity – will you split shares equally? Will your agreements be static or dynamic?)

2. **Titles** – Noam Wasserman's research, detailed in "The Founder's Dilemmas" indicate three major factors in determining who gets which titles:
    - Each founder's level of commitment
    - Which founders are the *idea* people (i.e., who had the original idea or developed the intellectual property on which the startup was founded)
    - Each founder's human, social, and financial capital

Procuring the necessary technology – every business, no matter the size, has technology needs, including:

1. **Website** – Having a website is as necessary as having business cards or a phone number: Everyone expects it, so at the very least, it signals that your business is credible. More importantly, a well-designed site gives the impression of a well-run business. Don't scrimp and try to do it yourself (unless, of course, your business is web design). This is part of your face to the world. Make it count.

2. **Social media** – The use of social media has become as ubiquitous as having a web site. Create (and populate) pages and accounts for your business on sites such as LinkedIn, Facebook, Twitter, and Pinterest. You can also look for blogs that cover the types of products or services that your company offers and link to them on your website for potential co-marketing opportunities.

3. **E-commerce** – If your business is an online venture, then it will have an e-commerce component that enables orders to be placed and payments to be processed. Do your research as to which vendor platform to use. Once you've committed and begun using a platform, it can be very difficult and costly to change.

4. **Back office** – Every business has some form of back office technology needs. These include:
    - **Bookkeeping/QuickBooks** – software that supports invoicing, customer payments, purchases, bank deposits, a chart of accounts to record equity and capital acquisitions, etc.
    - **E-mail** – create an e-mail address with your company domain; a personal account reflects a lack of professionalism or commitment to your business.
    - **CRM (Customer Resource Management)** – a CRM system may be unnecessary to start with, but you'll realize quickly that tracking contacts, prospects, and sales pipeline activity is (a) essential to the growth of your business and (b) overwhelming without a formal CRM system.
    - **General applications (Microsoft Office or Google Docs)** – Every business will generate documents such as proposals, letters, spreadsheets, and presentations, decks, so it helps to decide what application to use and establish a logical digital filing system before business picks up too much. Another choice you'll need to make is whether this system will reside on a local computer/network or in the cloud.

- **Back-up system** – You must also create a system to back up all of your electronic data. To be most effective, this system should be automatic and reside off premises.

While the topics discussed in this chapter may seem daunting to the prospective business owner, much of the work can (and should) be done by professionals such as your attorney, CPA, insurance broker, etc. In fact, one is faced with an early opportunity to learn a valuable skill set – delegation. While you may be able to incorporate the business yourself by filling out the various forms found at different locations, could the 10 hours spent doing this be better served by working on your business and having a professional who has done 100’s of these filings handle it. Plus you have peace of mind that it was done correctly.

What can’t be delegated is the development of the value proposition – that’s on you. Also decisions about hiring people or partners cannot be delegated. Payroll yes – people and values no.

One final piece of advice is to think in terms of 3X as in 3 times the money you’ve budgeted and 3 times as long as you’ve planned to launch the new business. However, the more front-end work that you do, the greater likelihood of success you will have.

Chapter 4 | Business Planning and Analysis

Chuck Galas

Business plans come in many sizes, types, and forms. They vary by type of industry, specific business function being planned, time period, and even the purpose and audience for which the plan is being developed.

Varying any one of the elements identified above (industry, business function, time frame, purpose, and audience) and you could get a plan that looks very different in level of detail, presentation and even its content from others with the same name.

That variation is useful and actually makes a good deal of sense because it specifically addresses the focus and level of detail designed to fit a given circumstance. However, many times these differences are not understood resulting in cookie cutter copies of textbook business plans. When this happens, the real benefits of *true business planning* are lost.

The intent of this chapter is to provide a better understanding of business planning activities by identifying:

- types of business plans, to provide an overall context of business planning
- demonstrate that the reason why you are developing the plan is important
- *true business planning* is both a process and an art
- critical factors of success = knowing the right questions to ask
- numbers really don't lie

(*Along the way you will see notes in italics aimed at providing food for thought for different audiences: investors / venture capitalists, senior management, corporate planning staffs, middle management, business owners, or a functional department head).*

Types of Business Plans

A simple list of **types of business plans** should provide some feel for the complexity of various planning activities across a normal enterprise. It is the simplest and most concise way to demonstrate just how complex business planning can be.

- Strategic Plans (definition of corporate direction basic framework for long term goals and objectives, usually covers 5-10 years or more)
- Operational Plans (tactical, usually covering 3-5 years)

- Annual Plans (identification of changes to operations and communication of priorities)
- Annual Budgets (quantification of operations to highlight requirements)
- Project Plans (requests for funding and communication to insure coordination of efforts)
- Plans for a specific function or operation
    - product design and product introduction planning
    - marketing plans
    - production planning
    - sales and merchandising plans
    - plant and equipment plans (acquisition and maintenance)
    - purchasing
    - materials management plans
    - distribution planning
    - financial statement development
    - capital budgeting
    - treasury and cash flow planning
    - investment plan – portfolio management
    - risk management programs
    - safety plans and procedures
    - organizational development plans
    - management succession plans
    - workforce plans
    - systems and information technology planning
    - project plans

Every one of the above types of plans has its own purpose and requirements and this is just a list of the most common types of business plans that come to mind. The time frames, level of detail, and extent of integration of these plans can vary widely by industry.

Example: an industry that requires a large investment in plant and equipment or requires a long time to bring a product to market will require longer time frames for their plans than services industries that can refocus their priorities and direction in a much shorter time frame.

You can easily see how the introduction of a type of industry can significantly alter how you would go about developing your plans.

- Manufacturing
- Technology
- Retail Sales

- Healthcare
- Restaurant / Food Services
- Professional Services
- Commercial Services
- Residential Services

Note: There could be variation within any of the above industries depending on the specific circumstances of the firm, e.g., marketplace circumstances, introduction of a new product/service, the loss of some key personnel, etc.

You can see business planning can mean different things, to different people, even to the same people when they find themselves in different circumstances.

Food for thought:

1. *Using the exact same forms and instructions based on classical business planning sources for every type of business is not only unnecessary, but can also be harmful.*
2. *Tailored plans by division, function or department and circumstance should focus on providing the minimum requirements necessary, providing the most flexibility to those actually performing the planning, thus increasing the benefit they receive from the planning effort* ***It is their performance that will ultimately determine success or failure.***
3. *Avoid the tendency to assume that the best overall corporate plan is one that just adds up the lower level plans. The corporate planning staff, financial areas, or outside consultants need to create the bridge between the individual department plans, division plans and the corporate plans. If you choose to have a higher level plan that just adds up the lower level plans, your plan will contain the summation of all variances from each of the lower level plans. That is likely to make variance from plan larger. That is a function of pure statistics. Since one purpose of planning is to reduce surprises and variances, it only makes sense to use the proper statistical techniques to reduce variances, not increase them.*
4. *Resist the tempting fallacy that more detail means more control.*

Why are you developing the plan (and for whom)?

Unfortunately, an awful lot of business planning occurs because of some requirement from an outside force. If the reason for developing the plan is not understood by the people developing the plan, it certainly not only reduces the quality of the final plan, but just as important, you miss the opportunity for everyone participating to understand their common performance goals.

When the reason for the planning exercise is dictated by an outside force (the bank to support continued financing, corporate planning department as part of a corporate wide planning process, corporate functional department in an effort to support its functional responsibilities, etc.) you might not have any choice but to follow their prescribed format. Let me offer two things that you should consider while going through this type of exercise.

Understand the audience for your plan and *their* motivation.

There is great truth to the old adage "*Beauty is in the eye of the beholder*." Different audiences may require minor tweaking to complete rewrites of *your* plan, and that may be a different planning process than what might satisfy your needs *(more on determining your own needs later).*

Many plans that are developed to gain approval end up missing the mark simply because the plans were cast and presented from the perspective of the plan's creator, not aimed at the true audience. What you may need to actually manage your task, may not be the same as the plan that needs approval.

Some quick examples: *(Note: these examples can impart a different meaning dependent on whether you are the requester of the plan, or the developer.)*

- You need financing for your newly formed manufacturing company, so you need a plan for the bank or your investors that focuses on
  - definition of product /market potential,
  - marketing plans with analysis of the competition,
  - capital expenditure plan for plant and equipment,
  - design, development and production schedules,
  - cash flow projections
  - financial statements, most likely for the entire time period it takes to show a profit

- As the head of a manufacturing division of a major corporation and you need to produce your annual plan
  - the format and level of detail is likely to be defined by the corporate management
  - while all of the elements required of the start-up operation are still relevant, the level of detail required could to be a lot less, with a greater focus placed on improvements in product, production or marketing from the current year.
  - whether or not your marketplace has aggressive competition or the introduction of new technologies will determine how much marketing detail you will need, and you might not even need it at all if the market you are in is stable and no new products are on the horizon for your company or the competition. The next year's focus will be on efficiency of operations.

- You are the managing partner of consulting firm and you would like to open up new offices in three new cities, but need the partnership to approve the expansion. Since your audience thoroughly understands its business you will need to present a totally different type of plan, one that would focus on:

- the revenue potential of each of the new locations
- assessment of the competition in each location
- availability of qualified staff for each location
- projected start-up costs and break even points for each office
- identification of the person to head up each office location

As you can see, constructing acceptable plans for each of the above examples could be quite different. Even with two situations that closely resembled each other, there may be circumstances and special considerations that would dictate a different approach to plan requirements.

(Note: Thinking through what is requested and why, might cause you to consider developing what is required and then going further to develop additional analysis and plans that are more focused on managing your own operations. More on this later.)

Understand the *dimensions* on which the plan will be approved or rejected.

A division of a major corporation, which was well run and continued to produce steady profits year after year, wanted to produce a new product. It had one of the most stable management teams and was well respected throughout the corporation. However, virtually every major expansion plan that the division presented was never funded.

But how could that be? It just didn't make sense.

This division's management was very conservative. This was an older, stable division of the corporation, not one of the younger, high fliers. All of their revenue projections were conservative and so were their costs estimates and time frames to market of the new products. Most of the other divisions had quite different management styles.

The initial corporate review of new proposals fell to a group that really focused on the soundness of the plan's financial projections and the project's ROI (return on investment). The group saw its responsibilities as asking "What if?" questions in only the negative direction, raising only questions that would lower the revenue projections and raise the cost projections, thus removing as much speculative risk from the proposal as possible.

The division management style was exactly similar to the review committee and had already taken all the upside potential out of their projections. Not once were any of their previously submitted plan projections revised downward by the committee, so the committee was in total agreement with the soundness of their previously submitted plans.

So what was the problem?

There was an arbitrary hurdle ROI of 15% on submitted plans to allow them to move forward. The committee did not feel it was in their purview to adjust any of the submitted projections upward. After all, they saw their job as the conservative reviewer, not the true business plan review operation, which would take place at the next step of the process.

By making modest changes to the original plan's conservative revenue projections, lowering their cost projections, and moving the time to market estimates by only 1 quarter (management's original time frame included a 6 month cushion for unanticipated problems), that raised the projected plan's ROI from 14.5% to 20.7% and the plan was accepted. Knowing the dimensions of the decision making process made all the difference.

True business planning is a process and an art.

Whether you are the CEO of your company, president of your division, manager of your functional area, the project manager of a large project, or the corporate planning staff that defines the requirements for the entire company, the same basic considerations really apply.

You are really in a position to do some good for yourself and all the people who will be involved in the **PLANNING PROCESS**.

Notice that I used the term ***process*** and did not just refer to the end result, ***the plan***.

Too often, the main goals of plan development is to convey top down direction and on-going control. Certainly, having direction is an essential part of a well-run organization. Having a knowledgeable leader at the controls of a business is desirable as well. But all too often the old army adage of "It may take a general to say yes, but it only takes a buck private to say no!" has some truth to it.

If the completed plan is just placed in a drawer for future reference, while the very act of making people throughout the organization produce a plan might have some beneficial effects, the organization missed the boat. **Good planning is really a *continuous process loop* with multiple iterations for the plan to be fully developed, implemented, and refined.** It is natural to think of an organized planning process as a straight-line process from start to finish. However, that simply is not the case. **Good planning is an unnatural act!**

The Process

1. Current state analysis and establishment of direction, goals, and objectives
2. Communication of direction, goals and objectives including their refinement throughout multiple levels and in various levels of detail
3. Plans in some level of detail are developed, reviewed and either return to #1 or accepted
4. Once accepted, periodic reviews of performance against plans takes place
5. Analysis of variance from plan and plans revised or additional action taken as needed (analysis is what dictates whether revisions are made to the current plan or a brand new plan needs to be built all over

again)

Guidelines for the Planning Process

1. Business Planning and Analysis needs to be a process, a continual process, not a periodic adventure
2. Most planners, whether CEOs, middle managers, department heads, or project planners, view plans and budgets way too rigidly. Many view plans and budgets as cast in stone. That approach defeats one of the main benefits that a good planning process provides: **the opportunity to learn about your business by having an objective measurement that will help you analyze performance and make the proper adjustments.** Expect variances from your plan, because many times working to '*get back on plan*' is the exact wrong thing to do.
3. While there are plenty of 'Planning Cookbooks' that describe how to build a plan or budget, you do yourself a disservice if you blindly follow one. Reading through examples of business plans is a wonderful source to stimulate your thinking. But don't be afraid to tailor it to what fits your organization, your needs and your circumstances. Dropping useless sections, or scaling back detail requirements can be very important, because it causes great focus on things that are important.
4. In particular, every planning cookbook has a section for 'Critical Factors of Success', but very few define those at the level where they become useful management tools *(more on that later).*
5. Vary the level of planning detail required by different areas of your business. The amount of detail required by any level should reflect two things: the level of detail that is helpful in learning and managing management's responsibilities, and responsible manager's ability to actually produce it *(Whipping the horse to climb a steep hill that he is not capable of climbing results in only getting the horse all lathered up, with no discernible benefit).*
6. Design a process that allows lower levels to develop the level of detail that is appropriate to manage operations and provide more summary plans to corporate planning process. (Perhaps there is a need to check that responsible managers have actually developed plans that make sense, but requiring that lower level detail plans be submitted doesn't usually make much sense.) If you can't trust managers to go develop effective plans to manage their own responsibilities, your problem is not in the planning process.
7. The planning process should focus on analysis, understanding and assisting management at all levels to understand and manage the business's operations better, and not be thought as the activities that produce the documents to assist in top down command and control tendencies.

Note: what is described in the section above is not easily accomplished. It takes more skill and understanding of the entire organization to implement this more participative planning and analysis process, but what you have is an entire organization that is much more in tune to how each part fits together and how the organization needs to continually adapt to meet the changing environment.

Critical Factors of Success = Knowing the right questions to ask.

Whenever **Critical Factors of Success (CFS)** enter into a presentation or a discussion, it is easy to notice the rise in everyone's attention level. Every businessman would like to identify the CFS for his operation. Unfortunately, there is no single simple answer.

The CFS for companies and organizations even in the same industry might have differences based just on circumstances. However, it might be helpful to provide some guidance in how to determine the CFS for your operation.

First, always start by planning out your **cash flows.** While you may have the potential of making millions in the long run, without sufficient cash flow, you will go bankrupt in the short term.

After that, ask yourself a couple of basic questions:

- Is there a large enough long term demand for my product or service to support the level of enterprise that we already have or plan to build?

- Is the demand sustainable, or something that is likely to be just a fad or replaced by newer technology? Are long-term repeat customers something that is likely?

- Will competition enter the marketplace? If so, are there any barriers to entry like proprietary features that can provide some competitive advantage that will ensure a manageable share of the market?

- Is it possible to build brand loyalty or are we going to end up in the commodity type of marketplace?

- What can happen to prevent us from delivering our product or service initially? Long term?

- What are my break-even levels of operation? Do we have access to resources (raw materials, plant and equipment, workforce) readily available until at least break-even levels?

- What event or circumstance would do us serious harm? Is preventing it from happening under our control? Is there something I can do should it occur?

Answers to those questions would be a good start to identify some critical factors of success. **It really doesn't matter if your answers to some of those questions are negative. What matters is that your responses to those negative possibilities is covered in your plans.**

This next item is hard to accomplish, but the benefits to the entire organization cannot be overstated. Develop quantitative models of your **CRITICAL OPERATING PARAMETERS** (“**COP”**).

These models can serve to focus everyone's attention on the very things that are the most important metrics of your operation. Determining what those are might very well be the most important part of your planning process and your ongoing monitoring and management of your operation.

Critical Factors are specific items of great importance to your business.

Critical Operating Parameters are models that quantify acceptable ranges and relationships in the important business metrics of your business.

Let me give you a couple of easy examples of **COP.**

Development of a model of your cash flows, showing all the expenses, revenues, interim funding that might be needed if all of your raw materials don't arrive on schedule, or your customers take longer to pay their bills than you planned is one such example. The ability to have a model permitting you to play 'what if'' to alternative scenarios is almost guaranteed to be an important COP.

If you are planning a city park or construction of a venue, you need to develop a parking model to ensure there is enough parking to support actual operations. There must be enough parking to not only fill the seats, but also to allow parking for people arriving early for the next show, or set of games, while the current participants are leaving. (That COP model would include the number of parking spaces you need and would use the various event sizes and staggered starting times to build that model).

Most sustainable businesses need to count on high retention rates in order to produce growth past their initial years, yet have nothing planned that is focused on building longer-term relationships with their customers. Having a model breaking down new customers from returning customers will demonstrate just how important customer retention is to your long-term success. It will create the focus on customer retention your business needs to succeed. Understanding that dynamic can make all the difference in the world in whether your business succeeds or fails in the long term.

Good location and good food are certainly critical factors of success for a restaurant. However, so many restaurants fail because they never understood their COP.

Everyone starting a restaurant develops a menu of offerings and prices. They are careful to make sure that their pricing is such that it contains an acceptable profit level for each meal. But that is only half a restaurants COP model. Not only do you have to make enough profit per meal, but you also need to serve enough meals per night to cover all expenses and contribute to profit.

So now you must focus not only at the contribution to profit and overhead from each meal, but from each table during the course of a night / week/ month.

Working that math out, you might now decide to drop some items from the menu, not because they would not sell well, but because they would take too much time to cook, deliver to the table and for the customer to eat.

So our restaurant model now includes table turnover. The more times you can turn that table over during each day, the better chance you have of your restaurant being a long term success.

To get better table turnover you need to get customers served their food faster so they order, eat, pay and open up the table for the next customer. Trying to save money by having fewer cooks or fewer wait staff is the response that so many restaurants make. That response is what will cause the restaurant’s doom. Had they understood their COP, the correct decisions would be easier to see by everyone working at the restaurant.

Restaurants also need to consider parking. Once again, they need more available parking than to fill the tables. During busy periods they need people waiting in line to fill each table as soon as it opens. They can't be waiting in line if they have nowhere to park. Choosing a location that requires customers driving to it, and then not having a large enough parking lot, is another mistake that is easily avoided, if the restaurant managers understand their COP.

(Please note that correctly defining the restaurant's COP has not diminished one of the other CRITICAL FACTORS OF SUCCESS, which is to serve good food and reasonable prices. So CFS and COP need to be developed and monitored side by side.)

Successful consulting or service firms can tell you that having their on the jobs consultants or service personnel building relationships and looking for other opportunities, as well as performing quality work leads to expanded and new projects. An added benefit to having the actual on the job consulting developing new business is that they rarely 'sell what can't be delivered', as sales staff often do.

Other COP items for consulting and service firms is defining the percentage of billable time consultants or service people need to average every week in order to have sustainable operations.

Regardless of what business you are in, building of those COP models to provide both managers and workers a better understanding of critical operating parameters of their business can be the difference between success and failure for your company. With the COP being widely understood, the entire organization has a much higher probability of working as a team because they have a better understanding of the operation.

When it comes right down to it, communication within the organization usually is truly a CRITICAL FACTOR OF SUCCESS over the long term. I have never seen anything more effective than communication of the critical operating parameters at keeping everyone focused on the things most important to the business. That said, it is obvious that when building and selecting the COP for your business, you better make sure that you got them right.

Numbers really don't lie.

You hear that 'numbers lie' all the time. They don't if used properly. There are three rules of using statistics to prove or disprove your case.

1. Make sure you are using the correct numbers taken from a valid source
2. Know how the source calculates / derives / estimates the number
3. Always provide a proper context for your numbers by using a DENOMINATOR!

You really need all three to be able to trust that the numbers aren't lying to you.

Just because your source is from the BLS (Bureau of Labor and Statistics) and has the correct sounding stat title, doesn't mean it accurately measures what its title seems to claim.

The unemployment rate can be used as just one example of the point. It is taken from the BLS and since it is a rate, it does have a denominator... but the fact that it is calculated by removing those that remained unemployed over a certain period from the numerator causes it to woefully understate the true unemployment rate in time of prolonged high levels of unemployment.

Every night on the news the Dow Jones Industrial Index is reported. The fact is that it only measures the movement of 30 stocks, and doesn't use a denominator (at least in the normal sense of the word) so saying the Dow Jones Index is down 100 points appears to be substantial. But 100 points is on a base of around 16,000 points! One hundred points sounds like a lot, however it is only .00635 of the market, less than 1%, and only for a handful of stocks.

Another example is a recent meeting that I attended where the graph illustrated a large bump in defective units for the most recent month. A good deal of time was spent trying to determine the cause for such an increase. Some around the table blamed a new supplier of raw materials. Others were positive that it was the recent change in production line management. The real cause turned out to be neither. In fact, the quality on the production line was actually improving.

How could that be? Were the number of defective units just inaccurate? Turns out they were very precise. They just were not placed in context by the proper use of **DENOMINATOR**!

The new source of raw materials was far superior to the old source. Plus there were major changes implemented by the new production line management team that produced very positive results. The impact of both of those changes resulted in a 38% increase in total units produced. The number of defective units rose only by 12%, which taken out of context of a denominator, seemed like a large increase. However, the number of defective units expressed as a percent of total units produced showed a significant and a *real* drop in defective units per total units produced.

Another example occurred when a corporate safety team was up in arms when reviewing a significant rise in the number of injured workers during the last quarter. The team launched a full-scale investigation of the production line safety procedures to determine the problem and to address it.

Once again what they were tracking was the total number of reported injuries during the quarter. That might be fine if the workforce and production line output stayed constant, but it hadn't. The new plant that came on line three months earlier, finally got their safety reports integrated and summarized into the corporate totals. When the number of injuries were expressed as a percentage of either the total workforce or the total production units produced, the trend showed a remarkable improvement, not the serious problem indicated by the unit stats expressed without a denominator.

A large pharmaceutical company spent a good deal of time and resources trying to understand the month-to-month variance in their sales. They already applied a sophisticated set of factors to address the seasonal nature of their product, but they were at a loss as to the cause of the continuing month to month variances.

Once again, **choosing the right denominator solved the problem**. Purchase and delivery of their products were made and recorded on normal business days. Dividing each month sales by the number of days available in that month to actually make a sale and deliver the product produced the smooth sales trend of a well-run organization that they were looking for.

Management By Objective (MBO)

(<u>Conceptually appealing, but problematic in practice)</u>

This is a very tricky area. The entire planning process is all about setting goals and objectives, so what is the problem with the MBO approach? The MBO approach establishes well-defined objectives, embraces the KISS ("keep it simple, stupid") principle, and on top of that, usually communicates the objectives well. That sounds perfect. Hell, I am about to tell you why it doesn't work, and it *still* sounds good to me!

The first step of making a list of all the objectives (accomplishments) that you want to attain, is actually a very good thing. This could be equated to the development of a **working operational mission statement,** which is always my first step when helping businesses plan. It helps management take the time and focus on all the things that they want to accomplish and helps communicate those objectives throughout the company. Again, this is perfect. So far, so good.

The next step would be to quantify (put numbers to support) each objective. Again, the more you can quantify your expectations, the easier it is to monitor and analyze your progress.

Here is the point where most implementation of the MBO approach diverge from the continuous planning process that is ideal.

All of the objectives are placed in a hierarchy of importance and while conceptually logical, in practice the subservient objectives get dropped, never to be seen again. The surviving top-level objectives are tied directly to management compensation schemes and most end up without denominators (and by now you should realize how important denominators are) and worst yet, in many instances, the numerical support system for the objectives can be manipulated.

Often times, the first year, or even the first couple of years, the MBO approach appears to be working. This is especially true if the company is in a stable growth period. Many times, the actions required by MBO, in actuality work against the company's long term best interest.

The bottom line is that while conceptually appealing, most often the people setting the MBO and tying them into management compensation just are not smart enough to do it properly. While that may sound like an insult, I really don't mean it to be. As soon as you isolate objectives from the real world complex operational relationships, you lose the rudder to your ship.

Let me provide some real world actual examples.

- Management of the west coast offices had turnover tied into their year-end bonuses
    - Some offices went to temporary help that were not counted in the employee turnover stats and the quality of customer service suffered in policy issuance and claim processing errors.
    - Others provided special privileges to keep people from quitting, which included three- and four-day workweeks through the use of unreported personal days.
    - Still others actually paid a few employees for the month of December when they actually stopped coming to work after Thanksgiving in order to make the objective and receive their bonus.
- An objective was set to reduce the cost of raw materials by 10%
    - A long-term supplier was dropped for a new supplier that provided the required price cut, however, the quality of the raw materials turned out to lack the previous consistency and caused continual production line stoppages which resulted in an actual increase in the cost of goods sold.
- The most disastrous implementation of MBO that I witnessed was at the agricultural equipment division of a Fortune 100 company. Through the refinement of their MBO system over a number of years, each year stretching it to higher levels, they ended up combining two objectives: a stated production line output level and on the last day of their physical year, all of the machines that were produced that year had to be out of their yard and delivered to their dealerships. After processing and analyzing 15 years of production and sales history at the request of the newly appointed Director of Marketing, we were faced with the absolutely astounding fact that the wholesale sales line had crossed over the retail sales line for the past seven years. Surely, someone had screwed up with extracting the data or I had screwed up processing or analyzing it. This was not the case. Given that MBO, division management had worked out special financing plans where thousands of dealers across the country assumed title for delivered equipment with no down payments and no interest for 10 years, plus the

right to return all equipment that was not sold. This was carried to such an extreme that further analysis showed that very large pieces of equipment were delivered to small town dealerships that had no customers within 200 miles that could ever purchase it. How could this happen. Frankly, I wouldn't have believed it if I hadn't seen it with my own eyes. This was another case where every senior management executive in that division was tied to the same compensation scheme. MBO had been taken to such an extreme that it completely removed the normal checks and balances of a functional organization.

If the MBO approach still appeals to you, I would certainly recommend performing the first step of your planning process and listing all of the various objectives that you want to accomplish. However, tying it into your management compensation plan is a very risky business. Normal operations are too complex to effectively set specific objectives a year into the future. If your environment is stable, you might be able to do it, but it is doubtful that those objectives defined a year or two out will work out better than a continual observation, analysis, and planning process.

Understand that I am not suggesting you shouldn't set objectives, even long-term objectives. Good planning should have you do just that. However, they need to be continually reviewed, analyzed and adjusted. Keeping objectives that no longer are possible or in the company's best interest does not help the enterprise in the long term.

Final Thoughts

Before you embark on any activity, the very first thing that you should do is establish your criteria for success. That is especially true for a planning process, but literally true for every endeavor. Establishing those expectations up front is needed to guide the entire process.

The entire planning process should focus on the **NEXT PLAY!**

Development of plans should always test the result with two questions:

1) **What if our assumptions are wrong?**
2) **When should our plan be reviewed for validity?**
3) **Should the current plan be right on..... NOW WHAT? (Next Play!)**

Plans should be living things, where learning, better understanding, revisions and constant improvement are supported.

Plans, whether Strategic, Operational, Annual, or basic budgets, should be used as guides and information points, not cast in concrete.

When created they should have represented your best thinking. If you are off plan, you need to investigate why. Is it just a seasonal fluctuation that the plan didn't take into account and thus no change is necessary? Or was one of the plan's assumptions or projections wrong (timing, competition, production costs, competition, acceptance in the market, etc.)?

If one of the assumptions was wrong, what changes need to be taken immediately? If you are not sure that immediate changes are necessary, what additional information do you need for you to know if changes needed to be made or not?

You will note that the title of this chapter is “**Business Planning and Analysis**.” This is in stark contrast to many organizations that call their planning functions “Planning and Control” organizations and managers that use plans for the sole purpose of control, all of whom are missing the point of sound planning.

No one has a crystal ball that can foresee future conditions. Plans will contain all sorts of mistakes. Some mistakes reflect bad judgment, some merely the unavailability of information that was critical for the right decisions to be incorporated into the plan during its development.

Analysis is needed at times when things don't seem to be following the plan. A climate that uses the plan variance to exert control will force all levels to try to find reasons why current variations from plan are minor or just timing aberrations and an attempt to return to the original plan during the next time frame is the correct course of action. That instinctive protective behavior is brought about by the 'Planning and Control' environment. Taking the time to perform good analysis of plan variances may end up determining that a new course of action would be more beneficial.

The more people you can get involved in true planning and analysis (in a positive way), including staff, consultants, and vendors, the greater the possibility of getting everyone working far more effectively for a common goal, instead of viewing their part as a spectator. You will have a much better chance to react more quickly in our ever-changing environment.

Encourage everyone to bring unexpected results to the attention of management. This is truly not a natural instinct. The natural instinct is to cover it up or gloss over it. Make everyone understand that they don't live in a ‘kill the messenger’ environment.

Lastly, developing your organization's critical operating parameters will turn out to be a lot harder and time consuming than it may appear in this chapter. There are not many people who actually can do this well. However, if you succeed and get the COP right, nothing can contribute more towards the long-term success of your business.

Chapter 5 | Using Processes to Improve Your Business

Jeff Galas

"Process" is a bad word in many businesses. Those opposed to it argue that creating processes strips a company of what makes it special: individual creativity. For this reason, I will begin this chapter with a simple definition of "process."

> ***Process (noun): A series of steps or actions taken to achieve a particular end.***

By that definition, almost <u>everything</u> we do in business can be categorized as a process of some type or another. Thus, it is incredibly valuable to understand what processes people are using, even if those processes have never been explicitly defined. (Remember, a picture is worth a thousand words. Why not make your work visual?)

Once we accept this definition of process, our questions change. We no longer wonder what *is* or *isn't* a process, but rather *where* we should standardize the processes we're already using. How do we understand the processes driving our businesses? How do we go about improving those processes? These are the questions this chapter will address.

What requires a standard process?

We will start with what it means to be "standard." This is not some scary bureaucratic way to impose control. In fact, when standardization is done correctly, it is led and managed by those doing the work, not their managers.

So, what does standard mean? It is a **documented, best-known way to perform work.**

Peter Scholtes offers some characteristics of a standard process:

- Makes it easier for people to learn and to do their jobs
- Avoids known pitfalls in a job
- Assures safety throughout the job
- Makes it easier to track down issues associated with an undesirable result from the work
- Minimizes variation caused by multiple methods and thus makes prediction for management easier.

To determine when to standardize the work your team or company is doing, ask yourself these questions:

1. **Is the work repetitive?**
   Even in the most creative areas of business much of what we do is repetitive work. Repeatable work can be studied and improved. Why wouldn't we want to take the opportunity to do so?

2. **Is the work critical the success of the business or project?**
   There are many ways to categorize any piece of work; one way is to determine whether or not the work is critical to the success of the project. Most critical activities need to be managed and understood. It is my belief that the best way to manage and understand is to create a process that enables us to study the constraints, assumptions, and interactions at play. How do you test things for deeper understanding without a baseline definition of how the work happens?

3. **Does this work prove to be a source of leverage throughout the organization?**
   Oftentimes work can be leveraged throughout the entire organization, meaning a small improvement or change locally can be formalized as a process, leading to great improvement globally. (Conversely, a small mistake can create a deficit that is felt for some time.) This type of global improvement can be as simple as a meeting agenda – most companies can manage without meeting agendas but would see great improvement by using them.

If you can answer "yes" to any of these questions, then you should consider creating a standard workflow, or process, for this work. Be mindful, though, that this exercise will most likely involve multiple departments, information sharing will be necessary to create a comprehensive workflow (i.e., Marketing has to have insight into what Operations and Sales are doing, as they all work together closely; similarly, Accounting making decisions without understanding how they affect Finance may be shortsighted).

How do we understand the process?
Once we determine what work should be standardized, the next step is to understand and document the process. The first rule of process documentation is go to where the work happens. Process documentation cannot be accurate when completed by someone removed from the work itself; even one step removed from the work creates inaccuracies. If you aren't the person doing the work, then place yourself within reach (either visually or verbally) of those doing the work.

Here is a guide to documenting a process:
1. Determine where the process to be documented starts and ends.
2. Decide on the level of detail you will use in the process – this depends on who will be viewing the process and how you want to use it.
3. As you see work being performed, document what you see being done. (Hint: use post-it notes when first diagramming for easy visualization.)

Once you have documented the work, give the primary work team an opportunity to review what you have documented in order to ensure its accuracy.

How can we improve our processes?

Most companies exist in a constant state of "putting out fires," which limits opportunities for meaningful improvement and growth. In light of this, how can we undertake business process improvement in order to build a better future state?

Process improvement starts with acknowledging that you are suffering from one of these six common issues:

1. Inadequate knowledge of how a process *actually* works
2. Inadequate knowledge of how a process *should* work
3. Errors in execution
4. Failure to install preventative measures
5. Unneeded steps, unneeded inventory, and other wastes of time in the name of quality
6. Too much variation in process execution

To address these issues, I walk my clients through a five-step methodology, developed by Brian Joiner to create sustainable process improvement:

1. Understand the process
    a. Create a common understanding of the way the work is actually getting done
2. Eliminate errors through standardization of work
    a. Everyone makes mistakes – common mistakes are a matter for process improvement
3. Remove slack by understanding workflow and throughput
    a. Inventory in general can be seen as waste. Streamlining a process to focus on just-in-time work will by itself create improvement.
4. Reduce variation
    a. Variation ensures waste as you work to handle each case separately, which makes it harder to improve and scale. Understanding, managing, and reducing variation is key to process improvement.
5. Plan for continuous improvement
    a. At this step, much of the easy work is done. Now, look ahead in order to understand future needs and determine how best to serve internal and external customers.

A Methodology for Creating Processes

My recommendation follows the Plan – Do – Study – Act (PDSA) methodology. What this means is simple: in order to improve, we take small steps, create tests, and learn from the data we gather.

- **Plan**: Document a plan for improvement, including how you will test the results to understand if improvement has been made.
- **Do**: Enact the plan (using a sample if possible).

- **Study**: Determine whether or not the results generate the expected improvement.
- **Act**: If improvement was made, scale your process; if not, adjust as needed.

That said, not all cases are right for process improvement. In some cases, instead of attacking the root or structure of the problem, it's necessary just to put out the fire; however, even in these situations, we should try to find the *root cause* of the problem instead of stopping the moment our problem is solved. To do this with my clients, I also leverage the expertise of Brian Joiner's seven-step method:

1. Document the project and expectations
    a. Define the projects purpose and scope
2. Assess the current situation
    a. Focus your improvement efforts by attaining accurate data on the current situation
3. Run through *root cause* analysis
    a. Identify the causes of your problem and confirm with data
4. Create and test possible solutions
    a. Develop, test, and implement solutions aimed at the *root cause* of your problem
5. Analyze your results
    a. Use data to evaluate both the solution and your plans to implement the solution
6. Standardize improvement
    a. "Maintain the gain" by implementing your new work methods broadly
7. Create future plans for prevention
    a. Anticipate future improvements and preserve the lessons from this effort

Final thoughts: It all starts with purpose

To make processes work for you, it is imperative to understand the driving forces behind your business. Process improvement, or any improvement, is wasteful without understanding the company's larger purpose. All processes, and in turn all improvements, should support the larger purpose! With that in mind, here is the final question you must ask yourself:

If your customers don't understand the improvement, did you make an improvement at all?

Your business goals start and end with the customer, so for your business to thrive, you must understand what processes and process improvements advance those goals. Whether you recognize them or not, they are present, and seeing, understanding, and managing them is what all successful businesses have in common.

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Chapter 6 | Forms of Entity to Use When Starting a Business

Joel N. Goldblatt, Andrew Arons, and Neal Winston

In this chapter, we discuss the various forms of entities one might use in connection with the creation, ownership, and operation of a business. We examine the pros and cons of each entity type and discuss where you tend to see an entity type used. We also examine how the owner's goals and objectives relate to the form of entity to be selected.

As part of our inquiry, we consider exit strategies and how they may dictate the form a business owner would use to conduct a particular business. Finally, we summarize income tax implications that are associated with these various entities. We also provide resources and tools for the reader who wishes to obtain more information about a given topic.

Forms of entities for businesses and pros and cons of each

There are various forms of legal entities that one can use for the purpose of creating and operating a business:

1. Sole proprietorship
2. Corporation
3. Limited Liability Company
4. General Partnership
5. Limited Partnership
6. Limited Liability Partnership (LLP)
7. Trust
8. Cooperative
9. Not for Profit

1) Sole Proprietorship: When an individual alone conducts a business and does not form any type of entity, he or she is by default a sole proprietorship. On the food chain of business types, this is the amoeba or lowest form of business structure. The sole proprietor has no liability protection whatsoever. However, a sole proprietor can purchase insurance protection to minimize liability exposure. Any debts or liabilities incurred by a sole proprietor are met at the individual level. For tax purposes, the sole proprietor is the party taxed. When filing a form 1040 Individual income tax return, a schedule C is attached thereto to report all revenues received and deductions of "ordinary and necessary" (and legally permissible) business expenses associated with the conduct of the business.

The positive aspects of this entity type are that it costs nothing to commence in the form of filing fees or annual maintenance charges, and income tax returns are generally easier and less costly to prepare and may not require the expertise of a tax professional. The downside is obviously unlimited individual liability exposure and the inability to obtain some of the advantages of certain tax deferral strategies. Furthermore, an individual/sole proprietor has an elevated risk of audit (albeit not a large one) by the Internal Revenue Service.

This form of entity tends to be used for one-person professional practices (i.e., realtors, consultants, and other service providers where inventory is not involved and substantial assets are not required to conduct business). The activity to be conducted may be less risky as well. This is hopefully the case, as sole proprietorship results in *complete individual liability*.

2) Corporation: Dating back to the common law of England, corporations were originally created to allow capitalists and entrepreneurs to undertake risky endeavors for commercial benefit without exposing individual owners' wealth to significant liabilities. Early examples of corporate activity in the U.S. date back to the birth of the rail and steel industries. These types of business activities required intensive capital investments but had a high-risk nature and high incidence of failure; to incentivize investors to take on the added risk, it was necessary to shield the balance of the individual investor's personal assets from the enterprise's creditors. Without this protection, it was difficult, if not impossible, to get investors to contribute capital to the business.[2]

The word "corporation" refers to any association of individuals bound together into a *corpus*, a body sharing a common purpose in a common name. In the past, that purpose had usually been communal or religious; boroughs, guilds, monasteries, and bishoprics were the earliest European manifestations of the corporate form. They all owed their existence, and the privileges stemming from a corporate charter, to an act of a sovereign authority. It was assumed, as it is still in nonprofit corporations, that the corporate body earned its charter by serving the public good. The same thinking applied in the chartering of joint-stock companies in the age of exploration and colonization.[3] Pre-Civil War, the legislature had to pass a law granting a charter for a corporation,[4] but following the Civil War, this began to change. The corporate form was first created in a general corporation act by New York in 1811, but it was available only to corporations manufacturing textiles, glass, metals, and paint. Legislation permitting the formation of corporations for any lawful specified purpose was adopted by Connecticut in 1837 and Iowa in 1846.[5]

In today's corporate law environment, in order for the owners of a corporate entity to shield their individual assets from liabilities, they must follow certain corporate formalities. Failure to do so can result in a court

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[2] David McBride, *General Corporation Laws: History and Economic* at 3.
[3] Alan Trachtenberg, *The Incorporation of America: Culture and Society in the Gilded Age* 5-6 (1982)
[4] *Id.* at 6.
[5] Model Bus. Corp. Act § 3.01 (2008)

permitting a creditor to "pierce the corporate veil" and collect from the assets of the individual owners for what would otherwise be the responsibility solely of the corporation.

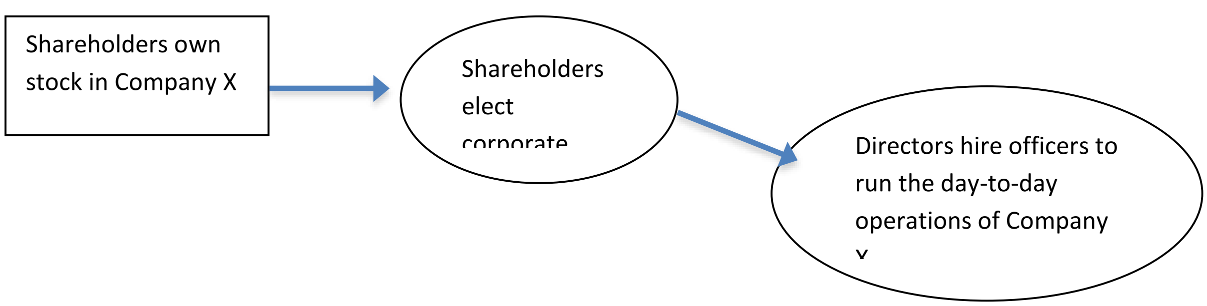
Corporate formalities are generally seen as:

1. Maintaining the corporate existence
2. Maintaining separate books and records for the company
3. Maintaining separate bank accounts
4. Titling assets of the business in the name of the business
5. Maintaining minutes of meetings of the shareholders and directors
6. Avoiding the commingling of personal assets and banking with corporate assets and banking

While each state and U.S. territory has its own particular rules about the formation, management, and operation of a corporation (as well as the ability to ignore its formation as mentioned above), the general rules and principles discussed here are applicable in all U.S. jurisdictions with each jurisdiction having its own flavor and peculiar rules. This should be borne in mind for all discussions of entity types and the legal implications each one carries. The tax issues discussed are also general in nature. The peculiar circumstances of a corporation, its location, how it operates, and what it does will govern the tax implications at the Federal, State and local levels of government.

Governance of a corporation is accomplished as follows:

a) Shareholders are the owners of the company and have the right to appoint the Board of Directors.
b) The director's duty is to appoint and oversee the conduct of the business by the corporate officers and report back to the shareholders.
c) The officers conduct the day to day operations and report periodically (usually at least quarterly) to the Board and take directions from the board as it relates to any decisions that are outside the ordinary course of business such as buying equipment, acquiring another business, or big-picture strategizing.



In closely held businesses, these different stakeholders owe fiduciary duties to one another. A closely held business is generally thought of as a privately owned (as opposed to publicly traded) company with a small number of shareholders. In closely held businesses, legal principles apply that do not necessarily apply in the case of publicly traded corporations and vice versa. For example, in many states, shareholders owe a fiduciary duty to the other shareholders. This is not the case in publicly traded companies. The Directors owe fiduciary duties to the shareholders and the officers owe fiduciary duties to the company and its shareholders.

A word on fiduciary duties is in order. Fiduciary duties are the highest duties of trust, loyalty, care, and confidence imposed by the law. These duties become breached when the person holding them acts in his or her own best interest at the expense of the business and or its owners. A court-determined breach of fiduciary duty is not dischargeable in bankruptcy and can result in damages, penalties, and disgorgement of profits related to the activity found to have breached the duty. Examples of breaches of fiduciary duties would be a director who fails to disclose a corporate opportunity and grabs it for himself; an officer who has a conflict of interest in a transaction with the business (perhaps a hidden profit's interest on the other side of the transaction); or a shareholder who oppresses and freezes out (terminates) another shareholder's employment in the business, just to name just a few examples. In fact, some states have laws stipulating that shareholders in a closely held company have an expectation they will be employed by the company for so long as they have an ownership interest and wish to work for the company.[6]

Given that these companies are generally owned and operated by a select group of a limited number of owners, it is wise to have agreements between the owners. Such agreements address various issues such as succession in the event of death or disability; transferability of ownership; rights to buy or sell in the event of termination of employment; dispute resolution; and valuation mechanisms in the event of a sale. In addition, such agreements generally address terms and circumstances of purchases of ownership interests (i.e., whether the purchases are required or rights of first refusal exist in the event of third-party offers). For more information on this topic, please see **Chapter 29: Succession Planning**.

The Federal income tax treatment of corporations depends upon whether the default "C corporation" status is chosen or a "Sub Chapter S" election is made. All corporations are designated C corporations automatically unless a taxpayer signs and files an election to be treated as an S corporation (form 2553) for Federal income tax purposes. Eligible shareholders must file form 2553 generally within 75 days of the creation of the entity or prior to the due date of the first corporate tax return. While we cannot be exhaustive in discussing every possible permutation of tax consequences as they relate to business entities governed by the Internal Revenue Code, it is worthwhile to discuss some of the more obvious issues that should be considered by owners and founders in selecting and operating their businesses.

C Corporations are treated as separate entities for tax purposes and are subject to what tax practitioners call "double taxation." This double taxation is possible due to the fact that any dividends paid to the owners of the company (the shareholders) are treated as taxable income to such owners, but the dividends are not

[6] Pedro vs. Pedro 489 N.W. 2d 798 (1992).

deductible as a business expense by the corporation. Furthermore, double taxation may occur upon liquidation if the C corporation has appreciated assets. The C corporation will be taxed on the appreciated assets, and the shareholders may be taxed upon the distribution of those assets if the distribution exceeds the shareholders' cost basis in the stock they own. The corporation, meanwhile, has a separate tax rate to apply to its income. As a result, double taxation occurs due to the taxes payable by both the company and its shareholders. More detail on tax ramifications of the tax issues associated with C corporations and S corporations is provided in **Appendix A**.

S Corporations are treated as flow-through entities for tax purposes, meaning all profits and losses flow through the entity to the business owners based on ownership percentages, and the entity is not taxed. An S corporation is not subject to double taxation the way a C corporation is; just as in the case of sole proprietorships (or of partnerships and limited liability companies, which follows), there is no federal tax at the company level except for built-in gains that may exist upon a conversion of a C corporation electing to change to an S corporation where such entity has retained earnings at the time of conversion.

To understand how this works, it is best to think of your checking account and how it fluctuates. When the owners of a business commence a corporation, they make capital contributions to the company or on its behalf to start the business. The capital contributed constitutes the owners' "basis" (for tax purposes) in the business. (In this case, "basis" is the invested cost of the shareholders' ownership interest in the company, which differs from its definition for financial reporting purposes.) Just as a deposit in a checking account causes the account balance to go up, in the case of an S corporation, the initial capital plus any subsequent contributions to capital from the shareholder cause the basis to increase. Profits to the company cause the basis to go up further because those same profits will be taxed to the shareholders regardless of distribution.

Losses, expenses, and distributions to shareholders all decrease the shareholders' basis. Losses may be deducted by the individual shareholders up to the amount of their basis in their stock (in other words, up to the point the basis is reduced to zero, losses are deductible at the individual level on the shareholders' individual tax return). Any negative basis is carried over until there is positive basis to which the loss can be applied. In some circumstances, a loss can be carried back by amending an earlier tax return or carried forward and used in subsequent years to offset future income. Profits and losses are allocated to the shareholders' personal tax returns (again, based upon the percentage of ownership). Distributions that do not exceed basis are not taxable to the shareholders, as those taxes have already been paid.

It should be noted that certain restrictions apply to S corporations in order to remain eligible for S corporation status. The more common of these are: non-resident aliens cannot have an ownership interest in the company; no more than 100 shareholders are permitted to own the company (U.S. citizens and resident aliens only); and only one class of stock can exist, although voting common and non-voting common of the same class are permitted.

Some of the more obvious differences and pros and cons of C corporations versus S corporations are:

- C corporations may have different classes of ownership and rights attendant thereto (such as preferred shareholder interests, preferences in liquidation, or convertible debt), while S corporations are permitted none of these attributes. Keep in mind that these attributes may be important if the company is raising capital from outside investors who desire a preferred return and a preference (over common shareholders) to obtain their funds back in the event of a liquidation of the company.

- C corporations have the ability to build up some capital at lower tax rates without being required to distribute this capital (up to a certain point; maximum allowances are determined by type of business). Such accumulated funds can be used to build the business of the company and the tax rates that apply to these funds can be less than those that apply to the highest paid individual taxpayers who face a tax bracket of 39.5%. S corporations have no such ability, as all income flows through to the individual owners and is taxed whether distributed or not.

- C corporations may be subject to unreasonable compensation arguments from the IRS, which causes some compensation to be treated as *dividends* (i.e., not deductible by the company and considered income to the shareholders) and imposes additional taxes, penalties, and interest at the corporate level. (Remember, corporations are not allowed to deduct dividends as an expense; by reconstituting compensation—a deductible expense—as dividends, the IRS turns a deduction into taxable profit.) However, dividends are taxed at the individual capital gains tax rates (20% if taxable income exceeds $450,000 [married filing joint] or 15%). Failure to pay the tax results in penalties and interest on the underpayment. None of this comes into play for an S corporation.

- As discussed below for limited liability companies, an exit event (sale of the assets of the corporation and its liquidation) often results in ordinary income as opposed to capital gains. The sale of stock representing the ownership of a corporation will be subject to capital gains if the stock has been owned for a year or longer. For C corporations that have been held for five or more years, the sale of stock ownership in such companies can completely avoid tax when qualifying for the section 1202 exclusion under current law.[7] S corporations and limited liability companies do not have this advantage.

- Fringe benefits (such as health insurance and medical reimbursement plans) can be used by C corporations but not by S corporations due to the flow-through nature of profits in S corporations. Shareholders holding more than 2% of an S corporation's stock are not able to participate in certain

[7] Current law is as of January 1, 2013.

plans that the owners of a C corporation may participate in, and they may not deduct certain expenses on their personal income tax returns. However, medical reimbursement plans for owners are fully deductible by a C corporation. (Note that such plans need to be nondiscriminatory between high- and low-paid workers if the company has employees other than its owners).

- With S corporations, there may be an opportunity to treat some of the moneys payable to an owner as a *distribution* instead of *compensation*, which avoids some of the new Medicare taxes imposed under recently enacted income tax laws. However, just as in the case of the IRS reconstituting some income as dividends for C corporations, there is the potential that the IRS could reconstitute S corporation dividends as salary and impose the additional Medicare taxes, along with interest and penalties for additional payroll taxes that would have been incurred had no "dividend" been determined and issued.

- Other provisions include section 179 depreciation, which is determined at the individual level for an S Corporation shareholder and at the entity level for a C corporation shareholder. Additionally, if a C corporation accumulates too much in earnings or has too much income, rental, interest, or dividends not related to the corporation's primary purpose, it might have to pay additional taxes. C corporations must also use accrual basis when gross receipts exceed $5,000,000, but this is not mandatory for S corporations; however, C corporations have more flexibility in choosing their accounting year-ends, while S corporations must file at calendar year-end.

For a more detailed analysis of the attributes of C corporations as compared to S corporations, please see **Appendix A**.

3) Limited Liability Companies: Limited liability companies ("LLCs") were first created by Nevada in the mid to late 1990's. Once the IRS settled the law on how they would be treated for tax purposes, their usage became widespread and commonplace. LLCs offer the advantages of limited liability protection (just as corporations do) while also offering partnership income tax treatment for tax purposes. Like S corporations, this partnership treatment means flow-through to the owners of the LLC, but LLCs offer far more flexibility than S corporations do. The rights, duties, and rules concerning LLC ownership and the operation of an LLC are statutorily based. Such statutes typically permit the owners and managers to override many of these statutes by agreement of the owners (such agreements are typically referred to as operating agreements and the owners are referred to as "members").

Statutes typically permit either member-managed LLCs or manager-managed LLCs; unless there are just a few members who own the LLC, management is often easier with a manager-managed LLC. Some states permit LLCs to offer series of ownership interests, which are basically subsidiaries that can be treated as separate independent entities for liability purposes but are not considered separate independent entities for tax purposes, so long as the formalities of the statutory regime governing the entity (the state where the entity is formed) are closely followed. Such requirements typically include separate record keeping, books, and accounts and segregation of assets and operations from the other subsidiaries (series). Depending on the state where the entity is formed, the type of filing to create the entity specifies a series type entity. Some states permit these to be created by the Operating Agreement without any special state filings. Although the managers of a given series do not need to be identical, the owners typically are, given the Internal Revenue Code as a practicable matter.

An example of a fine use of a series LLC is the scenario in which a real estate developer or holding company has many different buildings or parcels of real estate, each separately owned by separate series. In this example, the liabilities associated with one parcel will not bleed over to another, permitting the owner to manage and operate the properties as if they are held by separate entities without creating the necessary tax returns and complexities associated with actually separating the entities. The owners are identical for all series created, but separate bank accounts and record keeping is required for this to work.

The tax treatment for a single-member-owned (one-owner) LLC is that of a sole proprietorship, as the entity is generally “disregarded for tax purposes” when it has only one owner (unless the owner elects to file as a C or S corporation using form 8832). When two or more people own an LLC, it is treated as a partnership for tax purposes, although an LLC may conversely elect to be treated as a corporation for tax purposes. Just as S corporations are flow-through entities for tax purposes, so too are partnerships, meaning there is no federal tax at the entity level (with a limited exception for taxes at the state level in selected states). Rather, profits and losses flow through to the owners, typically based upon ownership percentages.

One of the advantages of an LLC over an S corporation is the flexibility of allocating profits and losses to the members. In an S corporation, no such flexibility exists, as profits and losses must be based strictly upon percentages of ownership of the shareholders. In contrast, LLCs may allocate profits and losses differently with certain caveats, the most important of which is that there must be an economic rationale for allocating profits and losses differently than ownership percentages *other than* simply avoiding taxes. For example, where one owner is investing capital and another is investing sweat equity, there may be a perfectly sound economic rationale for allocating profits and losses to the party contributing capital in more robust amounts until capital invested is recovered. In addition, non-resident aliens may own an interest in an LLC, unlike S corporations where this is not permitted.

Ultimately, the flexibility of LLCs makes them attractive choices for businesses. These vehicles are easier to unwind and are likely to reduce the taxes due and owing when the business is wound down, liquidated, or sold or its assets are sold. This is because such events usually result in capital gains rather than the ordinary income that results from selling a corporation’s assets and liquidating the business. Capital gains results when a corporation’s shares—ownership of the corporation as distinguished from the assets of the company—are sold and the shares have been held for at least one year, entitling them to long-term capital gains tax treatment.

Partnership tax treatment attempts to treat each of the partners (members in an LLC) as if they were the single owner of their share of the assets and liabilities of the partnership or LLC for tax purposes. The allocations of basis, profits, and losses, and the effects of a given transaction (i.e., selling a piece of equipment or real estate without liquidating the company), can be quite complex depending on the circumstances and whether all owners have contributed capital equally to the entity. Such discussions are outside the scope of this work, but the reader should understand from the 30,000 foot level that LLCs are treated as a partnership for tax purposes, and as flow-through entities for tax purposes, they are often more advantageous to wind down (especially when real estate is involved) and more flexible in how profits and losses may be allocated to owners. An additional advantage of LLCs is that management's fiduciary duties can be less stringent than those of closely held corporations.

4) General Partnerships: General partnerships are defined as two or more parties carrying on an activity with one another with the intent to earn and/or produce a profit for the participants. A filing with a state governmental agency is not necessarily required to create and form a general partnership. This being said, statutes apply to the creation and operation of general partnerships, and there are often specific procedures to follow in order to use the name under which the partnership operates. Tax filings are required, and for Federal income taxes, a partnership must file a form 1065 that, along with the accompanying K-1 forms, shows profits and losses flowing through to the partners. As mentioned in the section on LLCs above, the tax consequences related to partnership treatment also apply to general partnerships. What does not apply, however, is the concept of limited liability. State revenue laws also apply to general partnerships. In Illinois, for example, there is a "pick up tax" that adds a 1.5% tax at the partnership level, in contrast with the Federal regimen in which all profits and losses flow through to the partners and the partnership is taxed at the individual (partner) level only.

General partners are jointly and severally liable for all debts, obligations, and liabilities associated with the conduct of the partnership. This means that any one partner can be held liable for all partnership liabilities alone or with any combination of other partners. As such, general partnerships tend to not be very palatable unless the partners themselves have limited liability protection associated with their individual existence. As a result, it is more common to see joint ventures between two corporations or LLCs. (A joint venture is a general partnership designed to carry out a specific project on which two parties wish to join forces.)

5) Limited Liability Partnerships: Limited liability partnerships ("LLPs") were born out of statute and far more attractive for real estate matters and oil and gas transactions prior to the advent of the LLC. Since the advent of the LLC, fewer limited liability partnerships exist, except in the investment arena. LLPs are treated like partnerships for tax purposes, however the difference between a general partnership and an LLP is that an LLP has limited partners who cannot participate in the management of the company. As such, their liability is limited by statute to their investment in the company. Every LLP must have at least one general partner who is fully liable to the extent of its assets to the liabilities of the LLP. Typically, a general partner in an LLP is either an LLC or a corporation with only a small percentage of ownership in the entity (1%). Under the LLP agreement, the general partner has all say in operating the business.

All the rules governing taxation of partnerships apply to LLPs, however there are additional restrictions on the amount of losses the limited partners can deduct due to the passive nature of their activities (and the passive loss rules that were instituted in the 1986 Tax Act). Typically, passive losses must be matched to passive revenues of like kind (i.e., short term capital losses to short term capital gains, long term capital losses to long term capital gains revenue) and caps apply to losses that have no matching revenue. Deductions for mortgage interest are also limited due to the passive nature of the investor's ownership interest. In contrast, a general partner who has general liability on the mortgage indebtedness may deduct such interest to the extent of basis since it represents "at-risk capital" that the partner has invested in the partnership.

6) Trusts: In general, trusts are not optimal entities for holding assets unless an irrevocable trust is being utilized to shelter a beneficiary's assets for the beneficiary's creditors, or some other more specialized use is required (as would be the case for IRAs and qualified retirement plan). Trusts are also utilized in some investment scenarios under applicable Federal securities laws. For example, Real Estate Investment Trusts (REITs) are a type of real estate holding entity in trust with particular tax requirements, such as the duty to distribute at least 90% of all income annually. Every profit sharing or qualified plan uses a trust to hold plan assets and administer them. If you as the owner of a business have a qualified plan for your business, chances are you are the trustee of the trust governing the plan and you owe fiduciary duties to your employees, who are participating in the plan. For more on this subject, see **Chapter 30: Retirement Planning**.

In the early 1900's, trusts were utilized to avoid taxes that were applicable to succession planning and income tax planning. The Standard Oil Trust-busting cases were initiated due to the Rockefellers' use of several trusts to gain a monopoly in the oil industry and pass assets down through generations without any tax implication (there was no estate tax at the time). These advantages were eliminated long ago with the trust-busting cases.

As discussed above, a trust is not the preferred format for conducting a business; relatively high income tax rates and a lack of liability protection in the case of revocable self-settled trusts make trusts unattractive as the main vehicle for owning and operating a business directly.

7) Cooperatives and Not for Profits: Cooperatives are used most often in the United States by farmers, but there are other potential strategies for their use. Some of the uses that we have seen include:

- Farmers' cooperatives for selling crops

- Advertising cooperatives that take a group of franchisees, funnel a percentage of sales to a not-for-profit, and utilize these revenues to purchase advertising for the benefit of all franchisees
- Retail grocery store co-ops, where savings is passed on to the members who shop at the cooperative
- Charitable 501(c)3 foundations
- Insurance-related cooperatives that pool risks and profits from insuring them.

Depending on the type of entity utilized to form and run the cooperative, a co-op may be subject to taxation as a partnership, a for-profit corporation, or a not-for-profit corporation or foundation.

In **Appendix A**, we have added a list of the various tax issues that apply to each of the key entities mentioned above for further reference and comparison.

Appendix B contains a checklist for new businesses that can assist owners in addressing all of the issues a new company needs to be aware of and document.

Tip: use this checklist to create a ***recurring calendar for your business****. For example, insert the month before annual reports are due for preparation and filing. Insert a date for due dates of tax returns and filings. If there is bank financing and financials must periodically be provided to the lender, then add these dates to your quarterly end dates. Insert a date for employee reviews and awarding raises, and so on. This will give you a snapshot of what you have on tap each month, remind you of all necessary tasks, and assist you in organizing your to-do list to ensure success.*

Additional Information and Resources

- For more information on **incorporating**, visit the Secretary of State's website for the state in which you will form your company.
- For reviewing **state-specific laws**, Google your state and "corporate law" or "code for the statutory authority for the entity."
- For **tax issues**, visit www.IRS.gov (for Federal taxes) and State Departments of Revenue websites (for state taxes); both provide a wealth of information and registration forms.
- For **labor issues**, the Department of Labor's website (www.dol.gov) and a search at the state level will provide basic labor law information.
- For **laws governing pricing and anti-competitive activities that are prohibited**, visit the Federal Trade Commission's website (www.ftc.gov).

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The Editor.

Appendix A

Comparison of Form of Entity For Tax Purposes

Issue Description	**C Corp**	**S Corp**	**Ltd. Liab. Company**	**Ltd. Liab Partnership**	**Ltd. Partnership**	**Genl Partnership**
			(assumes more than one owner for all of these)			
Domestic ownership Required	No	Yes* *includes resident aliens	No	No	No	No
Limit on # of Owners	No	100	Same as Genl Partnership	Same as Genl Partnership	Same as Genl Partnership	At least 2 no publicly traded e Traded entity
Sale of Interest in Co	Capital gains	Capital gains	Capital gains (unless appreciated property or a/r)	Same as LLC	Same as LLC	Same as LLC
Limits on what entity can on	None	No more than 80% of another corp	None	None	None	None
Limit on Capital	None	Only 1 class	None	None	None	None

		you can have voting and non-voting				
How election is made	automatic default	File Form 2553 within 75 days of formation	automatic	automatic	automatic	automatic
Formation Transfers (Contribution of capital)	Tax free with basis carryover to stock	Same as C Corp.	Tax free with basis carryover to member interests	Same as LLC	Same as Genl Partn	Tax free with basis carryover to partnership interest
Conditions to Contribution Treatment	must be property solely in ex-change for stock & transferors control co following transfer	Same as C Corp.	excludes services but only affects service provider	Same as LLC	Same as LLC	Same as LLC
Treatment of Org. Costs	Amortized over 60 months following commencement of business	Same as C Corp.	Same as C Corp. (but not syndication expense)	Same as LLC	Same as LLC	Same as LLC
Effect of Transfer of Debt to Organization	Reduces Basis results in gain where it exceeds assets and value of stock -0- All income if trying to	Same as C Corp.	Reduces basis (taxable to exten basis is exceeded) but included in co. basis	Same as LLC	Same as LLC	Same as LLC

	avoid tax					
Transfer of ownership interest in return for services	Transferee receives ord. income if no Sec 83 election made sale of interest is ord. income	Same as C Corp.	Not if just an income interest otherwise same	Same as LLC	Same as LLC	Same as LLC
Allocation of Profits	Prorata based on number of shares unless different classes with different rights or preferred returns	Prorata based on number of shares only	Depends on statute and op agreement more flexible	same as genl partnership	prorata unless modified by agreement	percapita unless modified by agreement

Appendix B

Check List For New Businesses

Document or Action	Who is Responsible	Date Completed	Anniversary Date
Entity formed with State of origin			
Federal Taxpayer ID applied for (Form SS-4)			
State ID numbers applied for for resale sales tax if applicable			
For Corporations:			
By-laws,			
Minutes of Shareholders			
Minutes of Directors			
Stock Certificates			
Shareholder agreement			
For limited liability companies:			
Operating Agreement			
Registering in Foreign Jurisdictions where company operates			
Tax filing and registration for each foreign jurisdiction			
Local Licensing City and County			
Separate Bank Accounts formed			
Payroll Tax accounts and Returns			
Employment Manual			
Employment Agreements			
Customer Agreements			
Vendor Agreements			
Confidentiality and Non-Disclosure Agreements			
Workmen's Compensation Insurance			
Comprehensive and General Liability Insurance			
Property Damage and Personal Injury			
Employer Liability			
Auto Company owned and non-owned			
Maritime and Inland Marine (for products in transit)			
Fidelity and Employee Crime			
Director's and Officers			
Product Liability			
Health insurance			
Leases for equipment			
Lease for space			
Qualified Retirement Plan			
Qualified Plan Summary Description			

Company Calendar for Key dates and action items
Annual filing of franchise taxes and returns
Annual Corporate minutes
Special Mins approving items outside the ordinary scope of business
Domain name renewal date
Assumed Name renewal dates where applicable
Tax Return Deadlines State and Federal
Employment Tax Return Due dates and forms

Chapter 7 | Financing Your Business

M. Colleen Ryan and Mark Richards

When starting a business, many entrepreneurs think of the bank as the first place they should turn to for financing. In reality, it is nearly impossible to obtain a conventional business loan for a start-up or young business. With so many variables that contribute to the success of a business, management experience and capability is often the primary driver for success. Most banks are unwilling to lend to a business without a proven management track record of success.

Sometimes entrepreneurs will purchase a franchise or an existing business and then approach a bank believing that this action has resolved the stumbling block of being a pure startup. With the history of the previous owners or the experience of the franchise system behind them, it is assumed that this will overcome the objection that bankers have to the lack of a track record or experience. For bankers, this is not the case. The banking world is littered with the remnants of failed individual franchises despite a strong franchisor. Banks routinely see businesses that had been around for years but did not survive under new management. **Conventional bank financing is not a realistic possibility until a business has at least two or three years of profitable track record under the same management**. An exception to this is a bank loan that is guaranteed by the U.S. Small Business Administration (SBA). (More on this topic later in the chapter.)

Prior to the point where a business is qualified for a bank loan, financing usually comes from non-bank sources including personal savings, family, friends, and other investors. This investment in the business, known as equity or net worth on the Balance Sheet, is an important signal to a bank that the owners, as well as those who know the owners personally, have enough confidence in the business and its plan to put their own money at risk. Without this, a bank would be concerned that the owners don't believe enough in their own success to want to risk their own capital. If that is the case, how can an entrepreneur ask a bank to put its shareholders at risk lending someone else's money to a business owner with little or nothing at stake?

Business owners might consider other initial investors known as **angel investors** or **venture capitalists**. The term "angel investor" comes from the theatre community where several individuals step in to underwrite the costs of a play or other theatrical productions. An angel investor is often an affluent individual or a group of individuals who provide capital for a startup, usually in exchange for an ownership stake in the company. Angel investors are often said to be "investing with their hearts" and are usually organized for a specific investment profile that often raises capital and does some good in the world (i.e., investment in green technology or disadvantaged communities). The best way to find angel investors is through referrals from other business owners, attorneys, accountants, wealth management advisors, and bankers; you might also find them through online searches, community groups, or economic development organizations. Unless the business meets the profile of the angel's investment criteria, however, it is unlikely that it will receive an investment.

Venture capital is a more intense version of angel investment. The wealthy backers of these funds are typically looking for companies with the potential for above average returns, usually in high tech or other rapidly growing industries. Venture capitalists (VC) are looking for dynamic young companies that have a steep upside and can present them with greater return on investment as the business grows. VCs usually become more involved in the day-to-day aspects of the business than an entrepreneur would like and usually require a hefty ownership stake, often a majority interest, in the business. Rather than focusing on long-term viability, VCs usually favor maximizing ROI through a public offering or outright sale of the business in a shorter timeframe than an owner might have planned.

In the cases of angel and venture capital investment, the entrepreneur would most likely lose his or her majority ownership of the company. If that prospect is not appealing, then a business needs to have a plan that includes growth financed through a combination of retention of profits and bank financing. This process begins from the time a business makes its first deposit at a bank.

Choosing a Bank

The time to choose a bank for a business is not at the moment when money is needed; thought should be given to the type of financial services a business will need long before a loan is required. Usually the first contact a business will have with the bank is to establish a depository relationship. The business owner should think about his or her company's future growth and choose a bank that can support this growth with the products and services it will need beyond a basic depository account.

A business owner should consider starting with community banks in his or her local area, particularly if local access to a banker who is active in the community is valued. The Community Reinvestment Act (CRA) was put in place in part to encourage banks to make loans back to the same areas from which they take deposits. Banks determine their primary lending area after analyzing their customer base, noting the addresses where depositing customers reside or have their business, which is usually identified by census tract. Most financial institutions delineate their primary lending area and have a map of this area available to the public. If a business in within a bank's CRA area, the bank has additional incentive to make business loans within that area in order to comply with banking regulations. Banks are not required to make riskier loans or make loans that are outside their written loan policy; however, many community banks actively seek small business loans within their delineated area and may find ways to work with a business customer at a service level not found at larger national or regional banks.

There are many questions to consider when choosing a bank. Does the business need a specialty lender, or is it better served by a financial institution that offers a broad number of services, such as credit card processing, cash management, trust services, etc.? Is the financial institution of sufficient size and strength to grow as the business grows? Will the company be importing or exporting products? A larger regional or national bank may have a wider selection of service offerings based on its size and scope of operations, including departments specializing in international business. Something to consider, however, is that large banks might not provide a local commercial loan specialist to work with the business and may have someone in a remote location managing the account. If a local contact is valued in order to develop a relationship, the larger banks may not be able to provide that kind of service.

Personal compatibility and customer service are intangible aspects of each bank that shouldn't be overlooked. A good personal connection with a banker will contribute to a successful working relationship, especially if difficult situations arise in the future. Part of the search for a bank should include reaching out to others in the business community and asking about their experiences with banks that are being considered. These personal experiences will be more valuable and informative than a marketing pitch on a bank's web site.

Once a bank has been selected, a business owner will want to cultivate a relationship with the people who handle the depository relationship. Getting to know the personal bankers and their managers in the branch should be a priority. Handling the depository relationship in an exemplary manner is important. For example, an overdraft of an account is viewed by the bank as a loan made to a business without actually getting it approved. Use of overdraft protection products, while a profitable business for a bank, suggests some level of mismanagement or inattention to finances. When the time comes for borrowing money, as part of its due diligence process, a bank will check to see how the business and its owners managed their depository relationships. A history of overdrafts will be viewed negatively and could impact the loan decision.

Borrowing Money

Once a good depository relationship has been established, the stage has been set for an initial introduction to a loan officer. At this point, the time spent establishing a relationship with the people in the bank branch can be useful to determine the best way to apply for a commercial loan. Depending on the amount of the loan that is sought and the size of the bank, loan requests may be handled by employees at the branch level. In many banks, an application is completed and electronically transmitted to a central underwriting area where a decision is made either by a credit scoring computer system or by people using a combination of computer decision-making and human underwriting. In this process, if the loan is declined, there is rarely an opportunity for a reconsideration unless the loan request has changed substantially.

Some banks will require that the business submit a loan request through someone who is specifically trained to handle commercial loans. The branch bankers should know their commercial lending staff and should be asked to make an introduction on behalf of the business. The branch employees will know if there is a particular group for small business, SBA loans, or loan officers with specialized expertise such as working with contractors or other market segments. Once a time has been arranged to meet with a commercial banker, being properly prepared is critical to the successful outcome of the request.

Preparing a Financing Request

The key to start the engine of any new business is the business plan – a detailed, well thought-out account of all the vital aspects of the prospective business. (For a more expansive discussion of this topic, see **Chapter 2: Leadership and Management** and **Chapter 4: Business Planning and Analysis)**. Not only does the plan provide a roadmap for the business owner and managers, but it is also a crucial tool for any lender evaluating a loan request. Though the business plan is initially constructed by and for the owner, thought needs to be given to what data will be required by the lending institution.

The plan should begin with a one-page summary that should outline the specific information a bank needs to make a loan. It should be a summary only, with enough information to entice an interest in reading further. It should include:

- Name, address, and brief description of what the business does
- Ownership structure (corporation, LLC, sole proprietor)
- Specific amount of money that is requested
- Detailed use of the loan proceeds (equipment, working capital, etc.)
- Repayment terms (short term line of credit or longer term loan for specific financing)
- Name and addresses of the guarantors of the loan
- Collateral for the loan

The specific financial information that is required depends on many factors, such as whether the business is a start-up or existing. The following includes a broad list of items that may be required, encompassing many lending scenarios. It is important to note that the financial document requirements for a conventional business loan and a SBA loan are the same.

- 3 years of historical business financial statements (Income Statements and Balance Sheets)
- An interim Income Statement and Balance Sheet if the year-end statements are more than 90 days old
- 3 years of business tax returns
- 2 years of projected financial statements, the first year on a monthly cash flow basis and the second year on a quarterly basis
- Personal Financial Statement (PFS) for all guarantors of the debt
- 3 years of personal tax returns of all guarantors

Copies of other documents will most likely be required at some point in the loan process. They include:

- Resumes of all owners and any key non-owner managers
- Corporate or other legal organization documents
- Licenses

- Leases
- Franchise agreements
- Business purchase contracts
- Schedules of inventory, equipment, machinery, furniture, and fixtures
- Accounts receivable and payable agings

The PFS helps the entrepreneur organize his personal financial information in a standard way that is recognized by all financial institutions so that one can easily calculate someone's financial position, both for income and expenses (Income Statement) and assets and liabilities (Balance Sheet). Accurately completing the PFS is the first step to preparing the financial statements. A PFS tells the story of how well owners (and anyone guaranteeing a loan) manage their money.

Lenders use standardized financial statement forms in order to level the playing field for all loan applicants. Even if an applicant has his or her own version of a PFS, the lender will most likely provide a PFS template and a Business Loan Application to complete. The bank will insist on eventually having one of its PFS forms signed by the borrower and filed for future reference, as bank forms include mandatory disclosures required by federal statute.

How does a bank analyze a loan request?

Banks loan money fully expecting to have it paid back with interest. They will read the business plan and analyze the financial statements to be sure that there will be a reasonable assurance of the ability to repay the loan, not just for the first year but for the life of the loan. Everything the bank discovers about the owner and the business can be categorized into what is known as the five C's of lending.

The Five C's of Lending: Character, Capacity, Capital, Conditions, and Collateral

Character: One must be trustworthy and display integrity in all personal and business dealings in order to gain the confidence of the lender. That said, character can be somewhat subjective and therefore difficult to gauge. A lender looks for clues in interactions with the applicant that align with characteristics of successful business people; degree of attention to detail in the application, sincerity of responses to questions, and willingness to admit any shortcomings can all signal character in an applicant. Lenders will conduct searches to determine if credit was handled responsibly in the past. They will check Dun and Bradstreet (D&B), the three main credit reporting companies, public records (court documents, Secretary of State to see if assets have been pledged, county real estate records, etc.) They may submit tax returns to the IRS for verification of authenticity.

Capacity: This is where the lender analyzes the financial information to determine if the business has the ability to pay back the loan. Sales create revenue to cover expenses and create net income for the business. Lenders will be looking at where the cash will come from to service the debt and to make loan payments. Will the business generate enough cash to cover expenses, including paying a salary to the owners, and the loan payment, while also having enough profit to retain in the business for extraordinary or unforeseen events? Does the applicant have the requisite experience, product or service knowledge, and a good overall grasp of the business involved? How will the applicant handle obstacles presented by the market and the general business environment? The lender will conduct a cash flow needs analysis to determine how much money is needed and what kind of debt (short term versus long term) is required. An accounting for every dollar of the loan amount will be required to ensure the amount is in line with needs. For example, if the money is to be used to purchase a building, the request should take into consideration more than just the purchase price of the asset; consider permits, closing costs, legal fees, insurance, etc. in order to compute a more accurate project cost.

Capital: In order to be sure the borrower is committed to the success of the business and the loan agreement, banks expect applicants to have sufficient cash investment in the business. This equity provides a cushion to weather any downturns in the business cycle.

Conditions: A review of conditions requires a comprehensive analysis of the business environment at the local, regional, and national levels. Does the economic and political climate currently support business development? One can start generally by looking at principle business indicators. What are economists predicting for the short and long run? What obstacles have recent start-up or expanding businesses had to face to be successful (i.e., education and skill level of the workforce; employment participation rate; property, sales, and income tax rates; new business start-up and failure rates, and bankruptcies)? Is the business outlook positive, with company revenues and incomes growing, or is the outlook less favorable? Most of this information is available from government agencies such as the Small Business Administration, municipalities, and Chambers of Commerce. It is then necessary to drill down into the specific type of business, workforce, market, suppliers and customer base in which the company will be operating. Some of the areas to consider are:

- Are there sources of potential employees with skills needed for jobs in the company?
- Has a location been secured? If so, what are its advantages and drawbacks?
- If located in a strip mall or shopping center, how successful are the other tenants?
- If dependent upon foot traffic, what kind of traffic can the company expect to draw?
- Will the workers be members of labor unions? If so, what collective bargaining will be required?
- How successful have other companies in this industry been in this local area?
- What competitive advantages will this company have over its competitors?
- Are suppliers readily available? What kinds of terms do they offer to new purchasers?
- What transportation issues will the company face in the movement of raw materials or finished goods?
- What are potential customers seeking that is not currently available in the market?

Collateral: Should the borrower not be able to repay the loan as agreed, collateral in the form of assets owned by the borrower must be pledged to satisfy the outstanding loan balance at the time of default. Loans generally must be fully collateralized. Lenders typically value the collateral assets at an amount less than the owners think they are worth, called liquidation value, to insure that if a default occurs, the bank will have some protection from loss. The collateral has a higher value to an owner when the business is a going concern and profitable. That value erodes when loan collateral is liquidated at an auction sale.

Because of the gap between what a business owner thinks collateral is worth and the level at which a bank values it, banks will hire third-party appraisers to value the collateral. Most banks have an approved list of appraisers and will order the appraisal directly to ensure that the valuation will be independent. It is not likely that a bank will accept an appraisal that the bank did not order. The cost of the report that the bank orders is usually passed on to the customer.

It often seems to borrowers that banks consider “collateral” to be the most important of the “five C’s of credit” since it is the first thing banks seem to want to talk about. Most bankers would agree that the list presented in this chapter is in decreasing order of importance with “character” as the most important, followed by “capacity” or cash flow. Collateral is the least important. So why is collateral the first thing bankers want to know about? Commercial loans require collateral, and a business either has it or does not have it. All of the other “C’s” in the “five C’s” can take significant time and resources, resulting in costs to the bank that may not be reimbursed if a loan is declined. If a bank knows up front that there is not enough collateral for the loan, then it will not be necessary to go through the time and expense of the rest of the underwriting process. It can move on to other prospects that better qualify for financing.

What happens after a loan decision is made?
If the loan is approved, the loan officer may issue a loan commitment or a less binding term sheet with an offer to lend. The commitment or term sheet will have a very short window of time for acceptance by the borrower. After all the time the bank invested in analyzing and approving the request, it does not want a potential borrower taking the offer and shopping it around to other banks. It is because of this practice of shopping loans that banks sometimes require non-refundable application fees up front to cover the costs of underwriting.

The loan officer and/or assistant will usually provide a checklist of items needed to close the loan. The faster these items are assembled, the faster the loan can close. Closing may be delayed by things the bank can’t control, such as the time it takes to procure some items on the list (i.e., real estate appraisals and environmental impact assessments). If a great deal of time has elapsed since the original financial statements were submitted, the bank may require updated financial statements.

If the loan is declined, it may be because the bank has no expertise in Small Business Administration (SBA) loans and didn’t consider applying for a loan guarantee from the agency. A smart business owner makes expertise in SBA loans one of its criteria when searching for a bank.

Financing and the Small Business Administration (SBA)
Since 1953**,** the federal government, through the SBA, an independent agency, has administered several programs to assist in the development of small businesses, including the popular loan guaranty programs designed to encourage lenders to provide loans to small businesses that might not otherwise obtain financing on reasonable terms and conditions. The guarantee reduces some of the risk to banks and helps them make loans to businesses that they may otherwise consider too risky.

Conventional bank financing is usually not available for young and growing businesses because they lack sufficient collateral. Loans are considered fully secured if the lender has taken security interests in all available assets with a combined liquidation value up to the loan amount. For many businesses, the involvement of the SBA is the only way capital can be obtained as the SBA has less restrictive collateral requirements. The SBA requires lenders to collateralize the loan to the maximum extent possible up to the loan amount. If business assets do not fully secure the loan, the lender may be required to take available personal assets of the principals as collateral. Loans are typically not declined by the SBA solely for a lack of collateral if all available collateral is pledged.

Often the program is accessed to provide longer term financing for businesses than banks typically offer, resulting in improved cash flow for the business. The loan term depends on what the funds will be used for – up to 10 years for working capital, inventory and equipment, and up to 25 years for real estate. As an example, banks usually will not finance equipment for more than three to five years. The SBA will permit some equipment loans to be financed for up to 10 years, which reduces the monthly payment and can significantly improve cash flow.

The program is not designed to be used for marginal businesses that are failing or are inherently bad credit risks. On the other hand, the SBA does not want to compete with banks by providing guarantees on loans to businesses that are successful and credit-worthy. The proper use of the SBA programs is for transitional financing for businesses that will eventually outgrow the need for government assistance.

The SBA's **7(a) loan guaranty program** is the agency's most popular loan program due to its flexible terms and the wide array of purposes for which the funds can be used, including the purchase of existing businesses, acquisition, renovation and expansion of owner occupied real estate, equipment, leasehold improvements, inventory, working capital, refinancing existing debt, and start-ups. Funds cannot be used for speculative, rental, or investment real estate; partial business acquisitions; non-profits; religious organizations; or businesses primarily engaged in financing.

The 7(a) program is named after Section 7(a) of the Small Business Act of 1953, which authorized the SBA to provide business loans and loan guaranties to American small businesses. Often, the SBA will develop subprograms that offer streamlined and expedited loan procedures for particular groups of borrowers. This includes SBA Express for smaller loans and programs that address the particular needs of groups like veterans. Although these subprograms have their own distinguishing eligibility requirements, terms, and benefits, they operate under the 7(a) program's authorization and follow the same application, approval, and servicing process.

Borrowers often believe that the SBA provides loans directly to businesses, however this is no longer the case (several years ago, the SBA was a direct lender). The SBA offers loan *guarantees* to banks and other lenders to encourage them to make loans that they might not otherwise make. The SBA guaranty assures the lender that if the borrower does not repay the loan and the lender has properly managed and serviced the loan according to the regulations outlined in its Standard Operating Procedures (SOP) manuals, the SBA will reimburse the lender for its loss, up to the percentage of the SBA's guaranty.

There is a misconception that only very small businesses can qualify for SBA loans. This is not true. The federal government has different size standards for different types of businesses, depending on whether they are retailers, manufacturers, wholesalers, or service businesses. For example, the size standard for manufacturers relates to the number of full time or equivalent employees. For retailers, it is based on the company's tangible net worth and average net income after taxes. (The size standards for most businesses can be found on the SBA website, www.sba.gov.) Businesses are organized by industry and are given a six-digit business classification code (NAICS – North American Industry Classification System). A size standard is published for each NAICS code.

The guarantees are typically 75% of the loan amount but can reach as high as 90% when the SBA wants to encourage banks to make more of a certain kind of loan, such as smaller-dollar loans. The guarantee percentage has no impact on the loan structure (i.e., rate or term), nor does it impact the borrower's obligation to repay the loan. The business borrowing the money and any guarantors of the loan remain obligated for the full loan balance for the life of the loan. In the case of a loan default and the SBA's payment of the loan guarantee to the bank, the borrower and any guarantors may still be obligated to repay any amount still owing to the bank and the SBA. The SBA will turn the remaining loan balance over to the US Treasury for collection if further collection is not barred by a valid legal defense such as compromise, discharge in bankruptcy, or the statute of limitations. Recovery of the delinquent balance can be obtained through offsets to tax refunds and other collection efforts.

Any bank can submit a loan request to the SBA on behalf of a borrower as long as the bank has a current participation agreement with the SBA. If the lender determines that it requires an SBA guarantee in order to make the loan, it submits an application electronically to the SBA. The application contains forms specific to the SBA plus the business financials and the bank's credit approval memo. The time it takes the SBA to approve a loan is dependent on many factors such as the completeness of the loan package, the complexity of the deal, the quality of the lender's analysis, the accuracy of the information on the forms, etc. A poorly prepared loan application is most likely to experience significant delay or outright denial by the SBA. It is very important that the lender have experience in doing SBA loans and remain current with training and updates to the SBA loan procedure manuals.

There are higher-level certifications for lenders that can benefit borrowers. In order to provide more expedited loan application processing, the SBA established the Certified Lenders Program (CLP) 7(a) for lenders who have a successful SBA lending track record and a thorough understanding of SBA policies and procedures. CLP loans get an expedited processing time at the SBA, typically three days for a complete application. Sometimes, however, even complete applications take longer than three days if the SBA is experiencing backlogs due to government shutdowns or high application volumes, or if it wants clarification on items submitted with the application.

After a period of time during which a bank has demonstrated competency as a SBA lender, the institution may apply to be accepted into the Preferred Lenders Program (PLP). This program streamlines procedures by delegating the final credit decision and most servicing and liquidation authority and responsibility to the lender. PLP lenders must complete and retain in their files all forms and exhibits required for the standard 7(a) application. Many banks choose to use their PLP authority for some loans and submit other loans through regular SBA processing, especially if the loans are complex or there is a question on eligibility. PLP banks are at risk of having their loan guarantees revoked or denied if they are found to have improperly interpreted SBA regulations or inadequately serviced a loan.

Currently, the maximum loan amount is $5 million. Although the SBA does not set a minimum dollar size, many banks will not do SBA loans under a certain size. Some banks set a minimum of $100,000. Others may decide to only use the SBA for commercial real estate deals. The SBA regional offices publish quarterly reports on the SBA loan volume by dollars and by number of loans, broken down by state and by bank. By examining the list, it can be determined which banks do a significant volume in SBA business. By dividing the quarterly loan dollar volume for each bank by the number of loans funded, a rough average deal size can be calculated, shedding some light on the size of deals that particular banks seek.

Rates and Fees for SBA Loans

Many borrowers are surprised to learn that SBA interest rates are not deeply discounted, but are instead market rates. Interest rates are negotiated between the applicant and the lender and are subject to SBA maximums. The rate is composed of two parts: a base rate and an allowable spread. The **base rate** is the published Prime rate and the **spread** depends on the term. Rates for a loan with maturity of less than seven years would be up to a maximum of the Prime rate +2.25%. For loans that mature in seven years or more, the rate would be up to a maximum of prime +2.75%. Rates may be fixed or float with adjustments made monthly, quarterly, or annually. Banks prefer floating rate loans to avoid the interest rate risk of holding fixed rate loans in a rising interest rate environment. Also, a secondary market exists for the sale of pooled SBA loan guarantees. Loans that are priced with a floating rate are more desirable to investors who buy the pooled guarantees and sell at a higher price when sold. Only the guaranteed portion of the loan is sold. The bank retains the rest of the loan and services the entire loan until it is paid in full.

SBA loans are usually more expensive than normal loans and can include sizable fees. A guarantee fee must be paid by the lender to the SBA, which is usually passed on to the borrower, although it can be financed with the proceeds of the loan. The guarantee fee is computed based on the dollar amount of the guaranteed portion, *not* the total loan amount. The guarantee percentage of loans has traditionally ranged from 75% to 90% loan amount and the guarantee fee ranges from 2% to 3.5% of the guaranteed portion. For example, a $500,000 loan would be 75% guaranteed, resulting in a guaranteed portion of $375,000. The guarantee fee would be 3% of $375,000, or $11,250.

The lender may charge an applicant a fee for putting the loan package together (called "packaging" the loan) or for extraordinary servicing such as site audits for construction projects. The lender must advise the applicant in writing the amount of the fees which are subject to SBA review. The lender must refund any fee considered unreasonable by the SBA. The lender may also collect from the applicant necessary out-of-pocket expenses, including filing or recording fees, collateral appraisals, environmental impact reports, and other direct charges related to loan closing.

The lender is also allowed to charge the borrower a late payment fee not to exceed 5% of the regular loan payment when the borrower is more than 10 days delinquent on a regularly scheduled payment. The lender may not charge a fee for full or partial prepayment of a loan except for loans with a maturity of 15 years or longer. In that case, the borrower must pay a prepayment fee to the SBA when the borrower voluntarily prepays 25% or more of its loan in any one year during the first three years after first disbursement of loan proceeds. The fee structure is 5% of the prepayment amount during the first year, 3% the second year, and 1% in the third year.

The SBA's **504 Loan Program** is a long-term, fixed-rate financing tool used for acquisition and renovation or construction of owner-occupied real estate and equipment. The program targets areas where business growth will have a major impact on spurring economic growth. There are three components to a 504 project: owner equity of at least 10%, a conventional bank loan of up to 50% of the project, and the SBA participation of 40% financed by the issuance of a debenture. The SBA portion is handled by a Certified Development Company (CDC), of which there are over 250 in the United States, each covering a specific territory. The CDC is a non-profit corporation certified by the SBA to work with lenders to provide financing for qualified businesses.
Like the 7(a) program, applicants must meet SBA size guidelines and other eligibility considerations. The project must be owner occupied, defined as 51% or more of rentable space for existing buildings and 60% for new construction. The maximum loan amount is $5.5M with a maximum term for real estate of 20 years (10

years for equipment). The rate for the bank loan is negotiated with the lender, and the SBA portion of the project is set by the SBA and fixed for 10 or 20 years for equipment and real estate financing respectively. The current SBA interest rate can be found on the web sites of most CDCs.

The main difference between the 7(a) and 504 programs is that the 7(a) is fully funded by the bank and the 504 is partially funded by a bank and partially through a CDC. The 504 cannot be used for working capital and the maximum term is only 20 years, versus the maximum term of 25 years for a 7(a), which can also be used for working capital. In addition, the 504 loan cannot be used to refinance existing debt, whereas the 7(a) can be used for refinance. The most attractive feature of the 504 loan is that for 40% of the total project, the rate is fixed for 20 years.

Other SBA Services

Small Business Development Centers (SBDCs) are funded in part by the SBA to provide assistance to small businesses and aspiring entrepreneurs throughout the United States. SBDC's are hosted by universities, community colleges, Chambers of Commerce, and state economic development agencies and are staffed by paid managers and volunteer advisors to provide consulting and low cost training services such as business plan development. These centers also often include access to the Service Corps of Retired Executives (SCORE), is a volunteer group of retired executives and business owners who provide expertise as business advisors, as well as confidential counseling and mentoring.

Other SBA initiatives include disaster relief services—in the wake of a natural disaster, the SBA provides low-interest disaster loans to businesses of all sizes to help repair or replace machinery, equipment, fixtures, and other real property—and, for some businesses, business interruption expense loans to cover economic injury.

Maintaining an Ongoing Relationship with a Bank

A relationship with a bank does not end at the closing table, after a loan is funded. Banks are required to monitor loans until they are paid in full. Most loan agreements require updated financial information from borrowers, including annual tax returns, personal financial statements, and financial statements, during the life of the loan. Providing these documents to a bank in a timely manner creates goodwill and enhances the credibility of the borrower. Banks are examined by regulators who look at the quality of the loan portfolio and the individual loans that the bank has funded. Examiners can downgrade a bank's rating if the bank does not have current financial records and analyses in its customer files.

Communication is key in any business relationship, including banking – keeping a banker informed of any changes in the business that may impact the relationship can prevent that relationship from deteriorating. Letting the bank know about a difficult situation is always better than waiting until the bank finds out from a news piece or records search. The bank can often re-structure a loan to allay temporary cash flow issues, and the SBA allows for deferments for certain situations. Again, the key is to remain in contact with your banker and provide timely updates <u>before</u> there is a crisis.

Bankers are always looking for new customers. A satisfied current customer can be an important source of new business. Referrals work both ways, so bankers have a vested interest in a business's success and will often provide customer referrals to clients. Many banks will make it a point to patronize their customers' businesses, whether that means buying office supplies from local businesses or hiring the landscaping or cleaning services of a client.

Finally, remember that people and markets change – customers may outgrow a bank or need services that their bank can no longer provide. Re-evaluation of banking needs on an annual basis is important for any business to grow and succeed. By building a long-standing relationship with your bank, taking an active approach to fund management, and continually re-evaluating your financing needs, you'll ensure that your business has the resources necessary to thrive in any economic environment.

Chapter 8 | Bank Financing: What Your Lender Might Not Tell You

Joel N. Goldblatt and Michael Weis

One of the most difficult aspects of establishing, owning, and operating a business is obtaining capital for the company's operations. When it comes to obtaining traditional financing from a bank, there are some facts a business owner should know in advance of approaching any business banker.

Most business people do not realize that banks have internal lists of businesses that are considered (a) preferred borrowers to be actively pursued, (b) permissible borrowers, and (c) impossible to lend to under any circumstances. Bankers are risk-averse people, and banks are very cognizant of their reputational risk. Before deciding to lend to you, a banker will surely Google your business and industry. Because of this, certain business will never be able to obtain traditional financing (i.e., adult bookstores, adult toy stores, marijuana dispensaries). Large banks have long lists, regional banks smaller lists, and community banks smaller lists still.

If your business is actively solicited by commercial bankers, then your business is a preferred borrower candidate; such status often provides the business so categorized with leverage to strike a better lending deal with its lender. If you are a startup, you are not likely to get financing unless the owners have significant assets to pledge as a personal guarantee. Moreover, if your company has negative retained earnings, forget about obtaining financing from lenders. (This occurs when a closely held business strips out all profits for tax purposes, and then may even borrow to fund a qualified plan profit sharing contribution. This is unwise for any business wishing to obtain financing.)

It is also important to have strong record-keeping methodologies and systems. A prospective borrower who cannot quickly generate accurate and complete financial reports is not going to get a loan. It may help to have a business plan, or even an outline of a business plan, to give to a commercial banker when seeking financing. A commercial banker does not make the decision alone to lend to your business. He or she must submit any proposal to an internal loan committee, which reviews the borrower(s), the risk they represent, and the type of business and/or industry they are in. Your goal as a prospective business borrower is to give your commercial banker as much concise, relevant information as possible, which enables your banker to advocate for you to the committee and/or underwriter(s) who will ultimately approve or reject your request for financing.

When a business owner seeks financing, there are certain things he/she should do and certain things he/she should not do. A good starting point is to make sure you reach out to an experienced commercial banker. Experienced commercial bankers understand lending, what the institutions they work for will and will not do, and the types of terms the bank will require for any loan. (Loan term examples are negative covenants such as profit ratios and personal guarantees.) You do not want the newest commercial banker on the team; note that this is not an age issue, but an experience issue, both in the industry and with the institution you are approaching. Similarly, if you are banking at a branch that does not have a commercial banker on staff, you are likely being underserved or even wrongly served. This difference is analogous to the difference between a bookkeeper and a CPA.

A good business banker will understand your industry (or be willing to learn about it). Your lender must know what and how your business runs in order to best serve your needs. The commercial banker should know whether you conduct international, national, or regional business and how the business collects what it is owed, as your processes and timelines for paying bills and collecting accounts receivable are very important, closely scrutinize pieces of information. Your banker should also discuss fraud protection for the business and how fraud prevention programs can be instituted to better protect the business from risk. These are not free services, but any business that ignores these issues is playing with fire in today's increasingly global financial network, which can be subject to fraud from myriad foreign, hard-to-track sources. Business customers also have stricter requirements than consumers do to notify the bank of potential fraud within a set time period. If the business owner is not paying attention, then the business will be on the hook for these losses.

Services such as zero balance accounts and positive pay programs (where lists of acceptable payees, along with their account and router information, is set out in advance) are all effective anti-fraud techniques. ACH debit blocking programs are also effective. There is time and cost to closing old accounts, so avoiding problems in the first place is worthwhile; moreover, insurance often does not cover such losses (and if it does, that coverage is minimal). The fewer checks a client writes, the more desirable that client is to a bank.

It is also wise to pay attention to what you as the owner of the business are personally guaranteeing. A business credit card is likely personally guaranteed, and the rules concerning fraud on a business card are more favorable to the bank and less favorable to you than on a consumer card. Additionally, following recent amendments to U.S. bankruptcy laws, all credit card debt is more difficult to discharge in bankruptcy, which may be no small issue. This is especially true when you consider the fact that many startups often obtain finance their businesses early on with credit cards.

Most lenders are negotiable on the fees they charge for financing; some will cut or eliminate their fees, while others are totally inflexible on the matter. Almost all lenders use documents created by a company called LaserPro for some or all of their business lending. While these documents have standard terms, such terms are still negotiable to some degree, and none are written in stone. All lenders, however, are largely performing

the same underwriting standards, driven mainly by bank regulators. All lenders must treat all borrowers equally (no discrimination), and many lenders are hungry for small businesses that are good borrowing risks, as these help lenders fulfill their community reinvestment act requirements. Any business with less than $1M in revenue is going to be looked at as a consumer loan.
Some lenders will do real estate some will not. Investment real estate, mixed use, and new construction residential are not favored by most institutions. If such financing is going to be available at all, the best alternative will be small, community-based lenders and occasionally regional lenders (large national institutions are generally not interested in these types of loans). Owner-occupied real estate is more bankable at all levels of lending, and local, regional, and national lenders all favor such loans.

It is wise to ask to see the actual forms the bank will use to document a business loan before detailed negotiations on loan terms take place, as you may not want to proceed once you see the covenants required for the lending transaction. It is also imperative to get an experienced business attorney to review the documents and assist in negotiating and explaining the terms (for example, a good lawyer may be able to negotiate unlimited personal guarantees down to a more limited guarantee). It is also wise to shop terms from at least two banks and perform an apples-to-apples comparison to provide yourself with leverage when it comes to negotiations. Often pre-payment penalties are negotiable; you also want to ensure that you can refinance with the same financial institution without incurring a penalty. No penalty should exist in the final year of the term for three-, five-, and seven-year deals. Complete waiver of pre-payment penalties for business financing in a low-interest environment is not likely, though, as banks have to protect their upside. Such penalties may be waived where a borrower prepays some basis points (percentage of 1%) up front.

In order to understand why lenders call for the terms they do, it helps to have at least a rudimentary understanding of how bankers are compensated and/or penalized (for example, break funding fees negatively impact a commercial banker's compensation). A business banker is rated internally by a point system that measures all sorts of behavior. Everything is assigned a point value. Bankers are often rewarded for buckets of products they procure, such as the number of loans they obtain, the size of those loans, the types of borrowers they work with, whether the customer is using treasury cash management services, whether the customer opens checking and savings accounts concurrently, whether all accounts of the borrower are with the bank, and whether investments are also handled by the institution. Bankers typically receive a base salary and a percentage of that base paid at year-end based upon performance. Failure to obtain the requisite number of buckets of products may result in a banker losing as much as 50% of his or her annual compensation, depending on the institution. Bankers are incentivized quarterly as well, and such incentivizes may warp behavior such that the commercial banker is more interested in reaching his or her quota than doing what is in the best interest of the borrower. A banker may be penalized if a client refinances a loan and there is no pre-payment penalty in the instrument.

A representative list of key issues the business owner will wish to keep in mind when obtaining bank financing and establishing a business banking relationship is as follows:

- What are the account fees?
- What are the minimum balances required to waive these fees?
- Will personal guarantees be required? If so, can they be limited in scope?
- What services does the bank offer (i.e., cash management, international transactions, lines of credit, mortgages, checking, savings, investment, credit cards, ACH, on line access)?
- What additional fees or hidden fees will occur for any relationship that is established?
- What are the terms of the loan, up-front fees, interest rates, length of term, amortization, equity required from the borrower, etc.?
- Are there financial covenants? If so, what are they and how burdensome will they be? Will the borrower be able to comply with the covenants or is this negotiating a future default event?
- What are the environmental and insurance requirements?
- Are there *confessions of judgment* (sometimes known as “cognovits”) provisions that permit an easier process for the lender obtaining a judgment?
- Can the lending institution call the note if it deems itself “insecure?”
- What types of escrows for interest and taxes will be required?
- If there is a default, what kind of notice must the bank provide, and does the bank permit the borrower to cure the default?

In establishing a relationship with a bank, make certain there is no disconnect in knowledge between the commercial banker and what the bank’s internal underwriters will require in the final agreed-upon transaction. This can save time, money, and being backed into a corner where the borrower accepts a sub-optimal transaction in order to obtain financing. Involving your legal counsel and accounting professional early in the process and making sure everyone, including the lender, is on the same page is the best means to help ensure a successful banking relationship and desirable loan structures and terms.

After the banking relationship is developed and a credit transaction is closed, the work does not stop. It is important that the match be successful for several reasons. First, if the borrower’s company grows, it may need to seek more capital, including debt; the first place companies generally look for capital needs is existing lenders and investors. If the banking relationship has been successful to date, it follows that the lender can expand the loan/services with less due diligence, time, and expense than if the business tried to find a new source of financing. Second, lenders review banking relationships post-closing constantly. If the entity has performance issues, it may affect the cost and timing of financing, and in some cases lead to the entity being in default of its obligations and/or the bank “calling” the loan in its entirety. There should be constant reporting and performance communication between lender and borrower – banks do not like surprises. Information and performance today is more transparent than ever. Be advised that potential alternative financing sources will likely know the reputation and general financial performance of the entity, and what they do not know will be readily learned in due diligence. For this reason, accurate and timely reporting is crucial.

There are several types of lenders that may be appropriate for an entity's needs, and all possible options should be considered and evaluated for the best "fit." Asset-based lenders generally provide loans secured by tangible and/or intangible collateral. Cash flow lenders focus on a company's financial performance apart from its assets. Revolving credit lenders focus on specific assets, such as inventory, work in process, and accounts receivable. The cost of credit depends on many factors, including the borrower's payment history, loan type, asset type, and loan terms, to name a few. Interest rates may be fixed or variable, and may be tied to the prime rate, LIBOR, or some other index.

Understanding the process, information required, and types of transactions your lender is most comfortable with are all prerequisites to establishing a successful lender/borrower relationship. Advance knowledge is power, and it will help you obtain better financial products and foster stronger banking relationships in the long term. Ask plenty of questions at all points in the process, and if your contact does not have the answers you need, find out who can answer your questions before moving forward. Become knowledgeable about your banking options. A successful banking relationship can mean the difference between business success and failure.

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Chapter 9 | Raising Capital

Joel N. Goldblatt, Rick Prohov, and Andrew D. Arons

In examining the mechanisms used to capitalize a business it is helpful to have an overview of how businesses are funded. Initially, businesses are started by one person or a team of persons and typically the founder(s) who put in their own time, effort and hard earned money to get the business up and running. Often a founder will take on personal debt or even borrow from retirement funds (not recommended) to start the business. When the business begins servicing customers or clientele, the resulting cash flow from the operations of the business assists in funding the enterprise in a bootstrap manner. The problem quickly becomes a problem of timing of receipts and expenses and having enough capital to grow the business. Two kinds of businesses have great difficulty and often fail. Those that are growing too quickly and expenses outpace available capital eventually leaving the enterprise insolvent or those that cannot grow and eventually expenses overwhelm the ability to generate meaningful revenues for the costs of conducting business.

With the development of Internet technologies has come a new platform for raising funds known as a “crowd funding” mechanism. It is important to make a distinction here, as there are two types of crowd funding that are being explored in the marketplace and ambiguity in the law that is attempting to control its use. The first is the “Kick Starter” model where people who are attracted to a business idea are solicited through on line platforms to make a gift of money to the business effort without receiving any equity in the company in return for the gift. The second is the mechanism described in Rick Prohov’s chapter, **The Evolution of Capital Markets and the Democratization of Investing,** which follows this one (page 127). In the second mechanism, raising capital is based upon a prospective return to the investor and the issuance of an actual equity ownership interest (a security or stock) in the enterprise. Not surprisingly, the first is raising new possible income tax consequences to both donor and donee, and the second mechanism is subject to securities laws, which we describe in more detail below.

Often founders turn to friends and families in the next stage of capitalizing a business. Some friends or family members will invest for a percentage ownership of the company, while others will make a loan. Following these two initial stages of funding you get to the level described as “angel investors.” The term angel investor comes from the theater world where producers of plays looked to a few well-heeled “angels” to fund their productions. Just like the drama world, the business world seeks well-heeled individuals who are attracted to a business idea and wish to participate and own a portion of the company for their capital contribution. This too is early stage funding of the company, but here, investments are made by people in the business of making shrewd investments, and as a result, they may impose conditions that are more restrictive than those that family and friends may demand.

After these stages we see what is often termed “Series-A” funding, which is either based on a private offering or is received from a venture capital (“VC”) firm. The two are not necessarily synonymous as there can be a grey area between angel investors (where private offerings are used) and VC level funding and often the difference can be the sophistication of the investor and the rules by which they wish to play. VC funding is dedicated to gaining high rates of return on investment as quickly as possible. This requires two things that VCs will demand in return for their investment: 1, an exit plan that is sometime within the next 3-5 years at most, and 2, rights of control to force the exit where management is not staying on plan.

Once a business has achieved these levels of capitalization and is an on-going concern, the pace of growth (existing or strategically desired) may dictate the need for additional capital. At this stage you have mezzanine funding, so termed as it is a bridge between earlier stages of funding and traditional debt from a bank. Mezzanine funding may be in the form of debt, it may be in the form of equity but often it is in the form of both debt and convertible equity (where a portion of the funds originally invested as debt can possibly be exchanged for equity ownership on a pre-determined formula at a later date).

Following mezzanine funding you have the financing described in other chapters of this book (conventional bank financing, SBA financing, factoring, equipment leasing, receivables insurance, and insurance in general).

Whenever you are raising capital for an enterprise (with the exception of crowd funding, which is a gift-based endeavor), you are wise to be cognizant of the Securities Laws and the regulations that govern the issuance of ownership interests in an entity in return for someone contributing capital to it. Unless there is an exemption from registration, you must register the security with the Securities and Exchange Commission under Federal Law. Each state has its own securities laws (known as Blue Sky laws) that may apply as well and sometimes the exemptions are aligned between Federal and state laws and sometimes they are not. This chapter gives a brief overview of the Federal Rules, but we do not explore the state rules. Failing to comply with the rules can result in the issuers of the securities having to refund all moneys contributed and reimbursement of the investor’s attorney’s fees. Cases of actual fraud can result in criminal prosecution and incarceration where a crime is found. In addition, those issuers who are licensed can lose their licenses or be barred from trading in public markets.

Where you are going to have people capitalize a company and they will be officers of the company, the registration rules do not apply as such persons are not “issuers” of securities under the Federal laws. The laws are designed to protect investors from issuers who are those who are raising capital (or assisting in the process) for a company and the investors will not be participating in management. Since the Great Depression, the securities laws have largely been intended to protect investors and prevent general solicitation to people who may not be well known (or known at all) by the issuer and do not have the sophistication to assess the risks involved.

The rules governing exemptions from having to publicly register the securities being issued are found under Regulation D of the 1933 Securities Act (The 1934 Securities Act governs registrations of publicly owned companies) under rules 504, 505 and 506. The Regulation provides a safe harbor if those rules are followed and forms are fully, accurately and timely filed online with the SEC. Where someone raising capital approaches an "Accredited Investor" (generally for individuals someone with $1 million dollars or more in net assets not including a residence or they have high income $200,000 per year for last two years or combined with a spouse of $300,000 with expectation of same income for the current year) there are relaxed rules and exemptions from registration that apply.

Under rule 504, you can raise up to $1M in a 12-month period where there is no general solicitation of investors and re-sales of the securities is restricted.

Rule 505 permits a capital raise up to $5M in a 12-month period to accredited investors and up to 35 non-accredited investors provided written disclosure rules are complied with and re-sales are restricted.
Rule 506 permits any amount to be raised to an unlimited number of accredited investors and up to a limit of only 35 and no use of any general solicitation to market the securities. The Jobs Act of 2012 (discussed in Rick Prohov's chapter, which follows this one) added a new subsection 506 (c) to Rule 506 that permits unlimited sales to accredited investors through a general solicitation provided compliance is made with certain additional rules and forms are filed. General solicitation had previously been prohibited since 1982 when Regulation D was first established to keep the exemption very narrow. It was designed in a fashion to confine issuers to solicit only those investors that could be found within small restricted channels based upon personal relationships among issuers and their loosely affiliated private and professional networks with their higher net-worth clients. The potential for sales using Internet portals would have been a frightening prospect for regulators back then. It still explains the delay in the SEC's rulings that remains a roadblock to issuing the final approval of all aspects contemplated by the new legislative framework to open new channels for private placements to access far more potential investors in a more efficient manner without an open invitation to new types of security fraud.

There are two other potential exemptions for securities sold to accredited investors only for less than $5M raised, and for securities offered only within a state for a business largely conducting business in that state, the state rules will apply. In all cases, state Blue Sky rules for any investor residing in such state should be consulted, as some require a filing at issuance of the security (receipt of money from the investor) and some require it before the money is received.

In all cases, anti-fraud rules apply. Those issuers of securities have a duty to disclose all material information about the business and those involved with it when raising funds to capitalize the business. Where accredited investors are involved you are not required to provide a written memorandum disclosing material information about the business and the management team, however, if nothing is in writing there is great difficulty in the issuer being able to prove they disclosed all material information to the investor. When non-accredited investors are involved there is a duty to provide written disclosure. The written document that sets forth those disclosures is often referred to as "Private Placement Memorandums" or "PPMs" or "Offering Memorandums." PPMs must contain various items of information that includes a section describing the risk factors inherent in an investment in the company raising the money.

Anyone receiving a fee for bringing in money must be a registered broker dealer. "Finder's Fees" for unlicensed parties raising money are not legal.

There are other rules that apply to "restricted re-sales" of securities. Rule 144 comes into play in this scenario and permits limited sales where the buyer will hold the security for more than one year and the purchaser acknowledges they are not purchasing for purpose of resale.

Assuming you are complying with the various securities rules and exemptions from registration, the manner of structuring a given transaction can take a myriad of forms and offer various terms to the investor. Often the type of business and industry, as well as the type of entity formed to conduct that business, has a big impact on how a transaction and capital raise is structured. The following three examples will provide some instruction, but the reader must understand that there are many variations and other terms and structures used and or that are possible to deploy when raising money for a venture.

In the technology sector, you see a lot of C corporations and preferred shares. These transactions are so structured because the investors are not interested in deducting losses as much as they are gaining preferences over other shareholders and preferred returns. The preferences may be liquidation preferences, additional voting rights to maintain board representation regardless of dilution in shares with subsequent offerings and fixed interest rates and potentially additional rights such as rights of pre-emption to maintain the percentage of ownership they have if subsequently more shares are sold to raise more capital for the enterprise.

In the real estate industry, for developers and others seeking money to acquire and/or construct improvements on real property, you see the usage of limited liability companies and two (if not more) classes of ownership interest where founders may take a back seat to the investors until a set threshold return to the investors on their investment has been realized. The flexible nature of partnership tax treatment and the possibilities of the limited liability company (LLC) dictate the use of the LLC. (For more information on this subject, see **Chapter 6: Forms of Entity to Use When Starting a Business**.

In service-related enterprises, you often see Sub Chapter S corporations where the shareholders all must share in revenues based upon their percentage of ownership. In these instances, you cannot have preferred stock and treat owners differently. In these deals the investors do want the ability to deduct losses.
It is important to bear in mind some basic principles and issues that arise when an entrepreneur seeks to raise capital. Business owners who have investors owe those investors a bundle of fiduciary duties and there are statutory rights such investors have to access company information and financial data. These are not trivial rights and duties and some understanding and forethought should go into the tradeoff taking outside money entails.

Furthermore, founders often want a high degree of control whereas investors want some say as well. The better valuation you can rationalize for basing the value of the equity stake you are giving up for capital the more leverage and thus control you maintain. Raising too little money can be risky and seeking too much results in unnecessary dilution of the founder's interest. Timing is therefore of key importance and a founder who has a business generating a revenue stream is more likely to be able to raise money, maintain control and not seriously dilute his or her interest than the start-up that has not earned a dime.

Finally, paying attention to the laws that apply to capitalizing a business in advance offers an ounce of prevention, saving the issuer from great potential liability and complex legal ramifications at a later date. Assembling a wise professional team to assist the entrepreneur seeking capital is a must first step.

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Chapter 10 | The Evolution of Capital Markets and the Democratization of Investing

Rick Prohov

The year 2008 will be as memorable as 1929 in the memory of generations of Americans to come. What September 11, 2001, did to our sense of personal and national security, September of 2008, did to our sense of economic wellbeing and optimism for a brighter future. The Great Depression of the 1930's led to more than a decade of economic, political and social upheaval and eventually a worldwide war. The year 2008 marked massive and sudden losses experienced by bank debt sources and shifted those losses into the public sector based upon previously unthinkable levels of United States obligations for bailouts. Defaults on what were private investor debts shifted into a massive inflation of balance sheets of central banks of the developed and developing countries with capital infusions on a global basis to avoid a worse fate of what might have been an immediate and lasting global financial and social collapse. The American "Zeitgeist" or spirit of the times quickly went from what perhaps was in fact "irrational exuberance" to an equally unhealthy national malaise of melancholy plodding through a period of uncharacteristically slow economic development for a protracted amount of time the likes of which baby boomers and their children never anticipated.

By the end of 2013, the surviving banks in the United States recovered and once again have become profitable but job creation for a growing middle class lifestyle remains elusive. Essential changes in how investments in, and through private capital markets will be made over the course of the 21st century based upon the more sophisticated application of internet technologies and social media. The JOBS ACT of 2012 reflected a congressional attempt to accelerate what is slowly evolving into the new world order for possible investment to finance new start-up entities and existing small and medium sized business enterprises. While development of social media has created a very different national and international social structure, the internet and rapid paced software development has only begun to harness a new economic structure. Sales via the internet of retail products and services continue to increase but access to the internet for investment capital has not yet made it beyond executing trades in the public markets.

In the traditional underwriting world for investing capital as we know it, most have looked to insurance companies, pension funds, banks and certain government funded programs to supply debt financing for companies to capitalize their businesses and individuals to purchase homes. This has been a very centralized and mostly regulated process with the decisions for allowing the loans to be made at an institutional level by relatively few people. On the equity side of capital formation, investments are tightly regulated and funds have generally been restricted by the Securities Act of 1933 and Securities Exchange Act of 1934. These securities laws were enacted following the horrors from fraud and financial losses suffered by so many from bad investments leading into the Great Depression. This legislation continues to affect most investments, which are all generally deemed to be "securities." If an investor of capital is not directly involved in running the business that will make use of the proceeds of that investment, then either the interest represents an ownership interest traded in a publicly registered market or is issued on a private but still regulated basis. For those securities issued in the private market that are not registered with the Securities and Exchange Commission, they can only be lawfully sold or "issued" by a company pursuant to a statutory or regulatory exemption. When most think about equity capital, they think about the public stock exchanges that provide access to investments within a regulated industry and the Securities and Exchange Commission as the primary watchdog.

The public securities markets remain highly regulated. The barriers to raise capital in those markets require a registration of offerings that are complex and extremely costly to initiate and maintain. The restrictions on private markets were originally established during the 1930's to protect the public from wholesale fraud that had been committed in the 1920's and was among the causes of the great depression. It was believed that a federal government authority in the form of the SEC could monitor and provide controls that would limit the risks of securities fraud on the public by requiring all investments to be registered and submit to its controls. While certain limited exemptions were contemplated, their use was considered narrowly for decades out of fear of unlawful issuances of unregistered stock. As a result, investments in stock had been largely left to securities that can easily be bought and sold only through publicly traded exchanges like the New York Stock Exchange or NASDAQ where registered securities are bought and sold. For decades, this level of centralized control of directing investments has limited capital formation at the small, medium and start-up level for most enterprises to their ability to use personal savings and obtain commercial loans from banks.

In 1982 (during another recession), the SEC established Regulation D to clarify certain prior rules applied to exemptions to securities registration and expand the ability of private investors to make significant investments with private issuers if done within certain "safe harbor" parameters that have very specific guidelines that can be met at reasonable expense if accomplished with care and the assistance of competent legal and accounting advice. Rather than a complicated registration process, a simple Form D notice needs to be filed with the SEC (which now must be filed online). Among those exemptions is the Rule 506 (b) offering, which requires private offerings to meet the following conditions:

1. The company cannot use general solicitation or advertising to market the securities (strictly construed but recently changed with the addition of a new section for a 506(c) offering mentioned below);
2. The company may sell its securities to an unlimited number of accredited investors.[8] These include people who have individual net worth, or joint net worth with their spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person; or a person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse

[8] http://www.sec.gov/answers/accred.htm

exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year, and up to 35 other purchasers who do not meet that criteria. Any of those “non-accredited investors,” either alone or with a purchaser representative still must be “sophisticated,” which means they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the investment before purchasing the security;

3. Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. But companies must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well;
4. The company must be available to answer questions by prospective purchasers, and on certain offerings, financial statements need to be certified by an independent public accountant but if a company other than a limited partnership cannot obtain audited financial statements without unreasonable effort or expense, only the company's balance sheet (to be dated within 120 days of the start of the offering) must be audited; and Limited partnerships unable to obtain required financial statements without unreasonable effort or expense may furnish audited financial statements prepared under applicable federal income tax law requirements and reported in accordance with generally accepted auditing standards by an independent certified public accountant.

The establishment of a new Section 506(c) as part of the JOBS ACT will now allow for general solicitation to help issuers find a pool of accredited investors that can be found without restriction to investors they know or whom others they know can find and direct to the investor as long as these previously unknown prospects are in fact “accredited.” The status of someone claiming to be an accredited investor for a 506 (c) offering cannot be based upon a self-certified questionnaire signed by the investor which has been customarily accepted by issuers under 506(b) offerings. The new framework for this new 506 (c) section requires a new level of additional investigation to determine whether someone is actually an accredited investor. Verification will require materials providing the issuer with a level of reasonable reliance and ability to maintain sufficient evidence to verify that status. Two Examples of reasonable proof of accredited status might include bank or brokerage statements and income tax returns. One might also rely on a qualified third party's confirmation where the third party indicates they have investigated and determined the person is an accredited investor. Qualified third parties may include registered broker-dealers, attorneys, certified public accountants and other professionals but the question remains who will take on this additional liability for the level of verification required. Without the third party certification, most accredited investors may prove less willing to tum over such personal information to a relatively unknown third party. It is likely that financial advisors will be pressured by their accredited investor clients to provide this type of additional service to avoid full disclosure of their personal financial information.

Regulation D opened the door to capital formation for smaller business concerns attempting to finance new businesses or additional capital for growth but has been contained to what has generally been regarded as wealthy individuals who seek alternative investments from investments that cannot be found in the public markets. While these private investments generally have a higher rate of risk in exchange for a higher projected return, they also lack liquidity (the interest cannot be sold for at least one year unless it is registered). The theory has been that accredited and sophisticate non-accredited investors are regarded as investors who are more likely to assess the risks of an investment and more able to absorb the losses in the event of failure to meet those projections as forecasted by the issuer. Over time, the levels of assets and income established many years ago have widened the pool of possible investors as inflation brought more people into that limited class. It is likely that the threshold for those numbers will be increased someday. It is estimated that approximately six million Americans would be considered "accredited investors" at this point in 2013, but the dissemination of opportunity to seek out these types of investment opportunities is limited because no general solicitation has been allowed. For the most part, sophisticated entrepreneurs have been able to raise millions of dollars for their new enterprises by private placement of the investments with investors they either already directly know or whom are directly known to others with whom they directly work who can often obtain such investors.

The SEC released the following interesting statistics in 2012:

- In 2011 and 2010, the estimated amount of capital raised ***<u>in public registered offerings</u>*** was approximately $984B and $1.07T, respectively.
- In 2011, 2010, and 2009, issuers raised an estimated $895B, $902B, and $581B, respectively, in transactions claiming the Rule 506 exemption [***<u>private offerings</u>***].

This recent information would suggest that as much money is being invested into the smaller private investment markets available from Rule 506 offerings as are being raised for public securities offerings. The JOBS Act of 2012 is designed to encourage this trend. While the SEC has been slow to publish rules that would allow the act to take effect. Once those rules are fully published, what will follow will be increases in the type and number of investors that may invest in the exempt private offerings. This will be made further possible opening the door beyond those directly contacted privately as general solicitation will be permitted and that could include the use of internet.

When engaging in rulemaking, the SEC is charged to consider *"whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation."*

We constantly see the large institutional public companies in the news but most of the jobs in this country are still created by small and medium sized companies. It became apparent that the protective securities laws and policies often fail to protect the investing public from fraud and abuses with questionable accounting and business practices that continue to surface at large companies funded with publically invested funds.

The intent of the JOBS ACT of 2012 is to open the flow of capital to securities investments exempted from registration for smaller non-publically traded businesses by giving a new pathway in three distinct levels for purposes of: (i) making it easier to go through the registration process for certain companies attempting to go public; (ii) opening 506 offerings to general solicitation to give greater access to the market of accredited investors; and (iii) allow "crowdfunding" for the very small investor to invest small amounts while allowing the new or small entrepreneur to raise up to a million dollars from an relatively unlimited number of investors.

In January of 2012, President Obama declared in connection with the JOBS ACT of 2012: *"Right now, you can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it's time our laws did as well. Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors – namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."*

Insurance companies as well as casinos are founded on the concept of "spreading the risk," the science of probability and the law of large numbers. If the chance of someone having a fire in a home is one in 1,000, then if insurance companies collect relatively small premiums from 1,000 people, they can pay the claim that one homeowner will incur. The insurance industry performs research and expects to distinguish the risks of each business it underwrites or the habits of an individual they will insure. If they fail to predict accurately the chances of something happening, or the rates charged are too low, then the insurance company will eventually lose money. If they do this often enough, then the company suffers but by and large the law of large numbers and conservative experience leaves them with enough profits each year.

For casino games like roulette, somehow people misunderstand that sequences of red or black numbers or the frequency of odd or even numbers coming up on a roll will even out during a single session of play. That simply never works unless a much larger numbers of plays occur to shift the chances for possible returns to the gambler as opposed to the casino. Somewhere between the historical perspective of the conservative industry of insurance and the illusive but compelling thrill for the gambling found at casinos is the notion of "Crowdfunding."

Title I of the JOBS ACT of 2012 establishes a new rule for going public. Title II of the Act addresses certain changes for Rule 506 offerings with the main change allowing general solicitation. The potential for registered broker dealers to open internet portals to disseminate investment opportunities to other registered brokers seems on the horizon so long as someone will be legally responsible to ensure that any investor allowed to invest is truly "accredited." This chapter will not attempt to describe Title I of the Act.

It is Title III of the Act that addresses the new method for allowing certain types of Crowdfunding as offerings of unregistered securities through a registered internet intermediary website or broker to raise small amounts of money (up to $1,000,000) from a large pool of investors. The Act limits both the aggregate value of securities that an issuer may offer through a crowdfunding intermediary and the amount that an individual can invest. An issuer may sell up to an aggregate of $1,000,000 of its securities during any 12-month period. Investors with an annual income or net worth of up to $40,000 will be permitted to invest $2,000. Those with an annual income or net worth above $40,000 and less than $100,000 shall be entitled to invest 5% of their annual income or net worth in any 12 month period. Investors with an annual income or net worth greater than $100,000 will be permitted to invest 10% of their annual income or net worth. Investors are limited to investing $100,000 in crowdfunding issues in a 12-month period. Investors who purchase securities in a crowdfunding transaction are restricted from transferring those securities for a period of one year. This restriction is subject to certain exceptions, including transfers: (i) to the issuer; (ii) to an accredited investor; (iii) pursuant to an offering registered with the SEC; (iv) or to the investor's family members.

Crowdfunding under Title III is still not authorized at the time of publication of this book. We continue to wait for the SEC to finalize additional rules to implement the legislation. Title III provides that the moneys will be raised through qualified intermediaries. Qualified intermediaries are either a broker-dealer (who may offer advice and solicit for investment purchases) or registered as funding portals with the SEC. Intermediaries also must be registered with the Financial Industry Regulatory Authority (FINRA) and information and access to the issuer's Offering Statement are all requirements. There are detailed rules restricting resale for a year with limited exceptions. Issuers using qualified intermediaries have detailed reporting and disclosure requirements as to the issuers management, business, financial condition, planned usage of offering proceeds, target amount, deadlines, pricing, ownership and capital structure to name a few.

There are also rules concerning the formation and use of a funding portal by a qualified intermediary, which is exempt from broker dealer registration. The portals must be registered with the SEC and the qualified intermediaries will have significant burdens to meet in order to participate in the marketplace for this service.

Such a service provider will not be able to:

1. Offer investment advice or recommendations;
2. Solicit purchases, sales or offers to buy securities offered or displayed on the website;
3. Compensate anyone based on the sale of securities;
4. Directly hold investor funds or securities;
5. Allow its own directors, officers or partners to participate in a crowdfunding offering or have a financial interest in an issuer using its services;
6. Engage in any other activity the SEC prohibits by rule.

These qualified intermediaries will also have certain affirmative duties that will include:

1. The provision of certain educational materials regarding investing in crowdfunding offerings;
2. Securing certain levels of disclosure that would include reviewed or audited financial statements as well as other types of information to add levels of transparency in a manner yet to be dictated by the SEC;
3. Obtaining an acknowledgement of the potential risk of loss from investors;
4. Taking steps to reduce risks of fraud;
5. Holding back funds from an issuer until stated thresholds are attained;
6. Maintaining privacy of investor information; and
7. Monitoring each investor with regard to statutory limitations imposed for dollar, percentage of income and time period limitations.

Obviously, crowdfunding entails selling securities to a very broad base of new potential investors who will not only be non-accredited investors, they will not even have to be sophisticated so the rationale for a new set of limitations and the slow deliberative process of the SEC has been understandable.

The status of someone claiming to be an accredited investor and providing an issuer with a mere questionnaire signed by the investor will no longer be enough for reasonable reliance on the part of the issuer. The new framework requires a new level of additional investigation to determine whether someone is actually an accredited investor and provide proof of the materials providing reasonable reliance and maintain sufficient evidence to verify that status. Two examples of reasonable proof of accredited status might include bank or brokerage statements and income tax returns. You might also rely on a qualified third party's confirmation where the third party indicates they have investigated and determined the person is an accredited investor. Qualified third parties include registered broker-dealer, attorneys, CPAs and other professionals but the question remains as to who will take on this additional liability for the level of certification required. Without third-party certification, most accredited investors may prove less willing to turn over such personal information to a relatively unknown third party. It is likely that financial advisors will be pressured by their accredited investor clients to provide this type of additional service.

The potential for allowing many individuals to seek out and fund small business owners with small investments could tap the law of large numbers for positive economic growth based upon innovation and reward of creativity. This would seem to be leading us to a more efficient and effective global monetary investment ecosystem. If permitted to thrive, Crowdfunding could bring us closer to the "invisible hand" of Adam Smith for a free market on steroids due to the internet and away from a highly regulated and centralized control. For better or for worse, the internet, like all technology, can be applied toward the greater good or evil. Where electronic transfers of wealth have become the norm and money has the means to privately place money more freely around the world, another look at Adam Smith's theories in *The Wealth of*

Nations (1776) may take the reader to a new global cross border view of capital markets and the role of small investors in the faster paced world. As described in Book I, Chapter 7, Adam Smith points out that merchants:

> By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

There would seem to be a lot of vested interests that may wish these more open avenues of financial trade to remain closed and tightly controlled to force compensation their way in the existing narrow channels. Those channels were developed based upon the value and sale of proprietary information. Information is now fast, cheap and frequently pretty good in the public domain. If left to the forces of free markets, the power of the new internet economic paradigm just might be beyond control of those that would continue to gain by impeding its movement. It will, however, be akin to other types of social and political revolutions that cannot be contained by those with centralized authority and the elite interests that tend to benefit the few. The next decade will play out and we are going to see if freedom rings the less regulated electronic global cash registers or if we face reactionary pressures that are also at work to maintain the ancient regime. New forms of electronic controls and protectionism are also evolving with invisible big data hands in ways well beyond eighteenth century notions of what was understood then as economics and international finance and trade.

The universal nature of humanity will continue to apply with the same concepts related to international free markets and basic individual motivation for personal gains. How fast can those same individual forces be directed or harnessed and to what ends will they reach? We are in an era where travel, communication and the delivery of information, products, services and financial resources continue to accelerate at ever-increasing rates. Innovation and advancing science and technologies will remain the vanguard of civilization for better and for worse. Freeing financial markets for access to those in the lower end of investor capacity has been a slow evolutionary process. When the SEC finally allows crowdfunding to move ahead for what remains the largest economy with arguably still the most stable legal and financial systems for a national government on the planet, it will likely be more like a cracking dam that suddenly breaks wide open. For better and worse, an absolute torrent of constrained innovation and economic growth will soon be deployed. We will do what human civilizations have always done; welcome the next global cycle of positive developments and monitor the unintended consequences to mitigate adverse risks where and how best we can.

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The Editor.

Chapter 11 | Factoring: The Good, the Bad, and the Ugly

Robert Jaskiewicz

For the uninitiated, "factoring" is a type of financing based upon accounts receivable. In system, a borrower holds contracts with customers who promise to pay certain moneys owed. The borrower then enters into an agreement with a lender (a "factor") who loans money with the promise of receiving a stated percentage of the contract between the borrower and the borrower's customers.

Let's begin by asking the question, "why factor accounts receivable?" Business owners decide to factor or fund the invoices or accounts receivable for numerous reasons. If you agree with the statements below, then this type of funding may be a good option for you.

1. For whatever reason, the bank will not provide the business with a working capital line of credit. This prevents the business from growing and often strains relationships with suppliers and employees, because before you can pay others, you need to be paid first by your customers.
2. You are constantly worried about meeting payroll or upset that that you couldn't take advantage of a supplier discount because funds were not available at the time it was being offered.
3. You are constantly turning away new business or additional business from existing customers because your suppliers have you on COD or a low credit limit, or you will need to hire additional employees to service the new business, and you can't float the payroll while waiting for the customer to pay you.
4. You have no way of knowing if a new customer's credit is sufficient to cover an order placed, and you are afraid of doing the work and then waiting well beyond terms to be paid (if you get paid at all).
5. Family members have stopped providing you with loans and your credit cards are maxed out.

If you agreed with any one or more or all of the above statements, and you realize that one or two of these situations is stressing you out, then factoring may be a good solution for you and your business.

The Origins of Factoring

In the world of Alternative Finance, factoring was always looked at as the black sheep of the family, the prodigal son, or the unwanted stepchild. Now, in today's world of restrictive bank lending, the tightening of credits, and government watchdogs hovering over the traditional lending community, factoring, or the funding of commercial and government receivables, has become the darling of the industry. That said, it is necessary to take a realistic look at this vehicle as an alternative for funding of your business.

A brief history of factoring takes us back many years before Christ was born. It started with merchants in the trades who took goods to market but did not want to wait around to sell the goods. The solution? Sell the goods to a middleman and then sell the "note," or invoice, to another merchant willing to wait for the buyer of the goods to pay after all goods were sold. For the buyer of the invoice to make money, he had to buy the invoice at a discount. Once he collected on the invoice, he made his profit.

Factoring has evolved since those times; initially, factoring was used almost exclusively in the “rag” or textile trade. Cloth and clothing manufacturers who sold to retailers and other manufacturers couldn’t wait to get paid for their goods, as they had to meet payroll and/or satisfy suppliers well before they were able to get paid by their customers or account debtors. Therefore, factors concentrated in this area, setting up shop in the United States, mostly on the east coast, where a significant number of these types of businesses existed.

Today, factoring is used in every trade imaginable. The key ingredient for any business looking to manage its cash flow better through factoring is the possession of invoices from billing another business or government agency. ***Consumer receivables do not work within the world of factoring.*** The reason is fairly simple: a factor can check out the credit of any business or government agency quickly and without permission. To run credit on individuals requires the individual to agree to have his or her credit report examined. Factors want the ease of running credit automatically rather than having to jump through hoops with individual consumers.

Why is factoring becoming more and more popular in today’s market? Banks have become more and more conservative and restrictive about to whom they provide a business loan or line of credit. The recent real estate bust and other bubble bursts have made banks and other lending institutions leery of anything but good, clean, cookie-cutter-type deals.

Alternative lenders, especially factors, are able to finance companies that traditional lenders turn down because they view an application differently than how a bank views an application for funding. When a business owner applies for a bank line of credit, the bank looks at the business entity, how long it’s been in business, the financials of the business (a business usually needs at least two years of profit on its balance sheet to qualify), the collateral of the entire business, and the personal credit of the owners. Depending on how all of these items come together, the bank will approve or deny the loan.

Factors will ask for all of the above, but 90% of their decisions are based on the creditworthiness of the business’s customers. Regardless of whether your business provides goods or services, as long as your company is able to invoice for the work performed, and as long as your customers acknowledge that they are satisfied with the goods or services rendered, then the factor can say yes to funding. Technically, the factor is advancing funds to you based on your customers’ ability to pay their invoices. Therefore, if your customer has good-to-excellent credit and is in receipt of the goods or services promised, then a factor can fund the invoice and wait until the customer pays down the line.

Banks do not review the creditworthiness of their applicants’ customers; they make loans to business owners and business entities. Factors, on the other hand, take titles to invoices and pay those invoices up front, providing the cash flow a business needs to grow and survive. The factor, meanwhile, can wait for the payment to come in and not be stressed out if the payment does not arrive on time. That being said, factoring is not the best solution for everyone. A factor needs to address certain considerations with a business owner prior to approving him or her for factoring. Things to consider are as follows:

Clients: Does your business sell to other businesses or government agencies? If yes, you are a potential candidate for factoring. If the majority of what you do is for retail or consumers, factors cannot help you.

Cost: Since factoring is more expensive than a bank line of credit but cheaper than taking on a venture capitalist or equity partner, you need to have margins that make it worthwhile for all parties involved in the transaction. Where a bank line charges interest on the money, the factor will take a discount on the invoice. (Generally speaking, that discount averages about 1% per 10-day period the factor's moneys remain outstanding. Therefore, if your customers take 30 days to pay, the factor will discount the invoice about 3%; for 40 days, 4%; and so on. This is called a general discount rate, and it can go up or down depending on the total volume of invoices and dollar amounts a client is submitting per month for funding.)

Most factors will hold on to an invoice for up to 90 days. At the end of that period, the borrower must either buy back the invoice ("recourse factoring"), or the factor will stop buying invoices from this customer and make a concerted effort to collect the money owed from your customer ("non-recourse factoring"). Since the invoice is discounted, the factor wants to make sure that its client is still making a profit after all factoring fees are paid, allowing the business to maintain itself or grow if it so desires. Usually the factor likes to see a 20% gross margin in the business. Naturally, the higher the gross margin, the better for the business. If the margins are there but the business owner is reluctant to take on new business (due to problems meeting payroll, paying suppliers, etc.), then factoring will help eliminate the stress and provide dollars to the bottom line.

Factors will look at each business on a case-by-case basis. If your gross margins are lower than 20%, but you can show that this level will increase as you take on new orders, then the factor will probably take you on as a client. If your margins are in the single digits and your industry is known for slim margins to begin with, then reputable factors will turn you down and advise you not to factor.

Customer Awareness: If you decide that factoring might be a good option to grow your business, you must inform your customers that you are moving in this direction and introduce them to your factor. This will help speed up the factoring process; it also allows you to explain to your customers that this is currently the best way for you to grow your business and continue to provide them with quality service at the same time. By factoring your receivables, you will be able to control the dollars that come to you in a timely manner, allowing you to manage your cash flow, take advantage of supplier discounts, meet payroll, and, because the factor will pre-approve a potential customer's credit, provide you with some relief that the sale you are making is solid.

Choice of Factor: When picking a factor, it's not always an easy choice. There probably are at least 20-30 factors set up in each state, all with varying programs and structures. Terms or length of contracts will vary from month-to-month to 24 months. Some will expect a minimum number of invoices equaling a certain dollar amount to come to them every month and penalize you if this does not happen. Advances could be as low as 40% or as high as 95% of the invoice, depending on the program you join and your industry. Discount rates are all over the board as well; some factors will have a low discount rate but require a high interest rate on the moneys outstanding, while others will give you a pure discount rate that tells you the exact cost based on the payment history of each of your customers. You will find recourse and non-recourse factors (described above). A few factors still offer a non-notification product, but they are harder and harder to find. All of the above have their benefits and drawbacks. Only you can answer what is best for your business.

In the end, just like most things in life, factoring is about relationships. If you and the factor develop trust and understand one another's needs and expectations, regardless of the structure, factoring should work for you and help you grow and maintain the business you started. In any factoring relationship, communication is key. Once on board, many factors will even help out if purchase order funding is needed, or if some inventory has to be purchased, or if payroll needs to be met prior to invoices being generated. Again, every factor is different, and what they do or don't do is based on their perceived risk and odds of getting paid back.

Here is an example of how factoring actually works:

a. ABC Co. receives an order for $10,000 from XYZ Co., a new customer.
b. ABC Co. contacts its factor and requests he/she approve XYZ Co.'s credit for $10,000.
c. Factor comes back with a recommendation; XYZ Co. is approved for $10,000.
d. ABC Co. provides the goods or services within the time frame specified on XYZ Co.'s purchase order.
e. ABC Co. bills XYZ Co. $10,000 with 30 days to pay.
f. ABC Co. presents a copy of the invoice to factor and requests its normal advance.
g. Factor verifies (1) invoice amount, (2) goods/services provided, and (3) customer satisfaction.
h. XYZ Co. confirms with factor its satisfaction and plan to pay invoice when it is due.
i. Factor provides ABC Co. with an 85% advance against the invoice and wires $8,500 to ABC.
j. ABC Co. uses advance funds to pay suppliers, cover payroll, etc. as needed.
k. 30 days later, XYZ Co. pays $10,000 to factor's lockbox.
l. Factor repays itself $8,500 already advanced and takes a 3% discount on the face amount of the invoice, or $300 (10,000.00 x .03 = 300). $300 is subtracted from the $1,500 still due ABC Co., and factor sends ABC Co. the remaining balance ($1,200). This transaction is now complete.

If you would like to explore the world of factoring further, reach out to a local factor and ask questions, or feel free to email me and I will be glad to answer any questions you may have: bob@12five.com.

Chapter 12 | Trade Credit Risk Insurance: Why It's Necessary
Jennie Cullen

Trade Credit Risk Insurance protects an insured business from a loss occasioned by the nonpayment of commercial debt. This can arise as a result of a customer becoming insolvent or failing to pay within the agreed credit period. This insurance protection covers standard goods or services sold and delivered, and can also be tailored to cover many other risks, such as work in progress and binding contracts. Companies that export can protect themselves against a range of 'political' risks that may prevent or delay payment (i.e., war or civil war, cancellation of the contract by the government of your customer's country, or the imposition of governmental regulations such as an embargos). The Arab Spring is a perfect example of what can occur quickly overseas that could also affect being paid on the given terms.

Startups to Multinationals purchase Credit Insurance policies for various reasons. This insurance can help a company sell more by guaranteeing certain terms; it is also a great tool for a company's credit and finance manager to manage risk, and it improves a company's financial profile to lenders and addresses issues that may otherwise be obstacles to lending.

What is Credit Insurance?
Credit insurance is a Property and Casualty insurance product. Companies purchase insurance to manage risk. Although most businesses know to insure tangible assets, such as property and plant, many neglect to cover their receivables, which sometimes represent 40% of a company's current assets. It is far more likely that a client will not pay than a company will have a fire, so credit Insurance may be the single most important coverage missing from an average company's insurance portfolio!

An Example of Credit Insurance at Work
If a company's profit margin is 5% and one of its customers defaults on debt of $100,000, then the company will have to produce additional sales of $2M to make up for the lost profits.

A trade credit insurance policy helps manage account receivable and compensates a business in the event of non-payment. The lost cash flow could be devastating, as non-payment weakens a company and lowers its investment capacity. Credit insurance transfers this risk to a third party at a reasonable cost to the insured.

However, ***Trade Credit Insurance offers more than just protection against loss!***

Other great advantages to Trade Credit Insurance are:

1. Enables a company to manage risk while increasing sales
2. Improves a company's financial profile to lenders

Selling on Open Account and Managing Risk

One of the great advantages of credit insurance is that it allows a company to extend credit safely to its buyers and sell on open account. Today, companies cannot be competitive while also requiring payment "up front" and/or Letters of Credit, especially in a competitive, global marketplace.

An open account transaction is one in which goods are shipped and delivered before payment is due, which is usually 30-90 days after the delivery date. Obviously, this option is the most advantageous to the buyer in terms of cash flow and cost, but is consequently the highest risk for the seller. Companies must have a clear credit policy to sell and track buyers on open account.

The basic elements of any business's credit policy to sell on open account are:

1. Buyer, to whom credit is extended
2. Credit terms
3. Problem Detection
4. Collection Procedures

Making these determinations in a foreign country is much more difficult for small companies conducting business globally than it is for large multinationals. As such, the credit policy is critical to a company's success. Credit insurance addresses each of the above elements.

Today, businesses must address a myriad of factors and concerns.

1. Customer information: In an age where any type of buyer can find your business online, it is critical to be able to "check out" potential buyers and their credit prior to working with them. With credit insurance, the carrier (insurance company) takes care of everything for the seller (you). In many cases, the carrier may already know the buyer from one of many extensive databases; all that is needed is the purchaser's name and address, along with the amount of coverage required. The carrier then performs the investigation for you.
2. Credit terms: The seller knows what is needed and it can change by industry and buyer agreements. There can be different payment terms for different clients and products sold. Credit insurance does not force a cookie cutter program on the insured.
3. Problem detection: The insurance carrier is the "eyes and ears" around the world for its policyholders. If a buyer is having problems (i.e., bounced checks, downturn in business, etc.), the carrier will find out about it. If there is a downturn and coverage needs to be lowered or cancelled, ALL outstanding invoices are covered, even if there are changes going forward.
4. Collection procedures: Many business people do not realize that credit insurance carriers are the largest "unknown" collection companies in the world! Carriers are used to collecting on invoices as low as $500 and up to millions of dollars! If you are a policyholder, there may be a small fee for collecting, but some carriers do not charge at all.

Assessing and monitoring risk has become critical since the "Great Recession." This is a great tool that works with your credit and finance managers, while growing the business by selling on Open Account.

Credit Risk Insurance can help a company gain greater access to financing

Credit Risk Insurance can be used to provide security to a lender. Lenders, for example, are uncomfortable with issues such as customer concentration and foreign receivables. How does credit insurance allay these fears? Let's look at some common obstacles that businesses face when looking to finance their operations:

Customer Concentration

Customer concentration can be a very serious issue. Loan applications often ask the following question: "Does any customer make up more than 10% of accounts receivable?" I know from experience that if you tick the "yes" box, many more questions follow, and the business seeking financing may or may not be approved for a loan based on that question. Lenders can refuse a loan based on customer concentration issues, and without financing, the company may not have sufficient capital to fund its operations and meet its fulfillment obligations.

Credit insurance specifically assesses risk based on individual buyers, so if there are five buyers but one makes up 80% of sales, a carrier will underwrite all buyers, including the largest one, and make the lender the loss payee in case of a default. Doing this gives the lender the cushion necessary to include all receivables in the borrowing base. (Carriers can also write a Single Buyer Policy and only insure one buyer if necessary.)

Foreign Receivables

Lenders do not feel comfortable lending on foreign receivables because of so many issues that can affect payment. Insurance carriers, however, have underwriters around the world who monitor countries, industries, and buyers wherever they are located.

Since lenders will not include foreign receivables in the borrowing base, traditionally, Letters of Credit ("LCs") have been used to guarantee payment. However, there are many issues with LCs; they are cumbersome, expensive, delay the progress of the transaction, and do not give a seller a competitive advantage.

Credit insurance eliminates this administrative burden. The ease of operation is impressive. Policyholders can input the name and address of a buyer, including the coverage requested, and secure an almost immediate response in many cases. If it is an automatic approval, the carrier will do the investigation.

Once approved, the lender is made Loss Payee on the policy and will receive all updates that the policyholder receives. This coverage gives lenders the comfort level needed to include foreign receivables in the borrowing base.

Frequently Asked Questions

- **Who sells credit insurance?**
  There are several private carriers. The Federal government through EXIM bank helps exporters with credit insurance.

- **How soon will a claim be paid?**
  In the event of bankruptcy or insolvency, a claim is paid immediately. If it is a default, there is a short delay to try to get the company to pay, if that is not achieved then the company is deemed insolvent and the claim is paid.

- **How much does credit insurance cost?**
  The cost of a credit insurance policy is directly linked to the risk to which a business is exposed the amount of turnover you wish to insure. It varies with respect buyer location, a business's track record in credit management, the nature of the customers, the trade sector in which you trade, etc. Domestic is priced lower than export. Domestic is normally less than a quarter of 1% (25 basis points), while international is 20-75 basis points based on size and structure. All are certainly less than 1%.

- **Can this cost be built in or passed onto the buyer?**
  Absolutely! Many companies give a discount for paying up front and impose a carrying charge to extend terms and delay payment. In the export market, other countries do not enjoy the low interest rates that the U.S. has (for example, Mexico has rates of up to 20%), so if a buyer needs to borrow money to buy a product, it can be quite costly. In turn, many buyers will gladly pay a small carrying fee.

- **What is needed to secure a quote?**
  To secure a quote, you must complete an application. Important information includes sales and losses and top clients in the business. (Remember, oftentimes 80% of a company's sales come from 20% of its clients.)

- **Is this similar to other insurance policies?**
  Yes. There can be a co-pay (normally 10%), and there may or may not be a deductible.

- **Are there particular industries that use credit insurance more than others?**
  The most frequent users of trade credit insurance are now in the textile and apparel industry, retailers, electronics, food and beverage companies, and global industries such as steel.

For many reasons, credit insurance is a powerful financial tool that can help ensure growth and avoid the devastation a bad receivable can bring. It is a tool that should not be overlooked when assessing a business's capital and insurance needs and risks.

Chapter 13 | Risk Management and Business Insurance

Chuck Galas

The original title of this chapter was "Business Insurance," but as you will see, insurance is just one piece of the larger picture of a risk management program.

There are entire books that deal with the various aspects of risk management and business insurance in detail. This chapter is not meant to compete with those, but instead to familiarize you with:

- Basic concepts of risk management
- Reasons why having a risk management program (or at a minimum, an approach to risk management for your business) is important
- Examples of where and how risk management integrates into your business operations
- Insurance industry operations
- Various types of insurance coverage available to your business

This chapter will also provide you with a foundation for understanding what level of a risk management program your business might need and help you ask the right questions of your risk management consultant, insurance broker, or agent.

Many businesspeople consider the acquisition of business insurance to be an adequate approach to risk management. This is rarely the case.

Basic concepts of risk management

We all deal with a certain element of risk in our daily lives. **Risk** comes is all shapes and sizes; although definitions of risk vary by topic and field, a broad definition of the concept is the **uncertainty of an event that is detrimental to an objective.**

There are two dimensions to view these risks analytically:

- **Frequency**: how often the risk occurs or how likely it is to occur in the future
- **Severity**: the seriousness of the consequence of the risk occurring

Frequency and severity are the dimensions on which claims are analyzed as well, so these two concepts hold a prominent place in any risk management program.

One way to quantify risk is to multiply the **probability** of the detrimental event by the **severity** of the event, and then multiply that result by the expected **frequency** of the event. The result is **total risk exposure.**

Note that all of the terms in bold above represent important elements of understanding and developing a risk management program for your business. (While this might seem academic, getting the basics in place is necessary before traveling down some more complex paths in risk management.) Key terms and concepts will continue to appear in bold throughout this chapter, both to focus your attention now and to serve as a reference tool in the future.

Goals of risk management

The goal of risk management seems simple enough: minimize the detrimental impact of uncertainty on your business objectives. However, even in a simple business operation, unforeseen events can disrupt, cripple, or destroy the business. Most operations have a number of critical factors; some are easily seen, while others are hidden by interconnections with commonplace functions that we assume will continue uninterrupted.

As you start to think about some of the complexities raised in the next section, you will see that the simple goal of minimization of detrimental impacts to your business requires more than a passing thought or basic insurance policy. But before we start, we need to define the basic pieces of risk management. A risk management program must:

- **Assess** the various risks to business operations
- **Decide** which risks need to be addressed formally and which require less attention
- **Develop** approaches to
    - remove risks that can be removed
    - lessen the frequency and severity of risks that cannot be removed
    - transfer the impact of risks to someone else
    - establish an ongoing program to repeat the above on a periodic basis

In most small businesses, with a modicum of care, the frequency of very severe events is low, so most business operations are lucky enough never to have to test the real quality of their approaches to risk management. As business operations grow larger, however, the likelihood of these events grows. The larger and more decentralized the operations, the greater the need for formal risk management programs and procedures, because the knowledge and care instinctively ingrained in the small business does not exist in the larger one.

Even though the old adage "it is better to be lucky than to be good" remains true, it is better still to have a formal risk management program to fall back on in the event that your luck falls through.

Real-world examples

As stated before, each type of business, industry, and operation presents different types of risks and therefore requires a customized approach to risk management.

While incomplete, below are some examples of the types of considerations you'll need to make when developing a risk management program.

- **Financial**: exchange rate fluctuation, interest rate, credit risk, capital risk
- **Property loss**: fire, political takeovers (if you have operations in foreign countries)
- **Operations**: supply chain risk, product transportation risk, distribution channel risk
- **Workplace**: workforce exposure to hazardous events
- **Information security**: trade secrets dependencies, customer information leakage liability
- **Physical security** in various locations
- **Partnership**s: reversals or a failure of a strategic partner
- **Personnel**: loss of key personnel
- **Workplace safety**: issues harmful to productivity and increased turnover

This is just a short list of potential risks any business can face. By thinking through how your business would respond to each one, you'll be able to develop approaches that minimize the risks from occurring and better prepare you to take action *before* and *after* the event should the risk become reality.

How detailed or how formal your response is will depend on the risk management approach that you take. You may say to yourself, "I will take that risk!" Just remember that the decision *not* to minimize the chance of a particular risk or its impact on your operations *is still a part of your risk management program*. The elements of this management program are valid management decisions, however they should be *conscious* decisions, not *accidents.*

Below are some potential business risks presented in more detail to help you understand the importance of engaging in formal risk management (as opposed to simply purchasing insurance).

Example: you operate a business that produces widgets, and your business has grown from a small machine and production shop to a large operation that current employs 200 employees in a single location. Your company has two main competitors but controls 50% of the market.

What happens if your plant suffers a terrible fire?

A typical response: "I am covered. I have a fully insured fire policy for all plant and equipment, so I will be reimbursed for the loss and be able to rebuild."

Certainly, having the fire policy was smart thinking, and yes, you will be reimbursed for the *physical* loss of your plant and equipment.

However:

- What happens to your customer base and market share while you rebuild your plant?
- What happens to your 200 trained and skilled workers (who know how to produce your widgets) while you aren't producing your product?

- What happens to your distribution channels during your down period?
- Do your supplier contracts have guaranteed minimum levels in order to insure lower acquisition costs? If so, how will you satisfy these minimums while one of your plants is out of commission?
- Are the raw materials required to produce your widgets in abundant supply, or will it be difficult to restart operations after rebuilding your plant?

These issues can easily destroy your business.

How could a good risk management program have helped you to address these questions?

1. You could have considered expanding to more than one location during one of your expansion periods so that all of your production (and risk) was not located in a single plant.
2. Various provisions in a Business Continuity Policy might have helped you hold on to critical employees.
3. By understanding the devastating impact a catastrophic fire could have on your company, you would have realized that the cost of a high-tech sprinkler system was a smart investment.
4. Routine safety procedures, developed by skilled safety professionals, might have prevented the fire from occurring in the first place.
5. It might have been possible to work in some contingencies in the contracts with your distribution and supply channels that would have protected to your ongoing relationships.
6. Lastly, your risk management disaster contingency plan might have "thought outside the box" to include a reciprocal manufacturing facility agreement, even with one of your competitors.

These are some examples of how a well thought-out risk management plan can be the difference between saving your business and shutting your doors for good in the aftermath of a disaster.

That said, some of the suggestions outlined above have significant price tags to implement. To some, these measures may be too expensive given the low probability of a fire destroying an entire plant. All final decisions rest on your shoulders, and the expense comes from your business's profits. However, the cost of having a trained risk management/safety consultant review your operations and prepare the assessment for you to evaluate would not have been prohibitive. Some of the recommendations would have cost very little to implement (especially the idea that better safety procedures can prevent a fire in the first place).

You can often get an initial risk management assessment from your insurance agent or broker, or from the loss control representative employed by your insurance company. Many times these sources are overlooked or endured in order to get insured; if you feel this way, you might want to rethink your position, as you can't always rely on your luck to pull you through a tough situation.

Insurance industry operations

A quick overview of how the insurance industry operates might be helpful when purchasing insurance for your business. As your business gets larger, you will be interested in insurance policies and other forms of risk transfer where understanding the industry and its terminology becomes more important. However, understanding some basics will prove useful to a business of any size.

The insurance industry has two major industry components:

- **Life and Health (L&H)**: life insurance, health insurance, annuities, pension, and benefits
- **Property Casualty (P&C):** fire, auto, general liability, workers compensation, surety

Both industries have segments that deal with **reinsurance** products and services, where insurance companies themselves take out insurance policies with other insurers to cover the possibility of unusually large losses in their book of business.

Both L&H and P&C industries have **specialty insurers** that focus products and services to address very specific markets and types of risk.

Insurance companies can be **stock companies** (owned by stock holders, just like any other corporation) or **mutual companies** (owned by policyholders).

Insurance companies bring their products and services through:

- **Independent agents:** insurance agents who represent multiple insurance companies.
- **Direct writers:** agents who are employees of one specific insurance company.
- **Brokers:** individuals who present themselves not as working for insurance companies, but instead as working for you, the insured.
- **Managing General Agents (MGAs):** agents who usually work with a single insurance company in writing specialty lines of coverage, where the underwriting expertise and decision-making responsibility rests with the MGA rather than the insurance company. Other agents and brokers work through these MGAs to secure policies for their clients.

Insurance companies, whether stock or mutual, L&H or P&C, draw on the statistical principle of "the law of large numbers" to generate **underwriting income**; everyone pays a premium every year, but not everyone has losses that exceed the premiums they've paid, which accounts for some of the company's profit and overhead.

Insurance companies also generate **investment income** by investing their premiums and loss reserves (monies set aside to pay for losses earn interest income while they wait to be distributed).

The actual pricing model for L&H products and P&C products is quite different. In fact, the pricing models between various products within each industry are sometimes quite different. The main cause for this variance is the time between collection of premiums and payment of claims. This time period is referred to in the industry as a **tail**. The longer the tail, the greater the profit that accrues from investment income versus underwriting income.

L&H products in the areas of life insurance, annuities, and pensions are usually quite stable and predictable. For health insurance and most of P&C products, however, pricing and profitability varies significantly. This variability is worth exploring a little deeper.

Products like auto insurance have shorter tails between collection of premiums and payments of claims, while workers' compensation products characteristically have much longer tails, sometimes as long as 20-30 years. How insurance companies make money varies due to these tails. The longer the time between the collection of a premium and the payout of a claim, the higher the proportion of an insurance product's profit comes from **investment income** as opposed to **underwriting income.** Here is where understanding an insurance company gets a little trickier.

Insurance premiums are an insurance company's main source of revenue.

Insurance company expenses can be viewed as three segments:

- Acquisition expense: expenditures made in procuring the premiums.
- Operating/administrative expense: payroll, rent, utilities, etc.: everything it takes to keep the business running.
- Loss and loss adjustment expense (**LLAE**): paid claims, associated expenses, the change in estimated loss reserves that will be necessary to settle all currently open claims and any that might be filed in the future, and the **IBNR**, which are losses that have been incurred but not yet reported.

When you realize the following three things, you will understand why portions of the insurance industry are so volatile:

1. Acquisition and operating/administrative expenses occur during the same time period that you are managing the operation, and they are real, hard numbers.
2. Loss and loss adjustment expenses account for 70% of the total collected premium (and many times add up to more than the collected premium). They are comprised of paid losses, but they also include estimates that can vary widely as claims mature. The insurance company can only *estimate* what losses will be; the true amount of LLAE will not be known until all claims are paid.
3. LLAE is paid claims <u>and</u> the change in estimated loss reserves. Those estimated loss reserves include estimates for *all unsettled reported claims from prior years plus the IBNR!*

For long-tailed P&C liability lines (i.e., workers' comp, general liability, products liability, and professional liability), managing operations is similar to driving a car using only the view out of the back window.

What you see on an insurance company's financial statements, whether for a specific product or across all products, are **calendar year** financials. **These calendar year numbers represent what has transpired during that particular calendar year, *across all open accident years.***

Read that last sentence again: it is one of the two main factors that make insurance company financials different from the financials of other companies in other industries.

When you view a company's annual financial statement, you see the accounting representation of the quantification of what has transpired in that year. If there are write-offs or special income entries from prior years, they are marked and noted accordingly, but they appear in the current year's financials.

Although some of an insurance company's revenues and expenses are similar to those of other companies, the one major difference is in how insurance companies report **loss and loss expense**. The result is that an insurance company's current year financials can have more to do with re-evaluation of estimated losses for past accident years than with its current operations.

Let me provide one example that makes this point clear:

When the accident years for the Fiberboard Company (the primary producer of asbestos) were originally estimated, there was no knowledge of the harm asbestos caused on many of the workers and consumers who were exposed to the product. As people began to understand the harmful impact of asbestos, millions of new claims were filed for past accident years, and the estimate of the cost of settling those claims needed to be reflected in the current year's financial statement. Every year that passed has seen new claims on old accident year's increase, as well as a change in the current estimate for old claims. (When past loss estimates are too high, subsequent revisions can produce a windfall for the company's current year profitability, however things tend generally to go in the opposite direction).

Why is this important to you? Suffice it to say that understanding insurance company operations will help you understand pricing trends in the industry, where profit comes from, and how margins are calculated. This is definitely the case for very large operations where the premiums that you pay are adjusted retroactively (more on that later).

As stated above, in most P&C product lines, loss and loss expenses account for around 70% of the total expenses. The other 30% are acquisition and administrative expenses. Consider what that means when you are quoted substantially different prices from different insurance companies. When a company quotes you tremendous savings over others, you need to ask yourself where those savings are coming from.

When choosing your insurance company, don't just choose the low cost option. Think through the ways they can charge you a lower price for the same coverage:

- The company's acquisition expenses are significantly lower than its competitors
- The company's administrative expenses are significantly lower than its competitors
- The company's underwriting is superior to its competitors, thus, it writes policies for people who have fewer and less expensive claims
- The company is willing to take less profit than its competitors
- The company pays out less to claimants per premium dollar than its competitors

If a company is more efficient than its competitors and willing to share the benefits of that efficiency in pricing its product, then that is a good thing. Similarly, if the company pays out less due to great underwriting (it can afford to select only the best risks, i.e., those that submit fewer claims), then great! Regardless, you should take a serious look at how your business is evaluated; this will give you a good idea of how the particular insurance company with which you are working operates. You are purchasing insurance to help you in times of need, so going with a low-cost company known for difficult claims settlement might not be the best choice.

Remember, lowering your premium is only one part of your risk management program. In the long run, the quality of the company you select and the types of insurance you choose are more important than lowering your premium by a few dollars.

Types of Insurance

For small- to medium-size businesses operating in a basic industry, there are three fairly simple decisions:

- **Life insurance** for employees: usually a nice benefit for employees that you can acquire at a very reasonable group rate.
- **Health insurance**: a harder decision due to escalating health costs, but a good healthcare package is appreciated by almost all workers and keeps turnover low. Depending on your business, retaining good workers who are already skilled in your operations raises productivity and lowers workers' comp fees.
- **Combo Liability Package**: most insurance carriers offer a business package that pulls together general liability, workers comp, commercial auto, etc., commonly called a BOPP (Business Owner Protection Plan).
- **Industry/Professional Packages**: designed for specific trades, specialty business, or specific professional (roofers, general contractors, lawyers, architects and engineers, carnival operations, liquor stores, beauty salons, just to name a few). The benefit of one of these specialty packages is that they already have a great start to the development of your risk management program.

If your business doesn't fit into a Combo Liability Package, then you will need to consider separate policies for various types of peril (i.e., fire or other catastrophes), commercial, auto, and general liability. If your business performs service or construction work, you will also need a Surety Bond to cover any loss that you might have caused.

For larger businesses or specialty operations where a portion of the business contains a large amount of risk, standard off-the-shelf risk management programs or safety programs are not enough. You can usually do much better by customizing your insurance program as well. These customized insurance policies are called **manuscript policies,** which detail your coverage and specify the limits of what is covered in whatever special circumstance might exist.

Things to consider:

- **Large Deductibles Policies**: if you have an excellent risk management and safety program, then you might be confident that 'paying yourself the deductible' (another way of looking at the initial premium if you feel that you will come in under that claim level) is a good business bet; in this case, you may only need to take insurance for large catastrophic events.
- **Retrospective Policies**: these are insurance policies where the ***rate is determined by a formula*** and your final premium is calculated and paid by applying the formula after all claims have been paid.
- **Layers of insurance:** this refers to various rules of what is covered, and how each loss layer incurred is paid. Most commonly, these are referred to as **Aggregate Limits** covering all losses for a given accident year, or alternatively, as **Per-Occurrence Limits** (the cap on what is paid for each single loss event).

The advantages of the above-mentioned approaches are only realized if your risk management and safety programs produce a lower level of claims (frequency and severity) than the insurance company rates assume. This way, you benefit by saving on premiums paid. The insurance company is willing to issue a Retrospective Policy because it removes a layer of risk from its profits; you will be covering that risk, and the insurance company will receive administrative fees, which include expenses plus some profit, without incurring the risk of unexpectedly high losses. (However, many Retrospective Policies include an Aggregate Limit, after which the insurance company assumes the responsibility for settlement of the claims.)

Additional considerations:

- Setting up a **Captive Insurance Company** is the logical extension of assuming most (if not all) risk yourself. (Basically, you are setting up an independent insurance company to which you pay premiums that are then used to pay out losses.) You are responsible for seeing that the captive is funded to cover the claims it needs to pay, and your captive—instead of the insurance company—collects the investment income from the loss reserves that remain in its accounts until all claims are paid.
- **Reinsurance** is how you protect your captive (and hence your company, which would be responsible for the debts of your captive) from bankruptcy. There are many types of reinsurance, each with its own level of complexity, however, there are two main types of reinsurance:
    - **Facultative**: specific individual risk coverage
    - **Treaty Reinsurance**: coverage for similar type of claims for a specified period of time

  The other named types of reinsurance are specific instances where specified combinations of Facultative and Treaty Reinsurance are combined with Loss Limits on either an incurred or paid basis.

Common Business Insurance Coverages

Life Insurance

- **Key Man,** for the company to help financially cover the loss of a key individual.
- **Group Life,** for employees as a potential benefit provides a nice benefit at a reasonable cost.

Group Health:

- **Contributory**, where employee pays for a portion of the policy, or **fully paid** by the company.

It should be noted that the Affordable Care Act ("AFA") has requirements for companies that employ over 50 workers. Implementation of the law has been postponed, and it will likely be altered again before it is implemented, however over the long term, the AFA should reduce the cost of current employer healthcare for those already offering healthcare to their employees. We are already seeing that demonstrated in reports that have been filed on the AFA. Ultimately, offering good healthcare benefits should offset some of the additional costs associated with the AFA by increasing productivity and decreasing retraining costs.

Property

- Protection of direct loss of property: choose between named perils and multi-peril.
- Protection of indirect loss, e.g., coverage of expenses due to the loss of property, loss of income, etc., Insure for Cash Value or Replacement Value options.

Business Continuity

- Usually sold as an endorsement to property insurance, covering lost revenue and expenses associated with setting up an alternative location and continuation of employee payroll so that you don't lose valued employees during a down period.

Commercial and General Liability Umbrella

- Covers third-party losses for specified types of loss and/or pays for legal defense should your company get sued. Offers general coverage of unspecified third-party losses above basic liability insurance.

Products Liability:

- Covers losses from harm caused by the company's products.

Commercial Auto

- Covers first- and third-party losses associated with automotive vehicles.

Inland Marine

- Covers cargo transported over land as part of business operations.

Ocean Marine

- Covers cargo transported on water.

Workers Comp

- Coverage for employees who sustain injuries at work.

Errors & Omissions

- Commonly known as **Professional Liability Insurance,** this insurance is needed for professional and service firms covering liability for non-performance or malpractice. Many policies are designed to cover specific professions.

Directors & Officers

- Protection against suits against management actions and decisions that led to some form of harm to employees, customers, or the general public.

Surety/Fidelity Bonds

- Coverage against claims by customers/clients for non-performance of work or harm caused by some breach of fiduciary responsibilities.

Examples of the typical coverage required for various types of operations:

1. Almost every firm needs some form of General Liability Insurance. Third-party claims can arise from just about anything in today's litigious society.
2. Professional firms need to consider Professional Liability Insurance (which is just another name for Errors and Omissions; policies are usually crafted for specific professions).
3. Every firm that produces consumer products needs Products Liability coverage.
4. Contractors, tradesmen, and companies supplying services to the public need to carry some sort of general liability plus surety bonds.
5. Workers comp insurance is required by most states.
6. If your company operates fleets of cars for a portion of its workforce or operates a trucking fleet, then you need to have commercial auto insurance.
7. Companies involved in transporting cargo need an inland marine policy for land transport and ocean marine policy for transportation of cargo on water.

Final Thoughts

If this chapter did its job, then you should realize that there is quite a bit of thought required to safeguard your business and minimize risk. Undoubtedly, the right insurance policies with the proper endorsements and coverage limits are essential to the long-run survival of your enterprise. However, **insurance is not enough.**

This material is intended to provide a better understanding of the insurance industry and drive home the importance of establishing a comprehensive risk management program. Hopefully, it also prepared you to raise the right questions and better understand the responses you'll receive when establishing your risk management program.

You can start small and grow your program gradually. Including staff in the development of risk management and safety programs is an excellent first step to get your team thinking about "working smart," the importance of minimizing risk, and keeping everyone safe. Getting everyone in your organization to participate in the program will go a long way towards its success.

The examples provided in this chapter, while far from comprehensive, are meant to be food for thought. To learn more about risk management and safety, visit:

- The rmLibrary (risk management library) at www.rmlibrary.com
- The Safety Library at www.TheSafetyLibrary.com

These websites offer thousands of topics and resource titles that provide a much more comprehensive list of what to consider when developing your risk management plan. Remember: although it may still be better to be lucky than to be good, being smart and prepared never hurts.

Chapter 14 | HR Practices: The Human Side of Profitability

Nicole Martin

When I was asked to contribute to this book, I was initially surprised. Then, I reflected and realized my entire life's work has led me to a pivotal place in time. My fundamental beliefs have arisen from working through my own career evolution while being true to myself. Evolving to the point of realizing that once I was keenly aware of my very own drivers, values and burning desires it was clear that my work was in fact my play. Not an effortless journey, but a meaningful one, and not without determination or a demonstration in faith. Once I realized that I could apply my innate strengths to work, my work, in fact, became play. It is evident that every CEO I have ever worked for is, in essence, doing exactly that. The clarity of this realization has provided an undeniable calling to overcome fear and become willing to work in service. Not for my own pleasure, I now realize, but for something greater. I have found great reward in pursuing my own passions and realizing the things I take for granted are in fact helpful to others. Thus, my fundamental beliefs were born.

Fundamental Belief #1: Every person deserves to find work that plays on his or her strengths.
Every person deserves to do what they excel at naturally. If we all did that, perhaps the diversity of strengths in each of us could develop excellence in our work. This is not a new discovery and many have written about it before. Yet, day in and day out, I fail to observe people readily living their strengths, let alone, leaders that are leading their teams to their strengths. Often, I wonder if people are truly asking themselves, "If I did not have to work but only had to wake up each day and play, what would I do at play?" To be granted the freedom to be free to do exactly this is seen as a dream. Something unattainable, yet I believe it is attainable. With their answer they would find their true calling. Very few in fact do this. From my experience, I see firsthand that the founder of every business I encounter is certainly excelling at what they enjoy and are likely doing so with what comes to them naturally. It would seem obvious that those that come to work for others need only know this truth to be joyful and excellent in their own right. If every employee knew their own drivers, strengths and values were in alignment with the position, the revenue drivers and values of the business would it not be clear they would enjoy the work they perform? I had dinner with a friend recently and she openly declared, "I do not need to like my work, I just need to go!" I completely disagree. I believe that if every leader looked to the workforce with the intent to vet the talent with this form of alignment in mind, the work would in fact be gratifying. The critical factor is to have a relationship to be able to engage the talent in a discussion of authenticity and mutual respect. Personal gratification in work aligned to strengths is not only feel good advice but grounded in behavioral psychology as well as industrial/organizational psychology. It works and translates to the bottom line.

We have traditionally understood job performance through a two-part model: attitude, values, and motivation beside experience, skills and education. Experts and historical reference tell us that when employers are faced with performance problems; they typically look to the employee. If experience and skills were present, then it used to be viewed that motivation must be the problem. Much has been researched and done with respect to studies in motivation. One of the outcomes has been to use incentives. Employers would aim to motivate employees with incentives or threaten consequences for non-performance. Circumstances vary but predominately, the studies over the years have demonstrated that this approach would fail to motivate. If employees were motivated and performance was not satisfactory, it is common for management to presume the need for training or more experiential learning. Clearly, everyone can find themselves in a learning curve. Sometimes the training works and employers realize the benefits as well as the return on investment. Sometimes the experience on the job is developed and the learning curve ends. Many times however, the curve does not end and the training just does not appear to make a difference.

When making a hiring decision, would it make sense to start with the CAN DO information. The “CAN DO” is what you cannot change with coaching or training after hiring someone. Once you have confirmed which candidates CAN DO the job, behavioral interviewing can help you make the best selection from the favorable candidates. For years, employers of choice have used tools available on the market to assess talent. May I add, not necessarily the best talent but rather the best talent for their business? With validated and reliability tested tools, an employer can see what could be changed and what would not change with training and coaching. Behavioral Assessments can give employers and their respective candidates the information they need for true talent acquisition and development. Even better, leaders can hire strategically and engineer a team for diversity and strength. The cognitive abilities and personality traits describe what the candidate CAN DO. The most beneficial tools I have used in practice are validated to cognitive ability, normative scores, solid psychometrics, and hard-wired personality traits. Furthermore, they are integrated with critical performance factors and are intended for business use.[9] I have found in working with people throughout my career, many people are not self-aware of their innate strengths or how best to apply them in their work, let alone within the framework of the team they work within. Leaders in business can utilize assessment tools to enhance their recruitment process for improved outcomes. In addition, high performers can be assessed for critical factors in management for educational development and succession. The best of them are well intended not only for the business but for the talent as well. Thus, providing the information to allow a person to appreciate the factors for which they naturally excel.

This has become something I have incorporated into my own business as it grows. I did not just happen upon it. In fact, I have experienced many tools in my career in human resources but had always thought, “Those are nice but I know how to assess talent, I have reviewed thousands of resumes!” Not necessarily. I too, am guilty of interview bias. I had interviewed and hired a member to my own team shortly after experiencing growth. Thrilled and confident this person would be a great fit I extended the offer prematurely. She had the skills, experience it seemed and she was joyful, extroverted, and approachable. Within a week, it was clear it was not working for her or the team. This was a unique opportunity for me to experience what I first hand witness

[9] Chuck Russell. *Right Person, Right Job, Guess or Know*, Second Edition. (Amherst, MA: HRD Press, 2003).

in serving others in management. Had I used then the tools I recommend now, I would have found she did not have the degree of assertiveness that a consultative role requires. Not every HR role is the same in fact. As my team grows, I have found the benefit of truly practicing what we preach and identifying not what I perceive everyone's strengths are but what they truly are. The team is affirmed in their strengths and we bring transparency to them so all can appreciate the diversity of strength for the benefit of the team. The tools I speak of are not for the mere purpose of improving communication. Those tools are on the market as well but do less to help an individual past the assessment and on their way to success in work dynamics. As you build your team, as you grow your business, do not just hire for the position but with the team and business in mind as well. By understanding this first, it can be easily communicated and allow you to intentionally create a solid foundation by way of communicating your own innate talents as a leader and seeing that any candidate fits the needs of the team with talents that complement and add to its capabilities. In team engineering workshops I have worked with established teams that may appear diverse at first glance but when you review the team behavioral profile, the diversity may exist in areas that lead to contention when working together. Diversity initiatives excel when they are designed to bring people together vs. to highlight differences. It seems simple, and with the right philosophy it is. Why is this fundamental belief # 1? Because it will become advantageous when the skilled workforce is not readily available and your talent pool lacks experience.

Fundamental Belief #2: The Talent Deficit is here, and talent gets to choose where it wants to work.
The talent pool provides for some alarming statistics in coming years. It is no surprise that 70% of Generation Y (1965-1980) desire to be entrepreneurs themselves. In 2015 and beyond, the demographic shifts are leading to a framework where talent will have the luxury to choose where they work. The term office is now a verb for the talent of the future. Let us take a moment to define talent. There is the textbook definition of natural aptitude or skill and then the more typical talent acquisition view of *experienced,* meaning having knowledge or skill in a particular job or activity. To source seasoned talent would indicate a great deal of experience in a particular activity will require going beyond traditional tactical recruitment methods. In fact, some verticals of business have begun to find little seasoned talent readily available. There is evidence that the Fortune 500 companies have been making talent development a priority for years. Learning and Development Officers oversee full sponsorship training programs for successful talent succession for the business to meet demand in coming years. The make or buy equation in talent sourcing clearly points to the value of a strong talent development strategy linked closely to business strategy and thus outcomes.

On average, 10,000 Baby Boomers (1946-1964) retire every day. There are roughly 45 million individuals that identify as Generation X (1965-1980). Forbes® has published that by the year 2025, Generation Y (1980-2000) will represent 75% of the global workforce. The simple math tells us that we are about to enter a talent gap of approximately 30 million people between now and when larger segments of the millennial generation enter the workforce. Furthermore, as young talent enters into the workforce there will be a deficit of experienced leaders. This solidifies two critical concerns for every leader at the helm of a business enterprise. One, for the vision to be strategized, implemented and lived, it will require people. People are not a commodity thus this is a variable that poses some complexity. Talent attraction, development and retention factors will be driving factors for every business seeking to grow throughout the next twenty years. This is a concept that every leader must comprehend. In an age where the job market swings cyclically toward and away from career seekers advantage, much of the responsibility for attracting top talent rests with leadership.

If you are the leader of your business, you must become the one that must inspire others to a cause or purpose that brings diverse people together. The entrepreneurial spirit and passion can be contagious. With experienced Generation X rising to the occasion, and Generation Y taking stride through technology and the search for meaningful work, it will be no surprise when many new businesses take shape and flourish. The continued acceleration of change continues to place greater emphasis on the role of Human Resources (HR) practices to develop effective strategies for the current and future workforce. For us to truly be strategic everything we design, implement and measure should forecast into the future for sustainability. Not only are you currently identifying revenue driving competencies but what does the organization need two, three, five years into the future considering a segment of your talent will leave voluntarily and you may need to source more. What gaps will exist? Will training alone address the gap and what lead times will exist for a return on the investment? Will it be enough?

Year after year, I work with CEO after CEO and I witness the complexities that develop when these simple truths are not identified and upheld; transparent to all; reinforced consistently; and communicated time and time again. Communication in words and in action is credibility. Credibility in business is currency in business and I often ask leaders I work with, "how credible are you?" Leaders must consistently identify customer values but also internal core values; revenue drivers as they relate to skill competency; strength and strategy. The leader must be cognizant of these issues for the sake of people and the business. As you expand your business, you must constantly consider what talent looks like for you.

Fundamental Belief #3: The HR-to-Employee ratio does not work (and it is not a 1-800 number).
It is a misconception that an organization does not need dedicated HR support upon inception of the business enterprise. In fact, I believe that even one employee equally presents opportunity as a potential brand ambassador for the business. In contrast, every employee can also be a potential liability. Allow me to explain: early in my career, I was taught that the HR-to-Employee ratio was 1 to 100. Of course, this metric is long outdated. Yet, it seems I continue to discover businesses that operate under this premise.

"Why do I need HR, and what do I need exactly?"
This is a question I rarely get and yet I believe it is the first question that should be asked. In fact, the question I more often hear after explaining what I provide is, "what is HR? Because what you just explained is not what I thought of when I think of HR." Another favorite is, "how does HR impact business profitability?" The simple answer is "significantly." If you have one employee, you have at least 35 laws that apply to your business, many of which requires you to do something and be proactive, however these myriad workplace challenges

are often unclear to the untrained eye. About a month ago, I was on a call with a successful CEO. As we talked freely, he shared that he enjoyed our conversation, but that HR did not "impact his organization." (This was only moments after he explained he had some legal troubles with former personnel to the tune of "settlements.") He has chosen to outsource his HR services to a Professional Employer Organization, commonly referred to as a "PEO provider," which I believe is valid given his organizational size; however, his choice in outsourcing seems not to have prevented him from taking hits to his bottom line.

There are several variations on the PEO models that exist today, differing in the nature of the relationship formed between PEO and Client Company. PEO models are typically co-employer relationships. In 2012, according to National Association of Professional Employer Organizations (NAPEO), there is now approximately 700 PEO's operating in all fifty states. Three such firms caught some negative publicity recently when three PEO owners and one former employee were sentenced in a $133M fraud scheme; the case was high profile and investigated by agents with the Federal Bureau of Investigation and the Internal Revenue Service-Criminal Investigation Division. Overall, the PEO market was responsible for approximately $81B in gross revenue in 2010. Thus, outsourcing HR is big business. Other HR service organizations include Administrative Services Organizations (ASO). These models provide the principal difference between the two types being of service (PEO vs. ASO): in an ASO arrangement, the employer remains the employer of record for tax purposes, thus the limitation of the employer's liability is merely perception (if it is perceived at all).

There is certainly a space for such service providers but I must share that in my experience, I have learned two things key to the employee and employer relationship. Discretionary loyalty and effort is not tapped over the phone and I believe I would be hindered despite my experience to serve a leader well without being onsite, reviewing the files, meeting the people and learning the business. With that being said, throughout my years in the field I have worked in organizations as large as a Fortune 500 with 6000 + employees situated internationally to as few as 10 employees in my Consultant practice. In my experience, if I waited for the CEO's I worked for to call me, it would often be too late and I would be working towards cost containment vs. cost avoidance or prevention. I firmly believe the relevance of outsourcing can be compelling however. Considerations must be given to enabling the presence of HR practices in an organization for the benefit of the business not solely for compliance. The objective should not be to simply eliminate transactional responsibilities but rather automate what is necessary and providing little value adds. One must still align what is necessary, thus tactical components should not be designed in a silo. There are hundreds of tactical components that must align to uphold strategic HR tactics as both relate to the profitability of the business. For example, a company can put an incentive or recognition program in place. Such a program could easily be established and in fact automated; readily available to managers and/or employees. To do this alone is not enough. Leaders must identify success through reward in such a way that it reinforces the value system, the desired behaviors and the revenue driving competencies that define success. Often, the tactical components of HR are set forth with a lack of connection to the strategic tactics.

Fundamental belief #4: Business must have tactical (transactional) and (strategic) HR tactics aligned to fully optimize and witness (transformational) work.

I have witnessed the outsourcing phenomenon that has taken place in recent years. In fact, I often see marketing campaigns for HR "optimization" with respect to outsourcing. In my opinion, optimization has more to do with how a business structures its personnel on an organizational level and the methods the organization uses to organize how work flows through the business to align with the business' objectives to carry out the business strategy, not just the tactical necessities. How can a business experience "optimization" to the point of transformational HR if the business seeks only to "optimize" the tactical necessities meanwhile neglecting the strategic HR tactics that will truly "optimize" the business strategy? I believe in the relevance of outsourcing especially for organizations that find it cost prohibitive to employ a full service HR department. Regardless, I suggest careful consideration of the presence of strategic interplay between business strategy and HR strategy integration to realize the benefits of how HR can "optimize" the business not just the tactical components. It was 2007 when I, the Director of HR for a mid-size printed circuit board manufacturer, was presented the PEO services of a large provider targeting small and mid-size businesses. I recall finding how fantastic the tactical streamlining could be as it would allow a strategic minded HR professional to focus primarily on strategic business initiatives that are often put on the back burner for the sake of day-to-day tactical necessities. However, smaller businesses are being sold on the fact that these models are full service HR. Yet, they can lack the strategy of HR in alignment with the business strategy if in fact they stand alone. In my case, it was cost prohibitive for the business I served to accept the proposal for the services presented even if the business had elected to replace my position entirely. I have come to the conclusion that while there are software platforms on the market that can streamline much that is transactional in HR those systems alone cannot help a business to realize the truly strategic benefits true HR "optimization" can deliver.

The challenge for the smaller business is that often a growing enterprise can lack the time and resources to build infrastructure and processes that are beyond core business objectives. Typically, beyond attracting talent, entrepreneurs can miss the fact that HR process can be core and ultimately foundational in order for the smaller business to have the same competitive advantage through its people that larger organizations create with size. To do this every tactic in HR can be designed to specifically reinforce business strategy. The off the shelf, tactical approach that represents the mechanics of HR delivery vs. fully integrated HR Strategy can truly be a competitive disadvantage. This is especially true if the policy, program, process; even template form documents, etc. are not designed with the strategy of the business itself in mind. Both small and large businesses must attract talent, develop and retain the best talent for their business. Both must comply with ever changing state and federal regulations and global competition. Both must be concerned with issues related to compensation, benefits, training, employee grievance resolution, and cost control.

Every business must operate between the constructs of efficiency and effectiveness. Efficiency is short-term thinking and effectiveness is long-term thinking. Analysis must be allotted by HR perspectives working with leadership to define how organizational theory interprets the current business strategy and the internal and external environment with respect to contextual and structural dimensions. The actual strategy and structure of a business cannot be optimized if HR strategy is not related in this context.

There are literally hundreds of tactical HR functions that support eleven HR tactics throughout the employee lifecycle (Talent Acquisition, Talent Attraction, Compensation, Benefits, Payroll/Tax Administration, Performance Management, Workplace Liability Management, Workplace Safety Management/Worker's Compensation, Employment Compliance, Recordkeeping/HRIS Technology, and Separation). These eleven HR tactics support seven strategic areas that can drain, restrain and threaten profitability when not managed properly. The seven strategic areas include HR Expense Management (short term), Leveraging HR Time (HR Administration), Business and Asset Protection, Long Term HR Cost Containment (Health, WC, SUI), Turnover Reduction, Talent Attraction and Employee Productivity. Each of the aforementioned HR tactics and strategies has the ability to maximize profitability through Human Resources by influencing the bottom line. At the same time that small HR improvements can dramatically increase profits it is just as simple for small HR mistakes to devastate the bottom line. Small mistakes are missed when the trained eye is not in your process, observing your practice and in line with your vision.

While I agree HR can be an overhead department, I would argue not every HR solution has to be and in all actuality I have seen more profit lost to CEO's knowing full well each circumstance could have been prevented had a trained eye been involved in the process. In fact, the first time a CFO told me HR was overhead and had little value I began working to prove him wrong. Within twelve months on the team, our organization had been recognized as one of Best and Brightest Companies to Work For™. Back in 2005, I was pleasantly surprised; I was just seeking access to benchmark quantitative data. Examining engagement metric tracking by company size, the SHRM GloboForce 2012 Winter Survey results showed us that larger companies are more likely to measure employee engagement than smaller ones (65% vs. 30%). Needless to say, I have befriended every CFO I have encountered since as the collaboration of HR and Finance in driving quantitative and qualitative data is something every business should be doing. The difference then was that I was a peer to Finance and having the support of leadership was pivotal to my ability to be effective in the HR leadership role.

It has been well known that for years there is a link between workforce engagement and corporate performance. In fact, the term "engagement" is the entire buzz. The term itself fails to truly capture what I have experienced in a culture as such because I believe the word "engagement" can seem too tentative. I have become fonder of the term "entanglement" so coined in the book, "It's my Company, Too!" by Kenneth R. Thompson, Thomas J. Walter, Ramon L. Benedetto and Molly Meyer. Companies that achieve qualitative and quantitative yield on engagement have achieved something more. Of 75 possible drivers of engagement the one that was rated as the most important was the extent to which employees believed that their senior management had a sincere interest in their well-being. In fact, Towers Watson has published studies reporting companies with high engagement, enjoy 3x the operating margin. Other key factors to increases in revenue are attributed to 95% of employees believing they had the work tools and resources they needed to perform exceptionally compared to only 20% in contrasting organizations. Similar disparities appeared with regard to the ability to sustain energy throughout the workday (97% vs. 32%), and a sense of personal accomplishment at work (99% vs. 33%).

However, only 38% of the Canadian respondents believed their organization and senior leaders encouraged and supported a healthy workforce and just 39% thought senior leaders were sincerely interested in their wellbeing. In 2012, PwC reported that engagement and involvement are critical in managing change at work, yet nine out of ten of the key barriers to the success of change programs are people-related. There you have it! Business goes nowhere fast without people.

A Best & Brightest winner would rather re-post a job than give the position to a candidate who is not a fit. The culture of a company such as this is protected. The impact of a poor placement is viewed as more expensive than the delay in placement. I often observe many leaders in business discuss and debate the nature of culture. I believe every business has an opportunity to express an invitation to a culture. It is the invitation in fact, that requires careful consideration and development. When done well, talent is able to self-identify if the values of the business align with personal values. It is the invitation that establishes the intended culture but it is every communication, decision and behavior that follows in practice that in fact becomes the culture. Whether the lived culture and the invitation to culture are expressed as one is the basis for shared vision. As an entrepreneur and leader of a business, the vision is yours to establish and communicate for a shared vision.

For HR strategy to integrate to optimize business strategy, the HR professional must understand external influences on your business as well as the internal value proposition that clearly communicates what is in it for employees.

Why? What is the fundamental purpose of it all? To drill to that level of meaning is essential. HR must know business objectives in order to integrate HR initiatives that strategically support the workforce in performing to meet those objectives. I once referred to myself as conduit and the gentlemen, a highly respected veteran of our military and leader in his own right, corrected me and declared that I was a weaver. Honestly, HR should be able to tie your business strategy directly to their HR strategy, which in turn supports management and provides visibility and transparency to employees with respect to their role in achieving it. It must be reinforced and reinstated time and again. Everyone must feel part of “it,” whatever “it” is!

Fundamental Belief #5: Every manager of the future needs to be a manager of choice.
With new leadership development programs or current management onboarding initiatives, there will need to be more discussed than functional skill. The *State of the American Workplace: Employee Engagement Insights for U.S. Business Leaders report* highlights findings from Gallup's ongoing study of the American workplace from 2010 through 2012. Findings clearly demonstrate that in the most recent year, 70% of Americans do not

love their boss. Thus, knowing what managers of choice look like from the beginning is important when considering employees as brand advocates for your business. Not to mention, the investments leaders make in the talent in hopes of realizing the return on investment. Managers of choice are good at talent scouting to build their teams, relationship building, trust building, skill building and organization brand building. How many leadership development programs do you come across with those top five competencies? Once the foundational purpose for a business is identified and the business experiences growth it is important to acquire talent as well as acquire and/or develop managers of choice. If you are striving to be credible as the leader of your business, it is a must to practice being a leader of choice on the journey to your own vision to support the team. Given, talent development is a critical factor for a thriving business, it is important to define not just the best talent out there but the best talent for you, your business, and your team.

Fundamental Belief #6: Every person must have a clear explanation of what success looks like in each respective role and for the business overall.

Communication is critical to the role of every leader in the business and the challenge as your business grows will be to maintain the access and/or visibility of the shared vision for the employees across the business. Maintaining a shared vision will require leaders to communicate it clearly and often enough that employees feel part of it. The words will not be enough as communicating the shared vision is as essential as living it out in actions.

Relationship management skills become increasingly important in order for a manager to provide feedback communicated with care and respect. Ideally, real feedback in real time when possible and peer accountability is a wonderful component to a framework for accountability. This is built into communication forums and technology tools today but the face-to-face exchange strengthens it. Many can find their performance management process stuck in neutral and many employees feel their managers are unskilled at discussing performance let alone coaching to performance. Despite those two factors, not a single one of us can ignore that it is an important process that has the potential to motivate an employee to organizational objectives and keep them inspired on their own journey to excellence. Performance is only one factor to consider given the fact that talent development will be critical to the majority of businesses. Developmental potential and learning and development plans will begin to allow for strategic talent pipelines. A design initiative such as this is a collaborative process between functional experts and should build on revenue driving competency development. Ultimately, the make or buy equation with talent is unique to the talent pool, the turnover ratio, and the lead time required to establish competency. The emergency evolves as you hone in on your demand. Every employee should be able to identify how to plug themselves into the business. When done well it should build on what they excel in naturally and the definition of success should be reinforced each day, each week, each month, each quarter, and annually whenever possible. The identification of success should be readily available, simple to assimilate and ideally, objective. And if personal values are to align with business values, the framework for behaviors must also be developed and upheld. Without a clear definition of success, the objective can become vague and the culture will suffer.

I have a client that is a serial entrepreneur. I have found him to be extremely effective in his work. He has metrics for all transactions for his team and every employee tied to a revenue-driving competency has a metric goal. Years into the business, we met and he was observing that the employees did not understand that the metric goal was in fact the expectation. This is a function of performance management. Expectations are not goals and thus should never be communicated as such. We were able to redesign his job descriptions to include indicators of effectiveness for not only competencies but also specific measurements. In addition, the metrics as well as the effectiveness definitions allowed for transparency on what is necessary to reach the next level of performance. An effective leader absolutely must establish the definition of success. The challenge presents itself when the roles are not revenue driving but rather support departments. This is common in sales organizations with administrative infrastructure. Correlating the effectiveness of those departments as they relate is an opportunity in inclusion and team performance and when it is overlooked, the crux of a functional structure takes hold and silos emerge.

Think about these two sentiments commonly rated in engagement surveys: “The purpose of my company makes me feel my job is important” and “I am clear on my organizations goals and future direction and the way in which I contribute to them.” Last but not least, help employees know how to express what they would hope to gain in experiences by communicating career advocacy. Aim to retain what you invest in and remember to identify not the best people, but the best people given their role, the team and the business need. If someone is failing, every leader should ask him or herself why. This is a critical exercise in self-evaluation as a manager of choice before moving immediately to a call for separation. True, circumstances can prevail, but this question should always be part of the process.

Fundamental Belief #7: As the CEO, the Founder, and/or the Entrepreneur, you must lead!
Do not ever underestimate your role as a leader. Embrace the power and responsibility to create an environment where people love to come to work. The best workplace cultures exist in companies that value two-way communication. Employees are often *expected* to make decisions to improve the company vs. the traditional hierarchical decision making model. Companies that value communication use Intranet and Social Media tools to communicate with employees. They still have town hall meetings, pep talks, and team huddles. Collecting qualitative data is as important as quantitative data when it comes to the workforce. They were not the companies that blocked Facebook or LinkedIn from their websites, but rather the ones that took the lead in educating their employees how to represent the business as a brand ambassador on their profiles. They use webcasts and one in four has blogs from senior leaders. In culture assessments, employees can be asked whether or not they agree with the following statement: "When good or bad things happen at my organization, employees hear about it in a timely manner.” The CEOs I have served understand that very few things are truly confidential and often the absence of communication can lead to far worse assumptions than the actual truth. I was talking with an employee at one of my client’s locations last week, and the employee cited information shared with her from another leader that should have been communicated to her but was

not. The CEO in this instance lost credibility. I cannot express how damaging the most innocent of communications or lack thereof can mitigate the ability to tap into the employee's commitment level. Something as simple as common courtesy and discretion is still valued and what good news, right? What is often missed is that this is also a symptom of a CEO that decided to manage in a moment where they should have led. Employees take offense if they hear about something significant from the grapevine vs. management. I often witness leaders that own a business have a hard time leading after they hire talent to manage. Honestly, the philosophy behind communication should not be fear in communicating there is a pay freeze. Rather, a leader should confidently, bring the team together to inspire the change needed to impact a positive outcome. I have witnessed businesses thrive after significant challenges including pay freezes, furlough, even disaster recovery. I find myself in awe of the fact that one person may feel they need to solve all the problems of the business. The best leaders ask questions and truly allow other leaders to rise to the occasion. I have served among great managers and employees that were leaders in their own right. I have witnessed entire manufacturing teams who have worked through Memorial Day weekend simply because they knew their "boss" needed them to. Was there an incentive, you ask? No! I recall this leader going around the back of the CEO rather than speaking to him about the way in which he would work to the objective. Why? To simply avoid the discussion, and yet all I could see was nearly 100 people that would tie their loyalty to the leader that saw them as adults, real people contributing to the bottom line. They in turn, contributed, felt satisfaction in the collaboration and never asked once what was in it for them. Yes, I have witnessed discretionary effort and when it is present, you can feel it in the room. Underneath it all, some observe people at work and I observe people at play. Those people were doing the work for themselves. Examples like the one I share are real. The balance is the leader must not take for granted what has been benefited and gratitude must be expressed and be sincere.

The way that everyone can play is when they sense the passion from the leader, the call to action if you will. The "why" will bring people that align forth and if each role can be expressed in a way that supports the why sentiment, each person can sense their contribution and can tie their work back to profitability. When asked, I advise to tell the truth and if it must be withheld, simply share you are not at liberty to share but appreciate their inquiry. Never outright lie to an employee lest you lose credibility and trust. Very little is confidential in the end. Being up front is essential for business success; it lets the employee know they matter and even more important, shows that you care.

Fundamental Belief #8: Every Chief Visionary deserves a Chief Challenger (or Challengers)!

One key observation in my career in working for leadership is great leaders demonstrate trust by trusting managers to manage up. One example that comes to mind is the CEO that aims to be the unbiased party on the team. You know, Switzerland? At the end of the day, the CEO must understand they will never be viewed as the neutral party by everyone and even more evident is the fact that the CEO plays the role of Chief. That does not mean dictator, or even final decision maker. Chief Visionary works however. Regardless, every Chief deserves an adversary but ideally one that means well and is in fact capable of proactively expressing the contrary perspective. Thus, in my experience I have found it important to advise leaders to have a person on their team that is in fact the honest, unafraid yet caring enough to speak, interrogate the presented view respectfully and perhaps privately when appropriate. For if you are a leader who always hears affirmations, or if there is no drama in your business, then you should be concerned. Every good team deserves someone that veers from consensus. From my perspective, the Chief Visionary should set the tone and the expectations; this in fact is the expressed invitation that inspires. Without commitment to uphold the affinity of the expressed invitation, personality dynamics play out, and before long, someone else's invitation will have been accepted. Often, when I meet with individual managers that comprise a team, it is shocking how many crave the invitation and yet, without the presence of a trusted neutral presence, many opt out of the conversation. The importance of good collaborative exchange is to remember that constructive brainstorming sessions and dialogue between leaders must occur for the sake of the business. Furthermore, it is important to not concede in agreement for peace but rather listen and strive to understand the nature of disagreement while the Chief Visionary's role is to uphold the vision and values of the business never sacrificing respect for the contributors. This requires the Chief Visionary to set the tone. This belief I share with the sole intention of arming you with secrets to some of the best I have had the pleasure of working for. Seek the debate and provide for the neutral exchange free of perceived retribution. Never forget: perception is reality.

Fundamental Belief #9: Accountability counts!
You must walk the talk. In fact, take the open-ended question to the workforce and ask everyone to submit what they define as accountability in their role. It can be an enlightening exercise. Often the team knows well what a banned behavior is, but is it communicated by the grapevine or by well-established standards? Best case, it is communicated in who gets paid and who gets promoted, and in situations where accountability really matters, it can be seen in who is no longer with the team. Remember, there is not much that remains truly confidential so my best advice is to always lead and manage like everyone knows exactly what took place. One of the greatest challenges I see good people struggle with is doing good things for others and then getting burned. The old saying "no good deed goes unpunished" rings true. Something as simple as loaning employees money or allowing something like extended time off for illness or family matters—seemingly simple gestures of kindness–may establish precedent in subsequent similar circumstances in the future. The business may grow, evolve, and hit legal thresholds for protected rights for employees. Thus, it is not a bad practice to ask yourself, "would I do this with any person working for me now or in the future?"

With my employee relations experience, I can tell you that it should be the Chief Visionary's goal to allow for internal resolution whenever possible. However, keeping all complaints internal vs. external for proper resolution does not mean the fact finding process should be performed by an internal employee unless that person is trained in such matters. This is imperative to mitigate risk. It is reasonable to presume that people may not feel comfortable approaching the primary leader despite fair intentions. For this reason, it seems prudent to provide another layer that is neutral and unbiased. Any first line managers would require extensive training on various topics to best support an internal complaint procedure without the guidance of an experienced HR or legal professional. Ultimately, if there is not internal resource and only an internal complaint procedure then perhaps a confidential phone line could be provided to employees. Truly great managers demonstrate respect, by managing up and communicating for the sake of exchange and collaboration vs. the sentiment of reporting up and perceiving micro management. I have seen good managers derail their career by not understanding that unrequested status reports are not micro managing. Rather, it is the gift of peace of mind that every manager can give their leader.

Last, but certainly not least: tell the TRUTH. People talk about how accountability is broken and how people avoid difficult conversations; why? Some say it is a lack of standards, consistency, or follow-through. That may be true, but at the true core of the breakdown is communication. Everyone deserves to hear the truth. In fact, I believe it is the responsibility of leadership to deliver the truth. And on occasion it will be equally important to ask for the truth. Leadership must uphold the integrity to work through the communication breakdowns to provide for unity and shared vision. If necessary, begin with the belief that everyone comes to work with the hope to do well. Yes, there are some that do not operate within that statement in reality, but if you can begin with the glass half full, it may allow the communication needed to be set forth. You can explain to anyone the truth so long it is done with respect and sensitivity. Respect means it does not get personal and sensitivity implies the need to ask questions not diagnose. Ask and you may find something you were not aware of. If you are the person that finds it difficult to communicate proactively or address difficult situations without compromising fact with emotions then I recommend a simple four step process to facing the conversation head on with dignity and respect in mind. I hope it is easy to remember and works in bridging your communications with direct reports.

Step One: Begin with “I expect (insert)…….”
Step Two: Contrast and highlight the concern by stating next, “I observe (insert)……”
Step Three: Lastly, do not diagnose or speculate as to the cause, avoid judgment as a first course and ask, “Why is that?”
Step Four: End by reaffirming the expectation. Clarify misunderstanding and recalibrate.
This conversation is important in the most basic of circumstances. Not to speak or to avoid is to express acceptance (and in some cases, agreement). Those that gauge credibility and trust daily take note.

Fundamental Belief #10: Welcome, welcome, welcome the talent!
Orientation is more than paperwork and onboarding can be more than a day, a week, or a month. Your Employee Value Proposition (EVP) is as important if not more so than your Unique Selling Proposition (USP). Your brand is not what you *say* you are, but rather what your customers *experience* and what your employees *believe*. From passive recruitment to talent pipeline and even your alumni, the campaign for “Welcome, Welcome, and Welcome!” should be heard. A customized onboarding strategy for all new hires across the organization from the day they accept the position to potentially their variable career paths within the organization is ideal. The onboarding term can itself imply enculturation. To design a framework strategically,

the business should strive to support the employees' ability to perform and contribute. This would include expectations, clear lines to what success is at intervals tied to formal coaching and/or feedback exchange with management, access to peers or mentors with knowledge on internal networks, and I believe it should be implemented in a phased approach. (Often information can be too much if it is not phased with consideration to how and when the talent can best assimilate it for practical purposes.)

It is surprising how many businesses fail to connect strategic objectives to every person on the team. There is nothing more offensive than to witness *The Mushroom Theory of Management,* and when a human being is giving energy, strength, and time to his or her work, it is easy to understand that every person deserves to be informed of what is relevant. If there is a sentiment that "they will not understand" or "they don't care," then please be the leader that challenges assumptions by stating that "we can teach." Most of what "they will not understand" or "they don't care" about is, in fact, relevant.

Take the time to onboard and teach your staff about your business, clarify expectations, and highlight employee education opportunities. Forget the perceived "soft stuff": use hard data to determine if results have been met and explain which measures to aim for to achieve success. Remember that transparency is more important than pay. Celebrate team successes and consider profit-based pay programs. If you fail to start with the people that represent your brand, how can you positively affect the customer and build a competitive advantage?

Management assimilation is another opportunity for every business that intends to grow. Forty percent (40%) of promoted leaders fail in their new role in the first 18 months. The cost is significant and negatively impacts the ability to uphold consistency and credibility. Every person that is hired requires onboarding, even the most seasoned of professionals. There are positive ways to support the assimilation of management and strategically every business will need to focus on this initiative proactively vs. reactively. I have seen truly wonderful managers become ineffective simply because their leader did not lead by clearly establishing expectations, gaining commitment, and establishing a shared vision.

Fundamental Belief #11: Never be cured of your curiosity!

In closing, I would like to share some learning moments that may prove valuable for you. There are a few memories that really stand out to me.

1. I was working as a receptionist in an international Fortune 500 enterprise and I observed dozens of people in the lobby each day for hours (essentially, people hired under H1-B Visas prior to Y2K). It was a time of panic that preceded the year 2000 as fear was present in the financial services industry. I thought it was a drain on resources and practically unkind to keep people waiting for hours with no guidance. I created an orientation program for these people and presented it to the site manager proactively for approval. I had no clue what Human Resources was, but that man saw something in me

at the young age of 18 and explained to me that I belonged in Human Resources. I was promoted into the field and to this day I am forever grateful.

The lesson: If you are a leader and see youthful talent before you, then teach, share, and nurture that talent. Thank you, Jack Egan, for seeing my strengths long before I knew to recognize them for myself. And to Leigh Harte, my first manager in HR: thank you for believing in my potential and allowing me to feel part of the bigger picture every day we worked together. Had you never left, I likely would not have either.

2. I had to support a large layoff with people I had worked with for years. It was sudden, done with pink slips and totaled 300 individuals. It was the first time in my life I had seen and felt how business can treat people like numbers vs. people.

   The lesson: There is a right way and a wrong way to deliver bad news. Though I have had to do this type of work since, I will never partake in a termination meeting that is done without care for a person's sense of dignity.

3. I landed my first HR Manager position in Chicago, Illinois at a privately held ink pump manufacturer. I found myself in the midst of an Office of Federal Contract Compliance Programs (OFFCP) audit in my first six weeks in the role. New to the role, I knew little of the historical hiring practices. The audit involved specific review of the Affirmative Action plan in place and specifically the applicant records specific to positions posted and filled against evaluation of the placed individuals in given roles. The end result led to fines specific to each applicant that met the minimum qualifications on the job posting but had not been evaluated (meaning that applicants who applied to the job posting and were seemingly qualified were not interviewed; the questions were "why not?" and "what disqualified them?"). The end result was upwards of $50,000 awarded in settlement.

   The lesson: Surely, it would seem I learned the importance of record keeping, interview training, and standardization in hiring practices. The real lesson was that as well intended as employers may be, and as justified as the hiring decision may have been, the bottom line is that businesses are impacted significantly by external influences and ignorance is not bliss.

4. I was in the position of hiring for manufacturing with a peer manager, and we had two interviews scheduled. The first was a no-show who had been eagerly anticipated in review of the resume. The second interview was 30 minutes early and had ridden his bike to the facility. The value in applicant tracking for passive recruitment is that you can monitor who applies repeatedly and how often. After hiring someone with no experience despite the initial evaluation, we called in the repeat candidate, who had applied consistently for two years but had no qualifications. He was willing to start at the

bottom—a position no one would take—as he had read about the company in the paper and really wanted the opportunity to get his foot in the door.

The lesson: Who do you think got the job? Right, the man that found a way to get to the interview on time and the man that applied again and again and again. May character and perseverance always shine in your character assessments and may you evaluate the talent on what they do, not what they **say** ***they do***.

5. I was working in HR management and reporting directly to the CEO in another company. There was a longtime manager there who oversaw the production for two or more decades. One day, the CEO called me to explain that it had been reported that the people in production felt I was insincere and overly kind to the point of being "fake!" Needless to say, I was stunned and hurt. I could have quit easily but I did not want to concede to what was not true. I vehemently denied the claims and stated I would see to the people and sit down with their manager. With poise, I confronted the manager and let him know I was there to support the management not control the management and attempting to sabotage HR only hurts management in the end. I further demonstrated how my efforts, though they may feel like more work for him, would help vs. hinder the objectives production had. He apologized, and we never had another negative exchange.

   The lesson: People can be ugly and sadly manipulative but it often stems from misunderstandings and a lack of communication. It is a valuable lesson to confront the truth, speak for what you believe in, know the value of HR in support of management AND the value of loyalty through leadership support. It also taught me the importance of managers not allowing complacency to creep into management exchange due to hurt feelings or disagreements. To have stayed and not confront the manager would have stifled the relationship and the business. The support and affirmation by the CEO of HR as a supporter was a factor to the respect that developed in the years that followed in working with that person. Getting past secondary emotions to build bridges in honoring primary emotions in the workplace is important.

6. In 2008, I attended the National SHRM Conference and saw the founder, Dr. JP Pawliw-Fry of the Institute of Health and Human Potential present the Epidemic of Playing Small. In my role, I often witness disagreements, emotions and tempers flare. Not ideal I realize, but something I am quite comfortable in given my work. Comfortable, however, is different than truly understanding what you are seeing unfold before your eyes. When I sat through this presentation, I found myself move from a lens of judgment to the lens of compassion as I gained a greater understanding of emotional intelligence. The physiological response that occurs in our brains when we are compromised by stress is an automatic response whereby the hypothalamus releases cortisol – thus elevating blood pressure to help you escape danger. The revealing facts that I had witnessed but never understood occurred

when I saw two executives come together as tempers flared, one presented facts akin to "I asked for that on Tuesday and it was not delivered" and the other person, responded with no recollection, or memory when I had been present for the prior exchange on Tuesday and was absolutely perplexed by their lack of recollection. This exchange made me think the person must have lost their mind. Well, in fact they had! Stress affects us all the same physiologically given the automatic stress response of the release of cortisol, which in turn inhibits memory retrieval for a period of up to five minutes in this example. Shocking but common!

The lesson: Stress is not universally experienced, and thus understanding what triggers stress for different people is the responsibility of each person in understanding behavioral responses that can and do occur at work. Furthermore, Dr. Pawliw-Fry shared his sentiment regarding the importance of teaching that is okay to say, "I don't know!" In fact, promote it. It is more important to learn, unlearn, adapt and change vs. to build confidence in the "right answer" or being "smart." I hope to work with many a leader that allows him or her to say, "I don't know" and gain through inclusive brainstorming with diverse mindsets coming together!

Conclusion

HR may be thought of as an expense and not an asset, but this approach can be disastrous to the bottom line and counterproductive to business objectives. Every person deserves to find work that is in fact their strengths at play. A business with this approach will have a better chance at overcoming the talent deficit. The Talent Deficit is here, and the talent gets to choose where they want to work. Old norms for running HR departments and formulas for doing so do not work. Companies must be asking why they need HR and what do they need exactly to weave employees into a team that functions to achieve core objectives every day. Business must have tactical (transactional) and (strategic) HR tactics aligned to fully optimize and witness (transformational) work for a business to thrive and lead their industry or market. To do this every manager needs to be a manager of choice and every person in the business must be viewed as a leader and brand ambassador. This also requires that every person in the organization must have a clear explanation of what success looks like in each respective role and for the business overall. To establish core values for a business is not enough. They must be upheld in performance management. This all starts with the CEO who as a CEO, founder, or entrepreneur, must lead. To be effective, every Chief Visionary deserves a Chief Challenger or Challengers. Accountability Counts through every level of the organization and it all starts the first day you hire an employee and welcome talent to your company.

I wish you the best in success and in play! May your vision inspire many to bring their talents to a valuable exchange.

This work may constitute a Legal Advertisement

Chapter 15 | Labor and Employment Law from the Legal Perspective

Jasmine Simmons

The Merriam-Webster dictionary defines an "employee" as "a person who works for another person or for a company for wages or a salary."[10] Most enterprises, large and small, conduct their business through individuals that they consider their employees. However, as simple as that definition and concept may seem, federal and state employment laws define and treat employers and employees in different ways for purposes of determining liability in various situations. Therefore, an employer's first step in protecting itself from and assessing potential liability is to determine the composition of its workforce.

An employer can have one of two types of people perform the work of its enterprise: employees and independent contractors. Generally, the difference between independent contractors and employees is seen in the existence of a contract: independent contractors perform work for enterprises based on the terms set forth in a contractual agreement for services, which can last for the duration of particular period of time, or in relation to the completion of a particular goal. Employees, on the other hand, are continually engaged in providing work for their employer, with no specific goal or duration in mind.

Example: If Company A, a shoe making factory, hires Mary to work on its production line to perform a particular job for a particular wage, and Company A pays Mary on its payroll, Mary is likely an employee of Company A. Conversely, if Mary owns her own shoelace business, and Company A contracts with Mary's company to lace all of its shoes, Mary is likely an independent contractor providing a product and/or service to Company A.

While the above example might be simplistic, it provides a basic illustration of the differences between the two categories of workers. Problems arise, however, when the lines are blurred and the difference between employees and independent contractors become indistinguishable.

Because contract laws are dictated by state law, each state treats the material differences between employees and independent contractors differently. Additionally, certain state and federal laws require the exploration of

[10] http://www.merriam-webster.com/dictionary/employee?show=0&t=1392584025

specific factors, or tests, to determine whether an individual is an employee or independent contractor.[11] Despite these differences, however, the following factors regularly appear in this analysis:

- How much control the company has over the worker, including whether the enterprise provides direction on the worker's work performance or work schedule;
- The type of job the worker is performing, including the nature of skill required to perform the job, and whether and how much skill and experience the worker obtained solely by virtue of her work for the company;
- Which party, either the worker or the company, bears the worker's operating costs, including, but not limited to, costs for or provision of necessary equipment, supplies, fees, and/or licenses;
- How the worker receives his or her payment for the production of products or provision of services, and;
- The length of time the worker is committed to working for the company and/or the company's expectations of the worker.

Of these factors, the one typically cited as the most important is the first, or the level of control the enterprise exercises over the worker's production and hours of work.

While the differences between these categories of workers is explored in far more detail in **Chapter 17: Contractors vs. Employees: What You Don't Know Can Hurt You**, this distinction is important to raise here for one, very important reason: employers can only be liable under labor and employment laws in connection with issues regarding their *employees*, and not their independent contractors. If independent contractors are deemed to be employees, employers can unexpectedly face liability for employment-related issues for these workers as well.

The Takeaway: If independent contractors are deemed to be employees, employers can unexpectedly face liability for employment-related issues for these workers as well.

Discrimination

Most employees are considered "at-will" employees. This means that, in absence of a contract dictating otherwise, an employer can hire or fire its employees for a good reason, bad reason, or for no reason at all, and at any time after the employment relationship begins.

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[11] For example, the United States Supreme Court adopted a multi-part test for determining the difference between an employee and an independent contractor for purposes of determining rights and responsibilities under the Employee Retirement and Income Security Act, an important federal employee benefits law, and which is explained in light detail in later sections of this chapter. *See Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992).

Example: Brian, a manager at Company A and avid Chicago White Sox fan, fires Kim, an employee at Company A, because she is an avid Chicago Cubs fan and never ceases to talk about her cherished "Cubbies." Although the reason may seem silly or even illogical, it is a sufficient basis to end an at-will employment relationship.

The only exception to this rule occurs where failure to hire or termination of the employee is predicated on an unlawful basis. One such unlawful basis is **discrimination**.

Employees in the United States are protected by a bevy of federal and state laws designed to ensure that employees can enjoy workplaces free of discrimination and harassment. These laws act to keep employers focused on the implementation and the fair and even application of employment policies, practices, and procedures that operate to ensure equal access to employment opportunities for all applicants and employees. The range of employment actions to which these laws apply is broad, generally applying to all job decisions, employment practices, and other terms, conditions, and benefits of employment.

Employment Discrimination Laws

Although the federal employment discrimination laws do not apply to all employers, it is important for employers to understand how these laws operate, since nearly all state employment discrimination laws are based upon, and analyzed similarly to, their federal counterparts.

Title VII

Title VII of the Civil Rights Act of 1964 prohibits employers from discriminating against individuals or groups of individuals on the basis of their race, color, national origin, religion, and/or gender. While some related state employment-discrimination statutes prohibit discrimination on the basis of sexual orientation or sexual identity, Title VII does not. Title VII applies to public employers of any size, and to private employers with fifteen or more employees.

Disparate Treatment

When an employer intentionally discriminates against an individual or group of individuals based on their protected characteristics, this is typically known as "disparate treatment."

Example: Michael, an employee of Company A, is a member of a newly-discovered people with blue skin, known as "Blu-ions." Anthony, a manager at Company A, dislikes Blu-ions. One day, Anthony approaches Michael and fires him, solely based on the fact that Michael is blue, and stating to others at Company A that he was "glad to get rid of Michael" because he "hates Blu-ions." Such a discriminatory termination would be deemed "disparate treatment."

Disparate treatment claims with such overt, or "direct," evidence of discrimination are difficult for employers to defend against. However, when there is no demonstration of outright discrimination, an employer can successfully defend against disparate treatment claims if it can demonstrate that its policy, practice, or decision served a legitimate, non-discriminatory business purpose.

Example: Company A's handbook requires employees to be on time for every shift, or face discipline. Company A's handbook further states that employees that are late for five or more shifts within a one-month period can be terminated. Anthony, who is Blu-ion, is continually late for his shifts, and has received four warnings from his manager Michael during the month of August about his tardiness. When Anthony arrives late to his shift for the fifth time during the month of August, Michael terminates Anthony. Following his termination, Anthony files a charge of discrimination with the EEOC, alleging that Company A fired him because of his blue skin. Company A, however, can defend against Anthony's claim by showing that it has a policy requiring employees to be on time for work, which has obvious implications to its business operations, and that it fired Anthony not because of his blue skin, but because of his excessive late arrivals in violation of company policy.

The Takeaway: An employer can successfully defend against disparate treatment claims if it can demonstrate that its policy, practice, or decision served a legitimate, non-discriminatory business purpose.

Disparate Impact

An employer can, however, violate Title VII without an intent to discriminate, by enforcing policies that have an adverse impact on a particular group of individuals of a certain protected group. Typically known as "disparate impact" discrimination, Title VII prohibits the enforcement of employment policies that, although neutral on their face, operate to exclude employees that share a protected characteristic, therefore having the same effect as intentional discrimination.

Example: Company A has a requirement that applicants will only be considered for employment as shoe lacers in its shoe factories if they have masters' degrees. The average level of education for Blu-ions is a high school diploma. Therefore, although Company A's hiring policy is neutral on its face and is not designed to exclude Blu-ions, most if not all Blu-ions will be excluded.

Many cases involving disparate impact analysis involve objective requirements, including entrance examinations, various levels of education or experience, and the like. However, disparate impacts can result from subjective employment policies as well.

Employers can defend against disparate impact claims by demonstrating or otherwise ensuring that their employment policies bear "a manifest relationship to the employment in question," as Title VII requires. In other words, Title VII requires that a job's requirements must be reasonably necessary and sufficiently related to the performance of the job's essential functions.

Example: Company A has no specific requirements for promotion from server to manager; it allows its managers to use their judgment to select employees for promotion. Monica, who is a Blu-ion, is continually passed over for promotion to management by various Company A managers, and to the benefit of other, non-Blu-ion employees. Company A's managers, however, are simply selecting employees with whom they have worked for a certain period of time, with whom they enjoy working, or who company's customer's appear to like; it cannot be said that Monica is being repeatedly passed over because she is a Blu-ion. However, since this standard-less, facially-neutral promotion policy is operating to prevent Monica, the only Blu-ion in her department, from being able to move up within Company A, it is consequently having a disparate impact on the employment of Blu-ions, and is therefore forbidden under Title VII.

The only other way that an employer can defend against a discriminatory disparate impact claim under Title VII is to show that the practice or qualification is a necessary, "bona-fide occupational qualification," or "BFOQ." Title VII contains an exception for such BFOQs, even if the challenged practice or requirement does, in fact, operate to exclude a certain protected class of people. However, this exception is very narrow, and employers should not rely on it to save them from most disparate impact claims.

Example: Company A's owner was interviewed regarding the masters' degree requirement for his shoe lacers in his shoe factory, and he stated that the requirement was in place because he preferred to employ highly educated people to put laces into the shoes he produces. However, as common sense would dictate, a masters' degree is not necessary in order for a person to perform the job of weaving shoe laces into shoes. Therefore, since the masters' degree requirement is not sufficiently related to the job of shoe lacer, but operates to exclude blue people from employment in Company A's factories, Company A's policy violates Title VII.

A Lesson From Case Law

In the Supreme Court case *Dothard v. Rowlinson*,[12] the state of Alabama had a statutory requirement that applicants for corrections officer positions must be at least 5'2" tall, and weigh at least 150 pounds, in order to be considered for employment in its state correctional facilities. A female applicant challenged these requirements as having a disparate impact on female applicants, since most women did not fit one or both of these requirements. The requirements were further found to violate Title VII, since the requirements were allegedly in place for purposes of having physically capable and strong corrections officers, but there were no specific strength measurements associated with the job, or that could be certified based solely on a person fitting the mandatory height and weight requirements. Nonetheless, the height and weight requirements were allowed to stand in light of the fact that individuals below certain height and weight were at risk of danger and injury in the very dangerous prison environment, a claim supported by the fact that correctional officers were generally outnumbered, and the average prisoner in Alabama's facilities at the time was generally larger, than

[12] *See Dothard v. Rowlinson*, 433 U.S 321 (1977).

the minimal height and weight requirements for correctional officers. The height and weight requirements were therefore deemed a BFOQ for the corrections officer position, irrespective of the fact that they were proven to perpetuate discrimination against female applicants.

While the occasional discriminatory behavior of an uninformed, untrained rogue employee cannot be predicted, an employer's first preventative step is to ensure that its personnel policies, procedures, and decisions can be sufficiently traced back to legitimate business purposes. Such a step helps eliminate the potential for ill treatment of any protected groups, either intentionally or unintentionally. Such support should be as well documented as possible and as practicable for the size of the business, especially in instances of employee discipline or termination.

The Takeaway: Ensure that your organization's personnel policies, procedures, and decisions can be sufficiently traced back to a legitimate business purpose.

Retaliation

Another way that Title VII is violated is by retaliating against employees that exercise their rights under the law. An employer is forbidden from changing an employee's terms and conditions of employment, or in other words, committing an "adverse employment action" against the employee, for exercising his or her Title VII rights. According to the United States Supreme Court, a "tangible" or "adverse" employment action, is "a significant change in employment status, such as hiring, firing, failing to promote, reassignment with significantly different responsibilities, or a decision causing a significant change in benefits."[13]

<u>Example</u>: Kevin, a Company A employee who is a Blu-ion, believes that May, his manager, is discriminating against him on the unlawful basis of his race. Kevin complains to human resources about the alleged race discrimination. When May learns about Kevin's complaint to human resources about her alleged discrimination towards him, she fires him. May has just unlawfully retaliated against Kevin.

A Lesson From Case Law

In *Crawford v. Nashville*,[14] the Supreme Court held that an employee simply has to oppose discrimination in order to be covered by the anti-retaliation provisions of Title VII, even if the employee does not make the intital report of discrimination or harassment. In *Crawford*, a male employee of the defendant, the Metropolitan Government of Nashville and Davidson County ("Nashville") was being internally investigated for allegations of sexual harassment. Plaintiff Vicki Crawford, a 30-plus year employee of Defendant, was interviewed as part of the investigation. While Crawford, herself, never lodged any complaints against the employee under investigation, she was honest when questioned about the employees' harassing behavior,

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[13] *See Burlington Industries, Inc. v. Ellerth*, 524 US 742, 761 (1998)

[14] *See Crawford v. Metropolitan Govt. of Nashville and Davidson Cty., TN*, 129 S. Ct. 846 (2009).

confirming the allegations of sexual harassment against him. The accused employee was ultimately demoted. However, Crawford and the other two witnesses that provided adverse information about the male employee during the investigation, were all fired shortly after her interview. The Supreme Court held that because Title VII's retaliation provision protects employees from retaliation that both *oppose* any practice made unlawful by Title VII, as well as those that have "made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or hearing" pursuant to Title VII, the law does not require a person to "instigate" an action in order to enjoy its protection. Specifically, "a person can 'oppose' activity made unlawful under Title VII by responding to someone else's questions."

Other Title VII Considerations

Associational Discrimination
Title VII prohibits discrimination against employees that associate with members of protected groups.

Example: Katy, an employee at Company A, is married to a Blu-ion man. Even though Katy's husband does not work for Company A, Bill, a manager at Company A and who dislikes Blu-ion people, knows that Katy's husband is a Blu-ion. When Katy applies for a promotion, Bill denies Katy the promotion on the basis that she is married to, or "associated with," a Blu-ion. Bill's denial of Katy's promotion on this basis violates Title VII.

Race, Color, and National Origin Discrimination
Although people often do not make distinctions among these three categories when discussing or describing people, Title VII protects against discrimination on all three of these bases, and treats them separately, when and where necessary.

- An employee's race and color are treated differently to the extent that employees within the same race, but whose skin color differs, suffer differential treatment.
    - Example: An illustration of *race* discrimination is differential treatment of Blu-ions based on the fact that they are Blu-ions. Conversely, an example of *color* discrimination, is differential treatment of Blu-ions whose skin is dark blue, as opposed to Blu-ions whose skin is lighter or who appear to be members of another race of people whose skin is not blue at all.

- National origin discrimination under Title VII refers to an individual's nationality, or that individual's personal or ancestral country of origin.
    - Example: An example of *national origin* discrimination is when an employer engages in discriminatory or exclusionary practices against all people who are Canadian, or who are of Canadian ancestry or descent.

Religious Discrimination

The EEOC defines "religion" as any practice including "moral or ethical beliefs as to right and wrong that are sincerely held with the strength of traditional religious views."[15] This includes any and all aspects of religious observance and practice, regardless of how widespread the particular religious beliefs or practices are.

Protection from religious discrimination under Title VII differs slightly from the discussion above, since, in most cases, an employee's religious affiliation is not readily determinable. Specifically, religious discrimination is different to the extent that employers can discriminate not only through disparate treatment and impact, but also by failing to provide religious accommodations. Specifically, Title VII requires employers to provide reasonable accommodations for their employees' religious practices, such as leave to observe religious holidays, unless doing so would cause an undue hardship on the employer's business or operations.[16]

Sex Discrimination

Both male and female employees are protected from discrimination on the basis of sex. It is important to note, however, that sex discrimination does not occur solely between males and females. The specific phrase "because of … sex" in Title VII extends its prohibitions of differential treatment on the basis of sex to both genders, irrespective of the discriminating party's sex.[17]

Title VII, through the federal Pregnancy Discrimination Act, also protects female employees from discrimination based on pregnancy, child birth, or related medical conditions.

Sexual Harassment

Sexual harassment falls under the umbrella of protection provided by Title VII and its state-law counterparts. However, sexual harassment, or harassment based on any protected characteristics, is very specific in how it is legally defined, how it is analyzed, and the specific protections employers must take above and beyond its standard general prohibitions of discrimination.

Sex harassment claims are typically defined by the level of authority the harassing party has relative to the victim (*i.e.* whether the harasser and victim are co-workers, or whether the harasser is the victim's supervisor). The United States Supreme Court defines a "supervisor" as an individual authorized to take a tangible employment action against an employee. Generally, only sex harassment by a supervisor can subject an employer to liability for the harassing employee's actions, otherwise known in the legal world as the employer's "vicarious liability."

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[15] http://www.eeoc.gov/policy/docs/threshold.html

[16] What constitutes a "reasonable accommodation" is described in greater detail in the Americans with Disabilities discussion, below.

[17] Although this discussion is in reference to sex discrimination, Title VII prohibits discrimination against all of the groups listed in its umbrella of protections, including between or among members within the same protected groups.

Sex harassment has two unattractive faces: quid pro quo, and hostile work environment. Quid pro quo harassment occurs when a supervisor requires an employee to respond favorably to sexual advances in exchange for obtaining earned benefits of employment.

Example: Mary, an employee at Company A, seeks a promotion to a management position. Alfred, Mary's manager, tells Mary that he will only promote her if she provides him with sexual favors. Alfred has engaged in quid pro quo sexual harassment.

Quid pro quo sexual harassment can also exist when an employer threatens an employee with an adverse employment action when the employee rejects a supervisor's advances or requests for sexual favors.

Example: Alfred, a manager at Company A, repeatedly requests sexual favors from Mary, an employee that he supervises at Company A. When Mary rebuffs Alfred's advances, Alfred fires Mary. Alfred has committed quid pro quo sexual harassment by virtue of the adverse employment action he committed against Mary for her rejection of his advances.

On the other hand, a hostile work environment is one where discrimination and harassment so pervade an employee's work environment that it alters the terms and conditions of the employee's employment.

The law generally divides sexual harassment/hostile work environment claims into three categories: harassment by a colleagues or coworkers; harassment by a supervisor that results in an adverse employment action, and; harassment by a supervisor that does not culminate in an adverse employment action. Courts and administrative agencies treat these differently because of the variations in the potential for vicarious liability to the employer.

Most federal and state statutes do not impose vicarious liability on an employer for co-worker sexual harassment/hostile work environment unless the victim-employee can show that the employer was negligent in discovering and/or remedying the sexual harassment. In other words, an employer can usually only be held responsible for co-worker sexual harassment/hostile work environment if the employer knew or should have known about the hostile work environment that the coworker created, but failed to take action to prevent or correct it.

Supervisory sexual harassment claims are quite different, however. Supervisory sexual harassment/hostile work environment claims that culminate in either a quid pro quo situation, or a tangible employment action, are indefensible and subject employers to automatic liability, known as "strict" liability.

The federal law provides an affirmative defense to employers in cases of sexual harassment that do not culminate in an adverse employment action. Born out of the landmark cases *Faragher v. City of Boca Raton* and *Burlington Industries v. Ellerth*,[18] the Supreme Court devised a two-part affirmative defense, designed to drive employers to create policies and engage in practices to prevent and correct discrimination, and to encourage employees to exercise their right to a harassment-free work environment. In order to use the affirmative defense, the employer must have a policy directed at preventing and promptly remedying the harassment, and the employee must reasonably engage in using such policies to avail him or herself of the rights, remedies, and protections provided by the policy. The affirmative defense is designed to encourage employers to create and enforce effective anti-discrimination and harassment policies, and swiftly remedy swiftly any complaints of such harassment.

The federal law diverges from many of its state counterparts regarding whether supervisory sexual harassment claims are defensible at all, and if so, what an employer must do in order to be able to defend against these claims. For example, under the Illinois Human Rights Act, any and all supervisory sexual harassment subjects employers to strict liability; the affirmative defense discussed above does not apply to liability issues, and will only serve to potentially reduce potential damages.

The Takeaway: An employer's best and only chance to protect itself from liability for sexual harassment is to train its employee population on what constitutes sexual harassment, and to create and promulgate a sexual harassment policy in connection with the concepts taught to the employee population in that training. Critical components of the policy include:

- Use of language that is appropriate for the employee population's level of sophistication, and which the employee population can easily understand;
- Wide dissemination of the policy to all levels of the employee population;
- Directions on how to report instances of sexual harassment, including the names, titles, and contact information of any and all individuals to whom such complaints may be made;
- To the extent that the alleged harasser is the employee's supervisor and/or one of the individuals designated to receive reports of harassment, provision of a bypass procedure providing an alternative mechanism for employees to still be able to report harassment.

Also, even if an employer has a great and legally sufficient policy, it must then still immediately respond to its employees' reports of discrimination or harassment in order to head off potential liability. The employer must then act equally quickly to devise and execute plans for either disciplining and/or removing the harassing employee from the victim's environment, or engaging in other plans that will prevent further harassment or discrimination.

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[18] *Faragher v. City of Boca Raton*, 524 US 775 (1998); *Burlington Industries, Inc. v. Ellerth*, 524 US 742, 761 (1998).

The Age Discrimination in Employment Act
While Title VII covers discrimination based on many protected characteristics, claims for age discrimination are covered by the Age Discrimination in Employment Act ("ADEA"). The ADEA protects employees over the age of 40 from discrimination in employment, and applies to employers with 20 or more employees. Like Title VII, the ADEA prevents employers from making personnel decisions, including hiring decisions, or basing any terms and conditions of employment on an applicant or employee's age. Employers violate the ADEA by making personnel decisions unlawfully based on an employee's age, and also by retaliating against employees for complaining about age discrimination or otherwise exercising the employee's rights under the ADEA.

Section 1981
The Civil Rights Act of 1866, otherwise known as "Section 1981" based on its statutory designation (42 U.S.C. § 1981) prohibits racial discrimination in a variety of contexts, employment being only one of many. The statutory language provides that "all persons … shall have the same right … to make and enforce contracts … as is enjoyed by white citizens …" The United States Supreme Court deemed this language applicable to employment discrimination claims to the extent that employers engage in contract formation in hiring prospective employees (even in at-will employment circumstances). In other words, the agreement to hire someone to work is, itself, a contract in which all people should be able to engage absent racial discrimination, and which is sufficient to invoke the protections of Section 1981. Congress amended Section 1981 through the Civil Rights Act of 1991 to allow Section 1981 to apply to all aspects of the employment relationship, or, in other words, more than just the "making" of the employment contract.

Similar to Title VII, employers violate Section 1981 by considering race in the determination of any aspect of employment, from recruiting and advertising, to hiring, discipline, promotion, demotion, and termination. Employers also violate Section 1981 by retaliating against employees that complain of race discrimination, or that otherwise exercise their rights under Section 1981. Unlike Title VII, however, Section 1981 applies to employers of any size.

Genetic Information Non-Discrimination Act
The Genetic Information Non-Discrimination Act, otherwise known as "GINA," is one of the newest kids on the block in the context of anti-discrimination in employment laws. The law was passed in 2008 to prevent employers and issuers of health insurance from discriminating against people based on their genetic information. Genetic information is any information about a person's DNA or other genetic markers but, for purposes of the GINA, excludes race and racial characteristics. As a further illustration, "genetic information" includes any information that could indicate whether an individual (knowingly or unknowingly) suffers from or has a predisposition to a particular disease or disorder. For this reason, a person's family medical history and/or family genetic information also qualifies to trigger GINA's protection.

In the employment context, GINA applies to employers with 15 or more employees, and prevents the use of genetic information as a factor in any personnel or employment-related decision, such as hiring, firing, promotion, demotion, and the like, and/or harassing employees based on their genetic information or characteristics. Employers also may not retaliate against employees for complaining of discrimination based on their genetics, or for otherwise exercising their rights under GINA. In addition, GINA also prevents employers from requiring employees to engage in medical or other genetic testing or screening as a condition of employment unless such testing is specifically necessary and/or required by law with regard to the particular job and its functions. GINA also prohibits employers from requesting or purchasing genetic information about employees or prospective employees.

Example: Sharon is an employee of Company A, which is an employer subject to GINA. Millie, Sharon's supervisor, noticed Sharon crying in her office. When Millie stopped in to check on Sharon, Sharon told her that her sister was diagnosed with breast cancer. Millie is aware that the year previous, Sharon's mother had been diagnosed with breast cancer also. Millie now believes that Sharon may be predisposed to breast cancer based on her family history, and does not want to deal with the potential rise in health care costs on the P&L for her department if Sharon is later diagnosed while still employed in her department. Millie therefore fires Sharon. Millie's unlawful termination of Sharon based on her belief about Sharon's genetic predisposition to breast cancer violates GINA and subjects Company A to potential liability.

Example: Andrew, a Company A employee, has requested FMLA leave to recuperate from surgery on his ankle, which he broke playing baseball. Myra, Andrew's supervisor, reviews the medical documentation Andrew submitted to certify his leave, and notices that Andrew's doctor mentions minor complications with Andrew's surgery due to Andrew having sickle cell anemia. Myra once heard, and now believes, that higher incidences of sickle cell disease occur in African Americans than in other racial groups. While Andrew does not self-identify as African American, Myra, who is racist, terminates Andrew on the basis of her uninformed belief that Andrew is of African American ancestry since he apparently suffers from sickle cell anemia. While Myra may have exposed Company A to liability under other employment discrimination statutes, Myra has not violated GINA.

A Lesson From Case Law

In 2013, the EEOC settled its first lawsuit with GINA implications. It sued Fabricut, Inc., a fabrics distributor, on behalf of Rhonda Jones, whom Fabricut allegedly refused to hire on the basis of its belief that she suffered from carpal tunnel syndrome. According to the complaint, Jones, who worked as a temporary memo clerk for Fabricut, applied for and received an offer of permanent employment when her temporary assignment ended. Fabricut's offer was contingent upon a pre-employment drug test and physical. Jones took the drug test and physical at Knox Laboratory, Fabricut's designated medical provider. Prior to the testing, Knox required Jones to fill out a questionnaire, which included questions about her and her family's medical history. At the conclusion of the medical testing, the medical professional at Knox informed Jones that she needed further evaluation by her own doctor to determine whether she suffered from carpal tunnel syndrome. Based on

Knox's recommendation, Fabricut informed Jones that she had to see her own personal doctor to submit to the additional testing for carpal tunnel, and she had to submit the results to Fabricut. Jones did as Fabricut requested and, even though Jones' personal physician concluded that Jones did not suffer from carpal tunnel, Fabricut rescinded the offer of employment it made to Jones, on the basis that Knox indicated that Jones did, in fact, have carpal tunnel. Accordingly, Knox filed a Charge of Discrimination with the EEOC, and the lawsuit here described followed, alleging violations of the Americans with Disabilities Act and GINA.[19] While a settlement is, of course, not a judgment or other specific indication of liability, the allegations in this lawsuit are indicative of the kinds of mistakes employers make in relation to requesting, and then using, genetic information as proscribed by GINA.

Additionally, to the extent employers may collect certain medical information for other purposes, such as for FMLA certification or for determination of a suitable accommodation pursuant to the Americans with Disabilities Act, such information may only be used for *those purposes*.

Further, GINA requires employers to keep confidential any and all medical and genetic information collected about their employees. GINA prohibits employers from disclosing such information to third parties for any purpose, except under the very limited exceptions set out in the statute, and/or as expressly authorized by the employee whose information the employer seeks to disclose.

The Equal Pay Act

The Equal Pay Act is a federal law requiring employers to pay men and women equal pay for equal work. Unlike many federal employment statutes, this law applies to all employers, irrespective of how many employees are in the workforce. "Equal work" essentially means that men and women performing the same jobs must receive the same pay. If an unlawful or potentially unlawful differential exists between male and female employees performing the same job, the employer's only option is to raise the lower salaries to meet the higher ones: employers cannot reduce salaries to adjust for unlawful pay differentials under the Equal Pay Act.

While the jobs need not be identical, the jobs must comparatively encompass substantially the same skill, effort, and responsibility.[20] Each of these factors are examined in further detail below:

Skill

The important factor regarding "skill" is the consideration of skills required to perform the position's necessary job function. Necessary skills for any position are generally measured by factors including required experience level; the employee's ability to perform the job; the required education level, and/or; any specialized training

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[19] http://www.eeoc.gov/eeoc/newsroom/release/5-7-13b.cfm

[20] *See* http://www.eeoc.gov/eeoc/publications/fs-epa.cfm

required to perform the necessary requirements of the job.

<u>Example</u>: Mary and Bob are both staff accountants in Company A's accounting department. They both hold the position "Staff Accountant I," and are both in a position which has the same job requirements and functions, including that the requisite education level is a bachelor's degree. While Bob and Mary both have bachelor's degrees, Mary has a master's degree in biochemical engineering while Bob does not. However, all other facts remaining equal, Bob and Mary should receive the same wage rate for their jobs since, although Mary has a master's degree, it is not required or applicable to her job as an accountant for Company A.

Effort

"Effort" is essentially the amount of physical and/or mental exertion needed to perform a certain job.

<u>Example</u>: Kim and Barry are both employee's on Company A's production line, where they pack Company A's products into boxes for shipment out to distributors. Barry, however, is the last employee on the line. Barry's job includes not only placing products into the boxes, but when the full box reaches his station at the end of the line, he must tape it shut, lift it off of the line, and carry it to a palate, where the palates will be packed and placed out for delivery. If the extra effort of taping, lifting, and carrying the full box off of the product line can be considered "substantial" and is a regular part of Barry's job, it would not be a violation to pay Barry slightly more than Kim in this instance since Barry's job technically requires more effort than Kim's.

Responsibility

"Responsibility" is generally defined as the degree of accountability required in performing a certain job.

<u>Example</u>: Pam and Eddie are both salespeople in Company A's call center. However, Pam has the added responsibility of determining whether customers that call in must make a down payment upon placing an order, while Eddie must pass the call to Pam or to a manager when such a determination needs to be made. Although both Pam and Eddie are salespeople with the same title and general job responsibilities, Pam's slightly higher level of accountability and responsibility may be sufficient to justify a pay differential under the Equal Pay Act.

<u>Example</u>: Using the same example as above, the only difference between Pam and Eddie's responsibilities is that Eddie has been delegated the task of watering all of the plants in the sales center every Friday. Such a responsibility, while additional, does not necessarily invoke additional accountability to Company A in any material way, and therefore would not justify a pay differential between Pam and Eddie under the Equal Pay Act.

Working Conditions

Differing working conditions can also justify a pay differential among male and female employees. According to the EEOC, the two most relevant factors in reviewing working conditions are (1) the physical surroundings of the job, including evaluations of the temperature, exposure to fumes, and the level of ventilation in the working area; and (2) hazards associated with performing the job.

Example: Kenneth and Brittney both work in Company A's metal works factory. While both Kenneth and Brittney are employed as fabricators and deal regularly with dangerous hot pieces of metal, Brittney's responsibilities differ in that she must spend a portion of her day collecting the metal from an area that is not well-ventilated, and where she is exposed to noxious fumes from the material used to treat the metal in the pre-fabrication process. Although Kenneth and Brittney have the same job title and responsibilities, Brittney's time in the pre-fabrication area, and the additional hazards associated with these responsibilities, may justify a pay differential between them in paying Brittney more.

Other Statutory Exceptions

In addition to the above, the law provides for four, very narrow exceptions to requiring equal pay for equal work, which are when higher wages are paid pursuant to:

- A seniority system;
- A merit system;
- A system which measures earnings by quantity or quality of production; or
- A differential based on any other factor other than sex.

While the "catch-all" provision "any other factor other than sex" is slightly broader than the other three, employers must remember that the "other factor" must be a legitimate factor that can be measured, and that is in some way related to the job or job performance. Additionally, differential wages based on any of the four above exceptions must be tied to systems already in place.

Example: Company A pays Mary $10 per hour, but pays Michael $12 an hour for performing the same job. Although Michael has five more years of work experience in the relevant subject area than Mary, Company A has never paid employees at different rates for performing the same kind of job, and nothing in any of Company A's policies suggests that Company A has the discretion to pay different wage rates on the basis of experience or seniority. Company A therefore may have difficulty defending against Mary's Equal Pay Act claim.

Interplay Between the Equal Pay Act and Other Discrimination Laws

Importantly, the Equal Pay Act only applies to pay differentials between male and female employees. If an employee believes that he or she is suffering a pay differential on the basis of another protected characteristic, such as race, color, or age, for example, that employee will not have a claim under the Equal Pay Act, although he or she may have a claim under one of the other discrimination statutes discussed herein.

Similarly, an employee that believes she is suffering an unlawful pay differential on the basis of gender may have a separate cause of action under any of the relevant employment-discrimination statutes, such as Title VII. Importantly for employers, such a claim would not have to include all of the strictures relevant to the Equal Pay Act (*i.e.* same or substantially similar jobs). Equally as important, pursuant to the Lilly Ledbetter Fair Pay Act of 2009, if the pay differential is determined to be based on unlawful gender discrimination (as opposed to the Equal Pay Act), each "discriminatory" paycheck constitutes the grounds for its own separate cause of action. In other words, each "discriminatory" paycheck is, by itself, a separate discriminatory act against the employee.

Americans with Disabilities Act

The Americans with Disabilities Act, as amended, or the "ADAAA," as it is more commonly now known since the 2008 amendments to the statute, protects individuals from discrimination on the basis of a particular ailment or disability, as "disability" is defined under the law. While the statute deals with disability discrimination in various arenas, such as in the activities, programs, services, and benefits provided by public and private entities, this section of the chapter deals exclusively with Title I of the Act, which is in regard to discrimination in employment. In the employment context, the Act covers employers with fifteen or more employees, and prohibits discrimination against disabled people in all terms and conditions of employment, including, hiring, recruiting promotion, assignment, demotion, compensation, and the like.

Who is Disabled?

Under the law, an individual is considered disabled if he or she:

- Suffers (i) mental or physical impairment that (ii) "substantially limits" (iii) one or more "major life activities;"
- Has a record of an impairment that fits the qualifications of subpart (a), above, or;
- Is "regarded as" having an impairment as described in subpart (a), above.

Each of these shall be dealt with separately.

"Suffering a Mental or Physical Impairment that Substantially Limits One or More Major Life Activities"

This is the most traditional and common definition of "disabled" under the law. While the statute itself does not provide specific definitions of any of the three parts, the related federal regulations provide some limited guidance.

"Physical or Mental Impairment"

According to the relevant regulations, a "physical or mental impairment" is defined as:

- Any physiological disorder or condition, cosmetic disfigurement, or anatomical loss affecting one or more body systems, such as neurological, musculoskeletal, special sense organs, respiratory (including speech organs), cardiovascular, reproductive, digestive, genitourinary, immune, circulatory, hemic, lymphatic, skin, and endocrine; or

- Any mental or psychological disorder, such as an intellectual disability (formerly termed "mental retardation"), organic brain syndrome, emotional or mental illness, and specific learning disabilities.

"Major Life Activity"

In the absence of a specific definition for what qualifies as a "major life activity," the relevant regulations contain the following, non-exhaustive list:

- Caring for oneself, performing manual tasks, seeing, hearing, eating, sleeping, walking, standing, sitting, reaching, lifting, bending, speaking, breathing, learning, reading, concentrating, thinking, communicating, interacting with others, and working; and
- The operation of a major bodily function, including functions of the immune system, special sense organs and skin; normal cell growth; and digestive, genitourinary, bowel, bladder, neurological, brain, respiratory, circulatory, cardiovascular, endocrine, hemic, lymphatic, musculoskeletal, and reproductive functions. The operation of a major bodily function includes the operation of an individual organ within a body system.

"Substantially Limits"

In addition, the impairment must "substantially limit" the individual's "major life activity." While "substantially limit" is not supposed to be an exacting or difficult standard, especially after the amendments to the statute (which were meant to broaden the coverage to include more individuals with different kinds and durations of ailments), the regulations call for a "case-by-case" determination based on the facts and circumstances of each case. Specifically, the threshold analysis is whether the impairment affects and lowers the disabled individual's ability to perform the same major life activity as another person in the population that does not suffer the same impairment.

In engaging in this case-by-case determination, the duration of the perceived disability may be taken into consideration. However, mitigating measures may not be taken into consideration when determining whether an employee is or may be disabled. Mitigating measures include:

- Medication to treat the impairment;
- Medical equipment and devices, such as oxygen therapy or dialysis equipment; hearing aids and cochlear devices or implants;
- Mobility devices and other aids such as prosthetic limbs, walkers or wheelchairs; and
- Regular or intermittent therapeutic treatments, such as psychotherapy, behavioral therapy and physical therapy.

Mitigating measures are not supposed to be taken into consideration when determining the existence of a disability since they do not cure the ailment, but instead, only alleviate some of the limitations on that person's life activities associated with the disability.

Additionally, individuals suffering from ailments that are periodic or episodic, such as cancer, are still considered to be suffering from an impairment that substantially limits a major life activity, even when the ailment is not specifically active or limiting the individual's major life activity at a specific time.

Putting It All Together

While neither the statute, nor the attendant regulations, set forth any kind of specific list of what kind of impairments qualify to substantially limit a major life activity, the regulations set forth the following, non-exhaustive list of examples, and how these particular ailments "substantially limit" an individual's "major life activity" as associated with the ailment:

Deafness substantially limits hearing; blindness substantially limits seeing; an intellectual disability (formerly termed mental retardation) substantially limits brain function; partially or completely missing limbs or mobility impairments requiring the use of a wheelchair substantially limit musculoskeletal function; autism substantially limits brain function; cancer substantially limits normal cell growth; cerebral palsy substantially limits brain function; diabetes substantially limits endocrine function; epilepsy substantially limits neurological function; Human Immunodeficiency Virus (HIV) infection substantially limits immune function; multiple sclerosis substantially limits neurological function; muscular dystrophy substantially limits neurological function; and major depressive disorder, bipolar disorder, post-traumatic stress disorder, obsessive compulsive disorder, and schizophrenia substantially limit brain function.[21]

While many conditions constitute disabilities, two particular infirmities often thought to constitute disabilities are not: Pregnancy and chemical dependencies. Notably, however, women suffering *complications* from pregnancies, and individuals *in recovery* from drug or alcohol dependencies have been considered by courts as disabled under the law. But women that are pregnant with no abnormal or unusual pregnancy-related syndromes or complications, and active drug users and alcoholics, have been held not to be disabled.

Having a Record of an Impairment

An individual can suffer disability discrimination if he or she has a record of a disability, including if the individual has a history of, or even has been misclassified as having, a mental or physical impairment that substantially limits one or more major life activities.

"Regarded As" Disabled

Discrimination due to an employee being "regarded as" disabled is one of the trickier parts of the ADAAA, in that the employee need not ever have actually suffered any sort of substantially limiting impairment or ailment. According to the law, an individual is "regarded as having such an impairment" if the individual is

[21] *See* Federal Regulations on ADAAA, at 29 CFR § 1630.2.

subjected to a prohibited action because of an actual or perceived physical or mental impairment, whether or not that impairment substantially limits, or is perceived to substantially limit, a major life activity.

How the Statute Works

The statute protects employees from discrimination in all terms and conditions of employment. However, in order to be able to obtain the statute's protection, an employee must be:

- A "qualified" individual with a disability;
- Able to perform the essential functions of the job; and
- With or without a reasonable accommodation.

Prongs two and three, above, are where most disability discrimination claims are born, and are the two areas to which employers must be the most careful.

"Qualified individual"

In essence, a disabled individual must possess the same basic qualifications for any position as any non-disabled person; the law does not provide for special treatment on the basis of a disability – it precludes disparate treatment on the basis of a disability.

<u>Example</u>: Julie and Kate both apply for a job at Company A. The job qualifications require a bachelor's degree in mathematics. Both Julie and Kate have such a degree, but Kate is a paraplegic. Julie and Kate should both be considered for the position, as they both possess the requisite qualifications, but Kate should not receive special treatment because she is a paraplegic. Similarly, Kate should not be treated *worse* than Julie because she is a paraplegic.

"Essential Functions of the Job"

According to the regulations, a job's "essential functions" are the job's fundamental duties, and not including any marginal or one-off duties that a person in the job may sometimes perform. Certain duties can be considered "essential" or "fundamental" for various reasons, including:

- The particular position only exists to perform these certain functions;
- The functions require a specialized training, knowledge, or know-how that only the person that holds the position has, or;
- Only a certain amount of the company's resources can be dedicated to the certain specific functions, which is why they are encompassed in one or a few positions within the company.

Employers can demonstrate that a certain position's functions are "essential" or "fundamental" in a number of ways, but the most important and oft-cited is the job description. Employers must strive to create job descriptions for each of their positions to establish what the essential functions of each relevant position are not only to help limit liability in certain expectations, but also to help employees better understand the nature and functions of their jobs, and their roles in their organizations.

Importantly, however, the job description cannot take form over function; the employees must actually perform the duties listed in the job description, and the description must contain the duties that the employee actually performs in the position, even including those that, while essential, are not performed on a regular basis. This is important not only for the ADAAA, but, as explained below, this helps establish guidelines for determining whether and which employees are exempt from the overtime provisions of the Fair Labor Standards Act.

"Reasonable Accommodation"

A disabled employee must be able to perform the essential functions of his position (either sought or held) with or without a reasonable accommodation. A "reasonable accommodation" is an adjustment to the employee's normal working environment or circumstances that, when provided by the employer, allow the employee to perform the essential functions of the position.

Under the statute, a "reasonable accommodation" is defined as

- Modifications or adjustments to a job application process that enable a qualified applicant with a disability to be considered for the position such qualified applicant desires; or
- Modifications or adjustments to the work environment, or to the manner or circumstances under which the position held or desired is customarily performed, that enable an individual with a disability who is qualified to perform the essential functions of that position; or
- Modifications or adjustments that enable a covered entity's employee with a disability to enjoy equal benefits and privileges of employment as are enjoyed by its other similarly situated employees without disabilities.

In order to determine applicable reasonable accommodations, employers and employees must engage in what is known as an "interactive process." While the employee has the ultimate responsibility to communicate with the employer to begin this process, the onus is on the employer (and the best practice is for the employer to) initiate this process by opening the discussion regarding what the employees' limitations are, and how those limitations can be addressed in the workplace.

According to the EEOC and to case law, reasonable accommodations can include:

- Providing or modifying equipment or devices;
- Job restructuring;
- Part-time or modified work schedules;
- Reassignment to a vacant position;
- Adjusting or modifying examinations, training materials, or policies;
- Providing readers and interpreters; and

- Providing medical leave, or additional medical leave time if an employee is already on medical leave.

However, consistent with the title, accommodations need only be reasonable. An accommodation is not reasonable if it causes the employer substantial hardship, or, in other words, is significantly difficult or results in substantial expense. Also, an accommodation is also not reasonable simply because it an employee requests it.

Examples of unreasonable accommodations include:
- Removing another employee so that the disabled employee can take the “open” position;
- Creating of a new position consistent with the employee’s disability;
- Adding another employee or unit of employees to perform the essential functions of the employee’s job that he is no longer able to perform;
- Indefinite medical leave.

How the ADAAA is Violated
Employers violate the ADAAA in the following ways:
- Disparate treatment of an employee based on his or her disability in any aspect of his or her employment;
- Failure to accommodate a disability, either through a refusal to engage in the “interactive process” in good faith to determine a reasonable accommodation prior to an adverse employment action, or an actual failure to provide that reasonable accommodation, and;
- Retaliation for exercising rights under the ADAAA.

<u>Example</u>: Michael works as an executive assistant to the CEO of Company A. During his employment, Michael learns that he has an aggressive form of brain cancer. Michael tells his boss about his cancer, who then fires him. Michael’s boss has violated the ADAAA for firing Michael based on his cancer diagnosis.

<u>Example</u>: Kristie is a secretary at Company A, and learns during her employment that she has a degenerative bone disease that is concentrated in her spine. Kristie could effectively do her job without issue, however, if Company A would purchase a special ergonomic desk chair for her office. Kristie tells her manager about her bone disease, her back pain, and requests a meeting to discuss what options are available that could help her do her job in light of her bone disease. Kristie’s manager, however, ignores her. Unable to effectively continue to do her job, Kristie begins experiencing performance issues due to her inability to concentrate because of the pain in her back and, as a result, Kristie is fired. Company A has violated the ADAAA for failing to accommodate her disability, and specifically by failing to engage in the interactive process with Kristie.

<u>Example</u>: Same as above, except Kristie’s manager notes Kristie’s request for the ergonomic chair during the interactive process, but then refuses to get the chair for Kristie. Company A has violated the ADAAA for failing

to accommodate Kristie's disability.

Example: Sam is an engineer for Company A whose primary job is to install lighting in each of the offices. The essential functions of Sam's job include carrying heavy boxes of fluorescent lighting, and using the tools necessary to install the lighting in each office. Sam has an accident, however, and loses one of his legs. Without his leg, Sam is still able to install the lighting, but he has no way to carry the heavy boxes anymore. Since Sam is no longer able to perform one of the essential functions of his job, assuming there is no reasonable accommodation that would help Sam carry the heavy boxes, Company A would be within its right to terminate Sam for his inability to perform the necessary functions of his job, with or without a reasonable accommodation.

Example: Same example as above, except the only accommodation that Sam will accept is having another employee travel with him to every worksite to carry the boxes of lighting. Since the "second employee" is essentially engaging in one of the essential functions of *Sam's* job, and not Sam himself, this accommodation is not only unreasonable, but Company A remains within its right to terminate Sam for his inability to perform the essential functions of his job, with or without a reasonable accommodation.

Notably, employees advancing claims under the "regarded as" definition may not make claims for failure to accommodate or failure to engage in the interactive process, since these employees are only "regarded as," and not actually disabled, and thus, are not in need of an accommodation.

Another source of claims under the ADAAA is known as "associational" discrimination. This is when an employer discriminates against an employee or other individual qualified for employment because an "association" that such person might have with a disabled individual or individuals. Such associations can be familial or social relationships, and also include business relationships.

The Takeaway:

- Employees and applicants still need to be qualified individuals with disabilities, meaning applicants for hire and promotion need to have the necessary qualifications for the position at issue, just like any non-disabled employees or applicants against whom they are competing for the job.
- Employers need to ensure that they are aware of and document all "essential" job functions for each position in their enterprise, so they can establish whether a qualified individual, either seeking or seeking to return to employment in a certain position, can actually perform all such essential job functions.
- When an applicant or employee can be classified as disabled under the law, an employer must act quickly to engage in the interactive process with that employee, to determine whether or what reasonable accommodation can be put in place to allow the individual to perform the essential functions of the job.

- Not all requested accommodations are reasonable.
- Employers should take initiative to engage in the interactive process with employees, so that a reasonable accommodation can be determined as quickly as possible.

The Family and Medical Leave Act (FMLA)

The Family and Medical Leave Act ("FMLA") provides protection to employees that must take leave to care for specific medical and/or family-related situations. The law provides 12 weeks of leave, during which time the employee taking leave must be provided with the same benefits of employment that he or she normally enjoys, including health insurance benefits and seniority, and he or she must be returned to the same job upon return from the leave.

The FMLA covers public and private employers, and, with respect to private employers, to companies that employ 50 or more employees within 75 miles. There are also special sections of the FMLA dedicated to military employees, and to employees in the airline industry (*e.g.* airline flight attendants).

In order for employees to be eligible, the employee must have worked for the covered employer for at least 12 months, and must have accrued 1,250 working hours during the 12 month preceding the employee's use of the leave. The 1,250 hours must be hours actually worked, however; any leave days taken, whether paid or authorized, do not count toward the statutory minimum.

Employees that work for companies covered by the FMLA may take up to 12 weeks of unpaid leave for reasons related to the care of themselves or certain of their family members suffering from a serious health condition; for the care of a newborn or adopted child, or; under certain circumstances, to act as a caregiver for a family member that is a military service member. The employee need not use all 12 weeks at once. Known as "intermittent" leave, employees can utilize their 12 weeks of leave in smaller intervals, such as a certain number of hours a week, or working a reduced schedule, until all of the protected leave time has expired.

Employees are permitted to use FMLA leave to care for their own "serious health condition," or that of an immediate family member. Examples of a "serious health condition" include:

- Conditions requiring an overnight stay in a hospital or other medical care facility;
- Conditions that incapacitate the employee or the employee's family member for more than three consecutive days, and which require ongoing medical treatment; and
- Chronic conditions that cause occasional periods of incapacitation and which require medical treatment at least twice a year.
- FMLA leave can also be used for time off to care for and/or bond with a newborn, adopted, or foster child. To illustrate, many employees use FMLA leave in instances where their employers do not have an official maternity leave policy.

While an employee on FMLA leave must be provided with the same benefits and conditions of employment that he or she enjoyed before going on leave, the FMLA requires that the employee receive the same position upon return from leave. If the employer is unable to return the employee to the exact same position, the employer must provide the employee with a "nearly identical" position. According to the law, the "nearly identical" position must:

- Have the same shift or work schedule;
- Be at the same location, or at a worksite that is geographically proximate to the original location, such that the employee will not be required to increase his or her commute;
- Have the same or substantially similar duties, responsibilities, and status;
- Require the same level of skill, effort, and qualifications,
- Pay the same rate and offer the same benefits of employment, including bonus and overtime opportunities, and opportunities for pay increases, and;
- Offer the same non-monetary benefits, such as insurance, vacation and sick leave time, pension benefits, and tuition reimbursement opportunities.
- Additionally, if the employee would have received a raise in pay while on leave, the employee must still receive that raise in pay, irrespective of his or her absence at the time the original raise was offered to other employees.

An employer is not required to pay an employee on FMLA leave. However, if an employer chooses to either (1) require the employee to first utilize accrued paid leave before using FMLA leave, or (2) substitute the employee's FMLA leave for an employer-sponsored paid leave program, the employer must take special care to follow all of its normal policies in place regarding an employee's use of paid leave. However, if the employer substitutes its own paid-leave program for the employee's FMLA leave, the employer must make sure that the employee receives all of the same rights and benefits, and protections provided under the FMLA if the leave is for an FMLA-qualifying reason.

Both employers and employees have rights and responsibilities under the FMLA.

Employees' Rights and Responsibilities

Employees must provide as much notice as possible to their employers regarding their request for FMLA leave, generally 30 days when the leave is planned or otherwise foreseeable. If the leave is not foreseeable or there is insufficient time to give 30-days' notice, the employee must provide as much notice as possible and as practicable.

An employee may give verbal or written notice, but must provide enough information relating to his or request for leave such that the employer can know that the requested leave is covered by the FMLA.

In addition, the employee must follow the employer's normal attendance policies and/or policies for taking or requesting leave. If not, and the employer chooses not to waive these requirements, the employee may be disciplined accordingly.

Example: Company A, an FMLA-covered employer, has an attendance policy requiring employees to call in if they are going to be absent, and, if the absence is medically related, a doctor's note if their absence will be for three days or longer. The policy further states that employees that fail to contact Company A after three days' absence are considered to have abandoned their jobs and are terminated. Jackie, a Company A employee, was hospitalized on Monday for a ruptured appendix that required emergency surgery, an FMLA-qualifying event. Jackie is aware of Company A's attendance and leave policy. Although Jackie remained hospitalized following her surgery, she was awake, lucid, and fully capable of either calling her manager at Company A herself, or explaining the situation to a friend or family member on her behalf. Jackie, however, decided not to notify Company A about the reason for her absence. Having not heard from Jackie in three days, Company A terminated Jackie's employment on Thursday. Absent other facts, Company A's termination of Jackie would be permissible under the FMLA.

Notice of Eligibility and Employers' and Employees' Rights and Responsibilities

Employers must display a general notice about the FMLA, and the respective rights and responsibilities and employees and employers. Employers may use the general notice poster created by the Department of Labor (and available on its website) [22], or must create its own such notice based on the information contained in the Department's notice. The notice must be posted in a conspicuous manner and in a place accessible to all employees.

In addition to the posting requirements, employers must either place a copy of the general notice its employee handbook or provide employees a handout. If the employer does not have an employee handbook, or does not place a copy of the notice or the equivalent in its handbook, employers must distribute a copy of the FMLA general notice to each of its employees.

Rights and Responsibilities Notice to Employees

In addition to the general notice requirements described above, whenever an employer determines that an employee is eligible for FMLA leave, it must then provide the employee with a written notice regarding specific employee rights and responsibilities. An employer may use Form WH-381, available on the Department of Labor's website, [23] or it may create its own. In any event, the employer's "rights and responsibilities" notice must include, where appropriate, at least the following:

- Notice that the employee's leave may be counted as FMLA leave;
- A statement regarding the 12-month period that the employer has designated for purposes of counting

[22] http://www.dol.gov/whd/regs/compliance/posters/fmlaen.pdf
[23] http://www.dol.gov/whd/forms/WH-381.pdf

the employee's entitlement to FMLA leave;

- The amount of leave that is being counted as FMLA leave;
- Requirements for necessary certification or documentation related to the employee's need for leave, such as certification from a medical professional relevant to the reason the employee is seeking leave, and a full and fair description of the consequences for failing to provide such required certification;
- Information regarding whether the employee's leave can and/or will be substituted for an employer's paid leave program;
- Instructions regarding arrangements for any premium payments for maintenance of health benefits that the employee must make during leave, and any potential liability if the employee fails to make such payments and/or return to work after his or her FMLA leave has expired;
- Notice regarding whether the employee has been designated as a "key" employee, and what such a designation could mean for that employee; and
- A statement regarding the employee's right to job restoration and maintenance of benefits during leave.

Designation of Eligibility for FMLA Leave

Irrespective of whether an employee requests FMLA leave, an employer has a responsibility to identify which members of its employee population may qualify for FMLA leave, and then must notify those employees of their rights and responsibilities pursuant to the FMLA.

Relatedly, when an employee takes or requests leave for what could be an FMLA-qualifying reason, the employer is obligated to determine whether the employee qualifies for FMLA leave, and notify the employee of whether his or her leave qualifies under the FMLA. As mentioned above an employer may use Form WH-382, provided on the Department of Labor's website,[24] or it may create its own. In any event, the employer's designation notice must:

- Be provided within five business days of <u>either</u>:
    - the employee's original request for FMLA leave, or
    - the employer's discovery that the employee may have a condition that qualifies him or her from FMLA leave
- Inform the employee whether he or she is eligible for FMLA leave; and
- State at least one reason why the employee is ineligible for FMLA leave, if the employee's request is denied.

The "Key Employee" Exception

In limited circumstances, an employer may deny an employee certain benefits associated with FMLA leave if

[24] http://www.dol.gov/whd/forms/WH-382.pdf

the employee is considered a “key” employee.

According to the FMLA, a “key” employee is “a salaried FMLA-eligible employee who is among the highest paid 10% of all the employees employed by the employer within 75 miles of the employee's worksite.”

If an employer can demonstrate that holding a “key” employee’s position open for the duration of the employee’s FMLA leave will cause the employer’s operations to suffer “substantial and grievous economic injury,” the employer may deny the employee rights to the restoration of employment to the same or similar position. In such a case, the employer must notify the “key” employee of its determination of the employee as a “key” employee; the possibility that the employee may not be restored to full employment at the expiration of the employee’s FMLA leave, and the reasons why.

FMLA Violations

Employers can violate the FMLA in two ways: restraining, or what is known as “interfering” with the employee’s rights to FMLA leave, or by retaliating against an employee that requests and/or exercises his or her rights under the FMLA.

FMLA Interference

FMLA interference is exactly what its title describes: an employer interfering, or improperly keeping an employee from being able to utilize his or her FMLA rights. Claims of this kind can range from improperly denying an employee use of FMLA leave, to improperly narrowing or otherwise conditioning the employee’s use of his or her FMLA leave.

Example: Sarah, an FMLA-eligible Company A employee, must have non-elective surgery on her arm, and needs to be on FMLA leave for one month to recover. Bob, Sarah’s manager, does not want Sarah to be absent for a month, and denies her request for FMLA leave. Sarah now has the basis to bring an FMLA interference claim against Company A.

Example: Using the same example above about Sarah and Bob, Bob agrees to sign Sarah’s FMLA paperwork so that her leave request will be granted, but only if Sarah completes all of the work that she would otherwise have completed during her absence, before she goes on leave. Because Sarah did not finish all of the work before she went on leave (because she could not possibly have finished such an amount of work), Bob denies her request for FMLA leave. Once again, Sarah now has the basis to bring an FMLA interference claim against Company A.

Employers must understand that interference claims do not relate only to interference with an employee’s use of FMLA leave for their own FMLA-qualifying reason, but for *any* FMLA qualifying reason, such as the care of a close family member.

A Lesson From Case Law

Beverly Ballard, a former employee of the Chicago Park District, resided in Chicago with her mother, Sarah. Sarah was diagnosed with terminal cancer in 2006, and her health deteriorated quickly following the diagnosis. As Sarah's health began to fade, Beverly engaged the services of an outside vendor of hospice services to assist with caring for Sarah. However, Beverly herself was responsible for various aspects of Sarah's care, including administering insulin shots, operating a pump to remove fluid from around Sarah's heart, bathing Sarah, and providing her with oxygen. In 2007, Beverly learned that Sarah had been granted a trip to Las Vegas by the "Fairygodmother Foundation," which is a charitable organization that provides "wishes" for terminally ill individuals. If Sarah was going to accept the trip, as her mother's primary caregiver, Ballard needed to accompany Sarah on the trip to Las Vegas. The Seventh Circuit determined that Ballard had a valid claim of FMLA interference against her employer, since her need to be with her mother as a caregiver, irrespective of where, constituted an FMLA-qualifying event.

FMLA Retaliation

Employers can also be liable for retaliating against employees that use FMLA leave. Although retaliation claims are covered in greater detail below, the essence of this claim is that an employee suffered an adverse employment action (as defined above) because he or she exercised his or her rights under the FMLA.

Example: In reference to the example above, Bob grants Sarah's request for FMLA leave, but is very unhappy about having done so because he did not want Sarah to be off for a month. When Sarah returns from her FMLA leave, Bob suddenly terminates Sarah because he is angry that she had been off for a month on FMLA leave. Bob has violated the FMLA's anti-retaliation provisions, and has now subjected Company A to liability.

The Fair Labor Standards Act (FLSA)

The Fair Labor Standards Act ("FLSA") is a body of laws designed to ensure equitable treatment of all employees, based on the establishment of a minimum wage, employee protections related to overtime wage payment, and protections related to the employment of under-aged, or "youth" workers.

By definition, the FLSA applies to businesses that have at least two employees, and that either (1) have an annual volume of sales of at least $500,000, or (2) are hospitals; providers of in-home medical or nursing care, or for schools or preschools, and; governmental agencies. However, while all "businesses" might not be covered by the FLSA, all employees enjoy the rights and privileges of the law whose jobs require them to "work regularly" in "interstate commerce" or who are "engaged in commerce or in the production of goods for commerce." According to the federal Department of Labor, such employment includes the production of goods that will be sent out of state; jobs that require the use of "facilities of interstate commerce" such as making long distance telephone calls and travel on interstate roads; jobs that require travel to other states; and employees that do work in buildings that produce goods that will be shipped out of state or services that

will be provided out of state.[25] In essence, *every employee* is covered by the FLSA, even if the employer for which they work is not technically an "enterprise" that is "covered" by the FLSA. Therefore, all employers need to comply with the law Not do so based on the hope or assumption that the employee or enterprise is not covered by the law can be a very expensive gamble if litigation ensues based on a perceived violation.
In addition to the above, all employers subject to the FLSA must post a notice regarding employer and employee rights and responsibilities under the FLSA, and specifically regarding minimum wage. Employers may use the poster provided on the Department of Labor's website[26], or create their own so long as it contains the requisite information. The notice must be posted in a conspicuous place and manner so that all employees can see it.

As one can tell from the brief description above, the FLSA is multi-faceted. For example, different portions of the FLSA apply to wage payment issues in the following uncharacteristically dissimilar employment scenarios:

- Issues related to wage payment of "tipped" employees that work in service jobs;
- Issues related to what is considered "time worked" for employees in factory or other jobs that require them to wear specialized uniforms or other equipment, and whether putting on or removing such gear (or "donning" and "doffing" such gear, as it is referred to in the statute and related case law) constitutes time for which employees should be paid;
- Issues related to in-home and nursing care employees;
- Issues related to whether highly-compensated individuals should be allowed to collect overtime wages;
- Issues related to payment of employees in family owned businesses where the entire workforce is comprised of members of the same family;
- Issues related to the employment of individuals at or under a certain age, including the kinds of jobs that such individuals are allowed to have and the number of hours these individuals are allowed to work;
- Issues related to what counts as time for which employees should be compensated when employees drive company vehicles to and from their worksites, but also use the company vehicles as transportation to and from home at the beginning and end of their workdays;
- When and how long employees must be given to have meal breaks throughout the workday;
- And the list goes on.

Employers in different types of industries need to be aware of the various sections of the FLSA (and any attendant state wage payment laws) that apply to facts and circumstances related to their workforce. While an entire book can be dedicated to the FLSA and its many intricacies, this section of this chapter focuses on the most common issues related to the FLSA, and the issues that most employers face when staring down the barrel of a potential FLSA lawsuit. These issues are:

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[25] http://www.dol.gov/whd/regs/compliance/whdfs14.pdf
[26] http://www.dol.gov/whd/regs/compliance/posters/minwagebwp.pdf

- Payment of minimum wages;
- Payment and calculation of overtime;
- Recordkeeping requirements; and
- Employee classification as exempt from the overtime provisions of the statute.
- Each of these four items shall be dealt with individually below.

Payment of Minimum Wage

Employers covered by the FLSA must ensure that the members of their workforce make at least minimum wage. As of 2009, and through the date of this writing, the minimum wage established by the federal government is currently $7.25 per hour. Employees that work in service positions that receive tips, however, can be paid a wage of $2.13 per hour, so long as they customarily and regularly receive a minimum of $30 in tips per day.

Many states, through their own wage and hour laws, establish minimum wages that are higher than the federal minimum wage, and include the minimum wages established for "tipped" employees. No minimum wage paid to an employee working in a job or for an enterprise covered by the FLSA can be paid less than that established by the federal government, and thus, the minimum wages established by states are often higher. Twenty-five (25) states, including the District of Columbia, have established their own minimum wages, which were the following as of January 1, 2014: [27]

State	State-Required Minimum Wage
Alaska	$7.75
Arizona	$7.90
California	$8.00
Colorado	$8.00
Connecticut	$8.70
District of Columbia	$8.25
Florida	$7.93

[27] *See* http://www.dol.gov/whd/minwage/america.htm. Four states have minimum wages that are lower than the federal minimum wage, as displayed in the chart below. However, entities or individuals covered by the FLSA must be paid at least higher, federal minimum wage. Additionally, the states not listed in the chart either have minimum wage requirements that match the federal rate, or have no independent state minimum wage laws, in which case the federal minimum wage automatically applies.

State	State-Required Minimum Wage
Illinois	$8.25
Massachusetts	$8.00
Maine	$7.50
Michigan	$7.40
Missouri	$7.50
Montana	$7.90
New Jersey	$8.25
New Mexico	$7.50
Nevada	$8.25
New York	$8.00
Ohio	$7.95
Oregon	$9.10
Rhode Island	$8.00
Vermont	$8.73
Washington	$9.32
Arkansas	$6.25
Georgia	$5.15
Minnesota	$6.15
Wyoming	$5.15

Also, because states have the right to establish their own minimum wage rates, they are also entitled to change their minimum wage rates without permission or interference from the federal government. In fact, in 2014 alone, thirteen states raised their minimum wage rates. It is important to note that employers are required to follow the minimum wage rate that is most beneficial to the employee population (or, in other words, that pays the most), so employers must be vigilant in staying abreast of changes in the minimum wage rates for states in which they employ workers, and what such rates are in comparison to the federal minimum wage.

Earning the minimum wage applies not only to hourly employees, but also to salaried employees. In essence, an employee's wages, when divided by their hours worked, must at least meet the established minimum wage standards in their state, or the federal standard if the state in which the employee works has not established its own minimum wage rate.

Example: Anna, a Company A employee, earns an annual salary of $18,000 a year. Anna, however, nearly always works 50 or more hours per week. Setting aside whether Anna is entitled to overtime wages, Anna's salary alone breaks down to the hourly equivalent of just under $7.00, which is less than the federal minimum wage. Based on these facts alone, and all other facts remaining equal, Company A is violating the FLSA with regard to Anna's compensation, since she is not technically earning at least the federal minimum wage of $7.25 per each hour that she works.

Payment of Overtime

Wage payment, whether minimum or at some other rate, dovetails into the second most commonly disputed issue under the FLSA, which is the payment of overtime compensation. Under the federal law, overtime wages must generally be paid at one-and-one-half times the employee's regular rate of pay for every hour worked in excess of forty (40) hours per workweek.

There are variations to this theme, especially given the fact that the statute does not specifically define "workweek," "hours worked," or "regular rate," all of which have spurred massive litigation under the statute. Some state wage and hour statutes, such as those in California, have differing overtime requirements, such as requiring overtime after a certain number of hours worked in a day. Therefore, employers are well-advised to have their pay practices evaluated and audited by an attorney to ensure that (i) they are in compliance with the relevant state and federal laws as written, (ii) that they are also in compliance with the federal and state laws as generally interpreted, and (iii) also they are monitoring the state of law due to varying and ever-changing interpretation of the law by state and federal courts.

Recordkeeping Requirements

The FLSA also establishes strict recordkeeping requirements which, if not followed, constitute violations of the statute. Employers are required to keep records regarding wages paid to employees, the number of hours employees have worked per pay period, and other items specified in the statute, including the following employee and payroll information:

- Employee's full name and social security number;
- Address, including zip code;
- Birth date, if younger than 19;

- Sex and occupation;
- Time and day of week when employee's workweek begins;
- Hours worked each day;
- Total hours worked each workweek;
- Basis on which employee's wages are paid (*e.g.,* "$9 per hour," "$440 per week," "$2500 per bi-weekly pay check," etc.);
- Regular hourly pay or annual salary rate;
- Total daily or weekly straight-time earnings;
- Total overtime earnings for each workweek;
- All additions to or deductions from the employee's wages;
- Total wages paid each pay period; and
- Date of payment and the pay period covered by the payment.[28]

Employers must also maintain and preserve these records on their entire workforce for at least three years. Other records that must be maintained for the same time period include the employers' sales and purchase records, and any applicable collective bargaining agreement(s), if the workforce is a unionized workforce. While many employers maintain these records regularly for business purposes, employers need to be especially careful and make sure that their recordkeeping system complies with the FLSA requirements, as the federal Department of Labor retains the right to inspect any of these records at any given time to determine a company's compliance with the law.

Overtime Exemptions

Another hotly contested aspect of the overtime provisions of the FLSA are the "exemptions," or the terms under which certain classes of employees do not have to be paid overtime for working hours in excess of forty (40) per week. The FLSA provides for numerous categories of exemptions for a variety of employees, but the most common are known as the "white collar" exemptions. These are known as the "Executive," "Administrative," "Professional," "Computer Employee," and "Outside Sales Person" exemptions. Many salaried positions fall under one or more of these exemptions, including jobs like lawyers, doctors, administrative assistants, director-level employees, managers, and the like.

In order to be exempt from overtime provisions, each category of employees must fit certain "tests." One test that each of these exempt classes of employees all share in common is that they all must be paid on a salary (as opposed to hourly) basis, and must earn at least $455 per week. The only exception is that "Computer Employees" may be paid on a salary basis of at least $455 per week, or must earn at least $27.63 per hour.

The remaining tests for each category of exempt employee are the following:

[28] http://www.dol.gov/whd/regs/compliance/whdfs21.pdf

Exemption	Required Aspects (in addition to salary basis)
Executive Exemption	• The employee's primary duty must be managing the enterprise, or managing a customarily recognized department or subdivision of the enterprise; • The employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent; and • The employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.
Administrative Exemption	• The employee's primary duty must be the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and • The employee's primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.
Professional Exemption ("Learned Professional")	• The employee's primary duty must be the performance of work requiring advanced knowledge, defined as work which is predominantly intellectual in character and which includes work requiring the consistent exercise of discretion and judgment; • The advanced knowledge must be in a field of science or learning; and • The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.
Professional Exemption ("Creative Professional")	• The employee's primary duty must be the performance of work requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor.
Computer Employee Exemption	These employees be employed as computer systems analysts, computer programmers, software engineers or "other similarly skilled workers in the computer field," and whose job requires them to perform the following tasks as their primary duties:

Exemption	Required Aspects (in addition to salary basis)
	• The application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications; • The design, development, documentation, analysis, creation, testing or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications; • The design, documentation, testing, creation or modification of computer programs related to machine operating systems; or • A combination of the aforementioned duties, the performance of which requires the same level of skills.
Outside Sales Exemption	• The employee's primary duty must be making sales (as defined in the FLSA), or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client or customer; and • The employee must be customarily and regularly engaged away from the employer's place or places of business.

Another less-common but specifically relevant "white collar" exemption is known as the "Highly Compensated Employee" exemption. While "Highly Compensated Employees" must meet the salary basis test of earning at least $455 per week, they are exempt from the FLSA if they:

- Perform non-manual work;
- Are paid a total annual compensation of at least $100,000, and
- Perform at least one of the duties of an exempt executive, administrative, or professional employee, as defined by the tests set forth above.

Exemptions and the Primary Duty

While the FLSA and its attendant regulations are generally lacking in specific definition (allowing the courts' interpretation of the statute to generally dictate how these exemptions are defined), the one phrase that commonly arises, and that serves as the baseline for nearly all of the various exemptions, is "primary duty." According to the Department of Labor, an employee's "primary duty" is the employee's "principal, main, major or most important duty that the employee performs." An employee's primary duties are the product of a "totality of the circumstances" analysis, which is fact-based, and determined on a case-by-case basis. Factors considered in determining an employee's "primary duties" include the critical functions of the job, the relative importance of the major or most important duties of the job as compared with other job duties; and the amount of time spent performing the major or most important duties of the job.

Much like analysis under the Americans with Disabilities Act, as described above, one way for an employer to help define the "primary duties" of a position is to create or update a job description that defines the critical job functions, as well as the primary duties. However, much like the discussion above regarding the Americans with Disabilities Act, an employee's exempt status will depend heavily on the job duties that they actually perform, and not just what is written in their job description.

A Lesson From Case Law

In 2012, two major big-box retailers, Duane Reade and Rite Aid, paid out nearly $25 million to settle FLSA lawsuits filed by assistant managers alleging that they were misclassified as exempt employees. The general allegations common to both suits were that while the employees held "management" titles and were classified as administratively exempt "executives" by their employers, they had little or no discretion regarding hiring and termination decisions, they had no voice in setting store policies, and they had no discretion regarding rates of pay for the employees that they hired. Also in 2012, drug retailer Novartis paid a $99 million settlement to a class of sales representatives that claimed they were improperly classified as exempt. As mentioned in a previous example regarding settlements, while settlements are not an indication or admission of legal liability, these large price tags do indicate how expensive a misclassification of an employee or class of employees can be, even in absence of a definitive ruling or verdict.

Retaliation

While violating the FLSA can come in many forms, such as failure to pay minimum wage, failure to pay overtime, misclassification as exempt, and a host of other means not specifically addressed or identified here, another way to violate the statute is by retaliating. As discussed in relation to the discrimination and other statutes throughout this chapter, retaliation occurs when an employer engages in an adverse employment action based on an employee having exercised his or her rights under the FLSA.

<u>Example</u>: Kenneth, an hourly Company A employee, received his weekly paycheck, and noticed that, although he worked forty-three hours that week, he did not receive payment at one-and-one-half times his regular hourly rate for the three hours that he worked in excess of his normal 40 weekly hours. Kenneth reports to Michael, his manager, that he believes he is owed overtime wages for the three hours that he worked in excess of forty the preceding week. When Michael refuses to pay Kenneth the overtime that he believes he is owed, Kenneth reports the underpayment to Company A's human resources department as a potential FLSA violation. The next day, based on his complaint to Human Resources about the underpayment, Michael fires Kenneth. Michael, and thus Company A, has engaged in FLSA retaliation.

The Takeaway: Employers should be vigilant in their efforts to comply with the FLSA and any attendant state or local statutes and ordinances related to wage payment. Employers should engage the assistance of an attorney to help ensure compliance with these various laws, but they should also do at least the following:

- Ensure that its payroll practices are consistent with the FLSA and relevant state statutes, including paying overtime at the appropriate rate and at the appropriate point in time (*i.e.* when the employee has surpassed forty (40) hours of work in one workweek, or in such other times as the law dictates overtime payments should kick in, (such as in California);
- Ensure that they are paying the minimum wage rate relevant and applicable to the states where the employer has a workforce;
- Draft or update (as necessary) job descriptions for positions classified as exempt;
- Draft and enforce policies related to working overtime for non-exempt employees, such as requiring prior authorization to work overtime, and enforcing disciplinary measures when such authorization is not obtained;
- In light of such policies as described above (*e.g.* imposing discipline for working unauthorized overtime), ***always pay wages earned***, even if the employee was not authorized to work, with the discipline to be issued through the company's disciplinary policies, and not through a financial penalty by not paying the employee for working when not allowed; and
- Draft and enforce policies prohibiting retaliation for complaints regarding wage or overtime payment, or employee concerns regarding exemption classifications.

Some Additional Important Employment Laws

Although the topics covered in this chapter are many, there are still many areas of employment law that this chapter does not cover. While the statutes below are not covered in as great of detail as others, they are worth at least briefly mentioning given their importance in the employment law arena. Since the sections below are especially brief, like the laws mentioned in the other sections of this chapter, employers are encouraged to seek counsel from specialized practitioners in these areas and those set out above to address their particular needs and situations:

National Labor Relations Act (NLRA)

The National Labor Relations Act ("NLRA") specifically provides rights to employees to organize and collectively bargain with private employers regarding the terms and conditions of their employment. Many employers are under the mistaken impression that the NLRA only applies to unionized workforces; however, as federal law, the NLRA applies to private employers, irrespective of whether their workforces are unionized. Certain limited employers are excluded from the NLRA's coverage, including certain government or municipal employers (or private employers that act in an essentially municipal function), employees of labor unions themselves, employers subject to the federal Railway Act, and schools with specifically religious affiliations (unless the school is generally secular, and not substantively affected or pervaded by any particular religious purpose or medium).

The sections of the NLRA most relevant to private employers are Sections 7 and 8. Section 7 provides employees with the rights described above; specifically, the statute provides that Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in Section 8. Similarly, Section 8 describes "unfair labor practices," or, in other words, labor practices that violate Section 7. Specifically, the statute provides that an employer commits an unlawful unfair labor practice if it acts "to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in Section 7." And even if the employer's rule or practice does not violate Section 7 on its face, it can still be deemed illegal if "(1) employees would reasonably construe the language to prohibit Section 7 activity; (2) the rule was promulgated in response to union activity; or (3) the rule has been applied to restrict the exercise of Section 7 rights." [29]

The NLRA has been prominently figured in various recent decisions of the National Labor Relations Board regarding the activities and rules of non-unionized workforces, including in relation to invalidating class action waivers in arbitration agreements; invalidating at-will employment policies set forth in employee handbooks; non-disclosure of information provided or obtained in employee investigations conducted by human resources, and; social media policies.

Employment Retirement Income Security Act (ERISA)

The Employment Retirement Income Security Act of 1974 ("ERISA") provides the minimum standards required for pension and health plans established for use by private employers. ERISA, in essence, protects by requiring employers to provide certain relevant and important plan information regarding their pension and health plans to employees and other plan participants, including information about the plans' features and sources of funding. The amendments to ERISA also provide important employee protections related to their health, welfare, retirement, and benefits plans. To illustrate, one ERISA amendment with which many employers are specifically familiar is the Consolidated Omnibus Budget Reconciliation Act, or "COBRA," which provides continuation coverage of health benefits to employees and their families when such employees separate from their jobs.

ERISA also provides fiduciary responsibilities for those who manage and control plan assets, and also requires employers' health and retirement plans to establish grievance and appeals processes for plan participants. Finally, ERISA provides a private right of action, or in other words, a mechanism for employees and plan participants to file lawsuits, regarding issues related to their proper receipt of benefits under the plans, or breaches of fiduciary duty by those statutorily defined as plan fiduciaries.

[29] *See In the Matter of Martin Luther Memorial Home, Inc., d/b/a Lutheran Heritage Village-Livonia and Vivian A. Foreman*, 343 NLRB 646 (2004).

Occupational Safety and Health Act (OSHA)
The Occupational Safety and Health Act ("OSHA") is the federal law that sets standards for, and regulates safety and health hazards in the workplace. By setting minimum safety standards, which are usually industry-specific, OSHA provides protection to employees by helping them ensure and maintain a safe work environment. OSHA standards, recordkeeping, and reporting requirements also help employers eliminate or reduce risks of injury and other safety hazards.

OSHA generally covers employers of all sizes and in all industries, and its standards are enforced by either the federal Occupational Safety or Health Administration, or an approved state program. Employees that are not generally protected by OSHA are those that are: self-employed; immediate family members of farm employers (whose workforce is *only* comprised of family members and *no* outside employees), and; employees that work in industries or for employers whose workplace hazards are regulated by a different, more stringent federal agency (including, for example, the Federal Aviation Administration's regulation of safety issues related to flight and airlines, or the Mine Safety and Health Administration's regulation of safety issues related to coal and other mining industries).

Conclusion
While none of the information in this chapter is or should be treated as legal advice, it will hopefully serve to help employers to gain an understanding of the legal minefield that is employment law. Employers should consult a labor or employment specialist in the jurisdiction where the issue arises to navigate this minefield, especially in the event that some or any of the issues mentioned in this chapter arise. This is especially true in jurisdictions with complicated state laws that do not mirror the federal laws discussed herein, like California. Nonetheless, the notes in this chapter, including the "Takeaway" points throughout, the concluding points below, and the quick reference chart below, should serve to provide as some preliminary guidance on how to prevent some of the mistakes that many employers make (and that could have been easily avoided).

Additional Takeaways:

- <u>If there is not one, create an employee handbook</u>. No matter the size of an organization, setting forth minimum standards of conduct, company rules, and policies help create and manage employee and employer expectations, and help set a baseline for the employment relationship.
- <u>Document, document, document</u>. Whether engaged in an investigation of employee harassment, engaging in the interactive process to determine a suitable accommodation for a disability, or whether simply issuing discipline based the company's disciplinary policy, substantive documentation can make a huge difference in the defense of an employment-related claim.
- <u>Call a lawyer</u>. When in doubt, consult a licensed attorney who practices in the jurisdiction in question for assistance with understanding and staying in compliance with local, state, and federal laws applicable to the organization and its workforce.

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The Editor.

Federal Law	Number of Employees	Coverage/Protection	Administrative Filing R
Title VII[30]	15+	Protects applicants and employees from discrimination, harassment, and retaliation on the basis of gender, race, color, and national origin.	Must file charge of discrimination with the EEOC within 180 days of the alleged discriminatory act, or within 300 days if there is a state or local agency that enforces a state or local law that prohibits discrimination on the same basis.[31]
Age Discrimination In Employment Act[32]	20+	Protects applicants and employees 40 years of age and older from discrimination, harassment, and retaliation on the basis of age.	Must file charge of discrimination with the EEOC within 180 days of the alleged discriminatory act, or within 300 days if there is a **state agency** (as opposed to state or local agency, above) that enforces a state or local law that prohibits discrimination on the same basis.
Section 1981	No Minimum	Protects employees from discrimination, harassment, and retaliation on the basis of race.	No administrative filing requirement – May proceed directly to federal court.
Genetic Information Non-Discrimination Act[33]	15+	Protects employees from discrimination, harassment, and retaliation on the basis of genetic information.	Must file charge of discrimination with the EEOC within 180 days of the alleged discriminatory act, or within 300 days

[30] http://www.eeoc.gov/laws/statutes/titlevii.cfm
[31] http://www.eeoc.gov/employees/timeliness.cfm
[32] http://www.eeoc.gov/laws/statutes/adea.cfm
[33] http://www.eeoc.gov/laws/types/genetic.cfm

Federal Law	Number of Employees	Coverage/Protection	Administrative Filing F
			if there is a state or local agency that enforces a state or local law that prohibits discrimination on the same basis.
Equal Pay Act[34]	No minimum	Protects employees from receiving differential wages on the basis of gender.	No administrative filing requirement – May p
Americans with Disabilities Act[35]	No minimum	Protects employees from discrimination, harassment, and retaliation on the basis of a legally cognizable disability.	Must file charge of discrimination with the E discriminatory act, or within 300 days if ther enforces a state or local law that prohibits di
Family and Medical Leave Act[36]	50 (within 75 mile radius)	Provides employment protections to employees requiring need for leave to care for their own severe medical condition, or that of a family member.	No administrative filing requirement – May p
Fair Labor Standards Act[37]	2+	Provides protections to employees related to fair wage payment, including the timely payment of wages, overtime wages, and the establishment of a minimum wage.	No administrative filing requirement – May proceed directly to federal court.
National Labor Relations Act[38]	No Minimum, but coverage depends on type of employer	Provides rights to employees to organize and collectively bargain with private employers regarding the terms and conditions of their employment.	Unfair Labor Practice Charge must be filed within six (6) months of the alleged event or conduct.
Employee Retirement	No Minimum	Provides administrative guidelines and rules for how employers must manage	No administrative filing requirement –

[34] http://www.eeoc.gov/laws/statutes/epa.cfm
[35] http://www.eeoc.gov/facts/fs-ada.html
[36] http://www.dol.gov/whd/fmla/
[37] http://www.dol.gov/WHD/flsa/index.htm
[38] http://www.nlrb.gov/

Federal Law	Number of Employees	Coverage/Protection	Administrative Filing F
Income Security Act[39]		employee retirement funds and other related benefits.	May proceed directly to federal court.
Occupational Safety and Health Act[40]	10 + (for purposes of recordkeeping requirements and exemptions)	Regulations providing employee protections to assure safe working conditions for employees.	Must file a complaint with the OSHA commission prior to proceeding to court for judicial review.

[39] http://www.dol.gov/dol/topic/health-plans/erisa.htm

[40] https://www.osha.gov/

Chapter 16 | The Importance of Soft Skills in the New Economy

Gavin Martin

Very rarely is it a good idea to start a written work with a warning, yet that's exactly what I'm going to do.

WARNING: The following content is often perceived as being too “touchy-feely,” “new age,” and/or unnecessary when discussing proper business matters.

So why should you read this? What value could such “soft” subject matter possibly offer? In short, what you're going to learn is going to be the **single** greatest asset in the future of business. Companies like Google, Apple, Facebook, and Bain & Co. are already leveraging this asset, and it's the same asset that brought the Chicago Bulls six championships, the Green Bay Packers 13 league championships, and allowed the Oakland Athletics to set the American League record of 20 consecutive wins.

I'm talking about **character.**

Disclaimer: Before we get into what character is and how to leverage it to grow a sustainable business, please keep in mind that the purpose of this content is not to teach you all there is to know about character if you're not already familiar with it. There will be more on that later, but the short reason why is that it took me seven years of hands-on work with the best resources available before we (nGame) ever accepted our first client for character-based work.

With that said, what is character? Merriam-Webster defines character as:

> noun:
> *1. the way someone thinks, feels, and behaves; someone's personality*
> *2. a set of qualities that are shared by many people in a group, country, etc.*
> *3. a set of qualities that make a place or thing different from other places or things*

Let's add to that definition: character must be of the highest quality, otherwise there is no character, only the absence of it. With that in mind, character is what makes great leaders great, it compels the public eye to admire certain companies, and empowers teams—in business, sports, and otherwise—to achieve what in hindsight seemed impossible. Character is the cornerstone of being a game-changer.

Why the title? As of 2014, most of the business world values so-called “hard skills” over the soft ones. Over and over again, soft skills are labeled as mere complements to hard skills. Soft skills are treated as second-class,

“fluffy,” and are often seen not as *necessities* for a successful business, but instead as luxuries.
Let's be clear: The term “soft skills” is a complete misnomer. How does one define a skill as “soft?” Communication, conflict resolution, critical thinking, collaboration, innovation, inspiration, motivation, etc., all of which are a part of character, are considered by most to be “soft skills” or “intangibles.”

“Soft” kinesthetic, or touchable, yet something supposedly intangible is also soft. What we're really talking about are *non-technical* skills, and there's nothing “soft” about them. However, this is not an argument of semantics. On the contrary, what I'm pointing out is that 99% of businesses have effectively written off anything that doesn't have a hardline on a balance sheet.

To answer the above question, after the 2008/09 global financial crisis, many businesses, governments, and families went from being profitable (in the black) to being bankrupt (in the red). In this new post-2008 economy, the rules have changed. Non-technical (soft) skills are the new black. **Character** is the new black, meaning it's the only way the businesses of today are going to regain and exceed their previous profitability, rate of growth, and sustainability for tomorrow.

The case for character as the new black.
The technical skills that were once the bread and butter of the business world are now easier to learn than ever; outsourcing empires like China, India, and the Philippines are quickly becoming dangerously proficient at performing technical tasks. In short, between the Internet, e-books, video content, and online universities (many of which are now free), the barrier to entry on learning technical skills is gone***.***

Non-technical skills are without a doubt harder to measure than technical ones. That difficulty means we have a long way to go before we know how to assign a specific value to them in a way that would satisfy those who live and die by numbers. And before someone points out that Sabermetrics (the economic model applied to baseball that is credited with the success of the 2002 Oakland Athletics) is a “live and die by the numbers approach,” please consider two things:

1. There's nothing wrong with relying on numbers, but there *is* something wrong with ignoring anything that doesn't have a crystal clear number assigned to it. To do so is completely negligent.
2. In *Moneyball: The Art of Winning an Unfair Game*, Michael Lewis writes about how the Athletics weighed character quite heavily, trading one of their top players (on paper), Jeremy Giambi, to the Phillies because he was a poor character fit.

Non-technical skills, while difficult to measure, are also much more difficult to learn. How do you explain to someone in a book how to say something? You can explain to them *what* to say, but it's nearly impossible to teach *how* (tonality, pause, inflection, diction, context, etc.) in a book or article. There are a myriad unique contexts and subtitles around non-technical skills which are best learned experientially, and in my experience working with C-suites, sales teams, HR, team leads, employees, and even sports teams, I have yet to meet a

single person who mastered non-technical skills using only DVDs, books, articles, videos, the Internet, etc. They have always needed someone to teach them in person before it made any amount of practical sense.
This is the same phenomenon we see when someone studies a foreign language for eight years but is unable to hold even a basic conversation. In six weeks of using the language while living in a foreign country, one would speak more conversationally than eight years (or more) of on-paper study would have allowed. This describes the power of experiential learning.

The non-technical skill that we're focusing on from here on out is character, and we're going to discuss character primarily as it relates to business. In order for character to keep you “in the black,” you need a few other supporting pieces in this new economy.

The first supporting piece is a new approach to management. More than 80% of the management approaches used today are over 100 years old. As Dan Pink said, “How many 100+ year-old inventions do we still use today?” The 100+ year-old view is to value “hard” (technical) skills over character. Obviously, such a view undervalues character and therefore trumps any benefit it may have.

In sharing this perspective with others, I’ve often met with people rolling their eyes at me. A Chicago-based technology company (who kindly asked to have their name omitted) initially wrote off my emphasis on character, stating vehemently, “it's about P&L. That's what we're focused on – P&L, not this character business you're talking about.”

When their entire sales team – without warning – quit to go work for a competitor, two things happened:

1. The company was immediately more profitable.
2. In spite of this newfound profitability, the CEO called me in a complete panic, because things were, according to him, “completely falling apart.”

Suddenly, character was at the top of their priorities list. Profit wasn't the end-all, be-all guarantee he thought it was. Why? Because profit is an outcome; a result. Profit is also, quite literally, intangible. You can't hold it in your hand, you can't carry it into a business, nor can you directly install profit into a company. You have to do things that lead to profit, because profit is an outcome.

This seems obvious, yet all too often companies treat it in exactly the opposite way, implementing “cost-cutting” plans; divesting employees by lowering wages, ending overtime, and dropping benefits packages; and lowering quality in small increments, as though they're testing to see what they can get away with before their customers take notice. (Cost cutting appears in quotes because statistically, most cost-cutting plans end up costing more than they save in the long term.)

Shortsighted strategies like this can go on for years. The next thing we know, a once-iconic company like Hewlett-Packard gets dropped from the Dow Jones, which was announced to the press in September 2013. This is the same company that refused to invest in one employee who – acting with character – presented something called a "computer" FIVE TIMES (yes: five separate times). This employee was honoring his agreement with HP, giving them the first right of ownership of anything he invented during his time with the company. You might know of this employee; he's the co-founder of Apple, Steve Wozniak, and he told this story in November 2010, during the opening tour of the Computer History Museum[41].

Enough context, give me the content!

If you've made it this far, I'm assuming that you fit into one of three categories:

1. You are starting to see the immense value of character.
2. You're not sure yet, but you're curious enough to keep reading.
3. You are already a proponent of character, and you're examining the subject even further.

Any organization that values and utilizes character to promote growth follows a version of the following recipe for success:

1. **Vision:** decide the "why" of your company.
2. **Values:** decide the "who" of your company.
3. **Business Model:** keeping your "why" and your "who" in mind, decide how you are going to fulfill the "why."
4. **Strategy/Plan:** discover the "who" and "why" of your market and align it with your company's "why."
5. **Quality:** engage your market (customers) and employees every step of the way.

Let's dive into each of these steps of the character recipe separately.

The "why," or the vision of your company.

The importance behind knowing why your company exists cannot be overstated. Context Media, an award-winning Chicago-based media company, started because they felt patients were often uninformed outside of the information provided by their doctors, and they wanted to provide easy-to-understand and engaging content by using video. They didn't set out to charge for the video content (and they still don't) nor did they set out to gather advertising revenue in exchange for video content. In fact, a strong "why" comes before any of these details.

Their "why"/vision: Context Media believes in helping people, their families, and communities to become more empowered to take control of their health and live higher quality lives. In a little over six years, they were among Chicago's 101 Best and Brightest companies, they outgrew three different office spaces, and comfortably (and profitably) brought in over $20M in revenue by the end of 2013. They are on-track to double their business by the end of 2014.
A strong vision carries your company beyond trends and circumstances. Going back to the Context Media

[41] Ong, J.: "Apple co-founder offered first computer design to HP 5 times," *Apple Insider*, December 6, 2010.

example, even if video falls to the wayside in favor of a newer technology, their vision stands strong.
An example of when this was done incorrectly is Motorola. Motorola acted as though they existed primarily to make high quality phones, when the marketplace actually valued them because of their ability to connect people and technology. As a company, their value diminished as traditional phones became obsolete – leaving them to sell their patents as a way of recouping losses.

Vision keeps focus throughout your organization, and gives people a deeper sense of meaning, which is often times the only reason people can remain persistent during challenging times. Carrot-and-stick extrinsic motivators do very little long-term to keep employees inspired to bring their best every day. A well-thought-out, well-communicated vision is the fuel for a company to grow, and is the very foundation by which solid, ever-evolving strategies are built.

The "who," or the values of your company.
Whether you're an entrepreneur, a one-employee company, or a large organization, values play an important role in what you do.

Values are essentially representations of our beliefs, and we hold our beliefs as truths about our world, therefore people will live and die by them. To put it simply, values are extremely important to us. If we are going to grow a business, we need to know what our values are and how they are going to direct our willingness to do or not do something.

An overly simplistic example would be the tension a person may experience if he or she believes greed is evil but wants to build a billion-dollar empire. Depending on one's definition of greed, this could be a direct conflict of values, and the individual in question would be faced with a struggle to negotiate that difference. In turn, this "inner conflict" could cause someone to get in his or her own way, making action difficult. We don't usually think of our values consciously; instead, we act on them unconsciously. When value conflicts go unresolved, motivation suffers, because the internal struggle is difficult and energy consuming. When people are "stuck" or "at an impasse," this is often what is going on.

To put this in a business context, employee and customer pushback happens for many reasons, but one of the main reasons (the 20% that causes 80% of the problems, if you will) is people feeling that their value systems have been violated. If you want a company comprised of people who are willing to do whatever it takes for your vision to be realized, you need to know two things: what are their values, and what are yours? Eliciting – or finding out – values varies in difficulty from situation to situation. The most reliable way I have found for finding out someone's (or your own) values is to follow this process:

1. Think of a goal you know with absolute certainty you want to accomplish.

2. Ask, "when you accomplish that goal, what will that give you?" If you are looking to find out your own

goal, then ask, “what will that give me?”

3. What you're looking for are both emotions and values. Some examples could be:
    - Security
    - Pride
    - Confidence
    - Sense of accomplishment
    - Sense of contribution
    - Independence
    - Freedom of time
    - Joy

   There are infinitely more options than the ones I just listed. This is just to give you an idea of what we're talking about.

4. The answers you arrive at are values that are important to you.

Again, this process doesn't always cover all of the bases, but often you'll find out what's really important to people (and to yourself) by asking these questions. Once you have your values list, and the lists from your employees, you can turn those smaller lists into one big list and facilitate a discussion with your entire team for the purpose of deciding which of values work for the group.

This “quick-and-dirty” summary is essentially the process I follow to develop core values for a company. I'm not developing core values because it's the “right” and/or “popular” thing to do; I’m helping companies develop values because values tell you who your company is. Think of it like this: who is your best friend? Would you say you know what your best friend likes and doesn't like? Odds are, you have a good sense of what he or she likes and doesn't like. After all, you are able to remain friends because you both “know how the other one works.” Most of the time, this allows you to avoid stepping on one another’s toes, betraying or angering one another, and ensures that your friendship continues to thrive.

The same phenomenon that keeps friendships thriving will keep your employees loyal, appreciative, and motivated. As we say at nGame, “if you take care of your people, they will take care of you.” Knowing the “must-have” values takes 80% of the guesswork out of this process.

How are we going to fulfill the why?

This part of the character process is more about everyone being clear about what you ***aren't*** going to do, rather than specifically stating what you are going to do. In any case, knowing the vision of the company and the values on which you and your people stand permits you to start to formulate how you want to leverage your unique combination of skills, strengths, and resources.

This example may prove useful:

- The company: A car dealership
- The vision: “We connect people from place-to-place, enriching their lives by keeping them close to who and what is important.”
- The values:
  - “We always tell the truth.”
  - “Our reputation is always more valuable than a sold car.”
  - “We go beyond nuts and bolts. It's our duty to provide the best driving and purchasing experience possible.”
- How the company will fulfill its vision:
  - “For our inventory, we're going to prioritize reliability and overall quality over price.”
  - “Our job is not to sell cars, but to match the right vehicle to each customer’s unique needs. To do this, we'll operate off of universal profit sharing instead of commission.”
  - “Every car description will include not only the pros, but also the cons. It's our duty to give each customer the complete picture.”

Of course, this example takes a 10,000-foot view, but it's designed for you to get a sense of the correlation between each component of character.

Discover the values and vision of your market; align; and refine.

The last two points are hand-in-glove – one is linked to the other. The reason we want to know our market, which include customers, strategic partners, stakeholders, and colleagues (network), is not just to sell to them more effectively. We do this because quality is determined as much (if not more) by our market's perception than by our own. If we believe that our product or service has improved in quality but the market doesn't agree, then it really doesn't matter. Of course, businesses typically gain this information by sending out surveys, often asking questions that are more “business-centric” than “customer-centric.” *Never assume you know what the market wants.* You must always question that assumption and make every effort to stop shouting and start listening. The market is your greatest source of feedback.

With that feedback, you can refine your approach, strategy, hiring, training...really anything you're doing in business. The business is given life by the market, therefore you must keep your finger on its pulse at all times.

Using the same basic process for developing a vision and values internally (or a “why” and “who”), we are going to ask the market (which was defined above) why they do what they do and what they want to see in the world (vision). Then, we are going to learn their rules (values), thereby discovering the fabric of who they really are.

The two best ways to learn this are through phone calls and in-person meetings. This type of discussion is too multi-dimensional to be done via email. In fact, explaining such a conversation in a concrete, clear-cut fashion is challenging for that same reason. It goes back to what I mentioned earlier: the written word can only do so much to explain what is meant to be learned experientially.

The feedback you gather from these conversations needs to be communicated to every single person in the company. You need to create a **character profile** within your company such that each one of your employees can almost “step inside” of the customer, strategic partner, colleague, etc. More than anything else, this will increase your close rate, improve your marketing, create admiration of your company in the public eye, and refine your products and services in a way that creates a reputation for delivering top-quality products or services both internally and externally.

Why does this work? It's simple: we are building the fabric of our organization around the psyche of the people who make what we do possible. We don't have to sit around and guess what people want, regardless of whether those people are employees or customers. When you desire to have a company of character, and you commit yourself to it, meaning there is *no other option*. You commit yourself to total quality and to becoming a leader of the highest character.

Conclusion

Character exits within us all. It's that internal compass of what is the right way of doing things, and when we build a business, we must create an internal and external character that points “true north.”

There is no “set it and forget it” approach to character. It's a moving target. It's ever changing, but the pursuit of it will create a positive legacy. The pursuit of highest character already has created positive legacies.

Think of your heroes. Think of the businesses you admire – maybe even envy. Think of the greatest sources of inspiration and innovation that you know of. I guarantee you that a very strong, long-standing, and (when you know to look for it) obvious common thread amongst them all is character. Where character thrives, so does growth. Character is the new black.

Chapter 17 | Contractors vs. Employees: What You Don't Know Can Hurt You

Joel N. Goldblatt and Andrew D. Arons

Many employers are under the misguided notion that a written contract with an individual working for the employer as an independent contractor is all that is required to establish an independent contractor relationship. Nothing could be further than the truth and failure to properly treat an independent contractor as an employee when required to do so can result in personal liability for the employer's owners and such personal liability, once established, is not dischargeable in bankruptcy. This issue comes into play in three principal places: unemployment contributions; unemployment taxes, FICA, FUTA, SUTA; and in the worker's compensation insurance world.

The IRS uses a 20-factor control test based on common law principles to determine whether a worker is an employee or independent contractor for wage withholding purposes.[42] The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed.

1. **Instructions**: A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the *right* to require compliance with instructions.[43]
2. **Training:** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.[44]
3. **Integration:** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.[45]

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[42] Rev. Rul. 87-41 (1987-1).
[43] See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66- 381, 1966-2 C.B. 449.
[44] See Rev. Rul. 70-630, 1970-2 C.B. 229.
[45] See *United States v. Silk,* 331 U.S. 704 (1947), 1947-2 C.B. 167.

4. **Services Rendered Personally:** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.[46]
5. **Hiring, Supervising, and Paying Assistants:** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.[47]
6. **Continuing Relationship**: A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.[48]
7. **Set Hours of Work:** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.[49]
8. **Full Time Required:** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses[50].
9. **Doing Work on Employer's Premises:** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.[51]
10. **Order or Sequence Set:** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the

[46] See Rev. Rul. 55-695, 1955-2 C.B. 410.
[47] Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593, 1955-2 C.B. 610.
[48] See *United States v. Silk, supra.*
[49] See Rev. Rul. 73-591, 1973-2 C.B. 337.
[50] See Rev. Rul. 56- 694, 1956-2 C.B. 694.
[51] See Rev. Rul. 56-694.

order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so.[52]

11. **Oral or Written Reports:** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.[53]
12. **Payment by Hour, Week, Month:** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.[54]
13. **Payment of Business and/or Traveling Expenses:** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.[55]
14. **Furnishing of Tools and Materials:** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer- employee relationship.[56]
15. **Significant Investment:** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship.[57] Special scrutiny is required with respect to certain types of facilities, such as home offices.
16. **Realization of Profit or Loss:** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee.[58] For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.
17. **Working for More Than One Firm at a Time:** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker

[52] See Rev. Rul. 56-694.
[53] See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68- 248, 1968-1 C.B. 431.
[54] See Rev. Rul. 74-389, 1974-2 C.B. 330.
[55] See Rev. Rul. 55-144, 1955-1 C.B. 483.
[56] See Rev. Rul. 71-524, 1971-2 C.B. 346.
[57] See Rev. Rul. 71-524.
[58] See Rev. Rul. 70-309.

is an independent contractor.[59] However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. **Making Service Available to General Public:** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.[60]
19. **Right to Discharge:** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.[61]
20. **Right to Terminate:** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.[62]

The IRS has distilled these 20 factors into three categories of facts: behavioral control, financial control, and the type of relationship.

The IRS uses three key characteristics to determine whether a worker is an employee or independent contract:

1. **Behavioral control**: whether the business has the right to direct or control the "how."
   - Instructions the business gives to the worker, including:
     - When and where to do the work
     - What tools or equipment to use
     - What workers to hire or assist with the work
     - Where to purchase supplies and services
     - What work is to be performed by a specific individual
     - What order or sequence to follow
   - Training or other means: generally, an employee is trained by the business to perform services in a particular manner; however, an independent contractor uses his or her own methods.

2. **Financial control:** whether the business has the right to direct or control the financial and business aspects of the worker's job.
   - Who is responsible for expenses incurred?
   - Does the worker have a personal investment in tools and facilities?
   - Is there a potential profit or loss to the worker?

[59] See Rev. Rul. 70-572, 1970-2 C.B. 221.
[60] See Rev. Rul. 56-660.
[61] Rev. Rul. 75-41, 1975-1 C.B. 323.
[62] See Rev. Rul. 70-309.

- Is the worker free to offer his or her services to other businesses?
- How is the worker paid? Hourly, flat fee, time and materials?

3. **Type of relationship**: how the worker(s) and business owner(s) perceive their relationship
   - Are there written contracts describing the relationship?
   - Does the business provide employee-like benefits such as insurance, a retirement plan, vacation or sick pay?
   - What is the expectation of the length of the relationship – permanent or project-based?
   - How easily can the relationship be terminated?
   - How integral are the worker's services to the business?

Unfortunately, not all factors are required for either type of relationship. The best you can do is to build a case for your position and treat workers in similar situations in the same manner.

Conclusion

It is wise to monitor your independent contractor relationships as they may change over time. Someone may begin as an independent contractor and morph into an employee. Failure to form the relationship correctly can result in individual tax and worker's compensation individual liability and such liability is non-dischargeable in bankruptcy. Failure to procure worker's compensation insurance may even be considered a crime in some jurisdictions. Today these issues also affect health care under the Affordable Care Act. Remember, in the final analysis control is the key. If your independent contractor does the same work for others, is not exclusive to you, has a company (entity such as a corporation or limited liability) that is contracting with you, and historically the type of work performed for you is performed in the marketplace by independent contractors, then in such circumstances you can be fairly certain you have an actual independent contractor relationship.

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The Editor.

Chapter 18 | Control Groups and Affiliated Service Group Rules

Joel N. Goldblatt and Andrew D. Arons

What are "control groups and affiliated service group rules," and why should you care as a business owner?

We start our discussion with control groups. Rules governing control groups are tax rules and regulations promulgated by the Internal Revenue Service to lump corporations or other entities together to limit tax benefits the common owners of more than one entity could gain by having more than one corporation than they otherwise would be entitled to if they were operating as one single entity. The section of the Internal Revenue Code that keys in on these concepts is IRC. Sec 1563 and various subsections thereof. [63]

There may be perfectly legitimate reasons to have more than one corporate entity to conduct different businesses, but the IRS looks at them all as one company for the purpose of applying some of the tax rules. These rules can become a trap for the unwary and they are of particular concern where employee benefits (pensions such as defined benefit plans, profit sharing plans, health insurance benefits and the like) are maintained by companies in the group. This is particularly true for purposes of determining discrimination and whether a plan qualifies as a qualified plan entitling the taxpaying company to deduct its plan contributions. This chapter gives an overview of the topic and is not intended to, nor can it be construed as, the final word on the concepts addressed here and each taxpayer is directed to his, her, or its tax advisor for further information on the topics presented. We present the topic, however, as many business people and or their professionals overlook these issues, but doing so can have disastrous effects. The entrepreneur who is forewarned can partner with his or her professional advisors to avoid the problems ignorance of these issues can raise.

Control Groups

A control group is two or more corporations connected through stock ownership. They may consist of parent subsidiary groups or a brother sister group or a combination of these. This appears relatively straightforward until we consider the introduction of "constructive ownership rules," which can cause different family members to be treated as owning their relatives' stock for purposes of triggering control group status. Option holders too may trigger constructive ownership, which leads to a control group.

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[63] When we use the term "corporation" we also are referring to other entity types (limited liability companies in particular) as these rules can be used to combine different types of entities where the ownership has the requisite commonality that dictates combining the entities involved.

Using the above concepts, a parent subsidiary control group may arise where a parent owns stock of a subsidiary or options to acquire such stock. Similarly, stock attributed to the parent through partnerships, trusts, or estates interests could trigger a parent subsidiary control group.

A brother sister control group is a group of two or more corporations if five or fewer individuals, trusts, or estates directly, indirectly, or constructively own stock possessing more than 50% of the combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all corporations in the group taking into account each shareholder who is identical with respect to each corporation in the group. In addition, these five owners must own at least 80% or more of the combined voting power of each corporation and more than 50% of the combined voting power must be owned identically between the owners of each corporation in the group.

A parent controlled group means any chain of corporations controlled by a parent that holds at least 80% of the total combined voting power or at least 80% of the value of all shares of at least one of the other corporations. The 80% tests can be satisfied by the ownership of stock or option rights.

Constructive ownership rules also come into play in determining whether a control group exists. For example, the general rule is that ownership of one spouse (whether directly owned or indirectly owned) is attributed to another if doing so would satisfy the ownership tests leading to control group status. The exception to this general rule is that a spouse is not considered to constructively own the stock of his or her spouse if each of the following conditions are met:

- Such spouse does not own directly or indirectly at any time during the year any ownership of the entity in question;
- Such spouse is not on the board of directors, is not an employee or fiduciary to such organization and does not participate in management;
- Not more than 50% of the income of such entity was derived from passive type income such as royalties, rents, dividends, interest, or annuities; and
- The spouse's interest is not subject to any interest of the spouse's children, which interest limits the owning spouse's ability to dispose of such ownership interest.

Additionally, there are exceptions for spouses who are legally separated (or the spouses are under a decree of divorce).

Children (including legally adopted children) under the age of 21 have their ownership attributed to their parent(s), the attribution of which could cause the control group test to be satisfied. Parents, grandparents, and grandchildren are also included for meeting these thresholds.

A non-exhaustive list of examples of areas that are affected by these rules are:

- Revenues of a corporation are lumped together such that the one corporation with lower revenues is in a higher tax bracket;
- Potential excess over the $250,000 ($150,000 if the group includes a service corporation) minimum accumulated earnings test;
- Limited use of the $40,000 Alternative Minimum Tax exemption (less the 25% reduction amount); and
- Discrimination tests for benefit plan eligibility for qualified retirement plans under section 401(a) of the IRC are tested with all employees of all group entities instead of on a company by company basis.

Affiliated Service Group Rules

There are also additional rules known as the Affiliated Service Group Rules under section 414(m) of the Internal Revenue Code that come into play to force separate organizations to be treated as a single employer in certain circumstances for purposes of employer benefit purposes.

An Affiliated Service Group means a group consisting of a service organization and:

1. One or more A type organizations described below or
2. One or more B type organizations described below or
3. One or more A and B type organizations described below.

An **A type service organization** is a partner of the first organization and the percentage of ownership is irrelevant. The constructive ownership rules discussed above regarding control groups apply here too. The A type organization also must regularly perform services for or is associated with the first organization in performing services for the organization or third parties who associate Party A with the first organization. These are facts and circumstances case-by-case tests. If less than 5% of the services are performed for the first organization a safe harbor is found and the services are not deemed to be "significant."

A **B type organization** is one that performs a significant portion of its services for either the first organization, for A type organizations who perform for the first organization, or both. Furthermore, the services performed must be of the type historically performed by employees in the service field of the first service organization and 10% or more of the interests in the organization is held in the aggregate by persons who are "designated group members" of the first organization. These persons are officers, highly compensated members of the first organization or its owners.

The affiliated service rules are designed for those who deliver professional or consulting type services. They are used so that a doctor for example cannot set up one company with all his lower paid workers and sets up a different company for himself providing richer pension plan than he gives to what are in effect his employees. These tax concepts also come into play in various forms for the new health care act (the Affordable Care Act) as to the minimum employee number thresholds, which was held to be a tax law by the U.S. Supreme Court, and also in the workman's compensation space as to ratings of a company with adverse claims as compared to another with lesser claims so as to attempt to avoid having them seen as one to have the worse experience rating of the former.

Conclusion

Although this is just an introduction to the idea of Control Groups and Affiliated Service Group Rules, the key concept to keep in mind is to address these potential issues with your tax and professional advisors when contemplating owning more than one company in a family setting. In these situations, advance planning can avoid some potentially devastating tax results later.

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Chapter 19 | An Overview of Intellectual Property Practices

John Ambrogi

Why protect patents, brands, and copyrights in the United States (U.S.)?

The United States has the largest economy in the world. Corporations seeking to establish a presence in the U.S. should strongly consider protecting their intellectual property to maintain a competitive advantage and prevent others from infringing upon their rights and goodwill. Obtaining intellectual property protection in the U.S. can also provide an organization with added revenue through licensing and other such agreements. Moreover, organizations that prevail in a lawsuit involving the infringement of their intellectual property rights generally are entitled to injunctive relief and damage awards including, in some instances, attorney's fees.

What protections are available for patents, brands and copyright in the U.S.?

The Constitution of the United States expressly protects patents and copyrights. The Commerce Clause of the Constitution has been interpreted to include protection for brands through trademarks and/or service marks.

Patents

In the United States, two types of patent protections are available: utility and design. The basic difference between the two is that a "utility patent" protects the way an article is used and works (35 U.S.C. § 101), and a "design patent" protects the way an article looks (35 U.S.C. § 171). Both forms of protection can be obtained for a single article that possesses both functional and ornamental characteristics.

A. **Utility Patents**

1. **Patentable Subject Matter**. Utility patent protection is available for any new and useful process, machine, manufacture or composition of matter, or any new and useful improvement thereof. 35 U.S.C. § 101. This is interpreted to include methods of doing business. An invention is new (or novel) if it is not: (1) known or used by others in the U.S. or abroad; (2) patented or described in a printed publication anywhere in the world; (3) in use or on sale in the U.S. more than one year before the filing of an application for patent; and/or (4) invented by another. An invention is useful if it has essentially any use. Interesting side-note - perpetual motion machines (and time machines)

will be received by the U.S. Patent & Trademark Office, but require a working model to proceed in the examination process. As of the date of this chapter, the author has been unable to locate any true patents covering perpetual motion machines (or time machines) per se. An invention is non-obvious if the differences between what is sought to be patented and the prior art would not have been obvious to a person of ordinary skill in the pertinent art at the time the invention was made.

2. **Patent Application.** To obtain a utility patent, an applicant must provide a written description of the invention and the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains to make and use it. 35 U.S.C. §112, ¶2. In addition, the application must set forth the "best mode" contemplated by the inventor. Enabling means that one skilled in the art with the patent in hand must be able to carry out the invention. Best mode means that if the inventor is aware of the best manner for carrying out the invention then it must be disclosed.

3. **Inventorship**. Conception is the touchstone of inventorship. Conception is the formation in the mind of the inventor of a definite and permanent idea of the complete and operative invention, that is, the idea as it is to be applied in practice. An idea is sufficiently definite and permanent when only ordinary skill would be necessary to reduce the invention to practice (make a working model) without extensive research or experimentation. As to situations involving more than one inventor or joint inventors, each joint inventor must generally contribute to the conception of the invention. For the conception of a joint invention, each of the joint inventors need not make the same type or amount of contribution to the invention, which is recited in the claims of the patent. Rather, each joint inventor needs to perform only a part of the task that produces the invention. On the other hand, one does not qualify as a joint inventor by merely assisting the actual inventor after conception of the claimed invention. That is, an inventor may use the services, ideas, and aid of others in the process of perfecting his invention without losing his right to a patent. One who provides the inventor only with well-known principles or explains the state of the art without ever having a firm and definite idea of the claimed combination as a whole does not qualify as a joint inventor. A joint inventor need not make a contribution to every claim of a patent. A contribution to one claim is enough. The critical question for joint conception is who conceived, as that term is used in the patent law, the subject matter of the claim at issue. To determine whether a joint inventor made a contribution to the conception of the subject matter of the patent, it must be determined what that person's contribution was and whether that contribution's role appears in the claimed invention. If that person in fact contributed to the invention defined by a claim of the patent, then that person is a joint inventor of that claim.

4. **Marking.** Patented products must be marked with the patent number. One form of marking is "U.S. Patent No. 1,234,567." If the product cannot be marked, then the packaging must be marked. Processes cannot be marked; however, a product made in accordance with a patented process can be marked as "Made In Accordance With Process Protected By U.S. Patent No. 1,234,567." Failure to mark a patented product limits the remedies available to the patent owner.

5. **Rights.** A patent provides the owner with the right to exclude others from making, using, selling, or offering for sale, the patented invention, in the U.S. This includes the right to prevent importation of

a patented invention. 35 U.S.C. § 271. The right to exclude also includes the right to prevent others from contributing to infringement by offering to sell, selling or importing a component of a patented machine, manufacture, combination or composition or material or apparatus for use in practicing a patented process (method) that constitutes a material part of the invention, knowing that it is especially made or adapted for use in an infringement of the patent and is not a staple article of commerce that has a substantial non-infringing use. The right to exclude also includes the right to prevent others from actively inducing infringement. The right to exclude includes the right to prevent others from importing into the U.S. or exporting from the U.S. all or a substantial portion of the components of a patented invention, where the components are uncombined, and in such as manner as to induce the combination of the components outside of the U.S. in a manner that would infringe the patent if it occurred in the U.S. The right to exclude further includes the right to prevent others from importing into the U.S. a product that is made by a patented process, if the importation occurs during the term of the patent. Remedies for patent infringement include monetary and non-monetary relief, such as injunctions. In certain "exceptional" cases, the court may award attorney's fees.

6. **The America Invents Act Changes Things.** The Leahy-Smith America Invents Act of 2011 ("AIA") was signed into law by President Obama on September 16, 2011 and marks the first significant overhaul of the U.S. patent system in nearly 60 years.

7. **FIRST-TO-FILE.** One of the most significant effects of the AIA is that the U.S. converted from a "first-to-invent" system to "first-inventor-to-file" regime on March 16, 2013. The "first-inventor-to-file" provisions apply to applications (and patents issuing therefrom) that contain (or contained) claims having an "effective filing date" on or after March 16, 2013, meaning that on or post-March 16, 2013 applications will be scrutinized under the first-to-invent rules.

8. **One-Year Grace Period.** The one-year grace period remains under the AIA. As such, Inventors should strategically publish one or more times, and then file a non-provisional application within a year from the first publication date. They should note that the publications are prior art abroad, and they might give their competitors insight into their technologies. So, the AIA motto is Publish Early and File Often!

9. **Post Grant Review.** Unlike before the AIA, all patents issued from applications subject to first-inventor-to-file provisions of the AIA are eligible for a post grant review. A post grant review may be requested on or prior to the date that is 9 months after the grant of a patent or issuance of a reissue patent. Any person who is not the patent owner and has not previously filed a civil action challenging the validity of a claim of the issued patent may petition for a post grant review of the patent. The petitioner for post grant review may request to cancel as unpatentable one or more claims of the issued patent on grounds related to invalidity (i.e., novelty, obviousness, written description, enablement, indefiniteness, but not best mode).

10. **Micro Entity.** The USPTO established a new micro entity status for patent applicants, which went into effect on March 19, 2013. A micro-entity is entitled to receive a 75% discount on fees. To qualify as a micro entity, an applicant must meet either of two sets of conditions. As a first option, an

applicant can establish a limited income and limited experience with the patent application filings. That is, the applicant may not have been named as an inventor in more than four patent applications and may not have an annual gross income greater than $150K. As a second option, an applicant can establish employment by, or an assignment or obligation to assign to, an institution of higher education in order to be considered a micro entity.

11. **Term.** For utility patent applications filed on or after June 8, 1995, the term of a patent begins on the date of issue or grant and runs for a period of 20 years from the earliest U.S. priority date. If a patent issues from a first filed application, then the term runs for 20 years from the filing date of the first filed application.

12. **Foreign Priority.** A U.S. utility patent can claim priority from an international application (also known as a Patent Cooperation Treaty or PCT application) or from a foreign patent application. To claim priority from an international application, the international application must be properly filed and the U.S. must be designated in the application. To claim priority from a foreign patent application, the U.S. patent application must be filed within 12 months from the filing date of the foreign patent application.

B. Design Patents. Design patent protection relates to the visual ornamental characteristics embodied in, or applied to, an article of manufacture. Thus, a design patent protects only the appearance of the article and not structural or utilitarian features.

1. **Patentable Subject Matter.** The subject matter of a design patent application may relate to the configuration or shape of an article, to the surface ornamentation applied to an article, or to the combination of configuration and surface ornamentation. A design for surface ornamentation is inseparable from the article to which it is applied and cannot exist alone. The surface ornamentation must be a definite pattern of ornamentation applied to an article of manufacture.

2. A design that is dictated mainly by the function of the article lacks ornamentality and cannot be patented. In addition, as with utility patents, in order to obtain patent protection, a design must be original or new and non-obvious. A design is not original if it mimics a well-known or naturally occurring object or person. Furthermore, a design cannot receive protection if it could be considered offensive to any race, religion, sex, ethnic group, or nationality.

3. **Patent Application.** To obtain a design patent, an applicant must provide either a drawing or a black and white photograph of the claimed design. Because the drawing or photograph comprises the entire visual disclosure of the claim, it is extremely important that the drawing or photograph be clear and complete.

4. **Marking.** Articles protected by a design patent should also be marked. One form of marking is "U.S. Des. Patent No. 123,456."

5. **Rights** See Section A. 5 above.

6. **Term.** The term for a design patent is 14 years from the date of grant. 37 U.S.C. § 173.

7. **Foreign Priority.** A U.S. design patent application can claim priority from a foreign design application if the U.S. application is filed within 6 months of the filing date of a foreign application. An international/PCT application is not available for design patents.

C. Provisional Patent Applications

1. **GENERAL INFORMATION.** The United States patent and trademark office offers inventors the option of filing provisional patent applications to provide a means to accomplish a lower cost first patent filing in the United States. Provisional applications establish an early effective filing date for a non-provisional (“regular”) patent application and permit the inventor to label products using the invention as "patent pending."

2. **Specifics**. The filing date of a provisional application is established when the USPTO receives the filing fee, a written description of the invention and drawings. Unlike a regular application, formal patent claims, an oath of declaration, and an information disclosure statement (referencing prior art) are not required for a provisional application. The provisional application is not published and remains confidential unless a non-provisional application is subsequently filed. After the provisional application is filed, the applicant has up to twelve months to file a non-provisional, or regular application.

3. **Benefits**. In many circumstances, provisional applications are extremely beneficial. The application is simplified and considerably less expensive initially. Therefore, a provisional application allows a company to assess the invention’s commercial potential for one year before committing to the higher cost of filing and prosecuting a regular patent application. Also, inventions tend to change during development. As new, inventive matter is discovered, additional provisional applications can be filed. At times, two or three provisional applications can be incorporated into a single non-provisional application. This strategy saves the inventor filing costs and maintenance fees of multiple non-provisional patents while extending the protection of the invention by up to a year. In addition, the filing date established by a provisional application is useful when there is a conflict over who invented an invention first between two companies. Importantly, the early filing date and “patent pending” label allow a company to commercially promote their invention with greater security against having the invention stolen or copied.

4. **What To Be Careful About With Provisionals.** There are some cautionary aspects to provisional applications as well. First, provisional applications can be filed for utility inventions and may not be filed for design inventions. Also, a provisional application is not a

complete substitute for a regular application. A provisional application gives only "provisional" patent pending rights and does not mature into an issued patent. By law, a provisional application must be converted into a regular application within one year of the provisional filing date. If not, the priority date and other benefits of the provisional application are lost. More seriously, the ability to obtain a patent for the invention will be lost if the invention was on sale or in use and a non-provisional application is not filed during the one-year grace period. In addition, a patent must be issued to be enforceable in court. Therefore, a pending provisional application cannot be used to sue someone for infringement. On a practical level, the provisional application cannot be merely a general summary of the invention without details of how to make and/or use it. Like non-provisional applications, the application must disclose the inventor's best way the invention should be built and/or used and provide sufficient detail and support to demonstrate that the inventor conceived of the invention.

5. **Summary – Provisionals.** In summary, the provisional patent protection strategy can be useful in many situations. This strategy is extremely useful for emerging technologies where the invention, or the market for the product, has not been fully developed. The provisional application provides protection from copying while allowing a company to more safely promote their new product. Using this strategy, a company can continue to modify the invention (and file additional provisionals) without the higher filing fees and maintenance costs of multiple non-provisional patents. When an invention is well developed and appears to be profitable, a non-provisional application is likely to be the most economic route.

D. **Trademarks/Service Marks.** Any word, name, symbol, or device (or combination of these) that is used to identify and distinguish the goods/services from those manufactured, sold, or offered by others and to indicate the source of goods/services even if that source is unknown. 15 U.S.C. § 1127 (Lanham Act § 45).

1. **Rights.** Rights attached upon adoption and use of a mark. Rights may also begin upon filing of an application for registration with a *bona fide* intent to use a mark. The rights include the right to exclude others from using in commerce any reproduction, counterfeit, copy or colorable imitation in connection with the sale, offering for sale, distribution or advertising of any goods (or services) where such use is likely to cause confusion or mistake or to deceive. This applies to labels, signs, prints, packages, wrappers, receptacles, or advertisements that are intended to be used in commerce.

2. **Marking.** Registered marks should be identified by notice, such as, "Registered in U.S. Patent and Trademark Office", "Reg. U.S. Pat. & Tm. Off." or by the familiar ®.

3. **Benefits to Registration.** Registration provides numerous benefits, such as constructive notice, or notice to all regardless of whether they have actual notice of a trademark. Non-monetary remedies, such as injunctions and U.S. Border and Customs impoundment, are also available. Monetary remedies can include actual damages, infringer's profits, and recovery of attorney's fees and costs.

4. **Term.** The term of a trademark or service mark continues, indefinitely, so long as the mark is used. Abandonment, lapse (that is, failure to file required declarations of use and/or applications for renewal), discontinued use, and the like can terminate trademark rights.

5. **Foreign Priority**
   Priority to a foreign application can be claimed in a U.S. trademark application. If priority is sought, a U.S. trademark application must be filed in the USPTO within 6 months from the date of the foreign application filing.

6. **Not-registerable**
   The following material cannot receive protection:

   - Immoral, deceptive or scandalous, disparaging or falsely suggestive of connection;
   - Flag, coat of arms or insignia of U.S., states or municipalities, or other nations;
   - Name, portrait or signature identifying a living individual except by consent;
   - Resembles any other mark and is likely to cause confusion, mistake or to deceive; and/or
   - Is merely descriptive, deceptively misdescriptive, primarily geographically descriptive, primarily geographically deceptively misdescriptive, primarily merely a surname or is functional. 15 U.S.C. § 1052.

7. **Acquired Distinctiveness.** Marks that have "become" distinctive can be registered, even if descriptive, by showing the mark has acquired distinctiveness by its use. Generally, to become distinctive the mark must have been in continuous, exclusive use for five years.

E. **Copyright.** Copyright law protects works of original authorship fixed in any tangible medium of expression from which they can be perceived, reproduced or communicated directly or with the aid of a machine, including:

   - Literary works;
   - Musical works including accompanying words;
   - Dramatic works including accompanying music;
   - Pantomimes and choreographic works;
   - Pictorial, graphic and sculptural works;
   - Motion pictures and other audiovisual works;
   - Sound recordings; and

- Architectural works. 17 U.S.C. § 102.

Copyright law does *not* protect works not fixed in a tangible form, ideas, procedures, processes, systems, methods of operation, concepts, principles, discoveries, titles, names, short phrases, and slogans. Some of these, however, may be protectable under trademark or patent law.

1. Rights

Rights protected under Copyright law attach upon creation. Copyright includes the right:

- To reproduce the work in copies or phonorecords;
- To prepare derivative works based upon the work;
- To distribute copies or phonorecords of the work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
- To perform the work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works;
- To display the work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and
- In the case of sound recordings, to perform the work publicly by means of a digital audio transmission. 17 U.S.C. § 106.

1. Benefits to Registration.

   Registering a copyright is not required but registration provides advantages. One advantage is that it enables a person to bring a lawsuit for infringement if the work is of U.S. origin; a lawsuit for infringement of a work of U.S. origin cannot be filed until a registration is obtained. Damages for infringement include statutory damages or actual damages including infringer's profits. In the case of willful infringement, statutory damages can be awarded up to $150,000 in addition to actual damages. Non-monetary remedies are also available. Additionally, registration of a copyright that is made within three months after publication of the work or before infringement of the work enables a plaintiff in an infringement lawsuit to recover attorney's fees and costs. Furthermore, a work that has been registered before or within five years of publication establishes prima facie evidence in court of the validity of the copyright and the facts stated in the certificate. Finally, registration enables the owner of a copyright to obtain protection from U.S. Borders and Customs against the importation of infringing copies.

2. Marking.

   Although a copyright notice is not required, use of a copyright notice is important because it informs the public that the work is protected by a copyright, identifies the copyright owner, and shows the year of first publication. In addition, if a work is infringed, proper notice of a copyright will overcome a defense based on innocent infringement in mitigation of actual or statutory damages. Innocent infringement occurs when an infringer does not realize or have reason to know that the work is protected by a copyright.

THE COPYRIGHT NOTICE FOR VISUALLY PERCEPTIBLE COPIES SHOULD CONTAIN ALL OF THE FOLLOWING THREE ELEMENTS:

- The symbol © (the letter C in a circle), or the word "Copyright," or the abbreviation "Copr.";
- The year of first publication of the work; and
- The name of the owner of copyright in the work, or an abbreviation by which the name can be recognized, or a generally known alternative designation of the owner. **Example**: © 2008 John Doe.

1. Term

The term of a copyright depends upon when the work was first published or created. For works created or first published after January 1, 1978, the term is generally the life of the author plus 70 years.

2. "Work For Hire"

The "work for hire" doctrine deals with works created by an individual for and to be owned by another. If a work is a "work for hire," the author has no ownership rights in the work. A "work for hire" includes a work prepared by an employee within the scope of his employment and specially commissioned works such as: a contribution to a collective work; a part of a motion picture or other audiovisual work; a translation; a supplementary work; a compilation; an instructional text; a test; answer material for a test; and an atlas. A writing expressly identifying the commissioned work as a "work for hire," signed by both the author and the hiring party, is required.

3. Computer Software[64]

[64] Although algorithms per se are not patentable subject matter to the extent that they are merely abstract ideas, any algorithm that has a useful application that can be embodied within definite physical characteristics is considered patentable subject matter. The debate around software patents (as well as business method subject matter) is an arduous and on-going one that has manifested itself in a number of court opinions that are themselves the arena for patent legal scholar to battle over. Nevertheless, budget permitting, it may be advisable to try to obtain patent coverage for your software. In contrast to copyright protection, patent protection does not protect expression. Rather, a patent for a computer program gives the patent owner during the term of the patent the exclusive right over any algorithm that performs the same function and solves the same problem as the patented program. One major advantage to the owner of a patent on a computer program

Because such a large extent of entrepreneurs today are in the software sphere (including website development and mobile apps), the subject of protecting computer software deserves its own subsection.

Copyright protection extends to all of the copyrightable expression embodied in a computer program, but copyright protection is not available for ideas, program logic, algorithms, systems, methods, concepts, or layouts. In other words, copyright protection applies to the computer software code. Therefore, the main disadvantage of copyright protection for computer programs is it does not protect the functionality or technique of the program. As a result, another software developer can develop other software that performs the same function or can apply the technique of a particular copyrighted program to another problem in a different way without infringing the copyright.

Conversely, a major advantage to copyright protection is that it is relatively inexpensive and easy to obtain. This ease of copyrightability allows computer programmers to write code freely without fear of infringing on another person's copyright as long as the expression (the code) is different than the copyright protected expression (the copyright protected code). In other words, only the particular expression of an idea is protected, but the idea itself is not protected. Another advantage to copyright protection is its duration. For all works created on or after January 1, 1978, copyright protection endures during the life of the author plus 70 years after the author's death. Additionally, if a work is a work made for hire, copyright protection endures for a term of 95 years from the year of its first publication or for a term of 120 years from the year of its creation, whichever expires first.

One of the disadvantages and concerns that is often raised is the requirement of having to provide the Copyright Office with identifying material, which is of course the computer program code. However, this should not be the reason for deciding not to pursue copyright protection. When registering a computer program without trade secrets, the registrant sends one copy of identifying portions of the program, which is typically the first 25 and last 25 pages of source code, reproduced in a form visually perceptible without the aid of a machine or device, either on

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because the scope of the patent may be broad. Conversely, there are two major disadvantages to obtaining patent protection for computer programs. First, the shelf life for most computer programs is relatively short. Furthermore, patents generally take between eighteen and twenty-four months to issue after the filing of an application with the Patent and Trademark Office. Therefore, by the time a patent for a computer program issues, the program may be already out of date. The second disadvantage to obtaining patent protection for computer programs is the high cost involved in obtaining such protection. The government filing fees to obtain a patent will alone generally range from between $1,000 and $3,000, and most applicants must also retain patent counsel as well to prepare the patent application. Therefore, potential applicants must determine whether the cost of obtaining patent protection for their computer programs is worth the benefit of obtaining such protection over the life of the software.

paper or in microform, together with the page or equivalent unit containing the copyright notice, if any. If the identifying portion of the code contains trade secrets, then the code can be partially masked to prevent disclosure and loss of trade secrets.

There are certain specific requirements that must be met when the program is fewer than 50 pages or if the program is a revision of a previously published or registered mark. There are also specific procedures for handling software that the applicant feels contains trade secrets. An attorney familiar with the U.S. Copyright laws should be able to address such specifics. Therefore, the U.S. Copyright Office does have procedures available for handling software code such that competitors cannot simply obtain a copy of the code from the Copyright Office to use as a source for outright copying or rewriting. Likewise, code that contains trade secrets can also be handled confidentially.

F. Trade Secrets

Trade secret law, unlike patent, trademark, and copyright laws, is state-created law. As such, the definition, scope of protection, and remedies vary from state to state. There are some common threads among the various states that have trade secret laws.

1. A **trade secret** is defined as information that is sufficiently secret to derive economic value from not being generally known to other persons who can obtain economic value from its disclosure or use and is the subject of efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality. A trade secret can also be thought of as including any formula, pattern, device or compilation of information which is used in one's business and which gives one an opportunity to obtain an advantage over competitors who do not know or use it.

   Reasonable measures to protect the secrecy of the information include:

   - Oral or written notification that the information is proprietary;
   - Confidentiality/non-disclosure agreements;
   - Oversight policies and procedures (that must be followed);
   - Facility security, for example: fences, locked areas, alarms, security, or identification badges;
   - Access to the information on a need-to-know basis;
   - Confidential or proprietary legend stamps; and/or
   - Employee exit interviews with a reminder or signed understanding regarding the information.

2. Misappropriation of Trade Secrets

The misappropriation of a trade secret includes:

- The acquisition of a trade secret by a person who has reason to know that it was acquired by improper means; and/or
- Disclosure or use of a trade secret without express or implied consent by another person who used improper means to acquire knowledge of the trade secret, or at the time of disclosure or use, knew or had reason to know that knowledge of the trade secret was:

- derived from or through a person who utilized improper means to acquire it;
- acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; and/or
- derived from or through a person who owed a duty to maintain its secrecy or limit its use; and/or
- acquired by accident or mistake.

Improper means of acquiring a trade secret includes theft, bribery, misrepresentation, breach of a relationship or duty or inducing a breach, and espionage. Proper means of acquiring a trade secret includes reverse engineering, use of published materials, databases, website information, etc.

G. **How can I register a patent, brand, or copyright in the U.S.?**

1. Patents

A utility or design patent application must be filed in the United States Patent and Trademark Office ("USPTO") either by the inventor himself or by a patent agent or patent attorney. A patent agent or patent attorney is an individual who is registered to practice before the USPTO. The difference between a patent agent and a patent attorney is that a patent agent is not a licensed attorney at law.

Utility patents can take anywhere from 2 to 8 years on average to issue depending on the type of invention and the number of office actions received. Design patents issue much more quickly, generally within a year.

Application requirements for utility and design patents are <u>very</u> particular and an experienced patent agent or attorney should be retained. The general procedure for obtaining a **utility patent** includes the following steps:

- Filing a complete utility patent application and required filing fees;
- Filing an information disclosure statement (IDS). The filing of an IDS is a particular requirement under U.S. patent law. Under U.S. patent law, <u>any</u> person substantively associated with the filing and prosecution of a patent application has a duty of candor and good faith, which includes a duty to disclose to the USPTO all information known to that person to be material to patentability. This duty remains throughout prosecution or until the claim is withdrawn or cancelled. Failure to disclose material information can result in sanctions and/or the patent being invalidated in court;
- Publication of the utility patent application;
- Issuance of an Office Action;
- Filing a response to the Office Action (note: this can often take several iterations);
- Issuance of a Notice of Allowance;
- Payment of Issue fees; and
- Payment of maintenance fees at 3.5, 7.5, and 11.5 years.

The general procedure for obtaining a **design patent** is as follows:

- Filing a complete design patent application and required filing fees;
- Filing an IDS;
- Issuance of an Office Action;
- Filing a response to Office Action;
- Issuance of a Notice of Allowance; and
- Payment of Issue fees.

There is no publication of design patent applications nor are maintenance fees required.

2. **Trademarks/Service Marks**

A trademark/service mark application can be filed with the USPTO by the owner of the proposed mark or by a U.S. or Canadian attorney acting on behalf of the owner. It takes anywhere from 6 to 14 months on average for a trademark application to proceed through to registration. There are two types of applications: use in commerce and intent to use. If the mark is already being used in commerce, then a "use in commerce" application is filed. If the mark is not yet being used in commerce than an "intent to use" application is filed.

The application requirements for a U.S. trademark are different than those required in other countries, and an experienced U.S. trademark attorney should be retained. The general procedural steps for obtaining **trademark protection** are:

- Filing a complete trademark application (intent to use or use in commerce) and required filing fees;
- Issuance of an Office Action;
- Filing a response to the Office Action;
- Publication of the application for possible opposition;
- If intent-to-use application was filed: issuance of a Notice of Allowance and filing of Statement of Use;
- Issuance of Registration Certificate and any required fees;
- Filing a Declaration of Continued Use between the 5th and 6th years following registration and any required fees;
- Filing a Statement of Incontestability after 5 years of continuous use of the mark (optional) and any required fees; and
- Filing a Declaration of Continued Use and an Application for Renewal between the ninth and tenth year after registration and every 10 years thereafter and any required fees.

3. **Copyright**

An application for a copyright must be filed with the United States Copyright Office ("Copyright Office"). Any person, including non-U.S. citizens, can file an application for a copyright registration. An application for a copyright registration requires: 1) a completed application, 2) a nonrefundable filing fee, and 3) a nonreturnable copy of the work being registered for deposit with the Copyright Office. A copyright registration is effective on the date all required elements are received by the Copyright Office. The time taken by the Copyright Office to process the application has no bearing on the registration date. For works created after January 1, 1978, no further steps are required once a registration is received.

H. **Which kinds of international patents and brands have validity according to the U.S. Law**?

The United States is a signatory of many international treaties including:

- **Berne Convention for the Protection of Literary and Artistic Works ("Berne Convention")**: The Berne Convention is an international agreement governing copyright. Signatories of the Berne Convention are required to recognize the copyright of works created by authors from other signatory countries (known as members of the Berne Union) in the same way as it recognizes the copyright of its own nationals. In addition to establishing a system of equal treatment, the agreement also required member to provide strong minimum standards for copyright law.
- **Paris Convention for the Protection of Industrial Property ("Paris Convention")**: The Paris Convention was the first attempt at uniform treatment of trademark owners and international trademark law.
- **Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS")**: TRIPS is an international agreement administered by the World Trade Organization ("WTP") that sets down minimum standards for many forms of intellectual property regulation as applied to nationals of other WTO members.
- **Patent Cooperation Treaty ("PCT")**: The PCT is an international patent law treaty that provides unified procedure for the filing a patent applications in multiple countries. A PCT enables an individual seeking patent protection to file one application, in one language, in one receiving office.
- **Patent Law Treaty ("PLT")**: The PLT harmonizes particular patent application procedures in order to reduce or eliminate formalities and the potential for loss of rights. The PLT, however, does not harmonize the laws of each country that set forth the specific requirements that must be met in order to receive a patent for an invention in that country.
- **Trademark Law Treaty ("TLT")**: The TLT was enacted to simplify procedures in the application and registration process of trademarks in different countries by establishing the maximum requirements a contracting party can impose.
- **Madrid system** (comprises two treaties): The Madrid system provides a cost effective and efficient way to file for trademark protection in multiple countries. Under the Madrid system, a trademark owner files one application, in one language, in one national or regional office.

I. **What can be done to protect patents, brands, and copyrights?**

As noted above, owners of patents, brands, and copyrights have several specific rights. If a third party is found to be infringing upon those rights, the owner can enforce its rights in a variety of ways.

One option is to send a cease and desist letter to the infringing party. The purpose of a cease and desist letter is to put the third party on notice that it is engaging in infringing activity. Another purpose of the cease and desist letter is to inform the third party that the owner is going to take further enforcement action if the infringing activity does not stop. Many times, this can lead to a satisfactory resolution quickly and at a low cost.

To protect against the importation of infringing goods into the U.S, a trademark and/or copyright registration can be filed with the United States Customs and Border Protection ("CBP"), which has the authority to seize merchandise that is counterfeit or bearing infringing trademarks. The trademark and copyright registrations can be filed as soon as they are obtained even if no infringing activity has been detected. Patents cannot be registered with the CBP prior to infringement. However, if an exclusionary order is obtained, the CBP can begin excluding the infringing goods from importation into the United States. To obtain an exclusionary order, a complaint is submitted with the U.S. International Trade Commission ("USITC") and the matter is decided by an administrative judge. The USITC has its own particular rules and procedures relating to discovery hearings and the like, and is generally a speedy proceeding.

A further option in the United States for the protection of patents, brands, and copyrights against an infringer is the filing of a lawsuit by the intellectual property rights' owner ("plaintiff"). To commence an action against an infringer ("defendant"), a complaint is filed by the plaintiff in either state court or (in most cases) federal district court. It is generally preferred that the complaint be filed in federal district court as the judges are typically more experienced in intellectual property matters. There are no specialized patent, trademark, or copyright courts.

After the complaint is filed, the defendant will have time to respond. In its response (called and Answer), the defendant can include defenses and counterclaims. A plaintiff is then given the opportunity to respond in a Reply and include an answer to any counterclaims asserted. Sur-replies and cross-claims may also be made. Collectively, these are known as the pleadings. It is possible for a plaintiff to file for early injunctive relief in the form of a preliminary injunction or a temporary restraining order. Such relief will be granted if the plaintiff can show that the defendant's actions will cause "irreparable injury."

After the pleading stage, discovery begins. Discovery is generally a lengthy process that involves the gathering of relevant information that is unprivileged. Such information may be collected in the form of tangibles, e.g., documents, and/or from oral testimony in a deposition. A deposition is the live questioning of a person who has knowledge of relevant, unprivileged information or a person who will serve as an expert during trial. The information gathered during the discovery may be presented at trial if it meets certain criteria. Many times the discovery process will bring about settlement discussions so that an actual trial can be avoided, saving a lot of time and money.

A lawsuit for an infringement action can be tried before a judge or a jury. Either the plaintiff or defendant may demand a jury-trial. In a jury trial, the jury determines issues of fact and the judge determines disputed issues of law. In a trial before a judge (known as a "bench trial"), the judge determines both factual and legal issues.

J. **Useful Contacts**

- United States Patent and Trademark Office: www.uspto.gov
- United States Copyright Office: www.copyright.gov
- United States Customs and Borders Protection: www.cbp.gov
- International Trademark Association: www.inta.org
- American Intellectual Property Law Association: www.aipla.org

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The Editor.

Chapter 20 | Acquiring an Existing Business or its Assets

Joel N. Goldblatt, Michael Weis, and Andrew D. Arons

Many entrepreneurs at some point in their careers examine an acquisition candidate or seek to acquire its assets. The reasons for acquiring an existing business are myriad and run the gamut from vertically integrating an existing enterprise so that economies of scale, efficiencies and revenues are enhanced to diversification, procuring technology the existing company covets, adding complimentary streams of revenue or any one of several other possible reasons. When an existing business or an entrepreneur seeks to acquire another existing business and/or its assets there are many legal, technical, accounting, tax and business related considerations that must be addressed to reduce risks, eliminate surprises and to avoid entering into poorly considered and structured deals. This chapter discusses many of the issues any entrepreneur or business person acquiring another company or its assets will want to consider in deciding whether to proceed as well as how to best structure any transaction.

First Question: Acquire the Company or its Assets?

An important beginning point and initial consideration is the tax consequences of the structure one chooses to accomplish the acquisition. The capital gains treatment provided by the purchase of an entire company (and the lower taxes that result from a capital transaction) are often desired by the seller, whereas the buyer has several incentives to structure the transaction as an asset purchase.

Depending upon the specifics of any given situation, where corporations are involved, the sale of stock is optimal for a seller who has owned such stock for longer than a year will result in a tax rate of 20% to the Seller[65]. Conversely if the corporation sells all of its assets to the buyer and then liquidates and distributes the cash, the proceeds received by the owners of the company are now converted to ordinary income. Ordinary income tax rates at their highest federal rate are currently set at 39.5%[66]. There is obviously a substantial tax incentive to the seller to structure the transaction as the sale of the Seller's stock.

From the purchaser's perspective, there are major tax and liability concerns that may discourage an acquisition of the stock of a corporation. First, the acquirer will be subject to all of the existing company's liabilities whether exiting, contingent, known or unknown or otherwise arising in the future. In contrast, an asset purchase relieves the buyer of these concerns unless the buyer specifically agrees to pick up and assume the liabilities.

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[65] This is the rate that is effective as of the date of publication rates are subject to change and the Congress's whimsy and is the highest rate.

[66] See footnote 1.

Just as compelling is the acquirer who acquires assets is in a position to allocate the acquisition costs over the various assets of the business being acquired. Certain property can be depreciated more swiftly, generating deductions for tax purposes that decrease income that becomes taxable while not depressing cash flow. In addition some aspects of the allocated purchase price can be deducted up to 100% in year one. These are substantial considerations for a purchaser.

Sometimes it is not possible to structure the transaction from the buyer's preferred perspective due to licensing requirements and the need to avoid new licensing for a new company. Insurance considerations too can come into play as performance bonds may not be able to be procured by a start-up but an existing business with a good financial history may have little problem procuring such instruments. Bonds may be crucial to securing business and customers. Possible seller or buyer intransience also is a reason for a resulting structure. Ability to obtain bank financing for a start-up may also provide a hurdle. Regardless, the acquirer is well advised to involve their accountant and tax counsel in the process before documents are signed, even where such documents are non-binding letters of intent.

Once a form of the transaction is decided upon and accepted the next step is the creation of the documents necessary to carry out the acquisition. Many clients do not wish to have their counsel draft the first draft of the document as they do not wish to incur the expense. This may in fact be true in some circumstances but it is no guaranty it will save moneys or the resulting first draft will be acceptable. It's often just as wise to control the initial drafts to ensure the rules and playing field are defined by the client and their counsel and tax advisors who create the document first.

As in the case of commercial and industrial lease transactions, the next step often involves the creation of a non-binding letter of intent (an "LOI"). The business people often take a first stab at these documents to flesh out the economic terms before letting their counsel loose to draft the legalese that should accompany them. Following the completion of the LOI and its submission to the other party, a back and forth dialogue and negotiation can often be expected. Some business people heavily involve counsel, others have a great deal of experience in acquisitions and they hammer out deal terms and hand the document back to the lawyers for final work to ensure there are no traps. Once the business parties are on the same page it is time to draft the agreement. Here again, whether it is a stock purchase agreement or an asset sale the form of the agreement will change depending upon the structure.

Issues that should be addressed by these agreements or at least considered for their applicability at a minimum are:

1. **Stock Purchase Agreement**
   - Purchase price: often, these agreements will structure holdbacks and escrows or some other collateral to guarantee the level of income for some period. Incentive earn out bonuses also may be negotiated and included.

- Payment terms
- Clear description of asset (stock) being acquired and how title to the assets or stock will be free of claims, encumbrances, liens, option rights, etc.
- Whether financing is involved and any contingencies related thereto as well as contingencies related to the due diligence that will be required to review the company, its assets, customers, personnel, machinery, inventory, tax returns, etc.
- Representations and warranties of the seller become quite involved and detailed and include those concerning title of the stock or assets being acquired, the operation of the business, the legal and physical condition of the business and its assets, state of financials, representations of full disclosure of all material information, state of taxes and their payments, inventories on hand, how the company will be operated prior to closing, how capital on hand will be handled, licensing, whether retirement plans and employee benefits will be maintained and a host of other considerations depending upon the business. The length of time representations and warranties are to apply should also be addressed. Inevitably, sellers will want to limit and condition these to limit their liability, while buyers will want broad provisions to protect them if the business is not all as it seems.
- Structures and terms for handling return of existing capital to existing owners as well as inventory counting and adjustments to the purchase price are common to true up the figures provided in due diligence to the actual figures as of the closing date.
- Date of closing whether an escrow will be used and any contingencies and out clauses all are to be considered and are common in these transactions.
- Whether existing owners will be retained, for how long and upon what terms and whether non-competition and non-solicitation of employees and customer provisions also are a consideration.
- Personal guarantees and claw backs if performance metrics or covenants are not complied with should also be evaluated and used wherever appropriate for the business in question. Remedies in the event of default too are included.
- Indemnification provisions for pre-existing liabilities and contingent liabilities that arise following closing should be considered and carefully drafted and cover breaches of the agreement and of inaccuracies for representations and warranties. Sellers like to cap the periods these apply to and possibly build in a deductible so petty dollar amounts do not become the subject of expensive legal disputes. Purchasers on the other hand want the broadest contractual protections available.
- Notices to licensing agencies and department of revenue may be appropriate and called for and where plants are closed or employees are terminated there may be State and Federal laws to grapple with and these too can become points of negotiation relative to costs and responsibilities.
- What state law applies what jurisdiction will be used to resolve a dispute or will alternative dispute resolution processes be called for and the like need to be addressed. If alternative dispute resolutions are utilized, an agreed upon statute of limitations should be set out in the document.
- Examining what intellectual property of the company is or is not protected and its value is an issue both as a matter of tax law and ownership.

- Miscellaneous issues regarding venue for enforcement, notice, and signing in counterparts etc.

2. **Asset Purchases** (asset Purchase Agreements are much like stock purchase agreements in the issues they address.) Relevant issues and provisions are:
    - Purchase price: often these agreements will structure holdbacks and escrows or some other collateral to guarantee the level of income for some period. Incentive earn out bonuses also may be negotiated and included. Other times flat fees with no adjustments will be the method used. Provisions calling for the allocation of the purchase price for tax purposes and calling for the filing of appropriate forms with the IRS stating the allocation (IRS Form 8594 both parties must sign) are also included.
    - Payment terms run the gamut from installment sales to lump sum payments to seller provided financing.
    - Clear description of asset being acquired and a clear statement that liabilities are not being assumed or an indication of the specific liabilities that are.
    - Whether financing is involved and any contingencies related thereto.
    - Representations and warranties of the seller become quite involved and detailed and include those concerning title of the assets, authority to enter into the transaction, the operation of the business, the condition legally of the business and its assets (legal and physical condition) state of financials, representations of full disclosure of all material information, state of taxes and their payments, inventories on hand, how the company will be operated prior to closing, how capital on hand will be handled, licensing, and a host of other considerations depending upon the business. The length of time representations and warranties are to apply should also be addressed. Inevitably, sellers will want to limit and condition these to limit their liability, while buyers will want broad provisions to protect them if the business is not all as it seems.
    - Structures and terms for handling additions to the purchase price for inventory and supplies on hand the counting of same and adjustments to the purchase price are common to true up the figures provided in due diligence to the actual figures as of the closing date.
    - Depending on the state and size of the work force, whether the work force is unionized or not can also raise issues for a required notice period that notice be given prior to the closing and or shut down of any plant(s) and termination of employees.
    - Provisions making it clear the purchaser will not be required to hire employees or maintain insurance or qualified plan benefits will also be contained and addressed in these agreements. On these points whether the company is unionized and whether state law requires advance notification of sale must be considered and evaluated.
    - Date of closing whether an escrow will be used and any contingencies and out clauses all are to be considered and are common in these transactions.
    - Whether existing owners or key employees will be retained, for how long and upon what terms and whether non-competition and non-solicitation of employees and customer provisions also are a consideration.

- Personal guarantees and claw backs if performance metrics or covenants are not complied with should also be evaluated and used wherever appropriate for the business in question. Remedies in the event of default too are included.
- Indemnification provisions for pre-existing liabilities and contingent liabilities that arise following closing should be considered and carefully drafted and cover breaches of the agreement and of inaccuracies for representations and warranties. Buyers should also take note of who the indemnification is coming from. In an asset sale, the company will be left with limited, if any, assets after the transaction to pay the indemnified party.
- Contingencies, due diligence and or conditions that must be met before the buyer has to proceed.
- Notices to licensing agencies and department of revenue ("bulk sales" notices and "tax stop notices" may be appropriate and called for).
- What state law applies, what jurisdiction will be used to resolve a dispute, whether alternative dispute resolution processes will be called for and the like need to be addressed. If alternative dispute resolution methods are utilized, agreed upon statutes of limitations should be set out in the document.
- Whether there are any pension or retirement funding issues also should be considered.
- The value and existence of intellectual property is a potential asset that also cannot be overlooked.
- Various other miscellaneous provisions and substantive provisions based upon the peculiar situation, the risks, the nature of the business all are addressed based upon any peculiarities of the business and or parties involved. Examples are manufacturer sign-offs and consents for dealers or franchisor consents in the case of the transfer of a franchise.

Once the agreements are nailed down, the due diligence often then begins. Following this chapter is a representative **due diligence checklist.** Such lists indicate the various issues and documentation that should be addressed before the buyer commits to proceed with the transaction. At this stage the buyer, its counsel and buyer's accountants work together to carve up the "to do" list for the due diligence that will determine whether or not the sale will proceed. Everything from examination of the financials, tax filings, general ledger to review and valuing inventory and equipment, work in progress orders, terms of agreements between the company and its customers, lender, suppliers, employees and benefit plans, leases and the like are carefully scrutinized together with tax filings whether for income tax, employment taxes, sales taxes or any other applicable governmental filings. Loss experience under insurance policies and workmen's compensation and unemployment acts should all be reviewed and considered. Any pending litigation is examined together with the seller's rights in any tangible and intangible assets being sold. Joint notices to customers should also be prepared to maintain sales after the transaction is completed.

Conclusion

Acquiring businesses or their assets takes time, understanding, expertise and a team approach. The team should have sound business experience, legal and accounting capability and knowledge and should freely reach out to other industry experts insurance, valuation, or the like to obtain the best results. Failure to be detail oriented and to successfully analyze the risks and opportunities can result in disaster and loss of the investment. Being organized and using the right team members at the right time helps to ensure success.

POTENTIAL ACQUISITION OF CORPORATION | DUE DILIGENCE CHECKLIST

A. CORPORATE AND ORGANIZATIONAL

☐ 1. Certified copy of certificate of incorporation of Target (the "Company").

☐ 2. Certified copy of bylaws of the Company, as currently in effect.

☐ 3. Access to minute books of the Company.

☐ 4. Access to stock books and stock transfer ledgers of the Company.

☐ 5. List of states in which the Company is qualified to do business, including names and addresses of registered agents.

☐ 6. Good Standing Certificate, and proof of payment of taxes for state of incorporation and every state in which the Company is qualified to do business.

☐ 7. Current organizational chart for the Company and subsidiaries, operating divisions, and hierarchy of officers. This should include the salary history of key managers and key field operations leaders, their resumes, and the organized labor participation of key field personnel.

☐ 8. All names under which the Company or any predecessor thereof has done business in the past five years.

B. SUBSIDIARIES AND AFFILIATES

☐ 1. List of subsidiaries and/or affiliates of the Company.

☐ 2. Certified copies of certificates of incorporation or articles of organization (as the case may be) and bylaws or operating agreement (as the case may be) of each subsidiary and/or other affiliate, and access to minute books and stock transfer ledgers of each subsidiary and/or other affiliate.

☐ 3. Information requested in items A.1-A.8, shown separately for each subsidiary and/or affiliate.

C. SECURITIES

☐ 1. Statement of outstanding and treasury shares of common stock, preferred stock (including a complete description of the rights attaching to such preferred shares), and any other securities of the Company and each subsidiary.

☐ 2. Stockholders' list, giving name and address of each stockholder of the Company and its subsidiaries and of any voting trustees, his or her affiliation with the Company, the type of security held, the date of issue by the Company (the consideration received by the Company therefor), and the number of shares of such security owned by each such stockholder or trust.

☐ 3. List of holders of any options or rights to purchase any securities of the Company (including warrants), giving name, number of options held, option prices, date(s) of grant, expiration dates, position in the Company or subsidiary, and number of shares owned (excluding those subject to option).

- 4. Copies of all stock option agreements, stock option plans, and warrants.
- 5. Copies of all stockholder agreements and all other agreements with respect to securities of the Company or its subsidiaries.
- 6. Indicate whether there are any stockholders or stock certificates whose whereabouts are unknown, or any stockholders from whom it will be difficult to obtain approval of the transaction or stock certificates, as appropriate.
- 7. A description of all contractual restrictions on transfer of the Company's capital stock or assets.

D. BUSINESS DESCRIPTIONS

- 1. All market studies, feasibility studies, analyses, and similar reports concerning the Company prepared within the past five years, including those prepared by any brokers hired by the Company.
- 2. All marketing and other descriptive brochures regarding the Company prepared within the past five years.
- 3. All press releases issued by the Company during the past five years, and any press clippings that refer to the Company, if available.
- 4. Recent analyses of the Company or its industries prepared by investment bankers, engineers, management consultants, accountants, or others, including marketing studies, credit reports, and other types of reports, financial or otherwise.

E. FINANCING DOCUMENTS

- 1. All currently effective loan agreements, indentures (including industrial revenue bond indentures), debt instruments, and other financing instruments, and all related material documentation, to which the Company is a party.
- 2. A list of all mortgages, liens, pledges, security interests, charges, or other encumbrances to which any property (real or personal) of the Company is subject and all related material documentation.
- 3. All correspondence with lenders and other debt security holders for the past five years (including all consents, notices, or waivers of default from lenders with respect to borrowings by the Company).
- 4. Schedule of all short-term and long-term debt (including capitalized leases, guarantees, and other contingent obligations).

F. FINANCIAL STATEMENTS

- 1. Audited, reviewed or compiled financial statements, both consolidated and consolidating, for the Company and its subsidiaries for the past three fiscal years.

☐ 2. All unaudited interim financial statements of the Company prepared since the date of the most recent audited financial statements.

☐ 3. Separate consolidating statement for significant subsidiaries or divisions.

☐ 4. Brief description of contingent liabilities involving the Company.

☐ 5. Name of accountants and length of relationship with accountants; indicate whether the accountants own any interest in or hold any position with the Company or its subsidiaries.

☐ 6. Correspondence with the Company's accountants prepared or received during the past five years, including all management letters from accountants.

☐ 7. Brief description of depreciation policy.

☐ 8. Brief description of nature of prepaid or deferred income or expenses.

☐ 9. Copy of any sales projections and estimates, and copy of current budget and any budget projections including a discussion of any assumptions used in the preparation thereof.

☐ 10. Brief description of any change in accounting policies or procedures during the past five years.

☐ 11. Brief description of outstanding commitments for capital expenditures in excess of $500.

☐ 12. Any documents relating to material write-downs or write-offs of notes, accounts receivable, or other assets other than in the ordinary course of business.

☐ 13. Brief description of capitalization policy, including depreciable lives for both book and tax purpose

☐ 14. Develop a revenue mix chart for the past 3 years (labor/rent/sales).

G. TAX MATTERS

☐ 1. Copies of all federal, state, local, and foreign income and franchise tax returns filed by the Company and its subsidiaries for the past five years concerning the business, assets, or income of the Company.

☐ 2. All correspondence with the Internal Revenue Service or state or local tax authorities concerning adjustments or questioning compliance.

☐ 3. List of returns and the years thereof that have been audited by federal, state, or local tax authorities and copies of determination letters related thereto.

☐ 4. List of state and local taxes to which the Company or any subsidiary is subject with respect to the business, assets, payroll or income of the Company, showing assessment date, date return is to be filed, and date tax due.

☐ 5. Describe and provide copies of all agreements, consents, elections, and waivers filed or made with the IRS or other taxing authorities.

☐ 6. List and describe all pending or threatened disputes with regard to tax matters involving the Company or any of its subsidiaries.

☐ 7. Copies of "S corporation" elections, IRS notices of acceptance, and any other information pertinent to the Company's "S corporation" status, where applicable.

☐ 8. Copies of any tax indemnification, tax sharing, or tax allocation agreements involving the Company and other members of an affiliated group, including any joint venture agreements that have the effect of tax allocation agreements, and a statement setting forth how such agreement was carried out for the past five years.

- 9. Copies of all legal or accounting tax opinions received by the Company during the past five calendar years relating to the Company's tax reporting.

H. OFFICERS AND DIRECTORS, EMPLOYEES, BENEFIT PLANS, AND LABOR DISPUTES

- 1. Name, address, and telephone numbers (home and business) of each director and officer of the Company and each subsidiary (and, if applicable, principal occupation), and aggregate compensation at present and for the previous fiscal year.
- 2. All liability insurance policies for directors and officers of the Company or its subsidiaries.
- 3. A listing of all persons employed by the Company and by each subsidiary in terms of function (executive, sales, clerical, research, labor, or other appropriate classification), including their current salary and bonus/incentive plans.
- 4. Policies, memos and letters of agreement with non-union employees regarding wages, hours, working conditions and any other terms of employment.
- 5. List of all personnel practices and policies.
- 6. Name and address of each person who has a power of attorney to act on behalf of the Company or any subsidiary, and copies of such powers of attorney.
- 7. List of all labor union contracts and collective bargaining arrangements to which the Company or any subsidiary is a party, the number of employees covered by each such agreement, and the anticipated expiration dates thereof; and furnish copies of such contracts.
- 8. Brief description of "labor unrest" situations, all pending or threatened labor strikes, or other trouble experienced by the Company and its subsidiaries during the past five fiscal years.
- 9. List and brief description of the current status of all unfair labor practices complaints lodged during the past three fiscal years involving the Company and its subsidiaries.
- 10. Brief description of any pending or threatened request for arbitration, grievance proceedings, labor disputes, strikes, or disturbances affecting the Company or any subsidiary, and history of recent union negotiations.
- 11. All performance bonus plans adopted by the board of directors of the Company during the past five years.
- 12. a. Brief description and copies of all employee benefit plans, group life insurance plans, major medical plans, medical reimbursement plans, dental plans, retirement plans, supplemental unemployment benefit plans or welfare plans (for hourly employees), or salary continuation plans, long term disability, or other perquisites, and a brief description of policy regarding bonuses, salary review, severance pay, moving expenses, tuition reimbursement, loans, advances, vacations, holidays, sick leaves, and other benefits. Provide a list of all employee benefits and plan participants.
- b. List of all plan company and employee contribution amounts for the last 3 years.

☐ c. For each pension or profit-sharing plan, including multiemployer plans, if any, furnish copies of plan documents, including amendments (and a description of any changes in these plans proposed, agreed upon, or under consideration); actuarial reports, if applicable; trust instruments and trust balance sheets, if any; summary plan descriptions; the latest application for determination to the IRS; any IRS determination letters; and the last 3 years' Annual Reports on Form 5500, 5500-C, or 5500-K. With respect to each such pension plan that is a "multiemployer plan," furnish a statement of the employer's "withdrawal liability" within the meaning of ERISA § 4211.

☐ 13. Details on any terminated pension plans and unfunded pension liabilities. Provide copies of any pension trust statements and plan valuation.

☐ 14. a. List of all employees of the Company who received compensation exceeding $50,000 in the last fiscal year, giving name, date of birth, date hired, position, and compensation for the last fiscal year, and, to the extent available, similar information for all other employees, and retired employees who are receiving or will be entitled to receive any payment not described previously in item 9.

☐ b. Describe all written or oral employment or consulting agreements (other than union contracts) to which the Company or any subsidiary is a party or bound and, if any of the same are in writing, furnish copies thereof (except for employment contracts that can be terminated at will by the Company or a subsidiary without cost or liability).

☐ c. Brief description of all confidentiality, noncompetition, or similar agreements between the Company or any subsidiary and any of their present or former officers, employees, directors, consultants, or agents. If any of such agreements are in writing, furnish copies thereof.

☐ d. Brief description of all consulting and management agreements, arrangements, or understandings to which the Company or any subsidiary is a party and, if the same are in writing, furnish copies thereof.

☐ e. Description of all deferred compensation programs affecting officers, directors, or employees of the Company. State the amount accrued and/or paid during the most recent fiscal year under such programs, and amounts of accruals thereunder through a recent date.

☐ 15. A description of the manner in which the Company fulfills its workers' compensation and unemployment compensation insurance obligations in each state (i.e., insured or self-insured, etc.).

☐ 16. Copies of all unemployment tax notices and premium calculations for the past 3 years.

☐ 17. Documents representing or relating to workers' compensation or disability policies, and any material claims with respect thereto.

☐ 18. Copy of employee handbook or any similar document.

☐ 19. Outline and copies of any formal or other severance pay arrangements.

☐ 20. Copies of any formal or other employment agreements

☐ 21. Copies of all deferred compensation, stock ownership, or other executive compensation plans

☐ 22. Copies of any supplemental retirement plans, company owned key manager, or other life insurance policies.

☐ 23. List of any unique perquisites including company vehicles, club membership, etc.

I. Properties, Leases, Insurance, & Safety Related Information

☐ 1. a. List of real estate owned, leased, or used by the Company, stating whether owned or leased (whether as lessor or lessee) and brief description of property, structures, zoning, estoppel letters, reversions or remainders, lease provisions (including assignment and renewal), use, and location; furnish copies of mortgages, deeds, surveys, maps, profits, rights of way, easements, leases, and other contracts. All property values should be reported at replacement cost. Also provide the occupancy at each location.

☐ b. Copies of title insurance policies or lawyers' abstract reports covering real estate.

☐ c. Copies of zoning variances and local permits.

☐ d. List of agreements with railroads, pipeline agreements, agreements relating to water rights (such as certificates of appropriation), mining claims (patented and unpatented), and royalty agreements.

☐ 2. a. List of fixed assets, machinery, and equipment (whether owned, leased, or used by the Company), giving for each material asset or group of assets cost, depreciation reserve, method of depreciation, insured value, estimated remaining useful life, condition suitability for use, and (if available) appraised value.

☐ b. Results of physical inventories for the past 3 years.

☐ c. List of all re-rent balances from Brand and/or other suppliers.

☐ d. List of all rolling stock, automobiles, trucks, forklifts, trailers, and other registered equipment owned, leased, or used by the Company, giving a brief description and condition of equipment and lease provisions (if any), year made, state of registration, registration number, cost, estimated remaining useful life, and insured value.

☐ e. List of premises at which any assets of the Company are currently located or located from time to time, including (without limitation) terminals, plants, storage facilities, sales offices, and warehouses, and written agreements with respect thereto.

☐ f. Brief description of portfolio investments of the Company (except in subsidiaries), including cost basis and current value.

☐ g. All currently effective purchase contracts, leases, or other arrangements concerning material items of equipment used by the Company.

☐ h. All professional appraisals of any material property of the Company.

☐ 3. a. List and brief description of all liens, security interests, or mortgages on the property of the Company or any of its subsidiaries, and location and name of office where documents or financing statements relating thereto are filed.

☐ b. Copies of all material leases of or security agreements for personal property of the Company, including conditional sales contracts, equipment leases, chattel mortgages, accounts receivable, financing agreements, and factoring agreements.

☐ 4. List of all insurance policies relating to the business, assets, or properties of the Company (including directors' and officers' liability insurance), giving insurance company, policy number, term of coverage, property or risk covered, appraisal value of covered property (where appropriate), extent of coverage, annual premium, and amount of premiums that are prepaid or are unpaid from prior years. Furnish copies of all such policies.

☐ a. Include Business Interruption Insurance including ordinary payroll figures if coverage is required. Advise if any operations are subject to unique machinery, plans, or facilities that would be extremely difficult to replace.

☐ b. Include additional time element values – extra expense, rental values, contingent business interruption/contingent extra expense.

☐ 5. A description of all insurance claims (over $1,000 in amount) currently pending.

☐ 6. Schedule of Company's loss experience per insurance year.

☐ 7. Schedules and summaries of insurance for the past 5 years if historical program structures are different from current, e.g., deductible levels, etc. and schedules of all program costs/allocations by line of coverage. This should include insurance premium experience and rating.

☐ 8. List of states where the company currently maintains Workers' Comp Insurance with the state fund. Indicate the annual premiums paid to each state fund.

☐ 9. Complete files for all general liability, workers compensation, or other open or pending insurance claims for the last 5 years.

☐ 10. List of currently outstanding OSHA violations and violation summary for the last 3 years including disposition of all violations. This should include OSHA Form 200's, TOR, and other safety history.

J. INTELLECTUAL PROPERTY (PATENTS, TRADEMARKS, COPYRIGHTS, TRADE SECRETS)

☐ 1. Schedule of patent registrations and applications identifying each patent by title, registration (application) number, date of registration (application), and country.

☐ 2. Schedule of trademark (service mark and trade dress) registrations and applications identifying each mark and including date of registration (application), registration (application) number, status, and country or state where registered. In those instances where registration has not been sought, identify the mark, trade dress or trade name, and its date of first use anywhere in the United States.

☐ 3. Schedule of copyright registrations and applications identifying each copyright by title, registration number, and date of registration.

☐ 4. Manual or other written document detailing the procedures for maintaining the secrecy of trade secrets.

☐ 5. Licensing agreements, merchandising agreements (naming Company as licensee or licensor), or assignments relating to patents, technology, trade secrets, trademarks (service marks), trade dress, and copyrights.

☐ 6. Communications to or from third parties relating to the validity or infringement of Company's patents, technology, trade secrets, trademarks (service marks), trade dress, and copyrights.

☐ 7. Studies or reports relating to the validity or value of Company's patents, technology, trade secrets, trademarks (service marks), trade dress, and copyrights, and the licensing or merchandising thereof.

☐ 8. Agreements pursuant to which any patent, trademark, service mark, or trade name has been sold or transferred by or to the Company and evidence of recording thereof.

K. CONTRACTS AND ARRANGEMENTS

☐ 1. All standard forms of agreements used by the Company.

☐ 2. All warranty agreements, including all forms of product warranties, of the Company currently in force with respect to completed and executory material contracts.

☐ 3. A list and description of all significant oral contracts and commitments.

☐ 4. All currently effective guarantees given by the Company concerning the payment or performance of obligations of third parties.

☐ 5. All sales agency and distribution agreements.

☐ 6. A list of all contracts and commitments under which a default has occurred or is claimed to have occurred, setting forth the following:
   - a. Nature of default;
   - b. Name of party in default;
   - c. Monetary amount claimed; and
   - d. Current status of contract or claim.

☐ 7. A list of all contracts subject to negotiation (indicating those contracts currently being renegotiated).

☐ 8. All agreements to which the Company is (or was within the past five years) a party and in which any officer, director, employee, or shareholder of any such companies has (or had) an interest (whether directly or indirectly).

☐ 9. Copies of all agreements not to be performed within three months or involving over $25,000 whether or not entered into in the ordinary course of business, except (a) agreements for the sale of merchandise or standard sales order forms entered into in the ordinary course of business, and (b) agreements referred to elsewhere herein.

☐ 10. Copies of all contracts with advertising or public relations agencies.

☐ 11. Copies of all standard forms of sales and purchase orders.

☐ 12. A list of all significant suppliers (representing in excess of 5 percent of annual purchases) of the Company, with an indication of the amount paid to each such supplier during the Company's most recent fiscal year and the estimated number of alternative suppliers.

☐ 13. All executory contracts, as amended to date, with each of the above-referenced suppliers, and all related purchase orders.

☐ 14. Brief description of contractual or customary credit terms available from suppliers and manufacturers, and copies of all agreements with suppliers and manufacturers.

☐ 15. List and briefly describe all agreements and arrangements with distributors, dealers, sales agents, or representatives. Furnish copies of all such written agreements.

☐ 16. List and briefly describe all agreements and arrangements whereby the Company or any subsidiary acts as a distributor. Furnish copies of all such written agreements.

☐ 17. List and briefly describe all agreements relating to the supply of material and other raw materials and supplies. Furnish copies of all such written agreements.

☐ 18. Copies of all forms of product warranties or guarantees, if any, given by the Company or any of its subsidiaries.

☐ 19. Copies of all agreements and other documentation relating to the acquisition of any business constituting a part of the Company, or sale or proposed sale of any business owned by it in the past five years.

☐ 20. Copies of joint venture or partnership agreements to which the Company or any subsidiary is a party.

☐ 21. Copies of all franchise or distribution agreements between the Company or any of its subsidiaries and any third party concerning the manufacture, sale, or distribution of the Company's or its subsidiaries' products or services. If any such agreements are oral, summarize the terms thereof.

☐ 22. Copies of all agreements not previously listed with suppliers, independent agents, salespersons, or others involving the payment of commissions; or other consideration or discounts with respect to the manufacture, sale, or distribution of the Company's or its subsidiaries' products or services. If any such agreements are oral, summarize the terms thereof.

☐ 23. Brief description of any contracts restricting the ability of the Company or any subsidiary to compete in any line of business with any person or entity, or committing the Company or any subsidiary to continue in any line of business.

☐ 24. Advise if there are any facts or circumstances that may give rise to the cancellation or termination of, or claim for damages or loss under, any of the agreements, arrangements, or understandings referred to herein.

☐ 25. List and describe all leases, licenses, agreements, and contracts involving the payment of more than $1,000 in the aggregate, currently in the process of negotiation.

☐ 26. Copies of agreements granting to the Company any right of first refusal to acquire any business or assets, or pursuant to which the Company has granted any such rights.

☐ 27. List the material terms of all contracts and arrangements for (a) trucking and other delivery and (b) warehouse space.

☐ 28. List and copies of any applicable contracts where significant liability is assumed (voluntarily or by contract or agreement) for any third parties.

L. LITIGATION

- 1. List and brief description of each threatened, closed, or pending claim, lawsuit, arbitration, or investigation involving all claims for relief against the Company, any subsidiary, or any of their respective officers or directors.
- 2. List and brief description of any pending or threatened (a) claim or litigation involving alleged violations of laws or regulations for the health or safety of employees or others, (b) governmental or administrative proceeding, (c) equal employment opportunity claim or litigation, (d) antitrust claim or litigation, (e) claim or litigation seeking injunctive relief, or (f) other material claim or litigation to which, in either case, the Company or any subsidiary is a party.
- 3. A copy of all complaints, answers, and other material pleadings concerning any litigation not fully covered by insurance.
- 4. All letters from counsel to the Company to accountants relating to litigation or contingent liabilities involving the Company.
- 5. All correspondence relating to actual or alleged infringement by the Company of intellectual property rights of others.
- 6. All judgments, orders, and decrees to which the Company is subject.
- 7. List and brief description of all outstanding judgments, decrees, or orders.
- 8. All material governmental permits, licenses, etc., of the Company.
- 9. Any litigation involving an officer or director of the Company concerning bankruptcy, crimes, securities law, or business practice (past five years).
- 10. Description of any investigations of the Company, pending or threatened, by any federal, state, local, or foreign authorities.
- 11. All correspondence with, reports of or to, filings with, or other material information about any other regulatory bodies that regulate a material portion of the Company's business.
- 12. Summary of the company’s product liability errors and omissions exposure relative to the services provided.
- 14. Please describe any services and/or products that have resulted in unusual claim activity or litigation.
- 15. Please describe any practices or procedures the company has in place (contractual or otherwise) to limit risk exposure.

M. ENVIRONMENTAL AND RELATED MATTERS

- 1. All internal Company reports concerning environmental matters relating to current or former Company properties.
- 2. Copies of any applications, statements, or reports filed or given by the Company or any of its subsidiaries with or to the Federal Environmental Protection Agency, any state department of environmental regulations, or any similar state or local regulatory body, authority, or agency,

including, without limitation, any applications, statements, or reports with respect to emissions under Title V.

- ☐ 3. All notices, complaints, suits, or similar documents sent to, received by, or served upon the Company or any of its subsidiaries by the Federal Environmental Protection Agency, any state department of environmental regulation, or any similar state or local regulatory body, authority, or agency.
- ☐ 4. All Company or outside reports concerning compliance with waste disposal regulations (hazardous or otherwise).
- ☐ 5. Copies of all permits, shipping authorizations, manifests, and waste stream authorizations.
- ☐ 6. Description of any processes of facilities currently or previously operated by the Company or any subsidiary (or by others on property currently owned by the Company or any subsidiary) that generate or are suspected of generating any toxic or other hazardous material.
- ☐ 7. All pollution control capital expenditure reports (including budget requests) for the past five years.
- ☐ 8. All annual reports, manifests, or other documents relating to hazardous waste or pesticide management over the past five years.
- ☐ 9. All documents relating to equipment using PCBs, spills of PCBs, or worker exposure to PCBs, and all documents relating to the existence or removal of asbestos.
- ☐ 10. Any public records reflecting existing or recent environmental problems.
- ☐ 11. Identify the existence and location of any underground or aboveground storage tanks.
- ☐ 12. All environmental reports or studies performed for or on behalf of the Company within the past 5 years.

N. RECEIVABLES

- ☐ 1. Brief description of customary sales credit terms.
- ☐ 2. Brief description of aging of accounts receivable, giving collections since aging date and brief statement of reasons for all past due receivables.
- ☐ 3. Description of basis for establishing bad debt reserve.

O. INVENTORIES

- ☐ 1. List of products and services currently sold by the Company and its subsidiaries, together with applicable prices and discounts.
- ☐ 2. Brief description of inventory pricing procedure.
- ☐ 3. List of major sources of supply for material, dollar purchases from each in the last fiscal year, and brief description of available alternative supply sources for material items.
- ☐ 4. Detailed listing of all scaffolding inventory, including part numbers, descriptions, quantities, cost, list value, and location.
- ☐ 5. Are there any consignment inventories? If so, where, how much, etc.

P. LIABILITIES

☐ 1. List and brief description of all long-term and short-term indebtedness of the Company and each subsidiary.

☐ 2. List of guarantees or indemnity undertakings given by the Company or its subsidiaries.

☐ 3. List of all liabilities incurred by the Company outside the ordinary course of business.

Q. TRANSACTIONS WITH OFFICERS, ETC.

☐ 1. List and statement of amounts and other essential terms of any indebtedness or other obligations of or to the Company or its subsidiaries to or from any officer, director, stockholder, or employee.

☐ 2. List and description of assets or properties used by the Company in which any officer, director, stockholder, or employee has any interest.

☐ 3. List of all material transactions between the Company and its officers, directors, stockholders, or employees not disclosed under items Q.1 or Q.2.

R. CUSTOMERS

☐ 1. Uncoded version of "Top 20" customers for the past 5 years, grouping the customers by plant (location) where work was performed.

S. LICENSES

☐ 1. List of all federal, state, local, and foreign governmental permits, licenses, and approvals (excluding those listed elsewhere herein) either held or required to be held by the Company or its subsidiaries for the conduct of their businesses.

☐ 2. All correspondence, reports, and notices relating to laws and regulations administered by any federal, state, local, or foreign governmental agency for the past five years.

T. CONSENTS

☐ 1. List and brief description of any of the Company contracts, leases, security agreements, licenses, authorizations, etc., that may require the consent of any third party (including any governmental agency or instrumentality) to the proposed transactions.

☐ 2. Indicate any other notification required to be given to or consents required from any third party (including any governmental agency or instrumentality) in connection with the proposed transactions.

U. INFORMATION TECHNOLOGY

☐ 1. Copies of all telephone, hardware, software and other systems related leases and contracts.

☐ a. Inventory of all computers, monitors, modems, printers and other hardware equipment

☐ b. List of all network communications equipment.

- c. List of all pone and modem lines.
- d. List of all software applications on PC's.
- e. Copies of local and long distance land line and mobile phone bills for the past 2 years.
- f. All copyrights, trademarks and patents detailed and inventoried with back up.

V. MISCELLANEOUS

- 1. List of all bank accounts and safe deposit boxes, giving authorized signatories.
- 2. List of memberships in trade associations.
- 3. Review project cost control methods (labor, materials, and any related equipment).

Legal Disclaimer

Chapter 21 | Commercial Lease Negotiations

Brian Borkan and Joel N. Goldblatt

In this chapter, we present the viewpoints and knowledge and suggestions of a long time commercial tenant representative broker and a real estate attorney who has knowledge of lease issues and matters that closely held business owners will want to keep in mind when selecting premises to lease and the key issues they will need to understand.

The first stage in exploring the rental market is selecting a qualified tenant representative.

Any broker you select will best serve you if they can meet the following characteristics and have access to the following information:

REQUIREMENTS

1. Knowledge of the building (recent transactions in the building)
2. Knowledge of the landlord (personal relationship and past experience is best)
3. Knowledge of the building broker (personal relationship and past experience with them is best)
4. Knowledge of the surrounding market (recent transactions and an understanding of rates, concessions and the like)

Any commercial broker with experience will have a strategy he or she uses to better represent their clients. Tactics commonly utilized to maximize the benefit for the prospective tenant will help provide the prospective tenant with leverage. A good summary of the most important tactical considerations is as follows:

TACTICS

1. Start about 12-24 months' before the lease expiration
2. According to BOMA (the Building Office Managers Association), approximately 72% of all leases are renewed. However, shop three to four other deals to give you options and leverage as against the current Lessor is a must. Failing to take this approach reinforces the impression in your current landlord that you are not seriously considering a move.
3. Let your broker know who has called. Sometimes the landlord agent will call using a different name "trolling" for information).
4. Tour the market to get your company name out there as the market "talks." Landlords and their agents know what each is doing in the market place and they routinely share such anecdotal information.
5. Rent often should go down unless the market is heating up and space is scarce.

A TYPICAL PROPOSAL (keep it simple) is comprised of the following factors:

ADDRESS:
SUITE #
SQUARE FEET:
RENT COMMENCEMENT:
TERM:
GROSS RENT:
ESCALATION:
RENT ABATEMENT:
RE TAX & OPERATING:
LIGHTS & OUTLETS:
CONSTRUCTION:
EXPANSION:
RENEWAL:
CANCELLATION:
SECURITY DEPOSIT:
PARKING:
STORAGE:
SIGN:
BUILDING HVAC HOURS:
HVAC:
CONFERENCE CENTER:

Now that you have heard from a commercial broker with years of experience representing tenants and landlords, it will be useful to hear from a real estate lawyer with 30 plus years of experience drafting and negotiating leases. The leases we address in this chapter are what are commonly called or referred to as "triple net" leases. These are leases that permit the landlord to pass on all costs of owning, maintaining, insuring and paying taxes for the premises to the tenant, thereby enabling the landlord to retain base rent and not have such rental income eroded by these other costs. Triple net leases are regularly seen and utilized in the office, commercial store and industrial aspects of real estate leasing. They are to be contrasted with "Gross" leases which have a flat rental payment and none of the above referenced charges are passed on to the tenant or "modified gross" leases that only have a few select additional costs passed on to the tenant. Certain modified gross and net leases only pass on certain charges to the extent they increase over the amount of the charges in a base year.

When considering a lease and premises that will be occupied, it is important that the tenant consider what flexibility they would like to have built into the lease terms and how such terms may affect the business and its valuation going forward. After all a lease can either be an asset or a liability.

Issues such as the ability to expand or contract, the ability to exercise options to extend lease terms, rights of first refusal to obtain adjoining space, and in special circumstances the need for exclusive use are just some of the up-front issues a tenant should be thinking of before they enter into a lease negotiation. In this regard it is imperative that a knowledgeable commercial real estate broker be enlisted in the search and determination of likelihood of rates and lease terms being achieved given the market being explored. Many tenants wrongly believe that having their own broker will drive up the cost of their rent. Actually, the opposite is true. Coming to the table with a knowledgeable broker ensures the landlord is aware they cannot game you and the landlord is already represented by a broker and is paying a commission so the idea the tenant will be saving rent is illusory.

Once the broker has educated you and the choice has been narrowed to one favorite location, the typical transaction then proceeds to a non-binding letter of intent ("LOI"). The LOI helps the parties create an outline of the transaction's most important economic deal terms, without the need to enter into a full blown lease negotiation and the expenditure of legal fees on a project that may not proceed. Once the LOI is signed, then the landlord typically has a lease drafted and shared with the tenant, their broker and the tenant's counsel. At this point a much more detailed review and negotiation of lease terms occurs.

It may be stating the obvious, but the larger the premises the more likely it is the tenant will have greater leverage and say in final lease terms. Conversely, a large landlord (for example a REIT) or an owner who has lender restrictions may not be in a position to be very creative or flexible on the terms they will agree to. The market dictates this as well, as premises that have been vacant longer will possibly cause the landlord to be more flexible. The level of occupancy in the building or center in which the premises are located as well as the geographic region also plays an important role. These are all factors that are discussed with the broker before the parties get to the LOI stage, but these factors have a very large impact on what can be negotiated in any given leasing scenario, so they are important to bear in mind.

When reviewing lease terms, it is always wise to take the following approach:

1. Review basic terms such as rent, amounts, timing security deposits, whether the provisions called for in the LOI are addressed in the lease draft and whether such terms reflect the intent of the LOI.
2. Negotiable points addressed by the LOI often include: allowances for work to be performed by the landlord, hard and soft costs (design fees, wiring of telecommunications and computer systems, paint and carpet, as well as costs to move and set up) separate metering and who will bear the cost, rental abatement, security deposits or irrevocable letters of credit in lieu thereof, lease term, options and the like.
3. In reviewing specific lease terms, I have seen the following issues addressed routinely:

a. Premises accurately defined, broad use permitted, and zoning for use separately confirmed together with any occupancy permit requirements of local governmental authorities;
b. Rights to make alterations of a non-structural nature and what process will be required for approval of same;
c. Where additions are to be made to the premises or the tenant may wish to do so, a mechanism and clear delineation of responsibility for removal of such alterations at the end of the term or a process to determine whether removal will be required;
d. Make certain the lease has a provision causing the landlord to covenant to provide "quiet enjoyment" to the tenant who is abiding by the lease;
e. Clear signage rules and potentially allowances on the part of landlord;
f. Parking and accessibility issues are addressed and permit the use contemplated;
g. The definitions of "Common Area Maintenance" and "Rentable Square Feet" are key components of any triple net lease and should be understood and negotiated. What constitutes common area maintenance will be the expenses that are passed on to the tenant. Such definitions should not include the landlord's general overhead and mortgage interest or fees or costs payable for services related to a given tenant. In multi-tenant buildings or centers the rentable square foot concept is utilized to allocate a given tenant's prorata share of common area maintenance, taxes and insurance. The definition is not synonymous with square feet of the premises. Rather the term "rentable square feet" has a loss factor added to it so that common areas, walls and systems are allocated to each tenant's space so that rentable square feet is a larger area than the actual size of the premises rented. The result is to increase costs to the tenant and decrease costs to the landlord. A right to audit common area expenses should also be included and addressed. Landlords often limit these rights in scope, those who can audit, or the time period within which an audit can occur. A key issue for common area maintenance is whether capital improvements are included in such definition or whether an amortized cost for such improvements is included and if so the useful life that recovery will occur within pursuant to the lease's terms. In addition it is wise to address whether or not governmentally required improvements will be includable in "common area maintenance."
h. The insurance and indemnity provisions also must be carefully considered. The types of insurance and limits should be considered and compared to that which the tenant currently holds. The insured's insurance agent should be consulted to ensure the provisions of the lease are being complied with. Whether the tenant's insurance is considered to be primary whether the tenant is to name the landlord as additional insured and whether both parties are waiving subrogation (where they are not named as additional insured) are all important considerations. Subrogation is where the insurer who pays a claim steps into the rights of their insured and can sue the party responsible for the loss. A tenant who is negligent can have the landlord's insurer sue them where there is no waiver of subrogation required in the landlord's coverage as called for in a lease. With respect to indemnity provisions, here too the insured should run these provisions past their insurance agent. Indemnity provisions may contractually bind a tenant (or landlord) to an obligation that is specifically excluded by their insurance coverage. As a result, these provisions should be forwarded to and considered by the

agent to ensure there are no unintended gaps in coverage that are created as a result of a contractual indemnity provision.

i. The definition of what is included in taxes should also be considered so as to ensure income taxes are not included in what may be passed through to the tenant.
j. The termination of the lease and the ability to hold over and at what cost should be considered. Where a landlord has no new tenant waiting in the wings an existing tenant does not need to be penalized as leases typically do by raising rents as much as 200% or by permitting the landlord to declare the lease automatically renewed for one year.
k. If the space is to be built out for the tenant, careful considerations should be addressed such as timing, the permit process, whether there will be a drop dead date after which a tenant can declare the lease terminated if they are not occupying, the time rent commences, whether the tenant can move in and set up without paying rent until a given date arrives are all issues to consider. Additionally, the cost of the work, the amount of allowances, insurance and utility costs and obligations associated with the build out should be addressed.
l. Landlord duties and services should be spelled out together with access and where applicable elevator access and use, both passenger and freight. Services that are not included in the services called for as standard are typically charged to the tenant.
m. Access to utilities, whether they are separately metered who is responsible for paying for metering and whether the landlord can tack on fees over and above costs are part of the considerations a tenant needs to address. The adequacy of electricity and or water may be of concern depending upon use and additional components such as cooling systems for server rooms and who bears the cost for such systems is a negotiable point.
n. Interruption in use and or occupancy is an issue of concern and where possible a tenant should negotiate an abatement of rent where an interruption lasts longer than a few days.
o. The landlord’s and tenant’s respective duties to maintain and ability to conduct alterations is an important point that should be considered both from the prospective of the time period around initial occupancy and what may be required in the future.
p. The ability of a tenant to assign or sublease is a key negotiation point. Assignments relieve the tenant of any further obligation, whereas subleases leave the tenant who is subleasing (“Sublessor”) liable and exposed to the wrongdoing of the sublessor’s tenant. Subleasing permits flexibility if a tenant is leasing too much space, and the liberal right to sublease can be the difference between economic survival and thriving for a tenant with too much wasted overhead.
q. Environmental indemnifications are routine in leases together with prohibitions on use of certain chemicals. These provisions should be considered together with permitted uses.
r. Signage can be a big consideration together with size, shape, placement and cost of installing and maintenance.
s. Access and the American’s With Disabilities Act and who bears the cost associated with complying with the act and or other governmental requirements should be considered.

t. Landlord's remedies such as liens for distraint for rent should be considered in connection with the ability of a tenant to obtain financing going forward and should be eliminated where possible. In addition language should be added requiring a landlord to mitigate their damages. Timing for cure periods should also be addressed and for non-monetary defaults a tenant should be given the time reasonably required to cure where they are diligently seeking to cure a default.
u. Rules and regulations are often provided, and their applicability should require advance notice. Landlord's lenders often want notice of a default by either party, and any obligation on the part of a tenant to notify the tenant's landlord's lender should require that the tenant have knowledge of the lender and an address for notice to issue to.
v. Both parties should be required to sign a truthful estoppel certificate if their lender requires it and a tenant should seek to have wording included that the landlord shall request their lender sign a non-disturbance agreement (of the tenant who is not in default) in the event of foreclosure against the landlord.
w. Clauses are often inserted permitting a landlord to relocate the tenant. These should be resisted if possible and if not possible the clause should specify to reasonably comparable space in size, location and utility with expenses borne by the landlord which expenses should include letterhead and printing and moving and set up.
x. Where the landlord's consent is required, such consent should be qualified with the words "not to be unreasonably withheld, delayed or conditioned."
y. For eminent domain typically language is included that indicates the entire award belongs to the landlord. This wording can be softened by indicating the wording will not prohibit tenant from receiving compensation for moving or any additional compensation that does not reduce the landlord's award.
z. Security deposits are often now called for in the form of irrevocable letters of credit. Efforts to reduce the amount of security deposits over time are often successfully negotiated and the form of the irrevocable letter of credit and the bank issuing it are often called for by these provisions. The tenant should address up front whether the tenant's current banking relationship is acceptable as this can be a sticky last minute deal point that can be extremely disruptive if not addressed and understood up front. Personal guarantees should be resisted from the tenant's prospective and are encouraged from the landlord's perspective.

While the above list is not exhaustive and every lease has its own nuances and particular language requiring parties to the transaction to carefully consider the impact on their business and operations, it does offer a good overview and checklist of what the parties to a lease transaction should be considering. With some knowledge of these issues the business owner can interface with their counsel and commercial broker on a more level playing field and obtain a feel for the expertise of those who are representing their interests. Rent is often the third largest expense category behind salaries and insurance so taking these issues seriously is a must.

Legal Disclaimer

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The Editor.

Chapter 22 | New Construction

Joel N. Goldblatt

Any business person who is thinking about adding to an existing structure their business is housed in or creating a new plant office or warehouse for their business or is building out leased premises is well advised to be familiar with many of the key issues that are presented when an "owner" (the party contracting for the services whether they actually own or rent) wishes to embark upon a new construction project. Whether it is an office build out or a ground up 100,000 square foot-plus industrial facility with office and warehouse some familiarity with the types of documents and the issues to address in them is well worth knowing before any contractual commitments are signed. Having an idea of how these documents function what stakeholders are trying to do with them and how the business owner can better protect themselves are all goals any business owner should aspire to when taking the new construction plunge. No matter how sophisticated you may be in your day-to-day business, new construction is a totally different endeavor that most business owners do not have a wealth of experience with. Not knowing what you don't know can cost hundreds of thousands of dollars if not more and in a worst case scenario may be the difference between an enterprise that thrives and one that ceases to exist.

The starting point is to have some familiarity with the different players and roles that come into play as an overview of what is involved and must be addressed in any given new construction project. Then we delve into the general contractor's agreement in greater detail and discuss the most common issues an owner will need to address and negotiate. Finally we state a few words about other key types of documents the owner should be aware of and pay attention to in the global sense as a new construction project may impact banking, landlord tenant and insurance relationships that are in place and are generally affected by any construction undertaken by an owner.

The Players and their Roles

Any new construction undertaken by a business owner will more likely than not involve some or all of the following players:

1. Architect;
2. General Contractor;
3. Subcontractors;
4. Lender or existing banking relationship;
5. Insurer of the business;
6. Possibly a landlord;
7. Possibly a construction manager;

8. Possibly off-site fixture fabrication.

Each of these stakeholders has different interests and are desirous of protecting themselves from liability while protecting their fee or an existing property or contractual interest. We will address the general contractor ("GC") relationship first as this stakeholder will most likely be involved in any given project and even where an owner is acting as his, her or its general contractor these issues would apply where the owner has a direct relationship with each of its subcontractors. Where such a direct relationship exists the "subcontractor" would be a general contractor to the extent of the scope of work they were delivering to an Owner acting as his, her, or its GC.

The first issue to consider is what type of agreement is going to be entered into with the GC. Will it be a "fixed price" or a "time and materials" agreement. A fixed price contract sets a fixed price, and where properly drafted clearly defines the scope of work that will be included in this agreement for the total price to be paid for the project. A variant of a fixed price contract is a contract not to exceed. Such variant permits an upper level of cost and recognizes that all the parameters and entire scope of services is unknown and will be developed and agreed to by the parties within an expected range of total cost "not to exceed" a set sum. For not to exceed contracts, the parties commence the project and as more information about the parameters is developed and agreed to, the total final price (not to exceed) is locked in.

In contrast, time and materials contracts are just that, the contractor procures the materials at cost or a set mark-up over cost and continues with the project and usually at the direction of the owner completes it at an hourly rate or set of hourly rates for the workmen performing the services. A contractor may wish to mark up materials because they are spending time acquiring and delivering and loading and unloading the materials. In a time and materials contract, the owner is often directing the workmen or closely monitoring them or having an owner's representative (project manager) do so.

The authors favor fixed prices as they are easier to control and budget for where the key issues are addressed in the documentation setting out the parties' agreement and there is no incentive for the contractor to delay or stretch out performance as there could be in a time and materials project.

The General Contractor Fixed Sum Agreement

We spend the most time discussing this agreement as these issues often flow to and must be addressed in the other agreements with the other stakeholders mentioned above and so a more thorough discussion of this agreement will educate any owner about the big picture as well as some more detailed aspects that should be addressed in these agreements.

It is often not thought about, but the party you are contracting with is usually a corporation and it is rare that the owners of that corporation who operate the GC stand behind the contract personally. Requesting such owners to do so is going to be a non-starter and so it is imperative to do some due diligence and know about the reliability and track record for success, and the quality of workmanship of the GC you are selecting. Of course it is also useful to know whether the GC has a good history of performing on time and on budget. Speaking to others who have used the contractor's services, supplied subcontracting services and or materials to the GC are all worth checking into. A GC who is not paying subcontractors or material suppliers regularly and on time should be avoided as litigation is sure to ensue where this is the case. A GC that does not complete work, return to perform "punch lists" (items of work that need to be addressed at the very end of the project) or honor warranties is always a contractor to be avoided.

The most important point in any fixed price agreement and what every owner should understand at the outset is the concept of scope of services the GC will perform as part of its contract with the Owner. Where a GC contract clearly identifies and describes the scope of the work to be performed and indicates the fee that will be owed for that scope then anything that is outside the scope will be an extra and subject to additional cost as documented by what is commonly called a "change order."

A "change order" and the process surrounding its issuance is the method most used to amend both the scope of services to be performed and the price of the agreement. Just as the scope of services should be clearly defined in the underlying agreement, such scope should also be clearly and thoroughly specified in a change order. Specificity in the description of scope can go a long way towards saving the owner money and avoiding litigation. Where documents are not specific enough unanticipated cost is likely to be incurred.

When you are specifying scope as much detail as can possibly be reasonably expressed should be expressed. To do this effectively plans and drawings and specifications are attached to and incorporated in the parties' agreement. It is good to know the level of detail down to the models and serials numbers of fixtures that can range from plumbing, lighting and electrical to the size and frequency and type of studs, wall and floor coverings, whether doors are solid core, the types of windows, roofing materials and so on and so forth. Often GC's will insert what is termed an "allowance" in an agreement. Where possible these should be kept to a minimum as the Owner will get no more than the dollar amount indicated for the category of work or materials or fixtures to which the allowance applies. Without having a bid or quote on the component the allowance applies to it is very difficult to know whether the allowance is reasonable or of an amount that will wholly be insufficient resulting in greater cost to the Owner.

Another key issue is the term of the agreement and what rights the owner has to terminate the GC. It is important for an owner to build in a contractual mechanism whereby the owner can terminate the GC for any reason and only pay for the portion of the work completed. Where GC's are not performing and time is costing the owner money (in interest taxes, productivity or the like) the owner needs the easiest mechanism to hire a replacement GC without the need for expensive dispute resolution processes coming into play. Often a GC contract will have (or should) a "Gant" chart showing the timing of stages of work and the value of the component parts. Were a GC completes stated components that is all they are paid for and their percentage of profit is built into each component part. Many GC agreements call for the Owner to pay for the percentage of profit the GC would have earned had they not been terminated so care must be taken in negotiating and drafting these agreements to ensure the owner is not being boxed in to an untenable scenario where they must accept delays due to a high profit penalty having to be paid regardless of the timeliness of the GC's performance.

Another consideration is the definition of "substantial completion" and the timing and duty of the GC to complete "punch lists" following substantial completion. On larger projects the architect is typically charged with determining "substantial completion" and on smaller jobs it is often determined where the premises in question can be legally occupied in accordance with applicable law.

GC duties to repair punch lists should specify the timing of performance and holdback's of moneys owed (reserves) as well as potential liquidated damages (possibly in the form of per day penalties) or damage provisions should be established to recover the necessary funds to complete such punch lists where the GC is not timely doing so.

Responsibility for workmanship and the type of workmanship and materials should be addressed together with who is responsible for permit costs (typically the owner) and storage of materials and tools on site (and sometimes off-site) as well as risk of loss for all of the foregoing.

Insurance should be addressed and the owner should require the GC to have a builder's risk policy that names the owner. General liability policies alone will not cover new construction and thought and care must go into the type of coverages and the risks the parties are actually taking on. The owner's general liability and casualty coverage likely has exceptions to the coverage they afford (and thus the coverage is illusory in such construction scenarios) and separate coverages and endorsements are wisely considered, addressed and procured. Waivers of subrogation on GC policies that protect the owner are wise to demand.

Loan documents, too, present special issues. Most lender's documents require notice prior to commencing construction and doing so can even be a default of the loan documents. Such lender relationships may need to be completely restructured to put in place construction financing followed by a "take out" end loan that refinances all construction indebtedness.

Where a tenant is causing construction to occur they obviously need to consult and comply with their lease. Construction agreements will need to address certain issues raised by the lease. Such issues that regularly occur are no liens of the landlord's interest is permitted, insurance requirements and approval of landlord to final plans are all commonly addressed in leases and need to be set out in the owner's contract with the GC.

Another issue to address in any construction agreement is waiver of liens when payment is made. While each state has different laws concerning the construction process and lien rights for those performing labor and furnishing and delivering services and materials they all have some commonality with respect to the issues an Owner will need to address in the contract with the GC or other contractors an owner hires or does business with. In Illinois there are three key forms, the Contractor's sworn statement and partial and complete waivers of lien forms. The contractor's sworn statement is a statement under oath that is completed by the GC and details all contracts the GC has with subcontractors and ideally material suppliers and the amounts such contracts are for. When the Owner makes a payment an updated sworn statement is furnished for the portion of each subcontractor's work being paid for and a partial waiver is obtained from both the subcontractor and GC for the portion of the work (and materials and possibly delivery services) involved in furnishing such work and materials. When the final work of a given subcontractor's work is delivered they issue a final lien waiver and receive the final payment. This all presumes they have performed in accordance with their agreement.

Through the use of the above process an Owner keeps track of the progress of work, obtains lien waivers as the work progresses and can educate themselves as to the portion of the work completed and remaining to be completed in order to protect themselves from paying too much or leaving lien rights outstanding. This mechanism also helps to ensure the GC is regularly paying its subcontractors and material providers. As a result any construction agreement should memorialize and call for this process (and disclosure of information) to be adhered to and the wise Owner insists upon following it and obtaining all necessary paperwork on a regular basis to keep abreast of what is transpiring on the project.

In larger projects the right of the Owner to suspend work may be an issue that is addressed and the right of the GC and possibly subcontractors to assess fees for restocking and or re-staffing a project may come into play. Agreements often have mutual indemnification from the other party's negligence or breach of the agreement and such provisions often call for a duty to defend (pay for the other party's attorney's fees) and for a prevailing party to be able to recover their attorney's fees. Agreements often use alternative dispute mechanisms such as arbitration. These can save money but this is not always the case. Care must be taken with respect to the process as it is defined in any agreement and it is wise to place contractual limitations on rights and remedies so there is no disconnect between those that would apply in the court system versus those that apply contractually.

Other issues the parties will need to address in their contractual relations are contractor warranties, limitations on liability, mechanism for giving notice and calling for all amendments to the agreement to be in writing. For subcontractor agreements, such agreements are between the GC and the subcontractor. As such, the Owner usually does not need a great amount of say over the terms of the GC's agreement with the subcontractor. The Owner may, however, wish to insist on some provisions being required in subcontractor agreements with the GC such as no lienable interest in the building if a tenant is contracting with the GC and insurance requirements such as liability, builder's risk, workmen's compensation and casualty and property loss type coverage. As indicated above an agreement directly between an owner and a subcontractor, where they occur, is a form of general contract, albeit one that is limited to the scope of work related to the subcontractor's expertise and not a general contractor overseeing the entire project.

Agreements between the Owner and architects generally come in three varieties with variations on a theme. One common type is to identify phases of the project and have a flat fee or not to exceed range for each phase. Early phases may be well defined later phases may not be until earlier phases have been completed. Another type is a straight bill for time and materials (mark up on costs) basis. Still another approach is a flat fee engagement with scope understood and defined in advance. Construction management services may be straight hourly add-ons or the project may be of a size that once a month or once a week will be all the architect needs to visit and a per visit fee will be negotiated. Key issues again are being clear on the scope of the services and having an understanding of what is and is not included compared to what is and what is not needed. A differentiator is the intellectual property rights an architect has (copyright and or trademark) in the designs they create and whether the owner is obtaining such rights or an irrevocable non-exclusive license to such rights. Many homebuilders become surprised when they use an architect's design a second time and do not pay the architect for the rights the architect retained and are sued for copyright or trademark infringement. It is best to address these issues up front.

For large, complex projects, project management firms are hired. Such firms may be comprised of architects or knowledgeable construction professionals with experience in the trades and or construction projects. Hiring such firms or architectural services where an architecture firm is hired may charge hourly or on a percentage of the cost of construction (possibly with a cap) and can be worth their weight in gold. Such services can catch problems early and keep projects on budget with a minimal level of disputes arising. Construction projects may involve a great deal of math but they are not all science and much of what transpires is an art form. Having a professional intermediary between the various players whose sole role is to protect the owner's interest can be a very valuable investment, especially the more complex the project.

The Editor.

Chapter 23 | Telecommunications

Dave Dyson

Telecommunications, broadly defined, are the technology-based services and solutions that a business uses to communicate with vendors, partners, employees, and clients. Initially, the technological solution for communication needs was comparably simple. For the better part of the past century, telecom encompassed the telephone on your desk and the phone number associated with it. The past couple of decades, however, have brought about massive and constant change. Telecom has moved well beyond the telephone, and is now comprised of the internet, mobile phones and a wide array of mobile devices. Of course, telecom will continue to evolve, and as the telecom landscape continues to change, the policies managers and business owners must develop and manage in order to mitigate risks have become as important as the technologies themselves.

Simply avoiding technology is not an option. Businesses rely on communications services every day. In fact, the systems and infrastructure are so integral to the success of most organizations that businesspeople could not fathom how to execute their work without this technology. Telecom has become so normalized that it is nearly invisible, at least until it stops working. Budget and technology managers understand this and so often see communications as a necessary, albeit expensive evil that, because of organizational dependence, is one they must contend with.

As a telecommunications expert, I would suggest looking at it through a different lens. Although at times, the evolution of this technology may be disorienting and frustrating, in fact, the varying tools of communication present a wide array of opportunities to better communicate in all aspects of businesses. The right communications solutions can give a company the appearance of being bigger than it is, provide a better customer experience, and even give a company an advantage over competitors.

A Brief History of Telecom

Understanding the potential growth opportunities and how to best take advantage of them requires some historical context. The history of telecom is long, complex, and colorful. In this brief overview I certainly cannot cover it all, but will instead focus on some of the seminal development in both technology and legislation that lead to both great innovation and the challenges business owners and IT leaders encounter today.

In 1876, Alexander Graham Bell was awarded the patent over a rival inventor named Elisha Gray for what would eventually become known as the telephone. With that key invention, the birth of modern person-to-person communication was born. Over the next century the American Telephone and Telegraph Company (AT&T) built out the national telephone infrastructure allowing for real time voice communication throughout the country. Unlike most other countries, the telecom infrastructure in the United States was built without government finance and intervention.

In the 1940s, the first transatlantic telephone cable was laid in a joint venture between the General Post Office of the UK, the American Telephone and Telegraph company (AT&T), and the Canadian Overseas Telecommunications Corporation, extending the ability to make voice calls to Western Europe from North America. In the US, AT&T had a monopoly on the business of telecom, and generally did a good job providing service and supporting the massive amount of infrastructure required.

The telephone provided a revolution in the immediacy of person-to-person communications, the internet would eventually do the same on an exponential level. In the 1960's a computer scientist named J.C.R Licklidder proposed a conceptual idea of a worldwide computer network that would eventually become ARPANET, the precursor to today's internet. Much of Licklidder's instinct proved to be correct and the seeds for the modern internet were planted. Much of the early efforts in the building of the internet involved the insights and cooperation of both government agencies and major universities and it wasn't until 1995 that commercial entities were allowed to connect into the internet for the first time.

Eventually, the power of voice communication and the endless information of the internet would converge on the wireless devices we carry today. In 1973, an engineer at Motorola named Martin Cooper made the first cellular telephone call in New York City to his chief competitor at Bell Labs, Joel Engel. The prototype used to make the call became the iconic DynaTAC 8000 weighing in at 2.5 pounds and costing $4,000. It's incredible to think that the smartphones that are the evolutionary offspring of that phone have more computing power than the ships we used to send astronauts to the moon in the 1960s. The smartphone is a tremendous tool of business enablement, but also a complex computing resource that needs to be secured. The average telecom budget holder is now reporting telecom as the fastest growing budget item each year.

It has not simply been technology that has impacted telecommunications opportunities. Legislation and government intervention has greatly shaped the telco landscape, and continues to do so. The first major instance of legislative intervention in the development of the industry came in 1984 when Judge Harold Green ruled that the AT&T monopoly had to be broken apart (United States v. AT&T, 552 F. Supp. 131 D.D.C 1982). The divestiture resulted in the establishment of what came to be known as the 7 Baby Bells. The government asserted that the AT&T monopoly was no longer providing innovation at the speed the open market could, was underserving rural and inner city regions, and that the environment had become unfair to end-user consumers. The breakup regionalized local telephony and ushered in the first somewhat tempered wave of competition where upstart competitors such as MCI and Sprint proved that competition would lead to good service offers and lower prices for consumers.

The Telecommunications Act of 1996 was the final lowering of any barriers to competition in the telecom industry; it forced the baby bells to resell their services and infrastructure to competitors and led to a huge wave of new companies operating as competitive local exchange providers (CLEC). This ushered in an era of fiber build outs, broadband deployment, and price competition. Many of the companies that started in this era failed, were acquired, or otherwise merged yet as of 2012, there were still 312 local service providers in the United States. On one hand, competition yielded more innovation and lower costs for consumers and businesses, on the other hand, the rapid change in technologies and large numbers of competitors have created a lot of confusion in the marketplace.

This issue is compounded further by the eruption of cellular mobility on the telecom scene. As wireless networks and the equipment that supports them have become more sophisticated and robust, consumers and businesses are changing the way they communicate and do business around mobile devices. As of the last good count in 2010, there were 260,000 FCC registered cell phone towers in the US. That number is estimated to be approaching 500,000 today. In 2013 expenditures for wireless devices passed traditional wired expenses for the first time. This trend is expected to compound, not reverse.

After 100 years of monopoly driven stability, the last half-century has ushered in an era of innovation. With the speed of change however, comes frustration and confusion. There are a myriad of ways these new technologies in communications can be leveraged. The key is to take advantage of opportunities while avoiding the pitfalls that are inevitable because of the complexity that results from the legislative and technological evolution.

Telecommunications Evolutions and Pace of Change

Telecommunications has changed for the better. Is it better for your business, too? As the telecom industry has changed and evolved, especially over the last twenty years, opportunities to leverage technology to the benefit of business have increased, but so has the complexity of finding the right solutions. Like much of the technology world, the pace of change in telecom has sped up over the last two decades. The rate of change leads to faster innovation and stronger competition, but the rapidity of this change also has the downside of creating confusion. Three key areas of change in the industry create both opportunities and challenges for business: carriers, mobility, and the cloud. Each one is unique in terms of the potential for growth it creates as well as the technological and policy questions it raises.

Carrier Changes

As we discussed, for almost a century, there was only one game in town for telecom. Deregulation led to a flood of new providers and technologies. The barrier to new entrants is lower now than at any other time in history. There are hundreds of telecom providers in the marketplace today focusing on many different aspects of business. Choosing the right providers at the right time for a given business is a difficult yet critical task. There are companies that are great single technology specialists, and organizations that provide dozens of different solutions and compete on a global scale. The sheer number of providers has led to an unprecedented amount of merger and acquisition activity in the telecom space, totaling well over $1 trillion in merger activity in the last decade. Carrier mergers, while often resulting in better overall providers for the marketplace also cause serious pain for clients of the parties involved. When two large telecom providers come together, a lot of things happen in the integration that can create a degraded customer service experience. Merging multiple billing systems, workforces, and cultures is a complex act that creates peril for the end client for at least twelve to twenty-four months following a merger. Sales reps and client service people are shuffled around or terminated altogether and the end result for the consumer is the loss of the people who understood their business and knew how to get things done. Among our clients at Eclipse, one of the most common complaints is constant turnover of their assigned representatives. The repeated change of support leads to time-consuming interactions where managers and employees must explain their business, complaints, and projects over and over again to a changing cast of characters from the carrier's organization. Smaller clients will often lose local account management in these situations and be told to call 800-numbers which often lead to time wasting and frustrating experiences in call-center menus with people who are task focused and do not have the training or interest in an individual organization's business and communication goals.

Mobility

The biggest technological shift in the history of human communication has happened in the last twenty years in and around cellular and mobile technologies. The advent of smartphones has led to a massive change in the way we compute and communicate. The smartphone people carry in their pockets has exponentially greater computing power than the Apollo spacecraft that were sent to the moon in the 1960's, and innovation in this area is rapid. New devices and operating systems upgrades are rolling out weekly. In 2013 the number of mobile phones in service surpassed the number of home telephone lines in the U.S. for the first time. That trend will continue. The consequence of mobility is that employees and managers are in a world that is constantly connected and demanding of response. This is unlikely to change as the era of wearable technology that integrates into eyeglasses and clothing is just beginning to emerge. As the joke goes, you can be certain your new phone is obsolete when you have taken it out of the box and put it in your pocket.

The mobile industry is not just changing as a consequence of technology development. It has also been party to rapid and large-scale consolidation via merger and acquisition. There are far fewer competitors in the mobile space, however, the competition is just as fierce. The major cellular carriers constantly adjust their go-to-market strategies, pricing, and promotions in order to attract new customers and win market share. As a result, constant vigilance is required to ensure you have the right plans, technologies, and strategies in place. What managers realize and are often frustrated with is the fact that the best option three months ago is likely not the best today. Such changes require constant monitoring and review.

In addition to technology changes and carrier changes, mobility for business opens up companies to liability. Mobile devices can be used at the wrong times, such as driving for texting and emailing creating hazardous situations for drivers, other motorists, and pedestrians. It is important that companies understand their potential legal liabilities for their employees' use of mobile devices and potential damages they cause during said use. Now, in addition to just navigating the evolving technology and the carrier changes, technology managers must be aware of the legal ramifications of these devices.

The Cloud

The final and most amorphous change that telecom is navigating right now is the cloud. The term "the Cloud" can be heard echoed everywhere but seems to mean something different to everyone. What it boils down to is this, the cloud is when a business decides to use the computing and hardware resources of another organization. The benefit is that companies have the opportunity to procure an end service that they would have traditionally had to purchase, build, and manage in house. This can save an organization considerable time and resources. The cloud can provide anything from software, to telephony, to data storage and back up. It is not an issue of whether a business will use cloud services anymore, it's a matter of which services a business takes advantage of.

The most important point that managers should take away from the cloud conversation is that it is flexible and scalable. It allows a company to "pay for what you eat" and grow its consumption as business needs change and grow. It is a great resource for avoiding the large capital expenditures often associated with technology as well as the building, maintenance, and power utilization that go along with having one's own data center or data room.

Complexity Causes Confusion

The large number of providers, rapid changes in technology, and changing cost structures of communications can cause a lot of confusion for business leaders and can often lead to overspending on these critical elements. There are a series of challenges a manager or business owner faces when making communications decisions and many common mistakes that lead to less than optimal results. Various consulting and management groups estimate that businesses are overspending on telecommunications every year by 12-30%. Many of the most common causes associated with overspending are paying for services that are not being used, paying rates that are higher than the prevailing rates for similar services, and being locked into bad contracts that have you committed to command higher than benchmark rates for similar services.

The complexity of a business environment can also lead to higher costs and more complex solutions. The larger the organization is and the faster it grows, the more likely the organization is to lose a handle on the costs and solutions around telecom. As a company adds employees, they require visible assets such as smartphones and tablets, and invisible ones like bandwidth at the office and long distance calling. International business brings a whole other level of complexity into the equation. Staying connected while travelling internationally can be very expensive and the cost of connecting to offices overseas can oftentimes be the most expensive part of having an international presence. As organizations rely more on their data networks and the integrity of the information that resides on and traverses them, the need for business continuity and disaster recovery increases. There is a cost for ensuring that your business can communicate when the primary means of doing so are impacted.

Maximizing Communication Environments

Much as a person would hire an expert to do legal work, fix a car, or perform surgery, it is critical to find partners who have the expertise in telecommunications to ensure your organization is getting your needs met and gaining the maximum amount of value for the money you are spending. There are organizations that specialize in navigating the maze of the telecom industry in order to deliver maximum value to your organization. Since spending money on communication services is inevitable, and the telecommunications space is complex and constantly evolving, the trick is to not to attempt to become an expert in this space. Technology managers are tasked with a variety of responsibilities, and even though telecommunications accounts for a large portion of many budgets, it is not often the center of their responsibilities. One of the unforeseen consequences of the increasing cost and complexity of telecommunications is that there are now experts in this area who have spent decades following the trends and working in and with great variety of carriers and solutions.

Successful IT managers work with people who hold this expertise and who can advise which solutions within a budget can provide maximum business value. A good telecom advisor will have a broad understanding of the makeup of the telecom industry, the connections within that world to get things done, and an understanding of the upcoming shifts and trends that will impact the way we communicate. Additionally, such consultants should have an expertise in contract and rate negotiation as well an understanding of prevailing rates for services for companies of different sizes.

With the help of an expert, IT managers can turn telecommunications from a source of frustration and overspending to an area of innovation and business advantage. After all, communication is the most vital of human endeavors. How we communicate with our clients, employees, and partners matters almost more than anything else we do. Such goals are only maximized when experts are brought in who can guide your business through the maze of options available to help maximize the value that communication provides to organizations every day.

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Chapter 24 | Information Security

Steve Hamburg

INTRODUCTION

The objective of this chapter is not to provide prescriptive insight into how you should and/or could implement information security in your company/organization. The objective of this chapter is to provide you—the business owner/empowered influential executive—foundational insights into what information security is and associated best practices and resources. With this knowledge, you will be equipped with the competency required to contextualize information security best practices into your company and its supporting business operations.

As one size of shoe does not optimally fit all feet, one approach to information security does not fit all companies. As a business owner/executive, it is your responsibility to ensure you have effectively and sufficiently instituted information security mechanisms that make the most sense for your company / organization. This chapter will provide you with the building blocks necessary to help you achieve this vital business objective.

WHAT IS INFORMATION SECURITY, AND WHY IS INFORMATION SECURITY ESSENTIAL FOR EVERY COMPANY?

Think about companies in general. What are the core constituencies of a company? First of all, a company must provide products or services that are in demand; enough demand that consumers are willing to pay what is required to receive the products/services. As it pertains to the products and/or services, there must be a competitive advantage; something that motivates consumers to purchase your products and/or services vs. your competitors' products and services.

So what is your company's competitive advantage? Is it your people? Trade secrets behind what makes your products and/or services superior to all others' products and services? Your proprietary business processes/business applications? Whatever your competitive advantage may be, its protection is paramount to the continued success of your company. What I mean is, what are the consequences associated with the core constituencies of your competitive advantage becoming known to your competitors? For example, what would happen to KFC if its top-secret fried chicken recipe was broadcast on the Web?

In addition to your competitive advantage, what about your company's reputation? What would happen to your company if something catastrophic occurred that caused a severe deterioration of your company's brand? For example, consider if you were a retail company and you experienced a severe security breach where 75% of all of your customers throughout your global operations had their credit card information stolen? How do you think your customers will feel about your company? Do you think your company could survive such a catastrophic security breach?

This is where information security comes into play. Now, based on my diverse experiences as an information security consultant who has provided consulting services for companies ranging in size from ten employees to Fortune 50 companies, our business world is saturated with information security nay-sayers. You may be surprised to learn that many people fulfilling very influential executive management roles still today fail to see the value of information security. These business professionals may invest in information security due to regulations or due to pressures applied by boards of directors; i.e., they invest in information security not because they perceive it to be a fundamental business practice, but because their hands are forced to do so.

I cannot tell you how many times I have had conversations with prominent business professionals that have said the following things when engaged in information security related conversations with me: “We have been in business for X years and have never experienced a security breach”; “We’re not as big as five of our key competitors, so why would we be a target?”; “Until we experience a security breach of our own, I’m not going to invest in information security”; “Compliance with Sarbanes Oxley/the Health Insurance Portability and Accountability Act (HIPAA)/the Payment Card Industry Data Security Standards/etc. makes us secure and there is nothing else we need to do.”

When you review these examples of previous statements made by individuals fulfilling roles and responsibilities similar to those you are fulfilling yourself, you will see there is no regard to protecting the core constituencies of their respective companies; i.e., their competitive advantages and reputations. Rather than acknowledging the importance of information security and gaining an understanding of additional best practices they should consider instituting in their respective companies, they focus on questioning the value of information security. Just based on what has been presented to this point in this chapter, can you genuinely justify questioning the value of information security?

Another very common misconception of information security is that it is nothing but another name for an insurance policy. Think about the basis of insurance: insurance is there to protect you should an incident occur. For example, should you or a family member be involved in a car accident, ideally your car insurance is there to cover the expenses associated with car repairs, health care for all individuals involved in the accident, etc. Information security is never instituted solely to enable companies to react to security incidents/breaches; it is instituted to prevent such incidents/breaches from occurring to the fullest extent possible. Plain and simple, information security is not a glorified insurance policy.

Lastly, the extent of information security that should be instituted in your company should be that which is required in order to offset the amount of risk present in the context of your business operations. It has been proven time and time again that the greater the risk, the greater the reward. You may have convinced yourself that your company is among most risk-averse companies in business today. However, does your company conduct any form of business over the Internet? Do your company’s employees send and receive email in support of them performing their job responsibilities?

When you begin to engage in the thought process associated with determining the amount of risk at which your company is currently operating, you need first to understand which of the three pillars of information are most vital to your company. These three pillars are **confidentiality**, **availability**, and **integrity**. Each of these three pillars is explained below:

- **Confidentiality**: This is the most widely known and understood information security pillar. Confidentiality is exactly what you understand it to be: information that is sensitive to your company whose disclosure needs to be tightly controlled. Confidentiality applies to information, which is a very vital information security pillar. Examples of confidential information include personal information (e.g., social security numbers), information pertaining to your company's financial performance, and trade secrets.

- **Availability**: This is the second-most widely known and understood of the three information security pillars. Availability pertains to assurance that your computer systems, network connectivity, internet connectivity, business-related information, etc. is available to all people who rely on these aspects of your business operations. For example, if a company provides web-based payroll services to its customers, this company wants to do everything possible to ensure its web-based payroll services are always operational and available to its customers. Another example is a power generation plant that generates electricity whose computer systems are used to control how much electricity is generated. It is vital for this generation plant to ensure these computer systems are always operational (i.e., available) so that its customers (e.g., residential and commercial customers) may receive the electricity they need to live and conduct business.

- **Integrity**: This is the least known of the three pillars. Integrity pertains to the quality and the completeness of data (i.e., information). The best way to explain integrity is to provide examples. Imagine yourself being the CEO of Salesforce.com.

  Salesforce.com is a company that provides a software solution that enables its customers to manage many aspects of their sales operations and supporting sales activities effectively. As you can imagine, Salesforce.com's software solution is only as good as the data that is maintained in its software. What would be the implications be where data – after accurately entered into Salesforce.com's software solution by a company's sales professional – was somehow subsequently corrupted? This sales professional, and his management team and company executives, rely on this data in very profound ways. Therefore, it is imperative that Salesforce.com operate in such a way to preserve the integrity of the data that is maintained within its software solution.

  Now consider E-Trade, which is a Web-based stock trading software solution. If you are a stock trader/a stock trading "hobbyist," consider the implications if the stock pricing and accompanying historical data were inaccurate/incomplete? Stock traders would be making buying and selling decisions based upon inaccurate/incomplete information, which could result in substantial losses of money. Therefore, the integrity of the data provided by E-Trade is paramount to its ongoing success. Also, as an additional example to further explain the availability information security pillar, E-Trade needs to ensure its data is never outdated; i.e., that the data is updated in real time (i.e., the data is available to its customers at all times, and that the data reflects current stock prices and historical data).

So think about your company. Which of the three information security pillars are most relevant and impactful to your business? As you can imagine, the extent and nature of information security you establish for your company will vary dramatically depending upon the criticality of each information security pillar to your business. For example, the information security mechanisms a company would institute in order to preserve the confidentiality of its sensitive information will be quite different than those that would be implemented in order to ensure the availability of its computer systems.

Lastly, similar to many things in life and in the business world, you can't have everything at the same time. For example, when I was a child in middle school, I consistently got straight "A"s in my classes. However, my conduct grades were terrible. I remember going home to present my report cards to my mother and seeing a furious expression on her face when she saw my horrible conduct grades. So I told my mother, "Mom, you can either have great academic grades and poor conduct grades or great conduct grades and poor academic grades; you can't have both. Which do you want?" I think you can guess which she chose.

Managing the three pillars of information security – confidentiality, integrity and availability – is very similar. While you may be able to attain each of the three pillars to the fullest extent possible, doing so is not practical, cost-effective, and conducive to a positive working environment for employees. What I always suggest is that you strive to achieve an optimal balance among the three pillars, where your emphasis is placed on two of the three pillars. For example, if you lead a software company, you may find it most practical to place your emphasis on the confidentiality and integrity pillars and place a lower priority on availability. This may be practical given that you would not want your intellectual property to be leaked or stolen and you would want the integrity of your products to be as high as possible. In this scenario, it would make sense for availability to be assigned a lower priority.

However, what if your software products were cloud-based products? Availability then becomes a vital concern where perhaps integrity would be assigned a lower priority; however, integrity would still be important to this software company. As you can see from this example, the balancing act among the three information security pillars is not always simple. Achieving that optimal balance requires extensive thought and effective execution. Just make sure you make these strategic decisions at the onset of your formulating/refining your information security game plan.

WHAT IS DATA PRIVACY, AND WHY IS DATA PRIVACY ESSENTIAL FOR EVERY COMPANY?

How many times have you come across articles informing you that the security of customers' personal information was compromised and their personal information was stolen? Has this ever happened to you personally, say with respect to a merchant from which you purchased products? And how many times have you heard about identity theft victims? Odds are in favor of the fact that you know at least one person whose identity was stolen (and that person could be you)!

Each of the scenarios described above pertains to personal information. What is personal information? It is any information that is used to identify you as an individual. Personal information is commonly referred to as personally identifiable information or "PII." For example, a social security number is personal information as it can and frequently is used to specifically identify you. The same is true for your driver's license number and your license plate. Your home address may be used to identify you.

There are varying levels of PII, where there can be personal attributes that may be used to identify you in a more granular way. For example, imagine you are in the doctor's office and you just completed your physical. As the doctor is discussing the results of your physical with you, the doctor correlates aspects of the results of your physical and your current age and weight to individuals who have similar attributes in order to impart an understanding of your risk of having heart disease either if nothing changes or certain aspects of your life style worsen. The doctor performs this correlation by explaining a chart that contains trends associated with heart disease that represents 100,000 patients.

This chart does not contain any PII because none of the 100,000 patients are identified, and none of these patient's identities are in any way correlated to the data contained in the chart. However, now consider the same doctor presenting the same chart containing the same trend information, but this chart has patient's names corresponding with their documented results of their physicals. This now contains and involves PII, where the physical condition of individuals (i.e., personal attributes) are provided in addition to just the patients' names (among the most basic forms of PII). This is an example of a more granular level of PII where not only can you identify the person as an individual by knowing his/her name, you also know, for example, the individual is obese, suffers from a neural disorder, and has a history of seizures.

It goes without saying that all PII needs to be protected sufficiently. This concern is what is known as data privacy. A common question that has been presented to me is, "how exactly is information security related to data privacy?"

How are information security and data privacy related?

This question may be most effectively addressed by posing another question: how can data privacy be achieved in the absence of information security? Think about your personal finances. You want to ensure that your personal finances are sufficiently secured. This is why much of your disposable finances reside in financial institutions or are in the form of stocks. You know that you can withdraw money from your bank account/liquidate your stocks at any time, and while your finances reside in each, you can be rest-assured that they will be very safe.

The relationship between information security and data privacy is very similar to the scenario I just described regarding the safe-keeping of your personal finances. If you want to protect your PII, you need to ensure you apply sufficient information security in order to protect it. Examples may include having your passport and U.S. social security card in a bank safe deposit box when not in use, always having your driver's license on your person, not discussing personal details about yourself or your family in public areas, and placing a privacy screen on your personal laptop when traveling in an aircraft. The key thing to remember is your PII is only as confidential and protected as you make it.

And remember, when you assume a role where it is your responsibility to ensure the privacy of your company's employees, contractors, service vendors and customers, the same mind set needs to be applied as if all of this PII was your own. Following this single principle will help ensure you are effectively fulfilling your role in preserving the confidentiality of every one's PII.

REGULATORY COMPLIANCE VS. INFORMATION SECURITY

Understanding the role of security regulations

Let me begin this topic by emphasizing regulatory compliance never yields sufficient information security for any company in any industry! However, regulatory compliance serves a very important purpose in that it prevents companies from completely ignoring/overlooking information security. In some instances, regulatory compliance helps companies establish effective corporate information security frameworks.

Let me now take a step back. While the importance of information security has been demonstrated and explained in detail in this chapter, it is commonly neglected by business leaders and by companies in general. There are a few prevalent contributing factors to companies neglecting information security. One contributing factor is business leaders/individuals fulfilling prominent roles in companies are of the mindset that their company is not a target or is not susceptible to malicious activity being waged against them. Another contributing factor is information security is not perceived to be as high in priority as other business imperatives that require financial investment in order to nurture business growth and success. The third prevalent contributing factor is information security is considered solely as an operating expense vs. a core business enablement mechanism. For these prevalent reasons and many others, information security is commonly neglected.

This is where regulatory compliance comes into play; it forces companies to invest in information security regardless of whether they are otherwise not inclined to do so. As I stated when I began this topic, pursuing and successfully achieving regulatory compliance does not yield sufficient information security. The reason is that each security regulation that has been established by the U.S. government has been designed to address specific concerns; concerns that represent only a subset of companies' core focus / business operations. To expand on this aspect of security regulations further, overviews of several prevalent security regulations are provided in the following section.

Overview of prevalent security regulations and their limitations

Heath Insurance Portability and Accountability Act (HIPAA)
The Standards for Privacy of Individually Identifiable Health Information ("Privacy Rule") was designed to establish a set of national standards for the protection of certain health information. The U.S. Department of Health and Human Services ("HHS") issued the Privacy Rule to implement the requirement of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"). The Privacy Rule standards were solely developed in order to address the use and disclosure of individuals' health information—called "protected health information"—by organizations subject to the Privacy Rule—called "covered entities"—as well as standards for individuals' privacy rights to understand and control how their health information is used. Within HHS, the Office for Civil Rights ("OCR") has responsibility for implementing and enforcing the Privacy Rule with respect to voluntary compliance activities and civil money penalties.

A major goal of the Privacy Rule is to assure that individuals' health information is properly protected while allowing the flow of health information needed to provide and promote high quality health care and to protect the public's health and safety. The Rule was designed in order to establish a balance that permits vital uses of health information while protecting the privacy of people who seek medical care. The Privacy Rule consists of administrative (e.g., policies and procedures), technical (i.e., use of technology to establish, enforce and maintain required security and privacy protective mechanisms) and physical (e.g., facility security) safeguards that have been designed to protect and maintain the privacy of individuals' health information.

As you may have discerned from the focus of HIPAA, HIPAA was designed solely to protect and maintain the privacy of individuals' health information. HIPAA is not a regulation that was established in order to enable companies to protect all of its interests, which is a practical example that achieving HIPAA compliance will not yield sufficient information security for all companies' complete business concerns. For example, HIPAA does nothing to ensure that proprietary information / trade secrets of a manufacturing company are protected against inappropriate disclosure or theft.

Sarbanes-Oxley (SOX)

The Sarbanes–Oxley Act of 2002 (Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002), also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing

Accountability and Responsibility Act' (in the House) and more commonly called SOX, is a United States federal law that set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It is named after its sponsors, which were U.S. Senator Paul Sarbanes (D-MD) and U.S. Representative Michael G. Oxley (R-OH). As a result of SOX, executive management personnel are now required to individually certify the accuracy (i.e., integrity in the context of the three information security pillars explained at the beginning of this chapter) of financial information. Additionally, penalties for fraudulent financial activity are much more severe than they were prior to the enactment of SOX, and SOX increased the independence of the outside auditors who review the accuracy of corporate financial statements, and increased the oversight role of boards of directors.

SOX was enacted as a reaction to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals cost investors billions of dollars when the share prices of affected companies collapsed and severely compromised public confidence in the US securities markets. As you may have discerned from the focus of SOX, SOX was designed solely to ensure the integrity of financial information reported by public company boards, management and public accounting firms. SOX is not a regulation that was established in order to enable companies to protect all of its interests, which is a practical example that achieving SOX compliance will not yield sufficient information security for all companies' complete business concerns. It could be argued that achieving SOX compliance does nothing to enhance companies' information security posture as it is primarily geared towards providing the public assurance that reported financial information is accurate and representative of the companies' financial performances. For example, while a public accounting may be compliant with SOX, what assurance do they have solely through complying with SOX that a person they hire will not wreak havoc on their company or that a vulnerability present within an internally-developed business application will not be exploited, causing a severe security breach to occur?

Payment Card Industry Data Security Standards (PCI DSS)

PCI security standards are technical and operational requirements set forth by the Payment Card Industry Security Standards Council in order to protect consumers' cardholder data (e.g., their identities and credit card information). The standards globally govern all merchants and organizations that store, process or transmit cardholder data. Recently, new requirements under the Payment Application Data Security Standard for Developers have been established that are geared specifically towards software developers and manufacturers of applications and devices that are used to process credit card transactions. Compliance with the PCI set of standards is mandatory for their respective stakeholders and is enforced by the major payment card brands who established the Council, which include American Express, Discover Financial Services, JCB International, MasterCard Worldwide, and Visa Inc.

The primary objectives of the PCI DSS are to ensure all merchants and organizations that store, process or transmit cardholder data build and maintain a secure network, protect cardholder data, maintain a vulnerability management program, implement strong access control measures, regularly monitor and test networks and maintain an information security policy. As you may have discerned from the focus of the PCI DSS, PCI DSS is not a regulation that was established in order to enable companies to protect all of its interests. For example, while a merchant that processes cardholder data may be compliant with the PCI DSS, what assurance do they have solely through complying with the PCI DSS that a security breach will not occur due to a disgruntled employee or that a virus will not penetrate their IT environment due to insufficient awareness of how to handle email attachments?

North American Electric Reliability Corporation Critical Infrastructure Protection (NERC CIP) Reliability Standards

The NERC CIP Reliability Standards were developed by NERC in response to the Federal Energy Regulatory Commission's (FERC) Order 706. FERC Order 706 was designed in order to enhance the reliability of the U.S.'s bulk electric system (i.e., in layman's terms, the U.S.'s power grid). The NERC CIP Reliability Standards apply only to electric generation and transmission companies, municipalities and cooperatives that contribute in certain ways (e.g., electric generation and / or transmission capacity) to the U.S.'s power grid. Similar to HIPAA, the NERC CIP Reliability Standards consist of various administrative (e.g., policies and procedures), technical (i.e., use of technology to establish, enforce and maintain required security and privacy protective mechanisms) and physical (i.e., facility security) safeguards that have been designed to insulate electric generation and transmission companies, municipalities and cooperatives against diverse threats to information security. At the time this chapter was written, the NERC CIP Reliability Standards were available for download at the following link: http://www.nerc.com/pa/Stand/Pages/CIPStandards.aspx.

As you may have discerned from the focus of the NERC CIP Reliability Standards, the NERC CIP Reliability Standards is not a regulation that was established in order to enable electric utilities to protect all of their interests. For example, electric utilities offer health insurance benefits to its employees, so what are they doing in order to protect its employees' health information? They are protecting their employees' health information by fulfilling their compliance obligations with HIPAA and not by fulfilling their compliance obligations with the NERC CIP Reliability Standards.

Lastly, an interesting distinction between the NERC CIP Reliability Standards and all other security regulations is FERC has required compliance with the NERC CIP Reliability Standards to be enforced by NERC. Therefore, unlike enforcement of other security and data privacy regulations occurring in result of a whistleblower or security breach, FERC requires NERC to subject electric utilities, municipalities and cooperatives to compliance audits. Put differently, companies and organizations subject to the NERC CIP Reliability Standards will assuredly be audited by NERC.

California Senate Bill 1386 (SB1386)

The SB1386 is a California law regulating the privacy of personal information. SB1386 was the first of many U.S. and international security breach notification laws to follow. It was introduced by California State Senator Peace on February 12, 2002, and became operative July 1, 2003. SB1386 requires all companies to notify any resident of California whose personal information was or is reasonably believed to have been inappropriately disclosed to an unauthorized person or third party.

Put differently, SB1386 requires an agency, person, or business that conducts business in California and owns or licenses computerized 'personal information' to disclose any breach of security to any resident whose personal information was at a minimum believed to have been inappropriately disclosed. SB1386 requires various mechanisms and procedures to be employed should inappropriate disclosure of personal information at a minimum be suspected to have occurred. While SB1386 applies specifically to the state of California, as previously mentioned, many U.S. and international security breach notification laws have followed that encompass most of the U.S. and many other countries.

As you may have discerned from the focus of SB1386 and other related breach notification laws, these laws were enacted to address only two scenarios: 1. Personal information known to have been inappropriately disclosed; and 2. Personal information suspected to have been inappropriately disclosed. An interesting distinction between these breach notification laws and all other security and data privacy regulations is these laws have nothing to do with helping companies to enhance their information security posture; these laws focus on mandating certain procedures to be followed after a breach of data privacy has occurred.

PREVALENT INFORMATION SECURITY RESOURCES AT YOUR DISPOSAL

While there are many readily available information security resources, few have endured the test of time to become resources that are proven to effectively guide companies in establishing sufficient information security programs. Three such resources that have become widely recognized as standards that help companies establish very strong information security programs are the International Organization for Standardization information security standards (ISO 27002:2013), Control Objectives for Information and related Technology (COBIT 5), and various National Institute of Standards and Technology (NIST) Special Publications.

International Organization for Standardization Code of Practice for Information Security (ISO 27002:2013)

The ISO 27002:2013 code of practice for information security and its predecessors are among the most widely adopted information security standards/frameworks in the world. ISO 27002:2013 provides a very thorough information security framework that is organized in fourteen categories, which include: Security Policy, Organization of Information Security, Human Resources Security, Asset Management, Access Control, Cryptography, Physical And Environmental Security, Operations security, Communications Security, Information Systems Acquisition, Development, and Maintenance, Supplier Relationships, Information Security Incident management, Information Security Aspects of Business Continuity, and Compliance. At the time this chapter was written, more information regarding the ISO 27002:2013 code of practice for information security was available at the following link: http://www.27000.org/iso-27002.htm.

Control Objectives for Information and related Technology (COBIT 5)

The primary objective of the COBIT 5 framework is to provide a comprehensive controls framework that can assist companies in achieving their goals while delivering value through effective governance and management of their IT operations. The COBIT 5 framework was developed by Information Systems Audit and Control Association (ISACA) and has been adopted by a large number of companies worldwide. While COBIT 5 is a general controls framework that is designed to help companies establish IT governance and management operations, it is a framework that has been proven to effectively help companies establish effective information security programs. ISACA has prepared a resource—a Microsoft PowerPoint presentation—that provides an overview of how COBIT 5 can be applied by companies in order to develop information security programs. At the time this chapter was written, this resource was available at the following link: http://www.isaca.org/COBIT/Documents/COBIT5-and-InfoSec.ppt.

National Institute of Standards and Technology (NIST) Special Publications

NITS was founded in 1901 and is now part of the U.S. Department of Commerce. NIST is one of the U.S.'s oldest physical science laboratories. Congress established NIST in order to remove a major handicap to U.S. industrial competitiveness at the time – a second-rate measurement infrastructure that lagged behind the capabilities of England, Germany, and other economic rivals. NIST has performed extensive research in the field of information security and has published numerous "special publications" that address many information security considerations. One of the most popular and widely adopted NIST special publications focusing on information security is special publication 800-53 – Security and Privacy Controls for Federal Information Systems and Organizations – Revision 4 released in April 2013. At the time this chapter was written, this resource was available at the following link: http://csrc.nist.gov/publications/nistpubs/800-53-rev4/sp800_53_r4_final_word_ver.docx. I encourage you to peruse all of the special publications, both in draft and official release forms, which are available at the following link: http://csrc.nist.gov/publications/PubsSPs.html. Additionally, at the time this chapter was written, a complete directory of draft and official release NIST information security special publications could be downloaded by visiting the following link: http://csrc.nist.gov/publications/NIST_CSD_Publications_20131031.csv.

FOUNDATIONAL AREAS OF CONCENTRATION AND IMPLEMENTATION STRATEGIES

Regardless of which information security standards or resources you decide to leverage for your company, there are key considerations (or as many refer to as 'domains') that should be included in the scope of any corporate information security program.

Risk management (vulnerability assessments, risk assessments)

Many people believe that a company's success is directly proportionate to the company's risk tolerance; the greater the risk tolerance, the greater the reward. Regardless of whether this is an accurate statement, it is not advisable to operate a business amidst unknown risks or without the ability to identify and quantify present risks. Risk management is the practice of establishing and executing a program that enables companies to identify, quantify and manage risks to acceptable levels throughout ongoing operations. Before proceeding further with this topic, it is important to understand what risk is.

There are many complex definitions of risk, but the one I like best in a business context is risk being the potential of losing something of value weighed against the potential to gain something of value. This aligns very well to the adage "no risk, no reward." The risk management process begins with identifying present risks, continues with determining the degree of likelihood risks will result in undesirable outcomes, and results in establishing preventive measures that will maintain perceived risks at levels deemed acceptable by the business.

As was mentioned earlier in this chapter, there are three types of information security safeguards: administrative, technical, and physical. Vulnerability and risk assessments are two types of assessments that can help companies effectively identify risks that are present in their respective business operations. Vulnerability assessments focus on just as you would suspect; their primary objective is to identify vulnerabilities (i.e., weaknesses) that exist. Vulnerability assessments can be oriented towards each of the three types of safeguards.

For example, one very popular type of vulnerability assessment that is technically oriented is a network vulnerability assessment. A network vulnerability assessment is typically executed through using vulnerability scanner products (e.g., Nessus and GFI LanGuard). These vulnerability scanner products have libraries of known vulnerabilities that are frequently updated as new vulnerabilities are identified (i.e., as new vulnerabilities become known). When a network vulnerability assessment is conducted, the vulnerability scanner products are executed in a company's network. While these vulnerability scans are underway, the vulnerability scanner products engage in communications with the computer systems (i.e., workstations and servers) that are interconnected within the network that is being evaluated.

While these communications are occurring, the vulnerability scanner products are evaluating whether each workstation or server that is being evaluated is susceptible to each vulnerability contained in the product's vulnerability library. When the vulnerability scans are completed, the product provides reports that indicate to which vulnerabilities each evaluated server and workstation is susceptible. Just as vulnerability assessments can be applied to networks, they can also be applied to other core constituencies of companies. Examples include physical security vulnerability assessments, wireless network vulnerability assessments, personnel security vulnerability assessments, and application vulnerability assessments. The methods employed vary depending upon the nature of vulnerability assessment that is being conducted.

Another key practice associated with risk management is conducting a risk assessment. Risk assessments are designed to help companies identify and quantify the extent of risks that are present within their operations. There are two prevalent types of risk assessments that may be conducted: qualitative and quantitative. In quantitative risk assessments, the goal is to try to calculate in quantifiable terms objective numeric values for each of the components gathered during the risk assessment and correlating each numeric value with a cost benefit analysis.

For example, the true value of each business asset is estimated in terms of what it would cost to replace it, what it would cost in terms of lost productivity, what it would cost in terms of brand reputation, and other direct and indirect business values. The process requires the user to attempt to use the same objectivity when computing asset exposure, cost of controls, and all of the other values that are identified during the risk management process.

In qualitative risk assessments, the primary objective is not to attempt to assign quantifiable financial values to assets, expected losses, and cost of controls. Qualitative risk assessments are usually conducted through a combination of questionnaires and collaborative workshops involving people from a variety of groups within the company, such as information security experts, information technology experts, business asset owners and users, and executive management. Unlike traditional quantitative risk assessments, qualitative risk assessments results in a much more subjective determination of present risks given the broader community of individuals that contribute towards the qualitative risk assessment process.

Regardless of whether a quantitative or qualitative risk assessment has been performed, identified risks need to be managed. The risk management process can range from being very simple in nature to being extremely complex, and I always suggest applying common sense to the risk management process. Companies should not fall into the trap of unconditionally engaging information security consulting firms to provide risk management consulting services. If you have a high degree of confidence that risks are being effectively managed at acceptable levels, then you may want to consider engaging an information security consulting firm to perform a risk assessment so you may receive an objective evaluation of risks that exist in your business operation.

If you are concerned about risks present in your business operation and you do not feel they are being effectively managed, you should strongly consider engaging an information security consulting firm to potentially validate your concerns and assist your business in managing the risks accordingly. When engaging an information security consulting firm, it is imperative that you do not do anything to influence the outcome of the consulting services the information security consulting firm provides (i.e., you should not engage in any activity that could compromise the objectivity of the firm). Unfortunately, this undesirable scenario occurs more frequently than you would think.

Secure network architecture

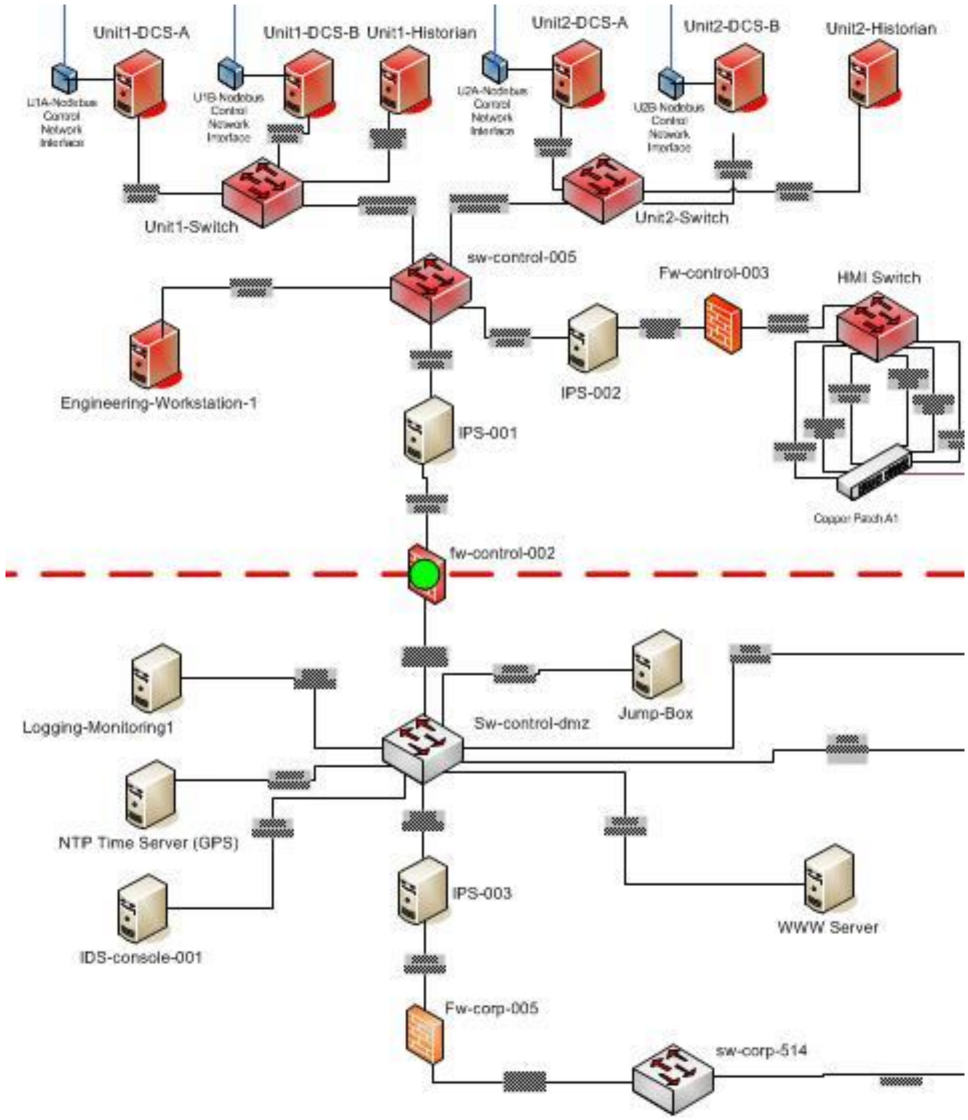
Secure network architecture pertains to the manner in which a company's workstations (e.g., a laptop/desktop computer) and servers are securely interconnected. Workstations and servers are interconnected most commonly through the use of routable protocols (e.g., TCP/IP) and network devices (e.g., switches and routers). When considering network architecture, there is a minimum of two zones of particular interest.

One zone is the internal network. The internal network consists of resources (e.g., email, Intranet site, internal business applications, etc.) that are available (i.e., accessible) only to the workforce and business partners. The other zone is the external environment; you may have heard security personnel/professionals say something to the effect of, "we keep the bad guys out and keep our employees' interests protected." Keeping the "bad guys" out pertains to this second external environment.

The external environment is inherently created once an internal network is established, and the boundary that exists between these two zones is most commonly comprised of firewalls. Since a picture is worth a thousand words, the illustration on the following page is a visual representation of a portion of a network architecture that could be established in a company.

As you can imagine, when establishing a network architecture, sufficient security needs to be implemented and applied accordingly. This is most commonly referred to as "secure network architecture." Whenever workstations and servers are being deployed that will be accessible by a workforce and connected in any way to the Internet, implementing sufficient information security mechanisms is key. Such information security mechanisms may include anti-virus, intrusion detection, intrusion prevention, application whitelisting, firewalls, and network segmentation just to name a few.

The topic of secure network architecture and the considerations that apply are extremely vast. The intent of this portion of the chapter is to help you understand the most basic of principles behind secure network architectures, as well as to receive a visual example of what to expect to see when network architecture diagrams are developed. There is a wealth of information regarding secure network architecture principles on the Internet; however, at your executive level within your business, this typically is not a topic you should expect yourself to be proficient in. That is, this is a great example of a responsibility that should be delegated to personnel in your Information Technology function/department.



Personnel security

Personnel security pertains to the security practices that are employed when recruiting and managing not only a company's employees, but also temporary and part-time employees, contractors, service vendors, etc. That is, personnel security applies to the security practices that are applied when recruiting and working with any individuals—or companies, for this matter—throughout the ongoing operations of a company. One example of a personnel security mechanism is a background check.

As I am sure you are aware, background checks are used to identify whether a prospective employment candidate, for example, has a criminal history. Another example of a personnel security mechanism is a drug test. The specific personnel security mechanisms employed should be dictated by the roles and responsibilities that will be fulfilled by the prospective employment candidate, partnering company, etc. For example, while a drug test may not be applicable to a person who will be an administrative assistant, it may very well be appropriate for an individual seeking to be a driver for a trucking company.

There are many other types of personnel security mechanisms that may be employed by companies in order to enhance their security operations. Some prevalent personnel security mechanisms, i.e., in addition to background and drug checks that have already been mentioned, are described herein.

Corporate security policies

Consider the purpose behind the establishment of state and federal laws in the United States. U.S. citizens cannot be held accountable for their actions unless laws have been previously established and understood and violation of such laws has been definitively proven. Information security is the same way, and the "law" in the context of information security is corporate security policies.

Corporate security policies are typically very succinct statements that prescribe what the business considers acceptable information security (and typically data privacy) practices/behaviors. For example, a corporate security policy may prescribe what is considered by the business as constituting acceptable use of the Internet and email. Another corporate security policy may prescribe at a very high level whether remote access into the internal corporate network is acceptable, and if so, what mechanisms must be used in order to secure such remote access and to confirm the acceptable identity of all accessing parties.

Once established, these corporate security policies need to become the laws within your business. And if these corporate security policies are to become laws, it means that your business must establish an enforcement mechanism to ensure the "laws" are not broken. It is very common for businesses to have disciplinary actions tied to corporate security policies that include potential terminations of employment. One example where an employee could be terminated for violating corporate security policies is if an employee is found to be engaging in the viewing and sharing of pornography on the Internet while using the company's resources.

Security awareness

No business can hold its workforce accountable if its workforce is not aware of the corporate security policies that require compliance. Further, accountability cannot be applied if a sufficient understanding of corporate security policies is not imparted in the workforce. Security awareness is a very prevalent technique that is used in order to impart required awareness and understanding among the workforce.

Security awareness is commonly achieved through posting posters throughout the work environment, posting articles in company's Intranet site (if such a site exists), including articles pertaining to information security in company newsletters, etc. The best way to institute and execute an effective security awareness program is to put yourself in your workforce's shoes and ask questions such as, "as an employee, where should I expect to be able to access and review my employer's corporate security policies?", "what would I need to know in order to feel comfortable that I will be held accountable to my employer's corporate security policies?", "what subject matter needs to be accessible to me so I can completely understand the consequences of my actions should I violate a particular corporate security policy?", etc.

Security training

Security training is much more involved than security awareness. Security awareness is just that: a program designed to make the workforce aware of what is expected of them in regards to information security. Security training consists of a program that is designed to deliver and instill a sufficiently comprehensive understanding of whatever subject matter is to be understood by the audience in question.

One example of what could be a training module is a module that imparts an understanding of how a network administrator is to tactically provision only the access a new-hire requires to the company's systems (e.g., workstations, servers, business applications, the Internet, etc.) when recruited by the company. Another training module could be one that focuses on explaining how the Human Resources function should interact with management as it pertains to the execution and outcome of background checks and how the results of such background checks should be analyzed before provisioning access to the company's computer systems. Every corporate information security program should include a very effective and sufficient information security training program.

Physical/facility security

Physical/facility security focuses on the following: a. keeping employees and other authorized individuals safe while on company property; b. preventing theft of company equipment/assets; and c. preventing unauthorized individuals from gaining access into areas within company property requiring authorized access. There are many physical/facility security mechanisms that you likely see on a daily/weekly basis. Many prevalent physical/facility security mechanisms include security guards, body scanners, badge readers, video surveillance cameras, biometrics, and key locks. There is a plethora of resources at your disposal; many may be accessed by simply entering simple search phrases including mentioning of each of the physical/facility security mechanisms in a prevalent search engine, such as Google.

Secure systems development

This is one aspect of information security that tends to be the weakest in companies. Secure systems development pertains to the security practices that are performed/applied when companies develop applications using their own personnel (i.e., internally-developed applications vs. procured commercially available applications (i.e., software)). When companies develop their own applications (this is not in reference to software companies whose core business is to develop software products (e.g., Microsoft and Oracle)), they tend to be very results-oriented where security tends to be neglected.

Examples of applications typically developed by companies' own personnel are time management applications, expense reimbursement applications, and applications that streamline the delivery of consulting services. While it may not be readily apparent to you why security within a time management application should be a concern, there are potentially many security implications. For example, consider an internally-developed time management application that is accessible by all of the company's employees, contractors, part-time employees, and business partners via the Internet. Also consider the fact that this time management application is hosted on a server that is located within and connected to the company's internal network.

Now consider this time-management application having very little/no security applied to it. What is to prevent someone anywhere in the world from being able to access this time management application via the Internet? And once a person accesses the time management application via the Internet, what is to prevent the person from accessing the company's internal network via the time management application? And once the person accesses the internal network, doesn't this person have a wealth of opportunity to potentially exploit vulnerabilities that exist within the entire internal network?

The basic principle that is commonly overlooked is security considerations are not applied from the onset of the development of internally-developed applications through their completion. Further, security considerations are typically not applied throughout the useful life of internally-developed applications. When embarking upon an application development effort, there are a number of security considerations that need to be applied. Several key security considerations are briefly described in the following sub-sections.

Secure application architecture

The topic of secure network architecture described earlier in this chapter is very closely related to secure application architecture; the difference is secure application architectures apply specifically to applications that have been securely deployed within a company's network environment while secure network architectures apply to the entire network that has been deployed by a company. As you may infer, secure network architectures encompass whatever application architectures may exist in a company's network environment.

When referring to application architectures in their simplest forms, there are commonly four components: a. presentation; b. database, and c. processor. The presentation component is what is responsible for delivering whatever is visible to a person using an application (i.e., the user interface). For example, when you use Microsoft Word, what you see on the screen when you open and use the word processing program is the presentation component. Additionally, when you use an Internet browser to perform a search on the Internet, what you see when the results of the searches you perform comprises the presentation component. The database component is where the data that is processed by the application is stored. For example, a medical practice you may visit when you are sick likely has a database server where your medical records are electronically stored. When you check in or when the physician is using a tablet computer, their ability to retrieve and review your medical history is made possible by extracting your data, which resides in a database server. This is the database component.

The processor component (essentially a name I created myself for the purposes of simplicity) is what is responsible for performing the inter-workings of the application itself. For example, the processor component is what facilitates the interaction that occurs between the presentation and database components of a secure application architecture. When a physician enters your name as the patient in order to retrieve your medical records on a computer, it is the processor component that performs the actions necessary to enable the physician to view your medical records.

Now that all three of the most prevalent components of any application architecture have been explained, it is important to ensure that all components that comprise the application architecture (i.e., the hardware, such as the presentation server (e.g., Web server) and the database server) are sufficiently secured in terms of how they communicate with each other. This is important since you want to ensure that only those individuals who are authorized to access the data that resides within a particular application may do so. To continue the previous example, there is likely staff in a medical practice that should not be able to access patient records (e.g., the receptionist and janitorial staff).

Additionally, you want to ensure the application architecture itself is sufficiently resilient against being accessed by unauthorized people who are in no way affiliated with your company. The manner in which you achieve this is very similar to applying the principles that were discussed in the secure network architecture portion of this chapter. A secure application architecture is a subset of an entire secure network architecture where the same security mechanisms that are implemented across the entire network architecture environment need to be implemented within the application architecture.

Application access control

Succinctly, application access control is no different than the considerations that are addressed a bit later in this chapter in the “Access control and management” section. Application access control within applications ensures that only those users who are authorized to access and use an application are permitted to do so and all other unauthorized individuals are not permitted to access (i.e., use the application). This stated, access control not only focuses on ensuring that only those users who may access an application are able to do so, but it also controls exactly what users are permitted to view and perform once access into an application has been granted.

For example, perhaps a sales professional has been granted access to the Salesforce.com product (i.e., application) within her company. This company’s use of Salesforce.com contains all information regarding its contacts across all other companies with which it conducts any form of business, as well as records of all correspondences (e.g., phone conversations and email correspondences) its entire sales force and other relevant personnel have had with these companies. Now, as it pertains to the aforementioned sales professional, she likely is permitted to create new entries within Salesforce.com in order to establish and maintain her correspondences with new people she meets.

She may also be permitted to generate various sales reports pertaining to her contacts, her general sales activities, and other items of interest specifically related to her sales activities. However, she likely is not granted the same reporting capabilities as the Chief Sales Officer in her company. Additionally, she likely is not capable of viewing everything that is stored and maintained with the Salesforce.com application, whereas the Chief Sales Officer is likely permitted to see any and all data maintained in the Salesforce application. This is an example of application access control where each user is granted specific capabilities (i.e., privileges) once access into the application itself has been granted.

Prevalent application security vulnerabilities

Applications, like many other things, have vulnerabilities; i.e., weaknesses, if exploited, could be very detrimental to the company. For example, when evaluating vulnerabilities that may exist at a home, you quickly converge on any doors and windows. Less obvious vulnerabilities may be the ability to break into a car parked in the driveway that contains an opener that grants easy access into the home's garage and subsequently into the home itself.

Applications are no different. Depending upon how applications are developed (refer to the "Secure systems development" section earlier in this chapter, which addresses key considerations to apply when developing applications), applications may inherently contain vulnerabilities. These vulnerabilities, if not effectively eliminated or protected, could enable malicious individuals to obtain unauthorized access into your applications and either steal or corrupt invaluable information or render the application unusable to your users.

Prevalent application security vulnerabilities you should be aware of and are encouraged to ensure your application development staff/technology partners are cognizant of include cross-site scripting, buffer overflow, SQL injection, operating system command injection, missing authentication, missing authorization, cross-site request forgery, inferior cryptographic algorithms, and uncontrolled format strings. All of these vulnerabilities become present due to inferior development (i.e., coding) of the applications themselves. There are many freely available resources that may be consulted if application developers require guidance on understanding and preventing these vulnerabilities from surfacing in the applications they develop.

Access control and management

Access control applies to two types of access: physical access and systems (e.g., workstations and servers) access. For both types of access, access control is used to ensure that only authorized individuals may access the facilities/systems in question. The core objective of access management is to base physical and systems access on a very prevalent principle, which is the "need to know." That is, access management is the practice of providing each individual (e.g., employee, contractor or service provider) the precise amount of physical and systems access that are necessary to perform assigned responsibilities.

For example, if an employee's responsibility is to receive shipments of goods at a grocery store, that employee likely would not require physical access into the grocery store's offices. Another example is a full-time employed accountant. While the accountant will require access to the internal network, the internal accounting system and other business applications, the accountant does not require access to the human resources application.

Access control for computer systems is performed through the use of software. For example, if you own a laptop/desktop computer, you likely are required to enter your user name and password before you can access the files stored on your laptop / desktop computer. Additionally, once you provide your user name and password, you are afforded certain capabilities (i.e., privileges) while using your computer.

So whether you are using a Mac, Windows, or other type of computer, the capabilities at your disposal once you gain access to your computer vary from individual to individual. This is a very basic example of access control. While this example applies to you as an individual, as you can imagine, access control becomes extremely complicated in the context of organizations that have employees, part-time employees, temporary employees, business partners, service vendors, etc. Deficiencies in access control and access management are key contributors to security breaches that occur on nearly a daily basis.

Access management is typically—and should be—governed by business processes and operating procedures that are commonly tied to software. For example, your company likely has a process it employs in order to provide new hires the access they require in order to be productive in a timely fashion. This process likely begins with the manager hiring the employment candidate indicating the facilities and computer systems access the new-hire will require. The process then likely continues with company personnel reviewing the access requested by the hiring manager, confirming it is appropriate, and then routing the access requests to the IT department.

The IT department reviews the access requests and "builds" and configures the company-issued laptop/desktop computer, configures required user accounts, establishes necessary facilities access (likely in collaboration with corporate security personnel), and performs other activities required in order to provide the new hire the required access. Likely concurrently with the activities performed by the IT department, the human resources department and other departments are performing the activities necessary to on-board the new hire. Examples are having the new hire's information entered into a corporate employee database, making an office/cubicle/workspace available, provisioning a desk phone, etc.

When the business processes and operating procedures have been established over time, it is common practice for larger companies to procure an access management or an identity and access management product to help facilitate and even automate aspects of the otherwise manually-intensive access control and access management activities. These types of products have been commercially available since 2000 and have grown in sophistication and reliability over the years. This stated, the implementation of identity and access management products is not trivial and are commonly extremely expensive.

Systems security

Systems security applies to the security that is applied to a company's infrastructure; i.e., the hardware that comprises a company's systems operations environment. Examples of such hardware and software include, but are not limited to, firewalls, routers, hubs, switches, workstations (i.e., laptop and desktop computers), servers, and network-based video surveillance and recording devices. These systems/infrastructure components, just like anything else, require ongoing security mechanisms to be applied or inherent vulnerabilities may contribute towards security breaches occurring.

The nature of security that needs to be applied varies depending upon the hardware in question. Examples of security mechanisms that need to be applied are provided below for a few of the aforementioned infrastructure components:

- Secure architecture design: in a network environment comprised of routers, switches, hubs, workstations and servers, all of these systems need to be interconnected in a secure fashion. This is necessary so that the internal network (i.e., the systems that are accessible by employees and other authorized users) is insulated from harm that can originate from external sources outside of the internal network environment. A key device that is used to keep the "bad people" out of internal networks is a firewall.

- A firewall in the context of a company network is typically a hardware device (there are software firewalls, too) that can be configured to only allow specific external users and sources of data (i.e., traffic) to enter the internal company network. The same is true as it pertains to internal users and sources of traffic originating from the internal network that is seeking to interact with external systems located outside of the internal network. Firewalls are the most common barrier that insulates internal company networks from external sources. Firewalls typically comprise what is known as the perimeter of internal networks; i.e., the border that separates internal company networks from "the outside world".

- Routers, switches, and hubs are network devices that are used to route traffic from sources to designated recipients. Designated recipients can be database servers, workstations, internal business applications, web servers (i.e., websites), etc. All of the aforementioned infrastructure components, workstations, and servers and network devices need to be interconnected in a secure way so as to safeguard companies from threats that can compromise their competitive advantages, reputations, customer / consumer confidence, viability, etc. Interconnecting all of these in a secure fashion is what is known as a secure architecture design.

- Workstations and servers: The data that traverses internal company networks is able to travel through the use of what are called protocols. And data is able to travel in an organized and structured fashion through the use of ports and services.

- Ports and services are somewhat similar to interstates and automobiles, respectively. To further the analogy, think of ports as being the mechanism that enables travel of data to occur. One type of port is a railroad that enables trains (i.e., services) to travel. Another type of port is a snow-covered mountain that enables skiers to travel. Another type of port is an ocean that enables ships and barges to travel. Just like you need to lock your car, secure trains and potentially staff trains with conductors, wear protective gear and clothing while skiing, and implement security on a ship for protection against harm, and just like you need to maintain interstates in order to keep the roadways safe and secure, maintain railroads to avoid derailments from occurring, the same is true for ports and services. Every workstation and server is configured with ports and services that dictate what is permitted to function on the workstation/server and how it functions.

  Now think of the border between Texas and Mexico. Border control is in place to control who from Mexico enters Texas, and more broadly, the United States, as well as to control who from the United States enters Mexico. Ports and services need to be managed in a similar fashion. Why? The reason is, if you do not manage exactly what is permitted to occur via each port and what services are permitted to be used via each port, you will have no way of knowing what data is expected and appropriate in support of your business operations and what data is malicious and will be very detrimental to the well-being of your infrastructure and IT operations. Therefore, your computer systems and network and infrastructure devices need to be secured accordingly. This is what is known as “hardening,” the process by which one ensures that only those ports and services that are required in support of business operations are used.

These are just two examples of security mechanisms that need to be applied depending upon the hardware / device types in question. There are literally hundreds of security mechanisms that are at your disposal; however, it is vital to balance security with usability and productivity. Too much security will impede upon your workforce’s ability to be sufficiently productive. Remember, as you know, the art of business is achieving and maintaining the optimal balance of risk and reward. You cannot allow information security to stifle productivity as this will also erode the morale of your workforce.

Relationships with external parties

I am sure you have heard the trite expression, "you're only as strong as your weakest link." This is extremely relevant as it pertains to business activities you perform with business partners / external parties. Depending upon the nature of business you conduct with external parties, engaging in such activities in the absence of sufficient security considerations could be very detrimental to the well-being of your company. For example, if your sales force is using Salesforce.com's cloud-based sales management solution, what would happen to your company if Salesforce.com's cloud-based infrastructure was hacked and all of your customer data was stolen? Or what would happen if Salesforce.com's cloud-based infrastructure was infected by a virus causing Salesforce.com to be inaccessible to your company for three business days? These two scenarios could be catastrophic to your business.

Whenever your business considers entering a contract with any external party (e.g., an independent contractor, consulting firm, service provider, software company, etc.), it is important that relevant security considerations are addressed in the contracts that are executed between your company and the external party. The nature of security considerations that should be addressed will depend upon the nature of business that will be conducted with the external party in question. Think of the scenario of engaging an independent contractor. Will you permit the independent contractor to use his own laptop computer that will store and process your sensitive data, or will you require the independent contractor to use a laptop issued by your company so none of your data will be permitted on the independent contractor's laptop?

Contractual information security considerations are among the most commonly overlooked aspect of information security. There are advancements currently underway in various industries where security-conscious procurement language standards are being developed. One such example is the electric utility industry. At the time I was writing this chapter, the Electric Power Research Institute (EPRI) had a project underway to develop procurement guidance to address how to apply information security requirements for new power delivery systems since the improper or incomplete implementation of controls due to lack of proper requirements and/or division of responsibilities between the electric utility and vendors can often result in costly backfit to meet requirements.

The most practical way to address this issue is to require contractually the very information security mechanisms you have instituted within your company to be applied by every external party with which you conduct business. The contracts you establish with external parties should address information security considerations including but not limited to background checks, information security training, information protection (i.e., how your sensitive information is to be handled and protected throughout its useful life), identity and access management, and acceptable use of your internal resources (e.g., your internal network and assets).

Security incident response

Security incident response pertains to the manner in which your company responds after a security incident has occurred. Examples of security incidents include exposure to a virus, malicious activity waged on your company by a disgruntled employee, an individual bearing firearms that is subjecting some of your personnel to potential harm, and a malicious individual gaining unauthorized access into your internal network. When, and not if, these security incidents occur, you do not want to be in a position where you are formulating for the first time a response strategy to the security incident that has occurred. It is for this very reason that a sound and very comprehensive security incident response plan should be established.

MAINTAINING A CORPORATE INFORMATION SECURITY PROGRAM

As intuitive/basic as this principle may seem, many business leaders fail to recognize that information security is not a point-in-time consideration. What I mean is, if one is capable of attaining an optimal level of information security in their company, it should not be considered an indication that the company's information security concerns have been addressed and now resources can be applied to other aspects of the business without maintaining the optimal level of information security that has been acquired.
Reasons for maintaining a desired level of information security are similar to the reasons for maintaining a bridge. In order to maintain a bridge, for example, the Golden Gate Bridge in San Francisco, the bridge is continuously painted. The painting process begins at one end of the bridge, and once the painting process has been applied to its entire length, the painting process begins once again at its starting point. Additionally, this bridge is inspected on a recurring basis in order to confirm its structural integrity is still intact in order to prevent a structural failure causing loss of life from occurring. This means that every key connection comprising the bridge is inspected, along with its concrete piers and other key structural elements of this bridge. The point being, just because the Golden Gate Bridge is supporting all of the cars, trucks, pedestrians, etc. on it today does not mean there cannot be some form of a structural failure tomorrow. Therefore, the Golden Gate Bridge needs to be maintained. Corporate information security programs need to be maintained for the same reason bridges need to be maintained; just because your company has not experienced a security breach today does not mean it will not experience a security breach tomorrow. There are numerous contributing factors that can compromise your information security program over time.

One such contributing factor towards compromising corporate information security is reorganizations causing turnover in personnel. Personnel that were key in establishing a company's information security program may be laid off where their talents and contributions are not effectively preserved following the reorganization. The absence of this core competency over time will yield weaknesses/deficiencies in the information security posture. Additionally, the termination of personnel can cause them to be disgruntled and therefore motivated to inflict harm on your company. If you are not maintaining your corporate information security program, what assurance do you have that your company will be able to withstand an attack waged by a disgruntled former employee?

Another contributing factor towards compromising corporate information security is the ongoing evolution of technology; with new or advancements in technology always comes new vulnerabilities. And if your company is leveraging evolving technologies without researching and remaining cognizant of new vulnerabilities that accompany them and then incorporating required new protective measures into your corporate information security program, how are you insulating your company from new threats that can breach your security?

CLOSING STATEMENTS

Firstly, does this chapter instill all you need to know in order to effectively establish and manage an information security program in your organization? Absolutely not. As is indicated at the beginning of this chapter, the objective of this chapter is to provide you – the business owner/empowered influential executive – foundational insights into what information security is and associated best practices and resources. With this knowledge, you will be equipped with the competency required to contextualize information security best practices into your company and its supporting business operations.

As one size of shoe does not optimally fit all feet, one approach to information security does not fit all companies. As a business owner/executive, it is your responsibility to ensure you have effectively and sufficiently instituted information security mechanisms that make the most sense for your company/organization. This chapter was specifically designed to provide you with the building blocks necessary to help you achieve this vital business objective. You should use the foundational information provided in this chapter to help you ask the right questions, expand your knowledge base and understanding of information security, and apply what you know in order to establish and execute an effective information security program in your organization.

As you may have concluded by now, the relevance of information security to your business should never be questioned; what should be questioned is to what extent does information security need to be implemented for your business. This is a very difficult question to answer as there needs to be an optimal balance between information security and productivity. If you implement an unnecessarily excessive amount of information security, it could stifle productivity and creativity, and could erode the morale of your workforce (e.g., your workforce could perceive instituted information security measures as being excessive and as a demonstration of lack of trust).

Finally, achieving an optimal balance of information security and productivity is extremely difficult; there are many well-known companies today that continue to struggle with this challenge. What benefits you from reading this chapter is you have a foundational understanding of information security at your disposal that you may use in order to either refine, completely revamp, or create an entirely new information security program for your business. As long as you remain practical in such an endeavor, I am sure you will be successful.

Chapter 25 | Do I Really Have to “Do” Accounting?

Charles Chewning Jr. and Judy Thornell

Ask yourself a question. Do you know anything about debits and credits? Chances are you might not know anything about these two words or perhaps have only a limited amount of knowledge about them. At some point in the life of a business there might be a need for an accounting system, and someone is going to have to deal with these pesky debits and credits as well as take ownership of the system.

Accounting and accounting software have become the life-line of a business owner or entrepreneur helping point the way to success with a “numbers tell the story” daily motto.

Business accounting isn’t just about debits and credits, income statements, balance sheets, payroll and tax returns. The real benefit of business accounting software is the potential knowledge gained from the accounting system that can help business owners and entrepreneurs make sound business decisions.

Getting Started in Business

When it is first launched a business may only have one employee; the owner, and the success of the business will be dependent solely upon the owner’s efforts. If the business is small enough, the only accounting related activities might be collecting receipts and maintaining bank deposit records. The firm’s CPA can then take this information and file appropriate tax returns and other regulatory filings. Does the business owner need accounting software at this early stage? Probably not.

As the business grows, the single owner/employee will most likely need an accounting system and someone to help with the accounting activities so the owner can continue to generate revenue.

Cash Management: Profitability does not Equal Cash Flow

All businesses need to manage cash flow. A business needs to deposit more money from revenue than it pays out in expenses and personal earnings. Generating income from the business while reinvesting in the business is a must. Most businesses do not get paid the same day an invoice is issued and it is imperative to constantly review Accounts Receivable and Inventory.

Now the kicker. You will never get this investment in Accounts Receivable and Inventory back unless you close the business. Inventory and Accounts Receivable are assets. While you don’t purchase these assets, they do require cash. As the business grows revenue will increase and cash flow will increase, but only a portion of the revenue will be turned into cash. The rest of the cash will go to increases in Inventory and Accounts Receivable.

Since the business owner needs to be paid at the same time cash is being invested in Accounts Receivable and Inventory it is critical to control spending and get customers to pay as quickly as possible.

Paying expenses is easy. Just write manual checks or pay invoices electronically through a business checking account as long as there is cash flow. Cash flow is the Holy Grail for any business regardless of its size.

What about invoicing? Some entrepreneurs just create invoices in a word processor. You can design a very slick invoice template, fill in the blanks, describe the products or services provided and e-mail the invoice. While creating invoices is easy, getting paid could be a real problem. Think about this for a moment. Until an invoice is paid it is as if the work was never done. This is a worst case scenario. The business could generate revenue, but too much cash is being used to fund increases in Accounts Payable and Inventory. The business then exhausts its cash reserves and must close its doors.

There are several specific steps to take to ensure getting paid as quickly as possible.

- Check the financial health of each new customer to ensure timely payments.
- Confirm that customers understand the company's payment terms (30 days is the norm) and specifically agree to pay received invoices on time.
- Create invoices that are "perfect". This means an easy to read format which allows the customer to find information necessary to approve and pay the invoice (including any necessary documentation). Make certain the correct unit price and product/service description is listed.
- E-mail invoices as soon as a sale is made or a project completed. The sooner the customer gets the invoice, the sooner the invoice is going to be paid.
- It is customary to require retainers or progress payments for large scale jobs.
- Track each invoice until it gets paid. Contact the customer once an invoice is "X" days overdue. Decide when to start the collection process (10 days after the due date might be a good starting point). Help customers change their payment behavior if necessary. When customers know their payment history is being tracked, they will begin to pay sooner in order to avoid that embarrassing collection call.
- Resolve disputes immediately. If a customer challenges an invoice, resolve this dispute as quickly as possible.
- Track the reason each invoice was not paid on time in order to launch appropriate steps to improve payment performance.

A business owner cannot spend 100% of their time selling. Yes, these sales efforts will generate revenue which will then generate a positive cash flow; however, it is necessary to stay on top of cash outflow and other key business health indicators.

Rapid Growth Great – Uncontrollable Growth Bad

While an organization may be prepared for growth, that doesn't mean growth will be achieved automatically. Certainly producing quality products and services and providing superior customer service before and after the sale will go a long way toward making it easier for prospects to invest in the organization. Growth that occurs as a result of business reputation alone will be modest at best. Growth depends on seizing opportunities for growth or growing the opportunities organically. Growth means setting bold targets.

- Growth isn't possible unless the organization and its people are ready to grow.
- Maximum profitability is possible only by combining a dedication to growth, superior customer service and internal efficiency and effectiveness. A business on a growth fast track must create internal business processes that can handle that growth.
- Eliminate any bureaucratic impediments that might hinder the firm’s ability to move quickly and seize opportunities for revenue improvement.
- Help employees dedicate themselves to growth by sharing profits that arise as a result of that growth and their efforts.
- Never sell physical products. Sell the benefits those products will bring to prospects and customers.
- Even though physical products and services might be similar to those of a competitor, create a real difference in the eyes of the customers by listening to their needs and giving them what they want. Identify these unspoken needs and then meet them.
- Look for opportunities to move into developing or niche markets where there is little current competition.

Why Do You Need an Accounting System and When Do You Need It?

New businesses need to adopt some form of accounting if for no other reason than to categorize revenue and expenses for tax purposes. The growth needs of the business will help determine what type of accounting software may be needed. There are several small business accounting products listed later that will adequately serve a firm’s business needs.

A simple small business accounting system may not meet longer term needs if substantial growth is planned during the next five years, a. A simple system may work fine today, yet not be adequate for tomorrow’s business needs. That is why a critical part of the advance planning process should be to define exactly what will be required from an accounting system. Some small business accounting products are designed for specific industries or market segments such as banking, medical, point of sale (POS), real estate, nonprofit etc. In other cases the small business might require advanced functionality typically found in mid-market or higher end software (e.g. customization, database scalability or internet access to name a few). The accounting processes of these hybrid systems may be simple, but one or more advanced features might be needed. It’s a bit of a hunt to find the “right” hybrid system, but it really makes no sense to purchase a powerful (complex) system that is far more expensive.

Accounting systems aren't just for paying bills and invoicing customers. These systems often contain information needed to make sound business decisions, especially in businesses with substantial revenue growth. Most small business owners manage their business using what could be called a "seat of the pants" method. They know everything that is going on simply because they are directly involved in every facet of the business. When issues do develop, the business owner knows exactly what happened and why and will be in a position to react quickly.

As the business grows, the business owner may need to turn over a portion of the sales and management responsibilities to other people. The owner/CEO is still the rainmaker when it comes to generating revenue, but can no longer continue to be solely responsible for the entire business. It is just not possible. That is where an accounting system comes into play.

Accounting systems fulfill two primary roles in virtually any size business. First, the accounting system helps complete required activities efficiently (e.g. enter sales orders, ship merchandise, record, track and bill project transactions, pay bills and pay employees). Second, the accounting system generates reports to help monitor business activities for efficient and effective control.

As the business grows, the owner will need to rely more and more on information generated by the accounting system to keep the business on the best possible growth and profit track. The business owner needs to make sound business decisions and the only way to do so is to utilize information provided in an accounting system. All this sets the stage for the first critical decision regarding accounting functions. What type of product should be purchased and when should it be purchased?

A computer based accounting system may not be needed if the business is launched with but one employee, the owner. Invoicing could be handled via word processor generated invoices. Bills could be paid manually via checks or bank payments. It's simple and the business owner can concentrate almost exclusively on revenue generation.

A manual system is not going to serve the firm's needs effectively as the business grows. There may be too many invoices and too many bills to pay.

Now what? Some form of accounting system is needed, (Cloud or on-premise it really doesn't matter). The question now is which accounting product should be purchased and with what capabilities. Any one of the small business systems listed later in this chapter would be a wise choice; however if the business is going to grow exponentially over the next five years (more revenue, more accounting activities, more employees, certainly many more customers, more products and services, possibly more locations) the complexity of the business is also going to grow. Some, if not all the listed small business products may not be adequate to meet future requirements, particularly information requirements needed for operational decisions and business growth.

Information Systems (a.k.a. Business Reporting)

As the firm expands, it will not be possible to keep track of everything without help. Reliance on the accounting system will become much more important to provide critically required information. That decision should not be left to other people in the firm. The business owner must participate actively in the selection of the new accounting system.
Features and functions help people do the work; information coming out of the accounting system is going to guide the owner to a more profitable future.

From the start, it is important to take control of the business with accurate, relevant information that gives clear financial perspective a small business needs to succeed. With control, there is a better understanding of how much money the company is really making and will provide the correct financial insight to make better decisions about projects, relationships, and business opportunities.

The General Ledger / Chart of Accounts
Any form of accounting system will rely on a Chart of Accounts. The Chart of Accounts defines categories that enable segregation of revenue and expenses into meaningful groupings. While a small business may start with very few reporting requirements, growth will dictate more and more detail. The Chart of Accounts has to grow with the business and that means adding new accounts as the business grows. If there is no room left for expansion, the Chart of Accounts is going to get so squeezed that it will no longer be possible to segregate revenue and expenses into meaningful categories.

Small Business Reporting Options

All small business accounting systems generate reports, in some cases so many reports that's it's virtually impossible to keep up. Start with Revenue reporting. What's the revenue trend? The revenue last month really tells you nothing. Revenue needs to be reviewed (hopefully for the past 12 months) to see the trend line.
Is the revenue trend increasing? Does your actual revenue compare favorably with the budget? It doesn't really matter what is earned this month; what matters is whether the revenue in the next few months (or longer) is going to sustain operations. Today is gone. Concentrate on tomorrow.

In addition to General Ledger financial statements some small business accounting systems support dashboards that display key business information. Some of these systems support the creation of user defined dashboards (sometimes through third party products). These dashboards are interesting, but they may not really provide the needed information.

Information and reports generated by any accounting system (small or large) should give users the ability to "see" at a glance whether some form of action needs to be taken. Row and column reports are a snapshot taken at a single point in time and the business owner cannot make a decision (to investigate the matter in more detail) based on a single value. Similarly bar charts and pie charts that many small business accounting products support suffer the same weakness.

Displaying a single piece of information doesn't really mean anything. As an example if revenue this past month was $50,000, does that really have any meaning? However, if the revenue for each month for the past 12 months was displayed in a graphical format would that provide meaningful information? It's not the absolute value of a single month. It's the trend over the past 12 months that really tells a story. This gives the owner a descriptive picture that instantly tells the story; where the business has been, where it is and where it appears to be headed.

When setting up an accounting system, decide what information is needed to stay on top of operations. This is a time to be ruthless! Ask questions. Does the report provide meaningful information? If it does not help make a decision or take some form of action, then the report is not needed.

Labor is certainly important (people to prepare and ship Inventory as an example). Labor is also important if the business is a manufacturing entity. However, labor dollars do not tell a business anything. Labor cost is generally influenced by revenue activity so the business needs to examine labor as it relates to revenue. Direct labor as a percentage of revenue is a better indicator and it's a value that can be tracked over time in a graphical format. This is the type of information needed.

Similarly a business might want to track AR, but not an AR balance. Once again the AR balance needs to be measured against revenue. This will give the viewer a much clearer picture of how well customers are paying their bills.

Ratios such as these two examples can be used to help people determine needed action. Rather than just budgeting revenue and cost as defined in the General Ledger, take whatever time needed to understand exactly what is important to the firm's financial health.

Most small business accounting systems do not support this type of analysis out-of-the-box; however, in many cases the information can be exported to Excel where it can be displayed in graphical format. Now the viewer can see at a glance whether the information being tracked is trending in the right direction.

Before looking at any small business accounting system, think about what specific information is needed to track key business information (also known as Key Performance Indicators). A small business consultant can help navigate and assist with creating a graphical approach to reporting.

Mid-market Reporting Options

As one might expect, reporting options will be enhanced in a more powerful mid-market accounting system. That does not necessarily mean these products will meet all information requirements; however the potential exists.

Mid-market accounting systems give users the ability to input/specify more information, thus increasing the flexibility on the reporting side. All mid-market accounting systems support dashboards, yet they still suffer from the same issue discussed above. While you are able to create bar charts that display historical information, it may be easier to create line charts that display the same information in a more visually appealing format. For some reason product developers think that row and column reports, bar charts and pie charts are effective business information tools. The General Ledger may give more business reporting options (since the General Ledger's support structures can go to just about any depth needed); however the decision still must be made as to which structure works best. One of the most significant data extraction improvements found in mid-market products is the use of" transaction analysis codes". As an example the Accounts Payable data input screens may contain a significant number of user defined fields.

These fields act somewhat like General Ledger accounts, yet they are not tied directly to the General Ledger, thus reducing the possibility that the Chart of Accounts will get squeezed as the business grows. Actually, it is quite possible to define ten or more user defined fields for each transaction and that might enable people to track as an example the costs for exhibiting at conferences.

Virtually all mid-market accounting systems support some form of data extraction that ties into Excel. Actual export information is not needed since Excel has been enhanced by functionality that reads information automatically contained in the database.

While there are more reporting options, please keep in mind the fact that the business owner still needs to create a system that allows critical "visibility" trends. Once again that leads to the use of graphs to display critical information that can be used to quickly access the firm's financial and operational health.

Plan for the Future, Not the Present

Businesses need to be ready for growth. A business management system cannot be created overnight (employees, business management processes and accounting system to name the top three). Look into the future. Define revenue and business activity goals. Decide how to cope with that revenue. What needs to be done and who should do it? These systems need to be in place or customer service may suffer. Growth will disappear if customers become frustrated.

Budgeting

Now this is going to sound a bit strange. Budgeting is an important exercise, but the instant a budget is created in the accounting system the budget is no longer accurate. There is no way to look into the future and get it correct.

OK so if budgets are instantly out of date (things change each day), why budget in the first place?
The payback is not the budget comparison two months or six months from now. It is the process of planning the firm's future and determining exactly what is needed to achieve that vision.

- What revenue can be generated in the next year and what specifically is needed to achieve that revenue?
- What operating budget needs to be spent on sales and marketing and why?
- What inventory is needed to sell and meet the revenue forecast?
- What new services should be offered?
- Are personnel requirements increasing and what skills do these new hires need to have?
- What are the fixed expenses each month?

Look at the budgeting process as an opportunity to tame the rosy view of all that money to be made. Define what can be achieved, and justify every expense. An expense that does not really help increase revenue, the quality of work or customer service is not needed. Controlling discretionary spending will make it that much easier to hit profit targets. As Peter Drucker said "All one has to do is learn to say 'no' if an activity contributes nothing."

While dollar budgets are instantly out of date, the budgeting process can be used to establish ratios that are not going to change as much. Remember the discussion regarding labor in the reporting section earlier; budget revenue as well as labor costs. These dollar forecasts might change quickly, but the ratio should not change. Labor as a percentage of revenue can then be the budget target.

Customer Relationship Management (CRM)
The business owner wears every single hat when the business is first launched. Remember though, the primary responsibility is going to be sales and nothing else must get in the way.

All companies must "sell" to prospects and existing customers. An integral part of developing an effective sales program is the frequency with which the business contacts each prospect or customer and the effectiveness of the follow up after each contact. CRM (Customer Relationship Management) and contact management software have proven to be one of the most effective means of organizing this cycle of contact and follow up. CRM software helps keep track of each contact, the nature of each conversation, a description of the contact's needs, ranking the contact according to their likelihood of purchase or relative importance, and a whole host of additional information including the scheduling of future contacts.

As discussed earlier bills could be paid manually or invoices generated in a word processor, yet sales activities cannot be organized effectively without using some form of software driven sales management system. A basic contact management system may be all that is needed if the business is going to remain fairly small. However, if the business grows quickly, consider purchasing a Customer Relationship Management (CRM) package. CRM products support many capabilities while contact managers focus on just the sales process. CRM systems tend to be more expensive (and comprehensive/complex) so decide very early on which type of product would best meet the firm's sales requirements.

As we will discuss a little later, the Cloud is one deployment option a business will need to consider. Although a Cloud accounting system may not be required; utilizing a Cloud CRM or contact management system gives people the ability to access contact records from anywhere (home, office or on the road).

Rapid growth may dictate the need to hire additional sales people and since it's very likely these people will be "in the field", a Cloud CRM system or hosted CRM system may be better support for the sales operations. Although CRM software is primarily oriented toward sales support, don't forget the CRM/contact software can be used as a task manager. Rather than just scheduling sales calls, needed tasks can be created (analyze budget figures, research market opportunities, address customer support issues, etc.).

While a business could launch operations using only CRM or contact management tools, it might be better to at least know with which accounting systems the CRM system integrates. This will enable the selection of a CRM system knowing in advance that it will integrate with an appropriate accounting system.

One final thought. CRM systems support the prospecting and sales process, but many do not support mass e-mail marketing. If one of the goals of the marketing strategy is going to be mass e-mail campaigns, consider or at least determine if the CRM or contact management systems will integrate with mass e-mail applications.

Customer Service

Customer service (a.k.a. customer satisfaction) leads to customer interest which then leads to customer orders.

If the needs of a firm's prospects are satisfied, they will become customers and that will lead to revenue improvement. Satisfying the needs of existing customers, will ensure continued purchase and loyalty thus sustaining revenues. Finally, the firm must be able to operate efficiently so that the revenues being generated are greater than the costs of doing business.

In the end, business success depends entirely on customer satisfaction. Customer satisfaction in not just customer service as it relates to a one-on-one connection with each customer or how customers are treated on the phone. It also includes issues such as quality, price, product availability, product offerings, shipping and anything else that directly impacts customer satisfaction. Even revenue improvement and cost reductions are related to customer satisfaction.

Revenue cannot be increased unless customers are happy with what a firm offers. Operating costs cannot be reduced if reductions have a negative impact on customer service and customer satisfaction. Everything that goes on in a company has a link to customer service and customer satisfaction, and that is the first lesson in best business practices that needs to be learned. The business owner must know this as self-evident. Adopt this principle and the firm will do well.

How does customer service relate to accounting software? Actually customer service starts with prospects and the firm's CRM or contact management system. That is where people first make the firm's acquaintance. Once a connection has been established with a prospect, schedule a follow up contact and use the call scheduling application to call a prospect back when promised. If they request information, add a note to the call back record to list exactly what this prospect wants.

Once a prospect becomes a customer, use the functions in the accounting system to take their order, schedule a service date or launch a project. Use these functions in the accounting system to provide the level of customer service that will ensure the work performed is of the highest level of quality and promptness. At this point the customer now resides in the CRM system as well as the accounting system and that is why the two should be integrated tightly.

Customer service is the key to a firm's success and that is why all people in the firm need to be invested in customer service. Landing a new customer is an important step, but if people don't provide what has been promised, this customer will leave just as quickly as they came. The information presented here regarding customer service is but a very small piece of the puzzle. Learn as much as possible. One of the articles on our web site might provide more information regarding customer service and revenue generation.

Let's close this section with some brief thoughts regarding customer service.

- While a firm can set the stage by defining what a customer is to them, customer service delivers the message. It is only through deeds that a customer will really understand how important they are to a business.
- Customer service is not just associated with generating new business. The ultimate objective of customer service should be focused on repeat business. That is where real long term profits will be generated. It takes a significant investment in direct and indirect costs to land a new customer.
- Customer service is all about friends helping each other.
- The objective of any customer service initiative is to keep customers for life by treating them as if that's your intention.
- Employees will be willing to add more value to your customers if they feel valued themselves.

- The key to superior customer service is serving people in the same manner each individual person would like to be served regardless of whether the person being served is internal or external.
- Communicate with prospects and customers via a means that is preferred by them, not by the firm.
- Ask each day "How can we better serve our customers?"
- Customer service begins with a commitment to each customer as an individual entity. The firm's objective is to serve that single person at that moment in time to the best of every employee's ability.
- Customer service isn't about meeting basic or minimal levels of customer expectations or about satisfying all of a customer's needs. Customer service is all about delighting customers by giving them something that wasn't expected or required.
- Excellence in customer service isn't possible if reducing the cost of serving customers is viewed as a means to increased profitability.
- Customers are more than just a source of revenue. They are full business partners and should be treated with the same respect and dignity afforded to each of a firm's employees.
- Every person in any business enterprise has customers. Some may be paying customers while many others are workmates. Ultimately, every person in an enterprise works for those people who purchase the firm's products and services. A person's employer isn't the person who signs the paycheck. It's the person who pays the company for its goods and services. Treat this ultimate employer with the respect they are due.

Selecting Accounting Software: The Process

Should a firm need a new accounting system (or people decide to purchase their first accounting system), don't go out and purchase a system the next day. Take whatever time is required to assess the firm's options. One of the accounting products listed in the next section might be the best alternative. However if the firm is growing exponentially, the firm's needs might exceed rapidly the capabilities of all of these products almost immediately.

Think about the firm's goals and business needs a year or two from now. Does it make sense to install a new and more powerful system in such a short period of time? Maybe that is not an issue. Maybe a product could be purchased that will grow with the firm. Some product vendors offer upgrade paths that will enable firms to start with a small business product and then upgrade to a much more powerful system in the future.
Be proactive by purchasing a new accounting system before it is absolutely needed. The new system might be underutilized in the short term, but its functionality and reporting systems will be ready "just in time" to meet the firms expanding requirements.

Customer Relationship Management (CRM)

As indicated earlier CRM or contact management is an application the entrepreneur or small business owner should utilize from the get-go. Generating revenue is the owner's primary responsibility and those efforts are going to be hampered without the use of a contact manager or CRM system. Ideally the CRM or contact management system should integrate with one of the small business accounting systems listed in the next section; however that may not be possible. The business might need a feature rich CRM system, yet that system may not integrate with any small business accounting system. Since it is better to have a single system with a common database of customers and prospects, it may be necessary to look at higher end accounting or ERP systems that integrate the CRM system the firm wants to use.

Selecting a Small Business Accounting System

All products mentioned in the following section have been well received in the market. In short they work; however do they offer the capabilities a firm needs? Rather than immediately looking at products, spend some time defining what's most important to everyone in the firm.
If the firm is going to primarily sell products, the accounting system must support strong Inventory control functions and equally strong Order Entry capabilities. That's fine, but the requirements list (or requirements document) may need to be a bit more specific.

- Which type of product is going to be sold?
- Will sales be made in a retail environment where a POS (Point of Sale) software and hardware will be required?
- Is the firm going to offer any form of service management with the products being sold (e.g. the firm sells generators and also services them after the sale)?
- Do these products need to be categorized?
- Do these products require three identifiers (type, size and color as an example)?
- Does the system need to support serialized Inventory or lot control?
- Will merchandise be sold via a web site?
- Does the web site need to accept credit card payments as well as create automatic sales orders?
- Will shipment take place from multiple warehouses now or in the future?
- Will some or all orders be drop shipped; (meaning that in some/all cases merchandise is not inventoried, but ordered from the vendor or a wholesaler)?
- Will there be different prices for different customers?
- Do some customers require special handling of their orders and do these instructions need to be given to the shipping department?
- Is integration with shipping systems (UPS, FedEx, etc.) needed?
- Is order tracking needed? How will tracking and replenishment of Inventory items be handled?

This is a representative sample of the type questions that need to be asked of product vendors if the firm is going to selling products.

Strong job and project capabilities need to be in place when selling services. Some of the questions below might be appropriate.

- Does the firm primarily offer services such as job and project management (e.g. construction), service management (field service) or professional services (primarily time based?
- When a job is created in the accounting system, to what extent is a description required to describe the nature of the job and the work to be done?
- What type of information needs to be collected in support of subsequent project billing (hours worked, description of work performed or type of labor provided?
- How do customers want to be billed?
- Is billing going to take place only when a job is complete or will some form of progress billing be required?
- Is the firm going to provide services to government entities that require specialized billing formats?
- Is billing going to be based on time and materials?
- What information is required to bill each job (labor, materials, subcontractors, overhead, etc.)?
- Can different billing rates for different customers or different jobs be defined?
- What information do customers require on their invoices?
- Does the firm need job budget capability??

Again this is but a sample of the questions that could be asked if the firm requires some form of job and project control.

People should not just go out and purchase any small business accounting system. The accounting system must support the manner by which the firm decides to manage its affairs. That is why it is necessary to spend time defining precisely what is required in terms of capabilities, functionality and information management. Finding a product that “does” what the business requires is the first software selection step. The second step is finding a product that gives the business owner or managers information needed to monitor the firm’s health. Do not look for detailed information that might be found in a more comprehensive (higher priced) products.

Income statements are nice, but are they really going to give managers any useful information?
Does the firm need to set up budgets to track revenue? As a newly launched small business the primary objective is to stay in business, particularly during the critical first year. If the firm does not hit its revenue targets, it is going to be hard to hit the profit expectations.

The owner or manager should also track what is being spent on anything that is not contributing to revenue generation. As discussed previously cash control is going to be critical to a firm’s success. The business owner may not be able to get detailed information from the accounting system, but at a minimum the accounting system should generate reports that isolate where the firm’s cash is going.

- How much is the firm spending on office equipment, office supplies and other overhead expenses?

- How much is being invested in Inventory? Is it too high? The one thing that needs to be watched closely is buying Inventory that's going to take too long to sell. Conversely are Inventory levels too low? In this case inventory for customer orders may have to be back ordered and that's never a good situation.
- How much is being invested in Accounts Receivable? Typical payment terms are Net 30 Days. If receivables are running at 60 days (AR balance / monthly revenue x 30), then action needs to be taken. Some accounting and ERP systems Accounting and ERP systems have the ability to give the user a form of a highly specialized contact manager to help control receivables, while small business accounting systems provide an ageing report and other collection functionality to encourage customers to pay earlier. This is a critical business activity.

The key here is to stay on top of all revenue generating activities while controlling cash (outflow and inflow).

There are several final purchase considerations.

- If the firm operates in a specific industry niche, look for a product that supports this industry. Some small business accounting systems offer some support for various industries. A few of these products actually offer industry specific functionality, usually through a third party application. If industry specific functionality (e.g. manufacturing) is required, make that one of your key purchase decision drivers.
- Purchase a small business accounting system that people in the firm like. It doesn't make much sense to buy a product's capabilities, but end up fighting the system every day.
- Look for a software solution that has convenient support options (procedural support, technical support, product upgrades, training, and more. In addition many small business systems are supported by resellers who can provide direct support as required.
- Find a solution that quickly checks for accounting errors using an internal accounting review. This type of feature will help identify common accounting mistakes as well as suspicious transactions. Some software will even provide advice on correction transactions.
- The firm may have to comply with various industry regulations and government reporting standards. Please make sure these governmental regulations are identified. If a product cannot meet these requirements, ask the vendor or reseller if reports can be created to serve this need. If the product cannot meet these requirements, find a product that does.
- No small business can afford to lose money because of accounting errors or fraud. Look for software with module- and screen-level security and audit trails In addition purchase a product that tracks data entry, or edits by user.

Embezzlement

Although everyone wants to assume that the person keeping the accounting books is honest, the first priority must be protecting the firm's cash. No cash = No business. If the owner of a small business is too distracted building the business, it's all too easy for the bookkeeper or accountant to steal from you.

The easiest way to steal money is creating fictitious payables invoices. The check is written to either the bookkeeper or to the fictitious company. The fictitious company is really the bookkeeper. If the bookkeeper is given the ability to enter payables invoices, generate checks, sign those checks and then do the bank reconciliation, the owner may never know there's a problem until there's no cash left and your bookkeeper has left the company.

Most embezzlers are caught eventually, but there may be no cash to be recovered and the owner may have no choice except to fold the business.

The owner should also have a relationship with a CPA firm and work together to prevent fraud or embezzlement In addition, the business owner should be the only person who has the authority to approve invoices and sign checks. There are other steps that can be taken and the business owner should meet with the firm's CPA to create the required internal controls.

Selecting a Cloud Accounting System

How can the Cloud benefit a small business firm? These days businesses can do just about anything they want to do in the Cloud. The more realistic answer is that the business owner has to decide what makes good business sense.

As a small business purchasing an accounting software system for the first time, a Cloud solution eliminates all implementation headaches; just sign up and then set up the accounting system. The only thing that is needed is a high-speed Internet connection.

Some of the products listed in the following section do not offer a full range of accounting functions and the business owner (or bookkeeper) needs to make sure the product selected will meet all of the firm's needs today as well as in the future (3 – 5 years).

As the firm grows and possibly upgrades to a more powerful accounting or ERP system, the cost of a Cloud system may prove to be higher than first imagined. It is like leasing a new car. The firm avoids having to purchase a new accounting system; yet never owns the accounting system. The firm just keeps on paying the monthly subscription fee. In the long run, subscription fees may exceed what the firm might pay for the more traditional on-premise accounting system.

Selecting a Mid-Market Accounting/ERP System

Although this article is really aimed at small business firms, one critical issue needs to be addressed. What happens if the firm's revenue grows to $10 million or more in three years? Is a small business accounting system going to be able to deal with the sheer volume of transactions? Is the system going to give the firm the functionality needed to compete effectively? Finally, is the small business accounting system able to give the owner and managers the detailed information required to understand what is happening in the business or enable them to make sound management decisions?

If the firm's business plan is based on explosive growth in a short period of time, it may be better to bite the bullet now and start with an accounting system that meets these future competitive requirements. It is really up to the owner to decide what is in the best interest of the business.
There are a number of articles on our web site that will assist in decision making if more detail is required regarding the selection of accounting systems,. The software selection tips listed below can apply when searching for a small business accounting system.

- Ask the critical question. Ignorance is one of the primary causes of failure when selecting accounting and ERP software. If the business owner or bookkeeper does not fully understand how to effectively organize and manage the selection process, find someone who can lead the firm through it.
- Acquire the knowledge required. Before anything is done, step back for a moment. Invest some time researching the market. Use the Internet to identify likely products. Speak with product professionals (usually resellers). Learn more about what these products can do (functionality and reporting options) and what capabilities might be of interest. Speak with product resellers about how this software selection project should be organized and managed.
- Define the firm's objectives. What is the firm or firm's owner trying to do? Is the firm moving into new markets? Does the owner or bookkeeper have current issues that need to be addressed (lack of specific capabilities, cash flow management, inadequate reporting, or anything else that needs to be improved?
- Organize the project. Selecting accounting/ERP software can be a tedious and sometimes frustrating process. The primary objective for the project is to make sure everything gets done and in the correct sequence. People have to be assigned specific responsibilities and each activity has to be completed effectively and on time. Without a detailed map that everyone can follow, it is likely the project will fail to achieve its objectives.
- Acquire buy in from all participants. If the firm is larger, anyone who is going to have a relationship with the accounting/ERP system (critical stakeholders) must be involved in the project and must support it 100%.
- Justify the decision. Accounting software or any other capital equipment should never be purchased until the project's ROI is analyzed. What monetary improvement can be expected and what is the cost to achieve this improvement?
- Organize the firm for success. Regardless of whether the firm is a small or large business it needs to be organized for success particularly if the firm is in the process of selecting software. If the firm is purchasing accounting software to meet its requirements in the future (2 – 3 years), the requirements specified have to be based on what the firm is going to become, not what it is today.

- Define functional requirements in detail. The accounting/ERP system needs to provide the user with required functional capabilities. Start by defining the most critical requirements. Then fill in the blanks to refine the firm's requirements in even more detail. These requirements will then be used to compare against each product under consideration. Do not define requirements simply because one or more products support that capability. Don't be a clone.
- Define reporting requirements in detail. The accounting/ERP system must carry out specific required tasks. Of equal or greater importance, the system has to give people the information they need to make sound business decisions. Spend whatever time is required defining exactly what information people need and how it should be displayed. If the firm is large, it needs to move away from row and column oriented reports and utilize performance metrics to monitor and control the firm's key business drivers.
- Identify best suited products. Once the requirements have been defined in detail, use this information to eliminate products that do not meet these requirements. The objective of this exercise is not really to identify products that might be purchased: rather products that are not of the same quality and capabilities as other products. If the requirements document is somewhat complex, it might make sense to utilize software selection tools that will support the entire needs definition / needs analysis process. The Accounting Library is one such product and it increases the efficiency and accuracy of this process.
- Touch each product. Once a list of candidate products (3 – 5 is a good number) have been narrowed down, the business owner and chief accountant need to meet with resellers of these products and evaluate product demos. Actually this is a two-step process. First, review a demonstration of the software that meets the firm's most important requirements. Second, evaluate the most significant business functions (e.g. evaluate each step in the sales order to ship process). While a product may "do" what is required, the way a product completes an activity may not meet expectations. One key\ to successful software selection is finding a product that people actually "like" to use.
- Evaluate reporting system. As we have mentioned before, one key to a firm's business success is to know what is going on. Spend as much time as practical evaluating each product's information management capabilities. Does the product give people the ability to track and display critically required information? Actually there are four questions that need to be asked. Does the product help the firm understand where it has been? Does the product help the firm understand where it's going? Does the product help the firm determine where it should be going? How can the accounting and information management system help people make sound business decisions?
- Evaluate reseller. A mutually beneficial business relationship should be formed with the product reseller. The vendor may provide the product; however, it is the reseller that can assist with installation, implementation and training to help the business and its employees to utilize the product to manage for success.
- Make a purchase decision. There is no right answer when it comes to accounting software selection. If the firm is extremely lucky, one product will have moved to the forefront and impressed everyone throughout the organization. Even if that product may not be the top candidate from a strictly unbiased functional point of view, the fact that everyone likes the product and feels comfortable with it and with

the reseller with whom the firm will be working indicates this product is the best one in this unique situation.

Selecting a Small Business Accounting System: The Products

As we discussed earlier, this e-book is dedicated to entrepreneurs and small businesses. While the firm might grow to the point where it needs a more powerful accounting or ERP system, the business owner needs to start from the beginning. The products listed below serve the needs of firms in this small business space and the products have developed a following in the market. Review these products and determine which one best suits the firm's functional requirements as well as the capabilities of people who will use the system.
Although we have suggested you might need to upgrade from a small business accounting system to an ERP system at some point in the future, this may not be necessary. Many small business accounting products offer advanced functionality. In addition some of these products may integrate with third party applications that offer advanced functionality or industry specific functionality. Finally many of these small business products are adding new functionality constantly. The net effect is that it might not be necessary to change accounting systems.

If the business owner decides that the firm really needs a more powerful mid-market accounting or ERP system, consider using a software selection tool such as The Accounting Software Library to help define the firm's requirements and evaluate a whole host of products.

QuickBooks Pro 2013 is an excellent desktop accounting system that supports up to three users.
QuickBooks Premier 2013 supports up to five users and also has versions that support the needs of firms in manufacturing/distribution, contracting, not-for-profit, professional services and retail. QuickBooks Premier 2013 also supports more Inventory items than QuickBooks Pro.

QuickBooks Enterprise Solutions supports up to 30 users and offers enhanced Inventory, field service management, payment solutions, payroll and industry specific features. QuickBooks Enterprise Solutions also integrates with a large number of third party products that add even more functionality and/or offer industry specific functionality (e.g. manufacturing).

QuickBooks Enterprise Solutions + Hosting Service offers all of the functionality of the desktop version while providing anytime/anywhere access via a Cloud hosted edition.

QuickBooks Online offers three different Cloud versions for small business.

Sage 50 Pro Accounting 2014 is a single user system that offers excellent accounting functionality for small businesses.

Sage 50 Complete Accounting 2014 supports up to five users and all of the features found in Sage 50 Pro Accounting 2014. It also offers additional support for a Customer Management Center, a Vendor Management Center, fixed assets, integration with UPS, an Inventory and Service Management Center, advanced job costing, Sage 50 Intelligence Reporting, streamlined service billing and sync with Outlook contacts.

Sage 50 Premium Accounting 2014 supports up to five users and all of the features found in Sage 50 Complete Accounting 2014. It also offers additional support for advanced budgeting, change order processing, a Company Consolidation Wizard, Crystal Reports 2008, departmental financial statements and serialized Inventory.

Sage 50 Quantum Accounting 2014 supports up to 40 users and all of the features of Sage 50 Premium Accounting 2014. It also offers support for Interactive Job Reporting, interactive job reporting, a Job and Project Management Center, dashboards, customer order processing workflow, role based security and industry specific functionality for construction, manufacturing and distribution.

Denali Business Accounting from Cougar Mountain Software supports three different product variations (Basecamp, Ascent and Summit) depending on the functionality you require. In addition Denali Business Accounting supports a turnkey POS system, the Not-for-Profit industry and a Cloud deployment option.
Xero is a Cloud accounting system that contains features such as an automatic link to your bank to import deposits and payments and transform them into accounting transactions. Xero also supports contacts, invoicing, payroll, bill payment, fixed asset depreciation schedules, a user dashboard and multi-currency transactions. Pricing for Xero starts at $19 per month. Mobile apps for Apple, Android and Blackberry are available. Third-party add-ons can expand Xero functionality by incorporating CRM, Inventory management, invoicing, job systems and other specialized business tasks.

Installing Accounting Systems

Installing a small business accounting system is relatively easy. The “critical” process is defining how the system is going to work. If the firm invests in a Cloud solution the system has already been installed; however, all the variables still need to be defined. If a mid-market or ERP system has been selected, the implementation process is much more involved and time consuming.

Rather than going into great detail, let us review briefly some of the most important implementation processes.

- Commit to the project 100%. If a new accounting system is going to be purchased, everyone involved needs to make the time to see this through.
- Understand in advance what is required. Review each set up tables that needs to be completed. Review each of the selections regarding the accounting system. Understand what fields need to be specified in Accounts Payable, Accounts Receivable, Inventory, etc. Understand how the General Ledger will be structured. A specifications document should be created and double checked for accuracy. The specifications document should be utilized for inputting initial data into the system.

- Define Reporting System. The key to any accounting system is the information it is going to give people so they can make sound business decisions. Spend whatever time is needed to understand what is possible in terms of business reporting.
- Train, Then Train Some More. It really does not make any difference whether the firm purchases a small business accounting product or a more comprehensive system, everyone involved must know how to use the system before starting to process information. People could do this in advance by following a product demo. Alternately a product expert (reseller) could be brought in to train everyone who is going to use the system. Finally a separate demo company could be set up within the accounting system and the firm's specific variables (including customers, vendors, inventory items, etc.) could be used for training purposes.
- Review System Set Up. Once the variables have been specified and all customer, vendor, and other information input, review everything to ensure the setup is correct.

The Annual Business Checkup

When a new accounting system has been installed, its performance will deteriorate over time. That is a guarantee. The business itself might change. The firm might move into new markets. The need for more detailed reports might increase. The product may have some/many bugs and they have not been addressed immediately. Finally data entry oriented employees may develop bad work habits or the firm might hire people who are not that familiar with the system.

All of these things can and do happen. Rather than just letting system performance deteriorate, adopt a proactive approach. Review the accounting system at least once each year. This is similar to going to the doctor for an annual checkup (hence the name of this concept). Everything might be fine, yet the owner or chief accountant needs to take steps to ensure the system will continue to serve the firm effectively.
Take some time to critique the current system. Make sure people are using it effectively and are properly trained. Analyze the reporting system and improve as required. Look at third party add-in products that enhance the system's functionality.

The key concept here is that people are taking positive steps to analyze and improve the entire system (business as well as employees) on a regular basis.

Become a Learning Fanatic

If a firm is going to be truly successful, adopt education as a key activity. Having a great idea will carry the firm only so far. The minute the firm creates a competitive advantage that attracts new customers; the firm's competition will meet this challenge.

Understand how to run a small business. If the long term objective is becoming a large business, then learn how to run a large business. There are hundreds of learning opportunities, particularly e-learning. Many of the accounting systems listed offer online training; resellers of these products also offer training. Skillshare and Udemy are two great eLearning programs, but there is a wealth of others available for newbie entrepreneurs, and some are absolutely free. As an entrepreneur, the courses recommended by Inc. magazine are viable options. Success Academy is a solid learning platform for entrepreneurs. They are more about conveying the real advice that has led to many of their facilitators' successes."

Learn what is going on in the market space. Identify opportunities before the competition does.
Make sure employees have the same passion for learning. Share the firm's success with employees and ask for their knowledge as well as their time.

Design a Web Site That Attracts Prospects, Not Sends Them Away
How often do people browse the Internet? How often do they land on sites where the web page design instantly turns them off? How quickly do these visitors go to another web site?

People want answers instantly and they don't want to read 500 words to get to the point. A firm's web site is the portal through which prospects travel to make the firm's acquaintance. Visitors to a website will leave in a few seconds if they are not able to quickly navigate to "how can this help me?" It is not really what products are sold or services provided. It is what the firm and its employees can do for this individual visitor. If this question is not answered immediately on a firm's Home Page, it really does not make any difference what accounting system or ERP system or CRM system the firm uses.

Conclusion

There is no magic answer when it comes to launching a small business and driving it to a point where its future is on solid ground. There is no right way to utilize software to maximum advantage. The business owner and every employee should do their very best and constantly seek improvement for themselves and the firm.

- Business owners need to find and target prospects, turning them into loyal customers and this is a repetitive process.
- Success in business is not dependent upon which accounting product is used. It is dependent upon the people who use that product.
- Information systems do not make decisions: people do! Give people the structure, incentives, tools, processes and data, and let them make the right decisions at the right time.
- The most powerful accounting or ERP system will have little or no effect if it is the wrong system for the organization and its employees.
- If a company is not organized for success, the most powerful accounting or ERP system will have little or no effect on the bottom line.

Chapter 26 | Digital Marketing Strategy

Cate Conroy

Digital Marketing is a growing industry that touches just about every part of a business. In this chapter, we'll take a brief look at a few particular areas of marketing as they relate to the Internet and our expanding digital world.

Keep in mind each of these sections could be a book in and of themselves and this is meant only to be an introduction.

Understanding Your Audience

When it comes to marketing, understanding your audience is the foundation on which your marketing strategy is built. If you don't understand your audience, you won't be able to communicate with them effectively, and ultimately you won't be able to turn them into a customer.

Market Research

Getting to know your audience can be a daunting task. That is where market research comes into play. Market research is the act of gathering data about consumers including who they are and what they need.

By doing market research on your target audience you will be able to better understand your audience and how your organization fits into their world.

To properly gather market research you need to follow these five steps.

1. Outline research objectives
2. Select a research design & methods
3. Identify information types and sources
4. Collect and analyze data
5. Formulate findings

As with anything in marketing, first and foremost you have to outline your objectives. What are you trying to achieve? What is your goal? Based on this you can select the "how" of your research – what is the design of the study and what methods will you use to follow that design?

Next you identify the information types and sources, collect and analyze your data and then based on this analysis, you formulate findings.

Market Research Designs

There are a few basic types of market research designs:

- Exploratory research
- Descriptive research
- Quantitative research
- Causal research

Exploratory research is collecting information in an informal and unstructured way. For example, if I run a store and I shopped at my competitor's stores to see how they laid out the merchandise and what kinds of sales they ran that would be exploratory research.

Descriptive research is research that is used to describe marketing variables. This is the kind of research you would do when trying to answer the *who*, *what*, *when*, *where* and *why* questions of your marketing.

Quantitative research is focused on assigning numerical values to market parameters. This includes things like measuring the market size, market shares and buyer sentiment.

Finally, causal research focuses on working to determine factors that are causing certain reactions. For example, if two items are the exact same product, what factors cause us to choose one instead of the other? Causal research is incredibly in-depth because proving causation can takes a significant amount of time and repeated testing to establish. Because of that, this tends to be the most expensive type of market research.

Market Research Methods

Now that you know what design you want the research to take, how will you actually gather data? You have to look at how you will gather the primary data, or the data that you are gathering for a specific purpose, and the secondary data, the data that already exists that you are simply applying to your question.

- Primary Data
  - Survey
  - Focus group
  - Personal interviews
  - Observation
  - Experimentation/field trials

- Secondary Data

When it comes to primary data there are lots of different ways to gather info.

You can do a survey, you can hold a focus group to ask people questions, or you can host one-on-one personal interviews.

The challenge with these research methods is that people often alter their answers or behavior when others are involved. That is why observation can be a great way to get a more accurate picture of a person's habits or behavior.

Finally experiments and field trials involve placing products in real-life settings and measuring the data you get. Did people buy the product? If they did, what did they think?

Creating Audience Personas

Let's say we went through all of this work to gather data, analyze it and formulate findings. Now what do we do with these findings? One common way to apply these findings is through a target audience persona.

Personas are a made-up character created to represent your customer or user.

Personas help you outline and understand your audience. The information included in a persona includes things like *demographic* data, *psychographic* data and *socialgraphic* data.

Demographics are quantifiable statistics about a given population.

- Demographics:
  - Gender
  - Age
  - Location (general or specific i.e. Chicago or "suburban area")
  - Ethnicity
  - Employment status (household income)

Psychographics focus on personality traits and lifestyle of the group. What do they value? What are their interests?

- Psychographics:
  - Personality
  - Interests
  - Values
  - Attitude
  - Lifestyle

Socialgraphics are a relatively new concept. They focus on an individual's online behavior and relationship with technology. What technology do they use? Do they have a cellphone? Is it a smart phone? How often do they use it?

- Socialgraphics:
  - Online social behaviors
  - Online platforms/trusted sources
  - Online influence
  - Technology use

Personas can be extraordinarily helpful when it comes to marketing because they help you understand your audience, their needs and how to reach them.

Personas can help you figure out what channels to use to reach an audience member. For example, your socialgraphics may show that your core audience uses Facebook but not Tumblr. As a marketer that would indicate to you that you shouldn't spend time and your budget on Tumblr.

Personas can also help you understand what will resonate with your customer. Let's say you handle marketing for a to-do list application. Your message may be something like, "we'll help you keep your tasks organized," but if you know your audience values family, you could instead say something like, "keeping you and your family on the same page."

By understanding your audience through research and personas, you can communicate with them more effectively and help them understand the value your organization can bring to their lives.

UX/UI and Marketing

The User Experience (UX) and User Interface (UI) are intertwined with marketing. For any marketer to understand their audience, they must be able to understand the user experience and user interface.

The *User Experience (UX)* is the experience that a user, visitor, or audience member has while using a product or service like a website or computer application. The *User Interface (UI)* is the place in which a user interacts with a product like a website.

To clarify, let's take a website as an example. The site itself is the user interface. As a visitor you can read the text on the screen, you can click the buttons, and you can select a tab to navigate further into the site. By taking those actions you are interacting with the interface.

The user experience is the experience that you have while using the site. Can you easily find the tab you are looking for? Does the site provide you with the information you need? Does the site load promptly when you visit? These are all parts of your experience as a user.

The question is, what do UX and UI have to do with marketing? They are the pieces that influence whether you get a lead or a website visitor bounces. If you don't take design elements into account when developing your marketing strategy, you will end up losing potential sales.

Personas are an easy way to gather information and keep everyone in your business focused on the customer. It's critical to apply these personas when creating any kind of design, even something as simple as where to place a button.

As with marketing, UX and UI design requires that you always have to think about how your audience will react to the design. Just like marketers, designers have to ask themselves:

- Why would our audience visit our site?
- What are they looking for?
- Can they easily find what they're looking for?
- What answers do they need?
- How can we help them?

Needless to say, the process of designing a beautiful and effective user experience or user interface is significantly more complex than simply asking yourself these questions. But at the end of the process, if you can answer these questions, you can usually figure out how a visitor to your site will behave.

As a marketer, understanding how a visitor to your site will behave gives you an edge. You now understand your visitor's challenges and you can provide a solution. You know what calls to action will resonate with your visitor and ultimately you will be able to communicate more effectively.

The best marketers work hand in hand with designers to understand their audience.

MEASURING SUCCESS

In order to be successful at marketing, you have to be able to measure success and recognize when it has been achieved. To that end, we recommend all entrepreneurs create marketing goals based on their overall business goals.

For example, if you have a business goal of growing your customer base, what does your marketing team have to do to help fulfill that goal? They need to increase the number of prospects and assist in the conversion of prospects to customers.

The key to being able to measure progress is assigning tangible numbers to these goals.

For example, you want to grow your customer base by 20%. You know that marketing currently brings in X amount of prospects and they convert to customers at a rate of Y. That means that to grow your base of customers by 20%, you need to increase Y by 20% as well. Work backwards and determine exactly the amount of prospects marketing needs to bring in and voila, you have your goal number of prospects for your marketing team.

Again, this is just an example of one marketing goal. The important part is making sure you have a measurable goal. Once you have a defined goal in place, you can determine what metrics can be used to measure progress.

A great rule of thumb when it comes to selecting what metrics to measure is the *SMART standard*. Ask yourself if the metric is:

Specific - Can the metric give enough detail to help you pinpoint problems or opportunities?

Measurable – Can you put a qualitative or quantitative attribute to it?

Actionable - Will people act on this data? If you discover people are confused by your company name and it impacts whether they click on your links in search results – will your company consider changing the name?

Relevant - Can this be applied to a specific problem?

Time-related - Can the information be viewed over the course of time to determine trends and changes?

If a metric doesn't meet the SMART standard it is likely that it is a *Vanity Metric*. Vanity metrics refer to metrics that look good on paper but are not action-related. For example, you could track the number of people who signed up for a free e-newsletter on your website. But how does that relate to your business's bottom line?

On its own, it isn't a particularly helpful metric but in the context of the conversion funnel it can be useful.

If you can demonstrate that people who sign up for your e-newsletter are 63% more likely to purchase from your company, the metric of increasing e-newsletter subscriptions suddenly becomes a lot more useful.

When trying to measure success, always go back to your bottom line. How are you helping your organization achieve success? If you can measure that, not only will you be more effective but also your work will be seen as having real value.

CONTENT MARKETING

Content is exactly what it sounds like – information that is expressed through various mediums whether it is a blog, an infographic or a video. *Content marketing* is the use of information to acquire customers. The purpose of content marketing is to build a relationship with your audience by providing them with information that helps them.

Great examples of content include how-to videos, links to free resources, or a template they can download. Thanks to constantly evolving technology, there is an ever-expanding list of ways to provide content to others. The most important thing to keep in mind when trying to get started with content marketing is your audience.

What do they need help with? Write blog posts on those topics. What platforms do they use? Deliver your content through those channels. When done properly, content marketing can help an organization connect with their audience and boost the bottom line.

Creating Content

Content creation is an involved process. Content marketing expert Jay Baer uses an average of 3 hours as a guide for how long it takes to research, write, and edit a blog post. The important part of that is that there is more to building a good blog post than just writing.

Creating good content takes time and in order to do it properly, you should have a process in place that you follow. Our recommended process is as follows:

- Research
- Ideation
- Storytelling
- Distribution
- Measurement & Adjustment

Research

Always start with research. This stage includes two components – ongoing research into your audience and industry, as well as individual research on a specific topic that you will be discussing in your content.

The first component is one that I recommend building into your daily routine as a content marketer.

If you're creating content, you should already understand who your audience is and what types of challenges they face. But even if you have already built out complex audience personas, it is critical to continually stay in touch with the daily lives of your audience members through ongoing research.

There are a few easy ways to incorporate your research into your daily work. First, envision your day as your audience member. Where would they turn for information? Set up accounts to follow the sources of information that you think your audience would turn to. I recommend using an RSS feed reader to build out feeds of industry specific blogs. Create Twitter lists of handles that your audience might follow, join LinkedIn groups for their industry and roles, and follow Google+ communities dedicated to their work.

Review these content aggregation tools on a daily basis. I always sit down first thing in the morning, check my email, and then open my social feeds as well as my audience's social feeds at the same time.

Out of curiosity, I did a very unscientific experiment and I spent one week following this daily method, and one week without this daily research. During the week that I did my daily research, ideas for blog posts came to me on a regular basis while I read through industry articles. But during the week I did not do daily research, it took me an additional 25 minutes per blog post to research topics and discard those that had already been thoroughly covered.

The bottom line is that by dedicating time every day to putting yourself in your audience's shoes, it will be much easier to recognize important trends and changes in the industry and create engaging content around those subjects.

The second component of our research stage is researching an individual topic. Let's say that you've done your daily work and you've noticed a few articles covering a new platform that could be of real use to your audience, but you've noticed no one has talked about one specific aspect of this platform. This is where research comes into play.

First, you need to make sure no one else has covered this topic yet. The last thing you want to do is become known as a source of stale information. Do a Google search, check news feeds, and confirm that you're boldly going where no one has gone before.

Next, gather your data from reliable sources and keep track of those sources (you'll need them in the storytelling phase). New platform? Go straight to the source, sign up for an account, and take screenshots. As often as possible, gather data and quotes directly from the subject of your content. When that isn't an option, make sure you're getting your data from a reliable source, and follow their citations to find out where they obtained their information.

If you see a study quoted but can't seem to access the study itself (let's face it, sometimes you can't afford to pay $400 to download a PDF), then the best practice is to gather at least two independent sources for the data.

Finally, make sure you've researched all sides of the topic. One of the tenets of our content marketing code of ethics is that we expect our marketers to discuss all sides of a subject. Don't ignore a bug in the programing simply because you like the new platform – inform your audience and leave the decision to them.

Once you have thoroughly investigated your audience and your subject, you have officially reached the end of the research stage.

Ideation

Now that you've kicked off the content creation process by doing your research, how do you turn this information into a conversation starter? This is where ideation comes into play.

I've borrowed the "ideation" term from my friends in the user experience (UX) industry for a very specific reason. I've always found that content marketing and UX work tend to run parallel to each other, both with a core focus on the audience. It only seemed logical to borrow their term for forming ideas or concepts from data. In content marketing, research requires time and continued dedication. On the flip side, ideation can happen in a flash when you get inspiration while walking the dog or standing in line at the grocery store. Other times, you may hit a creative wall, with no ideas in sight.

In order to keep our ideation as consistent as our research work, we've created the following strategy:

1. Let the research speak.

You've got your RSS feed of news your audience is reading – put it to use. Write down the following things:

- Keywords – What words are repeated throughout articles and headlines? Write these down as they are part of the language of your audience and you should learn them and incorporate them into your content marketing strategy.

- Questions – What questions arise when you read these articles? Write them down, your audience may have the same questions and these can be great topics for blogs.

- Experts – Who are the experts quoted in these articles? What are their roles? These people are the experts your audience trusts. Interview people in these roles and turn those interviews into blog posts, podcasts, and webinars that will provide real value to your audience.

2. Make the keywords work for you.

Now that you have a list of keywords you created as part of Step 1, put those words to work! Don't just think of them as part of an SEO strategy but as your inspiration center. This is one of my favorite exercises for coming up with interesting new topics.

- Take a look at your RSS feeds, your favorite blogs, and even news sites. What titles grab your attention? Write down a list of headlines that jump out at you.

- Go back through the list and replace the industry specific words with (Keyword) or (Common problem).

- Replace the placeholders with your keywords & industry problems.

  Example: 10 Great Local Business Ads.

  (Number) great (keyword).

  Example: Why Your Brand Marketing Needs A Chief Marketing Technologist

  Why Your (Industry) Needs A (New Industry Role).

Give this exercise a try and your wheels will start turning in a whole new way.

3. Step away from the content.

One of the hardest things to admit for a creative person is that you've hit a wall and you just are not inspired. The ideas are not flowing. This happens. It is OK. Don't beat yourself up; rather, step away from your work.

Over the summer, my company went a full month without posting any content on our blog. Our team had been going strong for months, writing multiple posts a week, and building great traffic and engagement. Then they hit a creative wall. Rather than forcing them to sit in front of their computer until inspiration struck, we put them to work on other projects for clients. The team was able to focus on a new content subject and stop stressing about our company content.

After three weeks, they came back refreshed and full of new ideas. In the meantime, we were able to tap into some of our evergreen content to share with our audience and continue engagement. We did see a 25% dip in visits during that time, but we actually saw higher engagement with an increase in pages per visit, visit duration, and a decrease in our bounce rate. Plus, the posts that our team wrote when they came back saw incredible engagement and 78% of visits to the site during that time were new visitors who were reached by our content.

The bottom line is, I made the call that giving our team time to step away from their content work may have created a temporary dip in our traffic, but the long-term positive return is worth it.

Storytelling

Storytelling goes to the heart of how you communicate your story to your audience. Whether you are communicating through copy, designs, or video, your storytelling has to connect with your audience. If you don't connect, they'll never stick around to hear the moral of the story (or your call to action).

"I do not claim that I can tell a story as it ought to be told. I only claim to know how a story ought to be told, for I have been almost daily in the company of the most expert story-tellers for many years." – Mark Twain

Storytelling is an art form. The form may change with the shift of technology, but a good story will always follow certain "rules." We've adapted those rules to the age of digital storytelling, and keeping in mind our friend Mark's words, here are our recommendations:

1. Stick with a structure. *Stories have a beginning, middle and an end. This doesn't change, no matter what the story or format. Take your time with each piece. Don't phone in the ending because you've already made your point in the middle. Instead, go out with a bang and drive your point home. But don't forget to set your scene and build a case as well. If you want your audience to stick around to the end, you have to get them invested in your story.*

2. Make your characters believable. *The best heroes have flaws and the scariest villains always make you feel just a little bit of empathy. Whether you are writing the next great American novel or bios for your company's website, go that extra mile to make your characters human. It will make it easier for your audience to understand them, see things from their perspective and maybe even like them.*

3. Show, don't tell. *In the digital age, this has a few implications. Images matter: 40% of people will respond better to visual information than plain text. (Source: Zabisco) If you have found that visuals are the best way to communicate with your audience, find or create images that convey your point quickly and effectively.*

If your audience prefers written text, that doesn't mean images are not important. Rather you should work to incorporate visuals into your story, but don't use them as a crutch. Paint your readers a picture with your words. Tell them how things smelled, tasted, felt and choose your words wisely. For example, don't tell your newsletter readers that you have achieved a major milestone, create an image showing this turning point and thank them for their role in making history by helping you reach this breakthrough. It is important that the words themselves are just as good as the story you are trying to tell. You are not thirsty, you are parched. Your company didn't exceed estimates, it blew past the goals and made history.

Your story only has a few seconds to grab someone's attention. Make sure you don't lose your audience because you chose boring words.

4. Teach your audience. From Aesop's fables to Pixar movies, the best stories always teach us something.

You have gone to great lengths to cut through all the noise and you finally got your audience's attention. Make sure your story enhances their lives by teaching them something about life, the world, or even themselves.

Last, but definitely not least:

5. Have fun. It's one thing to be a tortured writer (hello, Edgar Allen Poe), but it is another to feel like writing IS torture. If you don't enjoy storytelling, then don't do it. But that doesn't mean you shouldn't still invest in storytelling. Content for all intents and purposes IS storytelling and it is an overwhelmingly effective way to connect with others. Even if it isn't your forte, find someone who does love storytelling and get them to tell your story. Consider it ghost writing for the digital age.

Distribution

Distributing content is a job in and of itself. To get your content in the hands of your audience you have to understand what distribution channels they prefer. Do they have social media accounts? If so, which platforms? Do they usually search for your service on Google or do they trust referrals from friends and family?

These questions may sound familiar. If you researched socialgraphics as part of your audience personas, you should already have the answers to these questions.

Once you have an understanding of where your audience turns for information, you now know which channels you should use to distribute your content.

Measurement & Adjustment

As we talked about in the analytics section, you have to be able to measure your work in order to determine whether you have achieved your goals. That goes for content marketing as well. But don't let yourself get sucked in by vanity metrics like "traffic." Increasing traffic to your site is great, but if you can't tell whether that traffic led to sales, you are not measuring the real impact of your content marketing.

We recommend laying out the following pieces to properly track your work:

1. Define your organization's goal.
2. Explain how your content marketing will help achieve that goal.
3. Define what metrics you will use to measure progress toward the goal. Can you currently track those metrics with your analytics system? If not, what will it take to add the metrics to your system?
4. What will you do if you realize you are not progressing towards success?

If you explore your metrics and over time realize you are not moving towards your goals, it is time to adjust your strategy. It is tough to realize that the plan you had didn't work, but if you are prepared for that scenario, it will be easier to bounce back.

By outlining ideas on how to pivot your strategy as part of your initial planning, you will set yourself up for success.

LISTENING

Marketing is a conversation; don't let it be one-sided. Your audience is happy to give you feedback but you have to know how to listen. If you take the time to hear your audience, not only will you be able to give them what they are asking for, but you will ultimately have a more positive relationship with them.

It may seem counter-intuitive to use your marketing channels to listen, but in fact, sharing can be a powerful way to get feedback. Here is how you can use your marketing tools to hear what your audience finds valuable:

1. **Ask.** Send surveys using SurveyMonkey or even just a simple Google Form embedded in an email. I'd recommend asking your audience what types of content they enjoy the most and whether there are any topics that should be covered that currently are not discussed. A simple 2 or 3 question survey once every 6 months or so is a good way to gauge the best types of content for your audience.

2. **Read your metrics.** Paying attention to simple things like number of views and most shared pieces can really help guide your content strategy. But again, it is important to pay attention to this over time. Once a quarter, sit down and evaluate which items got the most shares and the most views.

   Determine what those pieces have in common. Are they all about similar topics? Were they the same format (all videos, all photos etc.)? Or maybe they were all included in a newsletter? Try checking out some of these new content analytics tools for details on new ways to measure engagement.

3. **Get social.** Social media is a great way to crowdsource feedback from your audience. Beyond just finding out which items were shared the most on social media sites, find out what items elicited reactions and engagements. Keep in mind, these things won't only happen on your brand's pages. That is why a social listening tool can help organizations stay aware of what people are saying about them on their own profiles. Check out social media listening tools like SproutSocial, Brandwatch, and Radian 6 for more information on how to keep your ear to the ground on social media.

Listening is a difficult skill to cultivate, but one your audience will appreciate. Be sure to spend as much time listening to your audience as you do talking to them.

Chapter 27 | The Sales Approach to Small Business Success

Tony Lenhart

At a young age, I was told innumerable times that I was a “natural born salesman.” I’ve always had mixed feelings about that description, yet it has clearly defined my professional path. At the age of 15 my dad handed me a copy of the classic *SPIN Selling* by Neil Rackham. Not long after that I worked my first retail job selling high-end waterski equipment & accessories. Upon entering college, I entered business school, but later found the Selling & Sales Management major – perfect! Early into my professional career I achieved great success at a Fortune 250 company. Since then, I’ve helped small market companies develop their go-to-market strategies and drive their sales initiatives. I have a continued thirst for sales-related knowledge and will do my best over the next few pages to share the top lessons I’ve learned along the way.

During my professional career I’ve had two very distinct paths; one in the corporate world and one in the private sector. My first nine years I learned military precision; the corporate world taught the importance of numbers, metrics, and setting goals. I knew exactly the number of calls I needed to make, appointments set, networking meetings to attend, and subsequent quota to hit to be successful. I also learned how to start building relationships, but only at a surface-level. I say that because it was all one-way; I learned reciprocity later.

The last five years my sales work has been in the private sector, and it has been 100% relationship driven. To form good relationships, my goal was to know and help good people. I looked at my job as knowing the best of the best in my industry. I became a conduit for aligning people to the connections and resources they needed to realize their personal and professional goals. I adopted a true pay-it-forward mentality.

In a relationship-driven sales environment you wear many hats – friend, confidante, advisor, advocate, and therapist. This type of sales approach was in my DNA. My father was in professional sales for 30 years and my mother practiced as a psychologist/therapist – a pretty potent mix, genetically speaking, for grooming a salesperson.

If you founded your business, chances are you were also its first sales representative. You could go out and passionately engage people and get them excited about your product or service. If you're the owner, perhaps you came up through the ranks or were brought in from the outside to turn things around. Regardless of where you're at along the path, driving future growth and sales can be a confounding beast. Founders often don't have the time they once did to get out there and sell themselves and their product or service let alone the time to begin condensing their knowledge into a digestible form and giving actionable items to their sales reps. So you might ask, how do you build a solid platform for sales success?

In this section of the chapter I'm going to discuss ideas around the lessons I've learned, how to build your sales playbook, and how to drive Top of Mind Awareness and subsequent referrals from centers of influence. Thousands of books have been written on any one of these topics and at the end I will provide a shortlist of my favorites for continued learning. Here I've done my best to lay out proactive, realistic steps you can take to tighten up your process.

The Sales Approach

There are a number of maxims out there that speak to the truths I've learned about professional selling. It's hard to pinpoint one that I adhere to on a daily basis, so I picked two! And they have a very symbiotic relationship:

> ***Nobody cares how much you know, until they know how much you care*.**
> **– Theodore Roosevelt**
>
> ***Sales is the Transfer of Enthusiasm*.**
> **– Brian Tracy**

Looking at the first, how do you show someone that you care? Well, if people allow it, you must shine the light on them. You ask good questions, you pay attention when they talk, and you rack your brain to think about how you can help them. Now, that doesn't mean only how ***your product*** can help them. It means that after you actively LISTEN and have asked the right questions, you draw up your experiences and your network of people to address their needs. It may end up they don't need your product/service (at this moment), but you know someone else that could help or be a good connection.

Next is the idea of transferring your enthusiasm. Not only do you need to share *your* excitement about why you can help them, you must also be open and willing to learn about why *they're* excited about their work and fixing whatever problem they may be having (which goes back to the first point).

The key is to first seek to understand, then to be understood. Ask good questions – understand why you're there. What does success look like for them? How is the current way of doing business not cutting it? How will doing things differently improve their situation? Was there a tipping point that prompted this meeting? If you understand their "why," chances are you can strike a common chord and empathize. Everyone can relate to trying at one point to be more efficient, save money, or striving to be better and achieve more. By practicing *empathy*, you can in turn get excited about supporting them in realizing their definition of success.

The second key? Understand why you are there; this time, by "there," I mean ***in your field***. What aspect of your job do you get excited about? How does your widget help people? What do you love about what you do? And the biggest question – *why* do you do what you do? If you can eloquently share and elaborate that with your potential customers, you'll be two steps ahead of everyone else.

By understanding not only your passion, but also that of your prospects, you will break down the classic sales resistance that occurs and build meaningful relationships.

> ***Working hard for something we don't care about is called stress. Working hard for something we love is called passion.***
>
> **– Simon Sinek**

The Sales Playbook

Just as a high-performing athlete needs to know the plays they're going to run, a high-performing sales professional needs to know the keys to closing business and getting it in the door. A playbook will lay out the game plan for not only what a company provides, but will also define your elevator/phone/email scripts, sales call execution, common objections, how to identify channel partners, and ideas around activity, quota, and goals. Once a foundation is built you can attack your plan with confidence and train your sales team to do it the right way.

The ideas I'll cover here will include figuring out activity metrics, how to find your prospects, how to stay engaged with them through the sales process, and how to execute the sales call.

Activity

As you start building a sales team, these numbers become crucial. You can't manage what you can't measure. Accountability is one of the biggest challenges I see owners face while trying to run a team. In sales, many things are out of our hands. However, when it comes to activity, it's controllable – and you must "control the controllables."

Example:

- Revenue Goal: $500,000
- Avg. Deal: $20,000
- Deals to get to your goal: 25
- Close Rate: 1 out of 4
- # of Prospects needed each week to hit goal: 2

So – take a minute to jot down your numbers. This works whether your sales force is just you or a team of 100. In the example above, we need a minimum of two prospects per week. BOOM! That's an important number – it's the benchmark for success.

Ok – so how do you get to those two prospect appointments every week? Only two ways – you either go find them or they need to find you. So, how many referrals do you need to generate? Where should you be spending your time networking? How many times do you need to pick up the phone (which is a whole different set of metrics!)?

> ***Never Confuse Motion with Action***
> **– Benjamin Franklin**

Finding And Getting Found

Referral Generation: One of the most important things I can say about generating referrals is this: if you want to receive referrals, first you must find ways to send referrals to others. Don't be afraid to open up your rolodex and see how you can help others, be it direct prospects or simply a good connection with a power partner that could be of value down the road. If you are looked at as a person who is always willing to help, others will be more inclined to help you when the opportunity appears or when you come to them looking for help.

So who do you need to meet? Simple – who else is selling products/services to your prospects? You need to develop a strong network of people that are knocking on the same doors and helping the same people you're looking to help. It doesn't take more than a Google or LinkedIn search to look up and find associations, people, and groups that fit the mold. Start meeting them – set coffee/lunch/beer meetings and build relationships. Look for ways to help them along their path.

Approaching Prospects/Cold-Calling: 80% of sales people give up after one or two calls. Unless it's a warm referral, you have to reach out to a person on average SEVEN times before you get some sort of movement. So first and foremost here: PERSISTANCE PAYS. But make it polite persistence. Using a combination of calls and emails, you must either give somebody a good enough reason to call you back or show enough desire to meet that they'll eventually listen to what you have to say. A few hints:

1. If you have any sort of personal connection to the person you're calling, use it. An alma mater, a mutual friend, past work experience, whatever.
2. Be short, sweet, and to the point. Introduce yourself, present a short benefit statement, and then ask a trial close.
3. Make it conversational – If you say more than five sentences in a row without asking them a question, they're just looking for an excuse to hang up.
4. Add value – when emailing, find an article that you think would be relevant/helpful to the person you're approaching.
5. NEVER ask, "how are you doing today?" at the beginning of a sales call. It's an insincere bad habit. Instead, say "good morning!" or "good afternoon!"

Prep & Follow-up

These are two areas where I see many sales reps dropping the ball: they are under-prepared for their meetings and then show a lack of consistent follow-up to help close out the sales cycle. Here are some ideas and best practices on what to do before, during, and after the meeting to make the best overall first impression.

Before your meeting:

1. Reply **promptly** and offer a phone call to schedule a time to meet. Emailing back/forth/back/forth can be painful and tedious for both of you.
2. Be **professional** & **personable** – polish up your LinkedIn profile and promote it via your email signature. Add your interests, social causes, and organizations you're involved in and review theirs. Some of my best clients and business partners came from a meeting where we talked as much about pleasurable subjects as we did about business.
3. **Show respect** for time – if you scheduled an appointment more than a week out, send a simple email the night before to confirm: Subject: Wednesday 3pm – "Bob – good evening. Look forward to seeing you at your office tomorrow afternoon."

During your meeting:

1. Be **confident** – firm handshake, smile, sit up straight, and look them in the eyes.
2. Don't be an eager beaver and shove your business card in their face; you can exchange toward the end.
3. **Genuinely Engage** – by having done your homework and asking the right questions, find the common thread. Keep the focus on them, but don't be afraid to share your experiences.

After your meeting:

1. **Follow-through** – within 24-48 hours send your new acquaintance an email recapping the meeting and laying out next steps. Include a timeframe in which you will call them unless you hear back first.
2. **Connect** with them on LinkedIn & personalize the message – "Great meeting you today. I look forward to being a resource for you down the road. Until then, let's link!"
3. **Be grateful** – send the person that introduced you a separate note thanking them for keeping you in mind.

All of these actions show professionalism and respect – for yourself, your prospect, and the person that referred you. Being mindful of these steps will put you in the best position to earn their business in the long run and keep more referrals coming your way.

Sales Call Execution

The old saying in sales is, "nothing happens until somebody sells something." It's one thing to know ALL the benefits that your product/service can offer; it's another to be able to identify the key one or two reasons why a particular person will buy from you. I've seen so many reps just go in and "throw-up" all over the prospect, only to scare them away with an over-bearing sales pitch. A good first call should be at least 70/30 with your prospect talking more than you. You're there to learn.

***The Lord gave you two ears and one mouth for a reason*. – Your Mom**

Every product/service will have their nuances, but I'd like to share a high-level model for running an effective first prospect call.

1. **Build Rapport –** This could be done a variety of ways. The question is – do you want to build personal or professional rapport – or both. Simple things include discussing how long they've been with the company, how long they've been at that location, or perhaps noting something of interest in their office. If you were referred in, you could discuss your mutual connection. Bonus points for proactively researching information on the company website and their LinkedIn profile and/or other social media outlets.
2. **Set Intention –** This is another way of saying 'set agenda', but I like "intention" better – agenda sounds too strict. This is simply letting your prospect know what you're going to discuss, what you hope they (and you) get out of the discussion, and how long you expect the meeting to last (showing you respect their time). Giving this genuine mission statement upfront gives the meeting direction, purpose, and a timeline.
3. **Profiling –** You need a list of 7-10 solid open-ended questions you'd like to ask on every call. These core questions will hopefully spark second and third level questions as you dive deeper into the conversation. You must display ***genuine*** curiosity and empathy about their situation and goals. This cannot come from a self-centered place – people will easily pick up on the fact that you're looking at them like a piece of meat. You are there to help solve/remedy a situation. If you don't ask the right questions, you're not going to be able to tell if you have a solution that makes sense. You are part detective, part problem solver.
4. **Discuss Solutions –** Depending on your typical sales cycle, this may not happen until the second or third meeting. During the profiling part of the conversation, you have hopefully uncovered not only the two or three reasons why you can solve their problem, but also why they would use you to do it. These might be pain points that your product/service is solving, or you're simply meeting the requirements that the prospect has laid out.
5. **Set Follow-up meeting/activity –** Never leave a meeting without knowing what the next step is going to be. Regardless of what that is, within 24 hours you need to send an email to that person recapping your discussion, thanking them for their time and energy, and restating what the next step is going to be.

Top of Mind Awareness

How do you get people to remember you when an opportunity arises? Here are some of the best ideas that have worked for me.

1. A newsletter with personality: For the last four years I have sent out a monthly newsletter. This newsletter has very little to do with what I'm trying to sell. I include information that I think people will actually find VALUABLE. To me, that short list includes sales tips, interesting things happening in our hometown of Chicago, new books videos, or music I've been exposed to, a charity people should know about, and a few quotes that I found funny or inspirational. Now sure, I do include a little bit about what's happening in my world and how people could help me, but it's not "salesy." This low-key approach of adding value has garnered me more referrals and goodwill than anything else I've ever done.
2. LinkedIn – There is an entire section of this book dedicated to the topic, so I'll be brief. You should connect with everyone you meet with face-to-face. Post something 2-4 times per week that could help your network. This could be an industry article, a meaningful quote, or something exciting that's happening with your work. Remember, every post cannot just be about you and your products – be well-rounded and thoughtful with what you put out there.
3. Pick up the phone – find time every day to call 3-5 people in your network; I would suggest before 9am or at/after 5pm. Increasingly, people are wrapped up in email, meetings, and social media. You'll stand out by simply calling and touching base. At the end of each day, write down the names (and numbers) of the people you want to call the following day. Perhaps that person posted something on LinkedIn you liked, or you read something that made you think of them. Then again, you don't necessarily need to call with a particular agenda.
4. Connect people – I've mentioned this already and it bears repeating – if you follow the sales approach I've discussed, you'll inevitably learn about how you can best help others. Since things happen when people meet one another, you in turn will help introduce your contacts to synergistic partners. This is not introducing just for the sake of introducing (or looking good). Be known as someone who makes quality introductions with positive intentions. This requires you to be thoughtful.

Your network determines your net worth. **– Jeffery Gitomer**

Top Five Action Items after Reading this chapter:

1. Figure out your numbers – how many prospects do you need to get in front of to hit your revenue goal? Calculate your average size deal and your close rate.
2. Write out three versions of your elevator pitch – a 2-minute, a 30-second, and a one-sentence.
3. Write down the top 10 questions that need to be asked on every prospect call and ASK THEM.
4. Write down your top professionals that can act as centers of influence. How many do you have in your network? Are they good? Go out and meet the best.
5. Compile these first four items and put together the skeleton of your sales playbook. This will help set the foundation for what sales success looks like. Then, as you start to build a sales team, you'll have a platform for success.

Suggested Further Reading:

- *To Sell is Human* – Dan Pink
- *The Little Red Book of Selling* – Jeffery Gitomer
- *The Sales Bible* – Jeffery Gitomer

- *The Psychology of Selling* – Brian Tracy
- *The Greatest Salesman in the World* – Og Mandino

Chapter 28 | My LinkedIn Journey: Tips for Success in Online Networking

Larry Kaufman

I have been in sales and sales leadership roles across industries for the past 25 years and counting. In 2004, I moved onto an entrepreneurial path, and one of my services for prospective clients was retained and contingent recruitment. I had secured some clients and I was in need of qualified candidates for open job opportunities that I need to fill quickly. I came across an invitation to join LinkedIn through a sales executive that used to work for me. It was sitting in my Inbox since late 2003. When I joined in 2004, I became the $1,115,008^{th}$ member of the networking site, which launched in 2003.

I began to explore LinkedIn's website, created my profile, posted job positions, and started my LinkedIn journey. At this time, I only used LinkedIn as a recruitment tool, and even with over 1M members, I was locating and placing candidates utilizing LinkedIn. After using this "recruitment tool" for about a year, I was approached by a woman who was in the sales training industry. LinkedIn came up in our discussion and I explained how I was using it at the time and she was very interested in learning more. She had formed a networking group of small business owners who expressed interest in learning more about LinkedIn, and she asked if I would speak to the group about my experiences.

I was flattered and nervous all at the same time. I wasn't an expert on LinkedIn. I was essentially a recruiter that leveraged this online tool, but I did convert my use of this tool into revenue. I agreed to speak and I prepared a PowerPoint presentation and a one page handout and did some online web demonstration. There were technology issues with the setup, and when I finally delivered the presentation, I thought it was horrible. However, I received applause and my audience was overwhelmed with my knowledge about LinkedIn. How could this be? I was a novice at best, but I realized I was actually the expert in a group without any LinkedIn expertise.

My first presentation was my springboard to making sure I became a LinkedIn expert. I needed to understand every tab, every page, everything about LinkedIn; I spent hours navigating the site, and I started to incorporate my LinkedIn speaking expertise as a part of what I did no matter where I worked or what position I held. If I was the Regional Vice President of Sales for a company, then I was also a LinkedIn speaker. In short order, my name started to circulate as a LinkedIn speaker, LinkedIn expert, LinkedIn trainer, etc. I was now slowly becoming "LinkedIn Larry."

What is LinkedIn?

I am a LinkedIn speaker, trainer, and coach, but what is LinkedIn? LinkedIn is the “Business Facebook.” Facebook can be used for business, but LinkedIn created the ultimate website for business networking, recruiting, business development, company research, and more. When I started using LinkedIn in 2004, it had just over 1M members, and it was incredible for my business. Fast-forward to 2013 when I authored this chapter, and there are 225M members. If this online tool was incredible for my business in 2004, imagine what it has done for my business with its membership base today.

The real question: is how do people, novice to advanced, use LinkedIn today? When I found LinkedIn, I used it to find candidates to place at companies that retained my firm or used my contingent recruiting services. Today, it is a powerful database of 225M people across the globe with business and personal information, phone numbers, pictures, company history, and so much more.

What can you do with all of this information at your fingertips? You can do a lot! Based on my LinkedIn keynote presentations over the past seven years, I estimate that only about 8% of those 225M members are really leveraging the power of LinkedIn. Today, this tool can be used for free with a fair amount of functionality. Paid membership is in that 8% base of members, give or take. I encourage you to review all of the membership options in the settings section. I have been a paid member since 2005, which is when I realized I was realizing significant ROI through LinkedIn.

Why or how would LinkedIn survive given the low number of paid members? LinkedIn is surviving because it began with a mission to create a recruitment tool/database and compete with the Monsters and Careerbuilders of the world. That is how LinkedIn survives and thrives.

The Ultimate Recruitment and Career Transition Tool

I mentioned in the beginning of this chapter how I found LinkedIn and leveraged this website as a recruitment tool. How does LinkedIn compete with online job boards? Put your Hiring Manager hat on and go through the visual process of going to a “traditional” online job board. This is where those in transition post their resumes for employers to view and source talent for their open positions. Those posting resumes are unemployed, because you would not want your employer to know you are looking for a job by posting your resume to one of those sites. You could or would be fired.

Put your hiring manager hat back on again and think about who you would like to hire. Most would prefer to hire someone who is already employed, as opposed to someone in transition. Where would you go to find a database of the employed and have the luxury to review their career history, education, and more? LinkedIn, where you could find 1M to 225M online resumes of potential candidates, is where you would go!

Why would you have more information about a candidate on LinkedIn than through another online job board? LinkedIn helps you find other people who worked with your prospective candidate to conduct reference checks even before you make a phone call to a candidate; you may also discover that you know people who also know your prospective candidate. LinkedIn also displays recommendations about those candidates. The best part about LinkedIn is how much information you have access to about a candidate before even sending an email.

What if you wanted to contact a candidate currently employed? The old fashioned way was through referrals, cold calling into a company, and doing significant research/employee blueprinting to identify the names of potential candidates. LinkedIn has created an introduction process and even an email option (a.k.a. INMAIL) as a paid member benefit to connect with candidates.

Now, put your "candidate hat" on and imagine you are in transition or considering a career change. How can LinkedIn help you? You can create a profile that is interactive and searchable on the internet and within LinkedIn by hundreds and thousands of hiring professionals. You can incorporate keywords within your profile so you appear in profile searches for your skills and experience. Resumes submitted to many companies today are filtered through sophisticated recruitment filtering software. This helps employers eliminate resumes by a ranking system based upon a hiring profile created by employers leveraging this technology. The same thought process is important to consider for your online LinkedIn profile. Do you have the appropriate keywords for the industry and role you are interested in finding today? Do you repeat those skills and keywords in your profile?

Companies today purchase individual or very robust recruitment solutions through LinkedIn. This has become a major source of revenue for LinkedIn today and into the future. Hiring executives with these memberships can filter their searches of profiles on LinkedIn to find exactly who they are looking to hire for their company. Have you optimized your profile to reflect all of the keywords one would search to find your profile on LinkedIn for a potential position? LinkedIn really is the future for helping those in transition and for employers looking to source the right talent for their companies.

LinkedIn has developed a focus with universities and colleges looking to attract students, for alumni, and for employers seeking talent from a particular university or college. Networking should really start in high school. However, at the very least this skill should be a coaching exercise with every new student entering a junior college or four-year college or university. Why are parents of students reaching out to me for internship assistance? Why are parents of students reaching out to me close to graduation for their child to assist with introductions for a career position? If you are a college student today, you need to be building a network so you can find an internship or a career position on your own.

Yes, this is easier said than done. How does an individual without a college degree and a job in the working world today build a network? LinkedIn is one tool to start that process.

A Networking Tool for "Pre-Graduates"

When I was at Loyola University Chicago back in the 1980's, networking was not a word in my vocabulary. 2013 has become a year where college students or "Pre-Graduates" appear to have an understanding of social media, but I see more emphasis on Facebook and Twitter and not as much, if any, on LinkedIn. However, LinkedIn is trying to capture the full college/undergraduate lifecycle. They have incorporated an education tab that promotes universities and colleges. This is helping to attract graduating high school students to alumni from those institutions to employers looking to source talent from those same institutions.

I have noticed that some institutions have incorporated some form of networking courses and events, and even some training around LinkedIn. I have spoken at two-year colleges and universities, to undergraduates and to MBA students. It is so important that we start our children on the path of building relationships and networking while in high school and without exception during their "pre-graduate" years at a college or university. Why is this so important? I know so many parents paying for ivy-league educations for their children. They are leveraging their networks inside and outside of LinkedIn to help their children gain entrance to these institutions.

Our children can learn from us, their parents who need to set the example about the importance of building relationships. What does this have to do with LinkedIn? LinkedIn allows our children to build their business profiles, set the path for internships, and connect with friends who will take different career paths locally and abroad. It allows "pre-graduates" to connect with their teachers from grade school, high school, and college, as well as with the siblings and parents of their friends and acquaintances. They can create a network on LinkedIn in the early years of their education and have the foundation of relationships and connections. These relationships and connections will help them exponentially as they enter the business world.

The Second-Degree Power of LinkedIn

I joined LinkedIn back in 2004 and, like most, accepted an invitation to set up a free account. I entered the most basic information about myself. I began to connect with other people I knew and others that I knew connected with me as well. I never realized the power of what I was building; in fact, many people with elaborate profiles and 500 or more connections do absolutely nothing with their networks.

Have you ever gone to a networking event or 1:1 networking meeting where you were given access to your fellow business professional's rolodex of relationships? Of course not. Now consider how many people you've connected to on LinkedIn just after you've met them (or just before a 1:1); those same people have provided you with access to their online rolodexes, 24/7, 365 days a year! This bears repeating so you can begin to realize the power of LinkedIn: everyone you connect with on LinkedIn has provided you with access to their online rolodex, 24/7, 365 days a year! This is unbelievable, and honestly, it took me a few years to realize the true value of the LinkedIn network I had created and was continuing to cultivate.
I would like to discuss the power of the second-degree network on LinkedIn. First, you need to understand that there are three degrees of connection within LinkedIn. When you invite someone to join your network, you can

only have three degrees of connectivity with that individual. When you connect, you are both first-degree connections. If that individual has 452 connections, those 452 connections will be your second-degree connections. Your third-degree connections will be the connections of your second-degree connections.

The true power is actually these second-degree connections, brought to you by your new first-degree connection. Let's say that I connect with John Smith, CEO of ABC Company, who is also a client of mine today. John built a network of 500 people, many of whom are fellow CEOs. John is my access point to a second-degree network of 500 people, many of whom are CEOs. Your first-degree network of connections and relationships is the pathway to all of the people they directly know.

The third-degree network is helpful for information, but the pathway to those connections is not as simple as finding a path to a second-degree connection. As mentioned earlier, LinkedIn allows you to purchase a membership to send an INMAIL to anyone on the site, including third-degree connections. LinkedIn has also created an introduction process to reach second-degree connections and third-degree connections. This can be productive, but if you have a sense of urgency to connect with second- or third-degree connections, this may be a time-consuming process.

When I see someone of interest on LinkedIn with a "2^{nd}" next to their name, I know I share one or more of my first-degree connections in common with that person. I can then determine which of my "shared connections" would be the warmest path to my contact of interest. I can call my shared connection, send him or her an email, and make my request for introduction. A third-degree connection has another person on LinkedIn in the middle of this process that we do not see or know. We are essentially relying on a third-party to make an introduction without knowing us. That's why many will purchase a paid membership to have the access to send an INMAIL. The takeaway? LinkedIn can only be an effective networking tool if you build the right network with the right people.

How to Build a Powerful LinkedIn Network

I just shared the power of the second-degree network, but without the right type of primary network, you cannot expect to have a powerful second-degree network to leverage. In 2013, I have built a first-degree network of 27,000 connections globally. My second-level connections are in the millions. Do you really have to have a network of 27,000 like me? Definitely not, and I don't recommend it. I started my journey with LinkedIn as a recruiter, so I needed to connect with a lot of people to have access to candidates to source for my clients that were hiring locally and nationally.

My recommendation is to build a network of people you know and trust. In addition, if everyone in your network has 100 or fewer people in their networks, then you will have developed a less-than-powerful network. You need to connect with someone like me. I have a strong global network and I like to connect people with people. So, connect with people you know that have strong networks of 500 or more connections. Connect with your high school, college, and post-graduate contacts. Connect with your professors, mentors, friends, family, accountant, attorney, financial advisor, etc. Getting the picture? Connect with those you know and knew. If you are in sales or a role where you need to bring in new clients (i.e., accountant, attorney, etc.), then connect with your clients and with executives and staff at your own company.

The network you build will help you to find a new career, secure new clients, and connect with past colleagues. It is so important to think about the network you are building and how you will leverage that network to help others and yourself. Think about that statement. LinkedIn is a network that can help you and others that you know. Has anyone ever asked you if you can help them find a job or open a door at a company, because they wanted that company as a client for their business? How often when people ask do you know anyone a particular company or in a particular role and you respond no more than yes? Stop saying no! Remember, it's not who you know directly, it's who your direct (first-degree) network knows directly – the second-degree network. You would be surprised who your network knows today that can help to execute on most of those requests for introduction into a particular company or contact.

Do you receive invitation requests with the standard template to join their network as opposed to a customized request? I would encourage you to type in the name of your past colleague, client, advisor, etc. in the search window at the top of the home page of LinkedIn. Click connect when you find your contact and delete the default invitation message and send a customized message. Make it more from you and less from LinkedIn.

If you join groups and see people you would like to connect with, when you find their profile on LinkedIn and click connect, you will see a group that you share in common as a way to connect. This is another way to build your network and create a customized message about the group you share in common. Maybe reference something you noticed in their profile. Personalize and customize the message.

It's important to be more cognizant about the people you are meeting and take a proactive approach to building a powerful and effective network. I feel very confident today in saying that I can open 70% or more of the doors to almost anyone to help me or someone in my network.

Another way to build your network is to have others you would like to know find you as well. If you have built a profile that incorporates your education and employment history completely, then your work and school contacts will find you as well. If you build it, they will come! Build the right profile and you will be found. It's amazing who I have found and who has found me.

One last point about your network relates to the decision to keep your first-degree network open or hidden. Over the past seven years, I have found that this is a point of contention for everyone from CEOs to attorneys. The premise of LinkedIn is business networking. Why would you join a business networking site and close your network? This is your network, this is your profile, and you need to build and use your network and profile to leverage fully the power of LinkedIn. My recommendation is to keep your network open. You selected your first-degree connections or accepted their invitations, so why not let everyone in your network see your network? 225M members can't see your 100 or 500+ connections; only those you allowed to join your first-degree network can see your connections. I have instructed those who hide their networks to let certain contacts know that you will change the privacy setting if they want to view your network. You can do this for a block of time one evening for a trusted relationship that questioned why you have hidden your network. LinkedIn allows compromises.

Creating a LinkedIn Profile that Generates Results

You joined LinkedIn six months ago or 10 years ago, but what have you done with your profile since then? Your profile is vital to how you build your brand on LinkedIn. How you will be found and how people will perceive you as a person, business professional, networker, educator, etc.? If you want to promote yourself, your company, or your experience, then you need to create a profile that is professional, but not a resume. If you do not care about your profile and do not want to add content so that people can find you on LinkedIn, then that is completely up to you, but I would ask: why are you on LinkedIn? Many people create an account and a basic profile just to have presence on LinkedIn. My recommendation is to determine why and how you want to use LinkedIn; the content of your profile will follow that decision.

For example, I want to be found, and I want people to view my content and seek me out as an expert on LinkedIn or an expert in sales. The profile really begins with your headline and picture. Who are you? What do you do? If I meet you for coffee or an interview or as a prospective client or business resource, what do you look like? Keep in mind that this is not Facebook, this is a professional business networking website. Is your profile phone a picture of you in a bathing suit, smoking a cigar, wearing sunglasses and a hat, holding a baby, or even a picture of your baby or dog? Remember, first impressions are lasting impressions. I would suggest having a professional picture of yourself on LinkedIn. Don't let someone else make a decision about you before you have had the opportunity to meet.

What is your headline? You can share your name and title only. You can include additional information about who you are. What would capture someone's attention (i.e., "CEO of the Year"/Author/Keynote Speaker)? This headline really defines you on LinkedIn. It's one of the first lines of copy someone will see when searching for you or if you happen to appear in a search. (Please include every position held and your education. Some people choose to include grammar school; I have mixed feelings about that, however, some people do search for alumni from a particular grammar school.)

Did you know that people will search LinkedIn to find someone like you? Yes, they are looking for specific titles, industry experience, alumni from companies and colleges, and more. Not everyone wants to be found, so keep your profile lighter in content if you fall into that category. However, if you do want to be found to market your experience, your company, or your firm, then build a robust profile.

Have you included keywords to make your profile searchable on LinkedIn and the web? Yes, your public profile allows people to find you on Google. For example, I mention my LinkedIn speaking expertise more than once in my profile. Repetition throughout your profile will help raise you to the top of a search within LinkedIn. So, think about what you say about your firm or your expertise and think how a recruiter or prospective client would look for that same expertise. Not all words are created equally. When I search for a CEO, I also search for a "Chief Executive Officer," and I put the phrase in quotes to keep the string of words together. Some CEOs only use the acronym in their profile, and if I was searching for the string of words as referenced, that particular CEO would not come up in my search.

Skills and Recommendations. No need to talk a lot about skills in this chapter. Please visit my LinkedIn profile www.linkedin.com/in/larrykaufmanlinkedinspeaker/ for an article I posted about skills from *Forbes*. Why am I sending you to my profile? This is something you can do to drive people to your profile. You can add video, marketing materials, PowerPoint presentations, articles, blogs, etc. to your profile. On your LinkedIn homepage, you'll see a status update box towards the top of the screen. You can type a message in that box that will be sent to your network. Let them know you just posted an article or a YouTube video, etc. to your profile. Now, you are driving traffic to your profile for that article and they will read all about you and your company.

Recommendations are a great way to have customers provide a reference about your business/services. You can have someone share a recommendation for you as a speaker, subject matter expert, etc. I highly encourage having at least 4-6 recommendations from those you worked for and those who worked for you. This is more for those in transition, but could be a great way for others to read what a phenomenal co-worker you were or leader, CEO, etc.

Is there a personal side to your life? Yes there is! Include some personal information in your profile (i.e., a hobby, sports of interest, awards you have won, patents held, books you like to read). This helps others find what they may have in common with you or find interesting about you as well.

Include your website and a phone number. If you want to reduce your level of interaction with others on LinkedIn, then reduce what you share on your profile. I highly recommend that you take the time to check your spelling. Your profile is your link to the network you know and want to know; build one that really defines you!

Turning 1:1 Networking Meetings Upside Down

Through the years, I have found that we all network in some way, shape, or fashion. Many of us prefer 1:1 networking meetings. Some of these meetings include you or a peer in transition and the other person is there to help you or that peer find a job. Other 1:1 meetings are with clients, prospects, referral partners, etc. Most people tell me that they walk away from the majority of these networking meetings feeling empty, like nothing was really accomplished. Have you felt the same?

Tell me if this sounds familiar: You get together with your networking peer and you catch up on personal things with your respective families and then you talk about your businesses. Then you remind each other who you both want to know and meet: “I want to meet CFOs of $20M-$500M companies”; “I want to meet CEO’s of $10M-$50M companies.” You both agree that you will “think” about possible introductions or contacts for each other. What really happens next? Nothing in 90% of the cases. This is because of the saying, “out of sight, out of mind.”

Now let me turn the 1:1 networking meeting upside down. What if you reach out in advance to the person you are meeting (this must be someone you know to some degree and to whom you are directly connected on LinkedIn) and suggest that he can select 5-10 connections he’d like to meet? If this person agrees, then ask if you can do the same in preparation for the meeting; if your contact declines, then he may not be the referral partner you thought he was. 99.9% of people will go through this pre-meeting exercise without hesitation.

Prior to your 1:1 meeting, you may have selected 10 contacts, while the person you’re meeting selected eight. In reviewing your lists with one another, you may only know one person on your counterpart’s list, however that’s better for him/her than leaving with nothing. This process is powerful and can be leveraged over and over again. If you both came up empty from your respective lists, then you can email each other another group of contacts. This takes a meeting without results and converts it into a meeting with results and action.

Think about how many times you have been introduced to someone you didn’t find value in knowing. LinkedIn allows you to select who you want to know. If someone asks if you know any CEOs and you do, will you name them on the spot? Typically, most of us will not. However, if a new contact, Tom, were to ask you if you know John Smith, CEO of ABC Company, whom he found him in your network, then you could respond yes or no directly. When someone asks you if you know someone by name, it’s much easier to respond than if someone were to ask you an abstract question referencing only a title.

One last step that’s missing with this exciting new way to have a 1:1 networking meeting is the introduction. What introduction? Do you have an introduction for yourself that is two to three sentences in length? Is this introduction simple for a contact to use when introducing you to another contact electronically? I have found the vast majority of business professionals, business owners, and so many more do not have an introduction. Why is this important? Has a peer, referral partner, or client indicated they have a referral for you and would be making an introduction via email shortly? Yes, but many tell me in this scenario they have received fewer of those referrals as opposed to more. Your referral source is busy, they forget things, and many times they do not know how to introduce you and, getting frustrated, decide not to make the referral. Why not make it easy for anyone to introduce you to anyone? Create your own introduction. Make it so anyone can cut and paste that introduction into an email introducing you to new contacts.

However, what you say in your introduction is very important. This shouldn’t be a sales-driven introduction. You can reference your role, company name, and a few words (not sentences) about what you do. Include something interesting about your background; why would someone want to meet with you? I say this especially to the traditional career professionals (accountants, insurance brokers, attorneys, bankers, sales people); not many people want to meet with us! You can change that by what you incorporate into your introduction. My introduction references my role as a National Keynote Speaker on LinkedIn, my Board-level roles with a tech start up and a charity, and so on. Very little is referenced about my firm. Before you continue reading my chapter, write your introduction and decide – would *you* meet you?

Joining and Creating Groups

You can join up to 50 groups on LinkedIn. Should you? Groups do have significant value. When you do an advanced search (the word advance appears to the right of the people, company, group search box at the top of your home page on LinkedIn), you can search for first-degree, second-degree, third-degree, and/or group members. If you join 50 groups, then you are likely to have that in common with a number of people on LinkedIn. That's just another common point of overlap with someone you would like to know.

Have you participated in discussions within the groups of which you are a member? If you join groups that fit your company or expertise focus, then your responses to group discussions can be very impactful. I have had attorneys and others tell me that they received business by always answering discussion questions within the groups they belong to today. You can become a subject matter expert and prospective clients will seek your advice and eventually services or products.

You can also create a group. There are thousands of groups already, but if a category is not highly saturated, why not create your own group? Once you click on the Group tab, you will see an option to create a group. It's a very simple process. You need to think of a title for the group that would drive the right contacts to your group. For example, if you sell a service or product to purchasing professionals, then create a group that would attract those types of decision makers.

Some create groups almost as a website exchange for a networking group you participate in today. Others create alumni groups for their past companies or universities.
If you are in transition, then there are job postings within these groups. If you want to promote a firm or an event, then reach out to the group owners and ask for their permission first; this is the proper LinkedIn etiquette. Groups are just another feature within LinkedIn to share information and share something in common with those you know and want to know.

Top 10 LinkedIn Best Practices

1.) <u>Prepare for a meeting or interview:</u> Search for that contact on LinkedIn. If the contact is second-degree, then carefully review your shared connections. Do you want to call any of those contacts in advance of your meeting or interview? Is there something interesting in their profile that will help you prepare for that meeting or interview?

2.) Create your own introduction: this will take you from novice to expert networker and connector.
3.) Research Companies: You can learn so much about a company through the company profiles already created on LinkedIn. You can see who your first-, second-, and third-degree connections are today. You can follow and receive updates about companies of interest. You can also create your own company profile if you do not have one today. This is just another way to market your company.
4.) 5-10 Approach to Networking: This process works, and I have secured clients and meetings through this approach. This will change the way you network.
5.) Build the right network: Start to connect with your clients, advisors, referral partners, colleagues from past companies and staff/leadership at your current company. Connect with alumni from your high school, college, post-grad, etc. Customize your invitations.
6.) Join or create a group(s): You can join a group that is aligns with your experience or focus in business. You can also create a group that will attract the people you want to know.
7.) Modify your LinkedIn Profile: From the right picture, your headline to content, marketing pieces, articles, recommendations, and more.
8.) Post status updates: Drive people to the profile you've created. Post an update on your home page in the status update box and reference an article you posted to your profile or a YouTube Video, etc.
9.) Don't say no: When someone asks you for an introduction to a company/contact, don't say no until you've checked your LinkedIn network.
10.) 15-30 minutes a day: Make LinkedIn a part of your daily regimen. Review updates taking place every day with your network (i.e., who is connecting with who that you may want to know).

Conclusion

My goal through this chapter was to inspire you to rethink your decision to use LinkedIn. There is so much more beyond my words; LinkedIn is the future of business networking. It's a recruitment tool, marketing tool, and business development tool. I want our children today to realize the value and power of LinkedIn and networking before they graduate from college and even high school. We all have to set the example. Thank you for allowing me to share my story and best practices about LinkedIn. I hope you will share your stories and best practices with me.

Chapter 29 | Succession Planning

Joel N. Goldblatt, Michael Weis, and Andrew Arons

Most entrepreneurs who begin a business focus on succession planning, which we define as who will take over and run the business in years after the company is formed and running. However, the smart entrepreneur takes a very different approach, one that includes an exit strategy in the business plan that is created before the business is even formed. Why is this the case, you might ask? The answer is pretty simple. If you do not have a goal, then you do not know where you are going, which means, by definition, that you do not have a plan. Without goals and a plan you do not know where you are headed. In fact, one can argue the two most important issues to address in the business planning stage are (1) your purpose and (2) your end-game (in a perfect world, where do you want to end up?).

Succession planning is about addressing number two: where you want to end up should everything go as planned. When we sit down with clients who wish to form a business, this topic comes up front and center in the beginning of our discussion. As you can see, it must, otherwise the owners are rudderless and do not have a vision (or at least their vision is only partially formed).

Complexity can arise in closely held businesses, often due to family dynamics. Future generations may have expectations, however realistic or irrational they may be, that they will take over the “family business.” An owner may also want to make sure that his estate plan provides equal treatment between family members who are involved with the business versus those who are outside of the business. Combine family dynamics with the typical lack of enthusiasm for thinking about end-of-life decisions, add in how difficult it is to shift focus from the present to the potentially distant future, and you get a perfect storm of planning avoidance. The good news is that there are planning tools that can assist with executing your decisions; however, those tools are only as good as the planning, thought, and effort that goes into them. If owners can hold frank discussions with their co-owners and families to set expectations as to what the owners’ intended transition plans are at the outset of a business, then an owner can at least ensure that the proper tools are in place. Once established, it is also important to update these discussions periodically and view the plans in place to ensure that everyone’s goals are still aligned and the chosen plan is achievable. Ultimately, advance planning helps minimize expensive surprises when it is time for a transition.

Carefully prepared organizational documents (such as shareholder agreements for corporations, partnership agreements for partnerships, operating agreements for limited liability companies, and buy-sell agreements) typically include provisions factoring in the owners' interest in transferring ownership between themselves, to family members, and to third parties.

There are a finite number of possibilities for an exit plan for a business. They are:

1. Selling the business in its entirety;
2. Selling the assets of the business;
3. Leaving the business to loved ones;
4. Merging with another business and cashing out one's ownership interest;
5. Bringing in partners or co-shareholders who eventually buy the founder's interest;
6. Selling the business to an employee stock ownership plan (ESOP) where the employees become the owners of the company;
7. Going public; and
8. Liquidation.

There is another reason why we discuss with our clients where they see themselves in the future and how and when they might exit their business. The reason is tax law. Tax law affects the structure in which you choose to function, and the tax results to the owners at the time of exit often play a big part in the decision of what entity to use. As a general proposition, with relation to taxes, limited liability companies are far more flexible for entry and exit than the corporate form. That said, the corporate form may offer advantages that a limited liability company cannot offer due to the nature of the business that will be conducted and the exit planned. See **Chapter 6: Forms of Entity to Use When Starting a Business** for an overview of the various issues and considerations in this regard.

Once clients have decided on entity structure and has some idea of where they may possibly exit the business, we look at what will occur in various scenarios, which we call "triggering events." A triggering event is a death, disability, termination of employment, and potentially a divorce. Termination of employment may take various forms: voluntary, involuntary without cause, or involuntary for cause. We make the distinction between types of terminations because the parties owning the business may treat the rights of the various owners differently in one situation than in another. A termination for cause may result in a penalty in the amount the terminated co-owner may receive when bought out of the business. A midlife crisis voluntary withdrawal from management of the company may give the other owners the right but not duty to purchase the withdrawing owners interest. Different scenarios call for unique treatment.

Once the triggering events are identified with our clients, they provide feedback on how they want the various scenarios to be treated. In this regard the issues that come to the forefront are:

1. How the ownership interest will be valued;
2. Who will determine the valuation;
3. Whether sale and purchase is a mandatory duty or a right without a duty; and

4. What the terms of the buyout will be (i.e., the period the payments end, interest rates, frequency of payments, up-front money, etc.).

Valuation

The first step is to determine how the departing owner's interest will be valued. Some companies require the owners to annually agree on the current value of the company, others will create a formula based upon book value, sales, or some other metric such as EBITDA (earnings before interest, taxes, depreciation and amortization), while other companies require an independent valuation of the company. All of the options have their pros and cons. From the standpoint of defending a valuation to the IRS or potential claims that a buyout value was less than fair, an appraisal is the safest option, although that also comes with a higher up-front cost, and careful thought must be given to dispute resolution provisions where valuations are not accepted by one or more owners.

While calling for the owners to agree on the valuation of the company annually is cost-effective, in practice it may be difficult for owners to determine the market value of a privately held company, particularly if they begin to disagree with one another. Owners also often let the practice of agreeing to an annual value fall to the wayside until it is too late. A formulaic approach is also cost-effective, so long as the company's books and records are properly maintained, although the downside is disagreements may arise as to whether all relevant factors are reflected in the company's financials and whether the formula is an effective calculation of actual value.

Ultimately, the additional cost of an appraisal frequently is worth the added security it provides. Dispute resolution provisions can and should be added in the event the departing owner disagrees with the company's appraisal. For instance, a departing owner can be allowed to hire his or her own appraiser, and the results of the two appraisals can be averaged as long as the appraisals are within a limited range of each other. Some agreements opt for further review in the event the company's valuation is challenged; instead of averaging the appraisals, the two appraisals are presented to a third appraiser who determines which appraisal is more reasonable. Sometimes, the mechanism chosen calls for two of the three appraisers to come to an agreement on the valuation. The cost of the third appraiser may be charged to one of the parties or shared by all parties.

With respect to minority ownership interests, the agreement should inform the appraiser whether or not discounts are to be factored in for the lack of marketability. Discounts can and often are justified on the basis that ownership is not in the form of publicly-traded stock, and as such, a minority non-controlling interest is a less attractive investment due to the lack of control a minority owner has on the business. Discounts can be punitive, however in this case, the concept of "fair value"—a valuation that does not discount the minority owner's ownership interest—will be utilized. Particular care should be taken if the owners wish to allow discounts; the IRS frowns upon excessive marketability and control discounts, and upon audit, could re-characterize the components of a sale. It should also be noted that the owners may want the buyback value to be limited if an owner has breached his duties to the company or been terminated for cause. This limitation should be drafted into the agreements governing succession.

Purchase Terms

The next step is to plan how the ownership interests will be repurchased. A balance should be reached between providing a departing owner with funds in a reasonable period of time versus avoiding excessive depletion of the company's cash flow. The owners may therefore wish to delay a lump sum buyout for several months after the sale, opting for installment payments over an extended period of time supported by a promissory note issued to the departing owner, or funding transitions arising from death or disability with insurance. In the case of death, many clients opt to shift the responsibility and risk of funding the acquisition of a deceased owner's interest to a life insurance company. This satisfies the needs of the decedent owner's successors who may be on the hook for estate or inheritance taxes or may be in financial extremis due to the loss of income of a primary breadwinner.

In the case of disability or termination of an owner, spreading the buyout payments over time may also serve as additional protection for the company if a departing owner will remain subject to non-competition or non-solicitation restrictions, since the agreement can tie a breach of those restrictions to forfeiture of the installment payments. If a disability is the triggering event, then the disabled owner needs payments over a longer period and the company needs time to pay the obligation; this option, then, can often align all parties' interests.

The agreement that addresses succession should also set an interest rate that will be charged by the departing owner on the installment payments. If no interest is charged, the IRS may still treat the departing owner as if they received an assumed amount of interest income. Fortunately, the Treasury Department publishes monthly rates ("Applicable Federal Rates," or AFR) that are broken down by the length of a loan. If the owners do want to charge the minimum amount of interest, then they may wish to tie the interest rate to the AFR published by the Treasury Department at the time the promissory note will be issued for the appropriate length of the loan.

As discussed above, life insurance and disability insurance can potentially serve as a pot of money to fund a buyout. Insurance can provide immediate funds without stressing the company's cash flow with the sudden need to spend significant sums to buyout an owner. This is particularly true in closely held businesses since the owners can be the lifeblood of the company's success and profitability, and an owner's departure will likely have an impact on cash flow regardless of the buyout structure. If the owners wish to use insurance, they must also decide whether the company will own the policy or if it will be owned by the owners, a decision that can be driven in part by competing administrative and tax implications. If the owners opt for a cross-purchase strategy, then each owner will own an insurance policy on every other owner. In businesses with several owners, this can quickly lead to a large number of policies that need to be maintained and updated as the business value increases and owners come and go. From a tax standpoint, the owners will receive an increase to their basis in the stock of the company when they each purchase the deceased or disabled owner's ownership interest in the company with the insurance proceeds received on the death of one of the owners.

In the alternative, if a redemption instead of a cross-purchase is used, the company will only need to acquire one policy for each owner and it will purchase the departing owner's interest in the company. The drawback of the redemption approach is that the owners will receive no increase in the basis of their stock upon the purchase of a deceased or disabled owner's ownership interests and receipt by the company of a large sum from an insurer can drive up everyone's stock value including the value of the selling shareholder's interest to his or her estate. This clearly is not desirable for the heirs of a deceased shareholder selling that shareholder's interest, as it can add to the estate's tax burden.

Flexibility is built into well-drafted succession documents in order to offer owners the choice of whether they acquire the departing owner's interests (a cross-purchase) or allow the company to purchase the departing owner's interests (a redemption). The benefit of a company redeeming shares is that the remaining owners' respective ownership percentages will be affected on a proportionate basis. For instance, if one of the remaining owners does not have the individual ability to fund a buyout of a sufficient amount of the departing owner's interests, then he/she may not be able to maintain the same percentage interest and control of the company. Alternatively, if the company lacks sufficient cash flow, the owners may prefer that they individually purchase the ownership interests directly from the departing owner.

Oftentimes the agreements provide a cascading level of buyout options. First, the remaining owners will each have the right to purchase the departing owner's interests on a pro rata basis. For example, if A owns 20%, B owns 30%, and C owns 50% of the company, then when A leaves the company, B and C can each exercise a right such that B will buy 37.5% of A's ownership calculated as the result of A's interest times the division of B's interest over the sum of B and C's combined interests (A's 20% X (B's 30% / (B's 30% plus C's 50%))) and C will buy 62.5% of A's ownership (A's 20% X (C's 50% / (B's 30% plus C's 50%))). B and C will therefore maintain the prorata ownership interests with respect to each other. Oftentimes, this ability of an owner to avoid dilution of their level of ownership is referred to as a "preemptive right." Preemptive rights can be given to individual owners conducting a cross purchase as well.

If either one of the remaining owners decides not to buy the full pro rata portion of the departing owner, then the other owner(s) will have the option to purchase any remaining portion of the departing owner's interest in the company. If neither owner decides to buy the departing owner's interests, then the company will be required to buyout the owner. The structure of these cascading purchase options can be modified as the owners see fit, and will necessarily change if the owners permit third parties to buy in. Furthermore, if disability or life insurance is available as a result of an owner's death or disability, the insurance payout will be the first option, and the cascading levels of buyout options will follow if the insurance does not provide enough funds to buyout the departing owner's entire interest in a company.

In addition to determining how ownership interests will be valued, how a purchase may be funded, and who will buy the ownership interests, the owners should also discuss whether the company should restrict who may buy into the company. While the relationship between the owners impacts all businesses to some degree, this is especially so for businesses owned by only a handful of owners. Owners of closely-held companies therefore often restrict the ability to transfer ownership to avoid unwittingly becoming a co-owner with someone with whom they would not otherwise go into business or at the very least provide existing owners with a right of first refusal to match any third party offer.

Companies Prohibiting Any Transfers

Closely-held companies' owners may wish to limit transfers so that no outsiders are allowed to become owners without unanimous approval. Under some states' limited liability company acts, unanimity is mandated by the law. Illinois is such a state. Specifying the number of votes required may be accomplished by providing in the organizational agreements that no outside transfers are allowed without unanimous consent of the owners. A mechanism should also be put into place for the eventuality that an owner leaves, suffers a permanent disability, or passes away. Commonly, companies that bar any transfer of ownership without consent will permit owners to transfer their ownership interests through their trusts for estate planning and possibly creditor protection purposes.

If the owners wish to allow trusts to hold ownership, then the agreement should clearly provide whether or not the death of the trust's grantor will require the trust to sell and either the company or other owners to purchase the deceased's ownership from the trust. The trust should be a signatory to the agreement as well.

It should also be noted that any restrictions on the transfer of ownership interests can have an impact on securities laws. If any certificates of ownership are issued, transfer restrictions should be noted on the front or back of the certificate, and it must be made abundantly clear in any purchasing document that an owner will not be able to freely transfer the ownership interests.

Transfers to Family

Particularly in a business controlled by one family, an owner may also want to pass a company on to future generations. As referenced at the outset of this chapter, the complexities of transferring a company down through a family may go beyond the legal and financial issues to also impact family relationships.

Communication seems particularly important in these scenarios so that a future generation's expectations are properly set. Failure to do so can result in disharmony and lawsuits. If a family-owned business owner prefers to enjoy the fruits of his labor in retirement by selling the business he has worked hard to build, a younger family member who may have worked in the business may be surprised that he/she is not inheriting the company. Harmony is not only important for the family, but also for the value of the business. If the owner wishes to sell the business to a third party, the potential buyer oftentimes will want to keep key employees on board for a few years to aid with the transition and limit customer confusion and competition. If an owner's child is not pleased with the surprise of a third party taking over the business, it may raise concerns for a potential buyer and impact the purchase price or transaction. A well-thought-out plan coupled with advance communication will thus help maintain the unified front which must be presented to potential purchasers to maximize the company's value. Such a plan may also directly address these very issues and build in a mechanism that rewards a loyal son or daughter in the event of a sale, thereby helping to ensure they stay on in the event of an exit as may be required by a potential buyer.

Similarly, if an owner believes that one of his/her children is better suited to take over than other family members, this should be communicated to all children, as failure to do so can create additional conflicts. Such conflicts can be exasperated further when the transition does not happen until an owner's death. In that case, the family is not only dealing with the pain of losing a family member, but also a change to the younger generation's career expectations. Once again, this may not be solely an emotional issue since it may lead to the departure of a key family member from the business and may even lead to a challenge to the deceased owner's will and or trust. Frank communication between the owner and other family members whether involved in the business or not can therefore ease a subsequent transition and help avoid unnecessary family discord.

An owner's estate plan should also be synchronized with the owner's business succession plan. Separate provisions can be made in a will or trust designating whom ownership of the business will transfer to upon the owner's death. Care should be taken to ensure that the estate plan does not conflict with the company's organizational documents. If an owner has several children who do not all participate in the business, the owner may also want to make efforts to split up his estate so that the business is transferred to one child, while other equivalent assets, if available, are transferred to the children who are not involved in the business. If the owner has a trust, then he/she can also designate specified parties to act as a special asset advisor to advise the trustee regarding how the business should be run until it is transferred or sold. For instance, a trust will typically name an owner's spouse or adult child as the successor trustee upon the owner's death. If the trustee is not familiar with the business' operation, they may face a significant challenge to step into the business and maintain its profitability to either maximize sale proceeds or transition to new ownership. A key employee or other trusted acquaintance with specialized business knowledge can instead be named to advise the trustee as to business decisions. In most states, this advisor will owe fiduciary duties to the trust. Such duties when explained may or may not be welcome. The trust can reduce or eliminate some of these duties or call for them to remain in place.

Other common terms that must be considered are trustee compensation; provisions that permit the trust to retain a risky undiversified business asset as the main asset held by the trust; and provisions permitting real estate and refinancing of real estate or transferring such assets to another trust that has the same terms and will only hold real estate. Such flexibility may come into play in banking relationships or where environmental issues may be a concern relative to the real estate in question. Special provisions permitting the retention of subchapter S corporate stock also may need to be addressed. Thus, a business owner should ensure that he/she has a clear estate plan that can be updated as the business changes over time, and which is focused on the owner's needs in order to effectuate the owner's succession goals.

Another consideration is estate and inheritance taxes at the Federal and State levels. While the Federal Exemption has been raised to $5.25M (in 2014) per spouse who is a U.S. citizen and the exemptions can be combined in the estate of the surviving spouse, State inheritance tax exemptions are smaller ($4M in Illinois for instance) and businesses, when successful, can often cause an estate and or inheritance tax to be incurred. Advance proper planning can create pools of money outside the estate through the use of life insurance held by an irrevocable insurance trust. Such trusts hold title to the insurance and once established cannot be influenced by the creator of the trust (the settlor or grantor). Yet, succeeding generations can receive the insurance proceeds estate and income tax free, thereby creating a pool of money that can address any estate taxes. Such devices can avoid a forced sale of the company to cover taxes and thereby a family can potentially pass the business down to the next generation. This issue is all the more magnified for non U.S. citizens, as the exemption amounts are in the low six figures, and most such owners will be forced to sell their businesses if they do not undertake advanced thought and planning.

Some of the most difficult plans on which lawyers are asked to assist involve family business succession issues. While the reason might be obvious, the family issues involved in any succession plan require honesty, some forthright difficult discussions, potential hard feelings, and often parents who are not willing to rock the boat and hurt their children's feelings. As a result, having meaningful discussions requires the decision maker to have the courage to enter into a process that can be frightening and emotionally taxing. Most people don't like change and have varying degrees of resistance to it. When family is involved and disturbing a relationship that has some level of predictability and comfort that has been accepted by the stakeholders to date, change is even more difficult to embrace, as the threat to family harmony often trumps sound business judgment.

When we meet with clients, we have to ask them some tough questions. Being cognizant of the alternatives and questions in advance can help our clients begin to organize their thoughts and prioritize their goals and values. Doing so is necessary for the succession plan to be successful (or even implemented in the first place).

As explained earlier, there are a finite number of ways to exit a business. They are:

1. Selling the business in its entirety;
2. Selling the assets of the business;
3. Leaving the business to loved ones;
4. Merging with another business and cashing out one's ownership interest;
5. Bringing in partners or co-shareholders who eventually buy the founder's interest;
6. Selling the business to an employee stock ownership plan (ESOP) where the employees become the owners of the company;

7. Going public; and
8. Liquidation.

To Involve Family or Not to Involve Family: Factors to Consider

1. What are the capabilities of the family members in question relative to:
    a) Having capital to buy in or sufficient assets so they are bankable
    b) Business acumen
    c) Trustworthiness
    d) Relationship with other family members
    e) Where the relative is situated in the family pecking order
    f) Vision they have for the business
    g) Experience
    h) Age
    i) Desire
    j) History with other family members (representative issues or ongoing acrimony)
2. Does the exiting family member intend to leave the business to family or sell the business to family?
3. Are family members who will be succeeding current owners already involved in the business as owners or employees? If so, how, and how is it working?
4. What is the timing of founder or the generation leaving the business, leaving the business?
5. Do the exiting owners require an income stream from the business or a sale of their interest in the business? For how long? How much?
6. How much control is existing ownership willing to cede to the next generation of owners? What is the timing the existing owners desire with respect to this process?
7. Does the next generation have an expectation the business should be left to them or they will have to buy the business? Why in either case?
8. What are the estate and gift tax implications and how might these impact the succession plan?
9. What is the existing debt structure and will the business be bankable where this transition occurs?
10. What loan covenants must be reckoned with in the event of the death of a principal?
11. Has any discussion with the current banking relationship taken place?
12. Has the business been valued? When? By Whom? How independent is the valuation party?
13. Who selected the business valuation firm?
14. What is the exiting owner's goal(s)? Of all the goals what is most important?
15. How realistic are the exiting owner's goals? Have other family members been asked this? If not why not? If so what was the response?
16. Is existing ownership willing to sit down with the stakeholders and have an open, honest and potentially painful (at time) discussion? Are the stakeholders willing to participate in such discussion? If someone is not why? And what is their position in the company now and what is the desired position for such individual(s) following a succession event?

17. Are there independent trusted advisors that know the family well? Who hired them? What is their agenda (if any)? Historically has their advice been helpful? Has it been followed?

We suggest sitting down and having our client write answers to these questions. However, we do not stop there; we also suggest that each of the stakeholders who may be involved in the plan write answers to these questions. If the family wants their answers to remain in confidence, then this can be arranged where the clients consent to this approach. We also can have anonymous answers compiled or even engage a third party who will see the answers and be under a confidentiality commitment to not disclose who answered and how.

While the optimal approach is to have everyone acting openly and honestly utilizing procedures as just suggested may help in causing the discussion to occur or an environment that will breed trust, overcome discomfort and permit the clients and their family to proceed on a helpful and productive basis that is ultimately healthy and useful.

Remember, failure to make a decision IS making a decision, and defaulting to kicking the can down the road often results in families fighting in court. The planning may be difficult, but failure to undertake a thoughtful, honest, and open approach can be far more detrimental to the family and ultimately bring about what the founders or parents who own the business are trying to avoid.

Third Party Transfers

Lastly, business owners should plan on how they will treat new investors allowed to buy into the company. If the new investors are buying ownership interests from existing owners, then considerations will include whether the remaining original owners have the option to buy the interests offered for sale, and whether so-called “drag-along” or “tag-along” rights will be provided. In the previous section on purchase terms, we discussed a cascading order of buyout rights; the nature of this order may be tweaked in the event the owners allow a third party to buy in. The agreements governing succession can provide that if an owner wishes to sell to a third party buyer, the selling owner must first provide notice to the other owners that he or she is intending to sell his or her interests and identify the price and terms of the proposed sale. The remaining owners will then be provided a predetermined amount of time to match the third party’s offer. If the remaining owners match the offer, the selling owner must sell to the remaining owners and not the third party. Thus, the company provides the owner with another mechanism to ensure that the owners approve of who controls a closely-held company while also providing a means for departing members to cash out of the business. Our cascading level of purchases is therefore modified so that the owners will have the first option to buy the selling owner’s interests, the company will then have an option to buy the selling owner’s interests if the owners failed to timely exercise their purchase rights, and if neither the owners or company exercise their options, then the third party can purchase the interests they offered to buy.

Drag-along and tag-along rights can also be included in the documents to require a third party buying into the company to acquire additional owners' interests, or to require minority owners to sell to a third party. Tag-along rights require a third party who purchases a majority interest in the company to also offer to buy out the remaining minority owners on the same terms as the majority owner. Thus, the minority owners can decide to "tag along" with the majority owner's sale so that they are not left in a company in which they do not have a meaningful vote. On the other hand, a drag-along right requires minority owners to sell their interests to a third party if the majority owner decides to sell its interests in the company. This vests the majority owner with additional power to force the full sale of the company. The majority owner may be unable to find a buyer who is interested in only a portion of a company, or may find that the ownership interest value can be maximized by a full sale. Drag-along rights protect a majority owner from a minority owner looking to extract a premium from the majority owner to approve a sale.

Life After a Sale

An owner should also plan for how he or she will be treated following his sale of his ownership in the company. In order to avoid an owner separating from a company and immediately opening up shop across the street to compete with his old company, restrictive provisions are often included in the organizational agreements. Non-competition agreements can restrict an owner from participating in any way with a competing business, non-solicitation agreements can restrict an owner from soliciting the company's employees and customers, and confidentiality agreements can restrict an owner from disclosing the company's confidential proprietary information. Care should be taken in crafting these types of restrictive covenants so that they have some teeth. Depending on what state's laws apply to the company and the owner, there may be specific requirements to limit the length of the restriction, the geographic scope of the limitation, the type of business for which the limitation applies, as well as other factors dependent on the state and scenario involved. Enforcement language should also be drafted into the agreement so that an owner in breach of these obligations is subject to injunctive relief which allows a court to order the departing owner to stop violating the agreement. Even without restrictive covenants, if an owner has taken steps prior to leaving the company to encourage the company's customers or employees to go elsewhere, some states may view the actions as a breach of the owner's fiduciary duties subjecting the owner to liability.

Another key aspect of these agreements is the ability to have alternative dispute resolution provisions included that can save the owners thousands, if not hundreds of thousands, of dollars in litigation expenses. Agreements can be quite creative in this regard. In addition to arbitration and mediation provisions, some agreements call for "shoot out" provisions. These are provisions that in the event of a deadlock between ownership each owner is required to make a blind bid for the other's ownership interest. The bids are opened at the same time and the high bidding owner must buy out the other owner. Terms of purchase can be agreed in advance so that none of this is subject to argument. Arbitration clauses can limit discovery and relax rules of evidence and address the expensive issues in which litigation would otherwise result.

Different Techniques for Succession Planning

Any succession plan may also utilize a myriad of techniques that may or may not be desirable for the business owner to use. Having some basic familiarity with some of the more commonly used plans can be helpful for an entrepreneur to know what options exist. The following discussion briefly explores and describes these devices and how they are used.

A good starting point in any discussion of succession planning techniques must begin with a short course on property law. In the U.S., there are two types of property: real property and personal property. Personal property has two categories itself: tangible and intangible.

How one holds title to his/her property affects where such property will go upon his/her death. A concept known as “probate property” describes property (real or personal) that is titled in the name of the owner alone. Probate is the court process whereby a probate court will see to it that in the event of the death of a person his/her probate assets pass to his/her loved one. Where a will exists and is admitted to probate, the will directs where the probate assets go. Where no will exists, the laws of intestacy come into play and each state’s respective intestacy laws state where the probate property passes in the event someone dies without leaving a last will and testament. Typically the assets pass to an individuals’ heirs as defined by the laws of intestacy.

However, probate only affects probate assets. As a result, if you hold title to property in a non-probate form, then probate will never affect those assets, and indeed, a will has no effect on non-probate assets either. Examples of non-probate assets are assets titled and owned by a trust; assets held in joint tenancy with rights of survivorship (title to which automatically passes to the surviving joint tenant in the event of the death of one of the joint tenants); and assets that pass due to a beneficiary designation (i.e., life insurance IRA’s qualified plans Totten trusts-a type of bank account) where the named beneficiary survives the decedent. A probate estate can also come into existence for someone who is disabled or incompetent. While each state has its own peculiar laws, as a general proposition, there are two types a guardianship: of the *person* and of the *estate*. A guardianship of the *person* is where an individual who is responsible for the care and well-being of a disabled person is appointed. A guardianship of the *estate* is where a person is appointed to care for the probate assets of a disabled person.

The instruments most commonly used in the first instance of succession planning are wills and Revocable Trusts.

Wills on their own can offer a series of benefits. They can:

1. Remove uncertainty of decedent's goals/wishes;
2. Help eliminate or reduce the chance of family disputes;
3. Save estate and inheritance taxes if proper planning is implemented;

4. Provide for the appointment of a guardian for minors and the administration of property in the minor's behalf;
5. Avoid the laws of intestacy and possibly unintended consequences; and
6. Provide for the payment of taxes, debts and the administration of decedent's property.

Revocable Trusts also offer benefits. They can:

1. Provide greater flexibility in administering assets;
2. Provide privacy;
3. Provide for estate and inheritance tax savings;
4. Avoid probate and the public nature of such proceedings and save time, money and avoid complexity;
5. Avoid guardianship if the grantor was disabled during life;
6. Provide for the payment of taxes, debts and the administration of decedent's property;
7. Remove uncertainty of decedent's goals/wishes;
8. Help to eliminate or reduce the chance of family disputes; and
9. Offer asset protection for beneficiaries other than the grantor in the form of spendthrift protection against the creditors of beneficiaries.

Revocable Trusts are very flexible and helpful estate planning devices. Before death, their creation results in no income, estate or gift tax consequences and they are called "grantor trusts" under the internal revenue code and are disregarded for tax purposes. Following the grantor's death (or incompetency), they become irrevocable and are their own entity for tax purposes. During life, they are also more easily amended than wills are (wills have some strict execution requirements and if those are not followed the will is of no legal force or effect). Following the death of the grantor, they can be used to avoid probating the grantor's estate provided all of the grantor's assets are titled in the name of the trust. To retitle the assets, assets such as bank accounts, beneficiary designations, real estate, or titles to personal property such as vehicles are titled in the name of the trust. For example, if John Doe establishes a trust on December 15, 2013 and wants his trust called the "John Doe trust," then title to his assets would read: "John Doe as trustee of the John Doe Trust dated December 15, 2013."

When a grantor wants to reduce his or her estate for federal and/or state estate and inheritance tax purposes, he/she will often first use what is called an Irrevocable Insurance Trust. An irrevocable insurance trust is a trust that cannot be revoked, and in which the trustee of the trust is anyone other than the grantor establishing the trust. The trust owns title to an insurance policy on the grantor's life and the grantor has no say and cannot benefit from the trust. When properly structured, this device is used to eliminate the proceeds of the life insurance policy from the estate of the insured grantor. While there is some complexity involved, this device takes an asset that would otherwise be in the estate of the insured, leverages it (premiums turn into a pile of cash where the policy remains in force until the death of the insured), and permits the beneficiaries to receive the policy proceeds estate-, income-, and gift-tax-free.

Another device utilized in estate planning is the “installment sale.” Here, the grantor often sets up an entity owned by other family members. A gift of cash typically approximating 10% of the value of the assets to be sold to the entity is made to the owners of the entity being formed. The family members owning such entity then enter into an installment agreement or a sale agreement whereby the new entity purchases an income producing asset belonging to the grantor, say an apartment building. The purchase obligation could be secured with a mortgage or a note or an installment agreement. The family members who purchase the asset pay monies over time to the grantor so this is not a gift but a sale. The grantor typically realizes capital gains (such assets are favored due to the lower taxes that apply to them) and the family members procure a valuable asset the appreciation of which will not be in the seller’s estate. As a result, a legitimate freeze of future appreciation occurs and the grantor locks in an income stream which often is needed by the grantor during his or her lifetime. If the grantor dies, then the remaining value of the contractual obligation is included in the grantor’s estate but not the appreciation on the asset that was sold. Care must be taken to structure such transactions on arm’s length fair market value basis to avoid part gift part sale treatment by the taxing authorities.

Where an individual prefers to make a gift instead of a sale and retain an income stream for a limited period of time, the device often utilized is called a “Grantor Retained Annuity Trust.” This mechanism is, as so often is the case with these techniques, regulated by the taxing authorities. For instance, the IRS requires the annuity term to include minimum pay-back periods. How the technique works is the grantor gifts an asset typically to an irrevocable trust for his or her children. The trust is duty-bound to pay an income stream back to the grantor over a set period of time. Because the grantor has retained an interest in the property for a period of years, the value of the gift is discounted, thereby incurring lower gift tax. If the grantor outlives the annuity term, then the beneficiaries of the trust receive the remaining assets in the irrevocable trust estate tax-free, and the grantor retains an income interest for a period. Through this process, she has successfully transferred an asset to his or her loved ones at discounted dollars. Following the completion of the annuity term, the trust can distribute the remaining asset(s) to the grantor’s beneficiaries. The one drawback is that if the grantor establishing the trust dies during the term, typically the entire asset is included in the grantor’s estate.

An offshoot of this type of annuity trust that focuses on an individual’s personal residence is called a Qualified Personal Residence Trust (QPRT), which is designed to transfer your personal residence to your beneficiaries for reduced or no estate taxes, while allowing you to continue living in the residence.

Depending on an individual’s willingness to give up control over assets he/she intends to gift to beneficiaries, other strategies are available to reduce gift and estate taxes. For example, family limited partnerships can be used to transfer interests in certain kinds of assets to beneficiaries while reducing the tax value of the transfers for reasonable discounts arising from the lack of marketability and control the beneficiaries may have over the assets. Irrevocable life insurance trusts can also be used to take funds out of an individual’s estate and create a pool of funds, which beneficiaries can then use to pay for estate taxes that might be due. Both of these strategies require careful planning and precise execution of the plans in order to qualify for the intended gift and estate tax benefits.

Other devices used often involve charitable gifting. Here, outright gifts from a revocable trust is possible; in larger estates, other techniques may be utilized: charitable lead or remainder annuity trusts and charitable lead or remainder uni-trusts. The annuity trusts call for a payment based upon a set interest rate. The uni-trusts call for a payment based on fixed percentage dollar amount of the entire trust's assets each year. One of two types of each of these (the uni-trust or annuity trust) is used, either as what is known as a "lead trust" or what is known as a "remainder trust": the remainder trust leaves the balance of the assets in the trust to a charity after paying income to the grantor's beneficiaries, while the lead trusts benefit a charity with income during the lifetime of the grantor and at his or her death the proceeds go to a non-charitable beneficiary.

Conclusion

If the owner or owners of a business take care at the start of a venture to discuss and plan potential exit strategies and continue to update those discussions as the owners and company progresses, then the owners can help weather the change of ownership without overly impacting the success of a business. Furthermore, advance planning can save hundreds of thousands (and in some cases millions) of dollars in taxes. If nothing else, proper planning will provide the owners with a roadmap to provide guidance when an owner wishes to retire or leave the company or when he/she passes away. Proper advance planning can avoid the substantial costs of litigation, taxation, time, and acrimony associated with these traumatic experiences, as well as help the entrepreneur in his or her business planning by maintaining focus on his or her desired end result.

Chapter 30 | Retirement Planning

Nick Economos

In this chapter, we discuss the techniques used by businesses and their owners to institute qualified retirement plans for themselves and their employees. As any business owner either knows or is likely to become aware of, attracting and retaining employees often requires competitive benefits for the employer's employees.

In addition, we will explore the different types and qualities of plans, limitations to them and the types of entities that can deploy them, how they can be used, strategies for implementation, and issues the employer must be aware of from a fiduciary duty and exposure standpoint.

Many companies spend an inordinate amount of time interviewing and ultimately hiring an Advisor. What's the problem with that? Most plan sponsors may ask for a proposal but if they haven't taken a series of steps to establish goals and elicit employee feedback, they don't actually know what it is they "want" in a plan and an Advisor. A variety of proposals could be submitted from Advisors who aren't specialists in the area where the company likely needs the most assistance in plan creation.

Instead, a solid process is needed to understand management's goals, give employees a greater hand in plan design, uncover the best elements for a plan that steers the financial direction of the company and even create a more evolved position for the Retirement Plan Advisor.

Data Gathering and Fact Finding

Long before specific investment vehicles within a plan are considered, the main focus of most Retirement Plan Advisors is to begin with a great amount of data gathering on the company and its employees. Several tools can be helpful to obtain this data with an eye on objectives that can be realistically promoted long-term:

- An **Organizer** that Advisors can walk through with their clientele, gathering all relevant information that may impact any issues related to retirement planning.
- A **Documents Checklist** that ensures that the Advisor has a record of all documentation
- A **Plan Sponsor Questionnaire** that asks clients to evaluate their current plan relative to several different categories
-

Goal Setting: Smart Conversations Here and Now for the Road Ahead

After robust data gathering, an in-depth conversation about goals and objectives can commence, such as what the business owner and their employees are striving to achieve through the business' retirement plan.

It is a misconception that all business retirement plans are created equal. In fact, few are exactly the same because a great factor in determining the direction of the plan is based on the unique goals and objectives of the business owner as well as the consideration of the employee base, such as how they would like to be communicated with, types of investments, what tools they'd like available, what type of access to an Advisor they prefer, if they want electronic statements or traditional paper statements, level of investment experience and more.

In addition to these particular choices, we must also look at the demographic composition of the company, including the age and overall retirement plan health. In my conversations with small-to-medium-sized business owners, the questions I typically receive are ones such as:

- What's the right type of plan for my business?
- What are the benefits to me as an owner?
- What are the costs?
- What's my liability from a fiduciary standpoint?
- Who are all of the service providers?

It's not that executives don't have a plan. In fact, they very well might. That said, with a lot of moving parts, they may still have a lot of questions and concerns about how the plan actually works.

Herein lies the crux of our challenge. For while the financial industry often speaks of risk in terms of the investments within a plan, what is neglected as a considerable measure of risk is the risk of *not administering the plan correctly*.

For example, employee contributions in the retirement plan may not be delivered on time. There may be confusion over the definition of compensation in the plan. The wrong investments are made. The Form 5500 is filed incorrectly or not on time. The plan sponsor has not documented the plan's investments in accordance with best practices and administration of the plan. Required notices haven't been maintained by the plan sponsors for employees annually, including the summary annual report, investment change notices or fee disclosure notices.

Without ongoing communication and an educational pipeline in regard to benefits, the goodwill between management and its employees can quickly unravel into confusion and frustration. Conversely, when communication is strong to the point of where employees have a thorough understanding of how the company is designing a retirement plan around them, it becomes a powerful value-add to that employee.

Therefore, to deliver on this value-add, there are 4 very important R's to remember when it comes to retirement planning.

The 4 R's of Retirement Planning

- **Recruiting**
  How do we design our plan as competitively as possible to recruit people from a different organization?
- **Retaining**
  Eliciting feedback from employees, what do they like or dislike about the plan? By allowing for greater participation in creating a plan that reflects their needs and preferences, employees have an important element of the company they can truly call their own.
- **Rewarding**
  Can we encourage employee productivity to hit certain company targets through profit sharing?
- **Retiring**
  How many employees can we help actually reach their retirement destination in exactly the fashion we designed in our plan – or better?

To preserve the lines of communication, ensure the 4 R's are delivered on and keep the company's financial ship on course, let's look at a couple of important ideas that can help increase the likelihood that the plan's investment goals and objectives are being consistently achieved.

The Investment Committee

One of the more under-utilized methods of creating "buy-in" within an organization is to formalize an **Investment Committee**. The Investment Committee helps ensure that management of the plan is documented and substantiated. The Committee is largely comprised of people who have a fiduciary responsibility, such as the CFO, Controller, Corporate Counsel, Human Resources, etc. Each member of the committee will have a thorough understanding of investments.

The agenda of the Investment Committee is to ensure the plan has features that promote the company's objectives. This includes obtaining the right vendors and getting the right procedures in place so that the plan is run at maximum efficiency. Naturally, how and what to communicate to the employees in regard to the plan is also part of what the Committee must address, such as how to obtain greater tax benefits.

Yet, there is still one other crucial role that needs to be filled as the internal view of retirement planning via The Investment Committee is only part of the equation. In order to gain a complete perspective, growing businesses also need to define a place for a CRO – Chief Retirement Officer.

The CRO – Chief Retirement Officer

We see the role of the financial planner evolving as one that is not merely an Advisor once a quarter, but truly an on-call and ongoing extension of the company known as a **CRO – Chief Retirement Officer**.

The CRO's responsibility is to be the primary conduit of all information in the company flowing inward and outward regarding retirement planning.

For example, let's say the company is about to bring several new associates on board as new hires. What is the step-by-step process for notifying these hires of the options before them in a retirement plan? How many meetings are required? What format is best?

The CRO addresses all of these concerns and then some, introducing people to the plan in one-on-one meetings and group sessions. In these interactions, the CRO notifies employees of all the essential elements of the plan and gives them the opportunity to ask any relevant questions.

Beyond enrollment and execution of plans on an individual basis, how does the CRO continually communicate to the company as a whole on aspects of plans that demand their attention?

The CRO adopts a point of view that is not singularly focused on investments but instead educating plan holders on budgeting, cash flows, asset allocation, behavioral finance issues and more. As part of best practices, the CRO might schedule several different topics throughout the year, delivered through a series of webinars.

Obviously as the CRO will have a deep background in financial planning for hundreds of companies and designed plans for a wide variety of financial situations, nobody internally will likely possess the same level of comprehension as the CRO in this area of expertise.

The value of the CRO is not confined to their own knowledge but other professionals they might bring into the environment, such as record keepers who track the assets and infrastructure that people can interface with and other 3rd parties who can handle the administrative and compliance work of who is credentialed.

Types of Retirement Plans

There are a number of retirement plan opportunities for companies to consider. Let's take a closer look at them to better appreciate the differences among them.

Defined Contribution Plan

A **Defined Contribution Plan** can give an employee greater control over investments in the plan, enabling them to select certain types of investment vehicles. Rather than criteria such as the employee's years of employment or earnings, the Defined Contribution Plan considers the employee's contributions to the plan and how the selected investments perform.

As such, the employee holds greater responsibility for investment risk and reward associated with the plan – though they face an investment risk for underperforming assets, the employer does not.

The employer's role in this type of plan distinguishes the Defined Contribution Plan from the Defined Benefit Plan as well: More is left to the employer's discretion in that they are not "locked" into a certain kind of contribution. The employer can choose to define their contribution as either a match or by a profit sharing formula.

Simple IRA Plan

The most basic form of retirement plan, a **Simple IRA**'s greatest advantage is its adaptability and portability by employees – if employees leave the company, all contributions go with them and each employee has control over how money in the IRA account is invested. Unlike other conventional retirement plans, the Simple IRA is relatively easy to set up and operate. It is often ideal for small companies under 100 employees.

While an employee may choose not to make a contribution into the Simple IRA, that option does not extend to employers. For the employer, a contribution is required in the form of a matching contribution up to 3% of compensation or a contribution formula in which the employee must receive a contribution to the Simple IRA equal to 2% of their compensation – which holds true even if the employee elects not to contribute.

The Simple IRA does have a couple of potential disadvantages to consider. 1) When an employer features a Simple IRA, it cannot feature any other type of retirement plan. 2) The annual contributions into the Simple IRA are more limited than a 401K – as of 2013, the maximum contribution into a Simple IRA is $51,000.

401(k) Plan

Tax-deferred growth and tax-free accumulation are the hallmarks of the standard **401(k) plan**. In this type of plan, the employee can defer receiving a portion of their salary, putting those dollars toward an employer-sponsored 401(k). Only upon distribution is the deferred money taxed.

The typical 401(k) plan offers more flexibility on a few different levels over a Simple IRA. For example, while a Simple IRA demands exclusive commitment to that plan, it's possible to have other retirement plans while being under a 401(k). There are fewer limitations on contributions as well – not only can an employee contribute more to a 401(k) than a Simple IRA, but employers can also contribute a greater amount to the employee's plan, up to 25% of the employee's eligible compensation.

Profit Sharing Plans

Profit Sharing Plans enable employers (who are the only possible contributors under this plan) to contribute without a mandatory set amount. The only stipulated contribution limit is that the employer contribute the lesser of either 25% of the employee's compensation or $51,000 as of 2013. This type of plan may be favorable to those companies facing cash flow challenges as the company can make contributions when it is able to do so. Types of Profit Sharing Plans include:

Traditional

Typically, when **traditional** contributions are made in a Profit Sharing Plan, the employer calculates the total compensation of employees and divides each employee's compensation by that number. The employee's fraction is multiplied by the employer's contribution, which arrives at each employee's share of that employer's contribution.

Age-Weighted

For a younger employee for whom retirement is probably not on the horizon anytime soon, it may make more sense for an employer to only contribute a small amount to a retirement plan. Meanwhile, the employer may choose to allocate a larger contribution to those participants in the plan who are older and higher paid. The employer does not have to be concerned with a required minimum contribution.

This **Age-Weighted** model may actually provide a "win-win" for young and older alike. Due to compound interest, the contribution made for the younger employee, though a smaller amount than the older employee, could provide similar retirement benefits over time.

Integrated Social Security

This type of plan factors in **Social Security** as it allocates the eligible employee's contribution into the plan. Social Security is paid on compensation up to a certain dollar amount, so in order to account for this, an employee with compensation over the Social Security Taxable Wage Base (TWB). This "excess" portion of compensation receives a higher allocation from the employer contribution in the retirement plan while the "base" level of compensation under the TWB receives a lower contribution from the employer. For 2013, the TWB is $113,700.

Cross Tested

A plan in which the employer provides different rates of contributions toward different grouped employee categories, the **Cross Tested** approach tends to favor older, more highly compensated employees who are closer to retirement. Under this plan, the employee's age, years of service and compensation are taken into account when determining how contributions will be allocated. Employees who are participants in the plan find contributions from their employer are not included in their taxable income and interest accumulates on a tax-deferred basis.

The Cross Tested plan can be very complex to administer compared to other plans due to its rigorous code testing. Each year, tests must be conducted to ensure the employer contributions do not violate non-discrimination regulations. However, if these regulations are met, any group in the plan could be favored depending on the design – and the employer may find the costs of administering the plan to be less expensive when compared to other plans.

Defined Benefit Plans

The **Defined Benefit Plan** leaves no doubt as to the type of contribution and benefit the employee is receiving. The contributions made are substantial, mandatory and ongoing – in fact, if the minimum level of contribution is not satisfied, an excise tax can be applied. Additionally, the plan needs to show a consistent level of profitability.

Defined Benefit Plans are more complex to administer than other plans and can be the most costly in comparison as well. Still, it can be a useful tool for a business to use for recruiting and retaining employees in that it offers subsidized early retirement benefits and an employer contribution that is often higher than other plans. The benefits are not linked to the returns from assets and those benefits within the plan are predictable. Vesting can be immediate or spread out over the course of seven years and the benefits are not linked to the returns from assets.

Separating Fact From Fiction: Behavioral Finance Issues

What might be stated in the media that causes an emotional reaction may not mesh with financial reality. The latest headline coming from Wall Street can send a wave of mixed messages and at times, create irrational thinking and behaviors. In the worst cases, psychology trumps all and leads to poor investment decisions and results.

Consequently, in addition to deftly communicating and coordinating on an ongoing basis with the company and its Investment Committee, the CRO also brings a strong knowledge of **Behavioral Finance** matters so that the company is not disproportionately influenced by external factors in its plan design.

What is Behavioral Finance? It assumes that while people generally view wealth management from a rational point of view, there are psychological and behavioral elements that may occasionally clash with conventional economics. This leads a range of biases that can impact decision-making.

For example, there can be an extrapolation bias - if the stock market is trending downward today, people may extrapolate that into the future, predicting that downward trend for quite some time based more on what they believe rather than what they know. This can cause employees to buy low, stopping their contributions into equity mutual funds.

There can be a familiarity bias – a person might only wish to invest in companies they know, like and/or work for. This is irrelevant to sound investment strategy.

Another type of bias occurs when someone selects a stock that performs exceptionally well. Naturally, since they were correct in that first selection, they feel they can identify another stock that performs just as well if not better. However, when a stock doesn’t perform, the person doesn’t look inward at what they might have done differently in making their selection criteria. Instead, they blame other factors on the disappointing performance, saying, “Nobody could have seen that coming.” There are likely logical considerations that the individual could be evaluating to hopefully prevent similar mistakes in their investment strategy, but they instead trust their “head” or their “gut.”

The sooner these types of biases due to Behavioral Finance factors are identified, the better the chance that rational decisions to investing and retirement planning prevail. In a company filled with a wide range of opinions that could be pulled in different directions with each passing sound bite from a financial news channel, it is the CRO's responsibility to be the voice of reason.

From our point of view, the answer is not to react irrationally in the face of volatility or necessarily select the "hot stock" of the week but to maintain a strategy that includes saving the proper amount based on a reasonable expectation of returns, understand the range of potential outcomes that may occur, find a comfortable tolerance of risk and diversify assets.

Is The Company Match Always Appropriate?

In the world of retirement plans, rather than figuring out the rate at which to contribute, what most employees do is default to a company match structure. However, a company match may not be the most appropriate structure for that particular company trying to accumulate enough money to meet their objectives.

For example, a dental practice may have a lot of profit and earn high income for its owner. But under some retirement plans, that owner may be only enabled to contribute 2-3% of their income into the plan.

This may instead call for a more creative design for owners to reward themselves and their people, such as a Defined Benefit Plan. Let's say the owner of that dental practice puts $450,000 in a pension plan, of which his participants get 3% and he keeps the rest. The employees can have a contribution from their employer while the owner has tax-deferred savings.

The Business Is Not The Retirement Plan

One final thought – while it is common for many small business owners to say, "*My business is my retirement*," we don't often advise this line of thinking. When business owners don't build up assets from other sources, it can be a detriment to succession and exit planning as well as future growth of the business. This may help to explain why 80% of family businesses don't make it to the next generation.

Value needs to be built elsewhere in addition to the business' cash flows and profits. **Diversification** across stocks, bonds and real estate outside of the business' performance helps provide greater flexibility, particularly in a down market.

Conclusion

A deep dive into gathering data and insight; proper establishment of goals; solid arrangement of company personnel; implementation of a CRO; and stronger lines of communication: when these elements are in place, a small or medium-sized business has the opportunity to brand its retirement plan as a powerful vehicle for retaining, recruiting and rewarding its most valued people with greater ownership of their retirement agenda.

Chapter 31 |

Having a plan in place for your family and personal assets. Investing for your future, your retirement - understanding the rules of the game.

Susan Templeton

You may not have heard of Jeffrey Karoff. He is the filmmaker behind the documentary "Cavedigger" that was a contender for the 2014 Oscar for best "documentary short."

Jeff was an entrepreneur and financed the film himself. What Jeff did correctly was to start saving in his early years and live a modest lifestyle. He followed a budget and had an investment portfolio that was professionally managed. When Jeff decided to go off on his own, he had the funds to self-finance his documentary without having to mortgage his house or change his lifestyle in retirement. Jeff is unusual when it comes to entrepreneurs.

In my 20-plus years in finance, I have found the area that entrepreneurs most often neglect, often unintentionally, is their personal finances and their family's financial well-being.
Entrepreneurs are passionate, devoted people who can't help but live for their dream, which is their business. They are so intensely focused on the details of their business, and consumed by all its demands, that they end up with so much on their plate that personal finance takes a back seat.

If this is you, think about the "three little pigs" fable. It was the pig that built the brick house that survived the storm. You too need to build a brick house so you can also run your business, and you and your family are protected from an unexpected storm.

The recommendations in this chapter are based on more than two decades in the investment business working with owners of small and mid-sized businesses as well as business executives. I have seen numerous scenarios of great success and unexpected disasters. As a business owner, you can only insure away so much risk. You cannot totally protect yourself and your business, so it is essential that at the very least you have a financial disaster plan in place, and even better, a plan for your future so you can enjoy the fruits of your labor and success. The following describes the steps to follow to establish a financial disaster plan.

First, protect your assets and your family against lawsuits and your death.

You must have your attorney, preferably an attorney with estate experience, set up a will and trust. Your assets will then be titled correctly and protected from lawsuits, and in case of death, will transfer correctly to your family. If something happened to you or you and your spouse, your children's future is spelled out and funds are allocated for their wellbeing. If you don't, your children's future and custodian will be at the whim of a judge.

Second, hire a financial advisor to help you with your personal finances.

The most pressing areas where an advisor can assist include:

- Determining upfront how much money your family will need to live on while your business is getting started. Granted, you may not be able to truly know, but it is important to estimate and to have a plan you can continue to update. Separate these funds as money you will not use for the business--no matter what.
- While you are running your business, don't leave your personal investments unattended. You want to maximize your overall wealth--not just your business wealth. An advisor can ensure your portfolio is properly allocated with the right investments for your situation.
- Along with having a will in place, obtain protection for your family should you or you and your spouse die. Have your advisor help you determine how much your family will need to live on in the event of such a tragedy. Purchase life insurance for this amount.

HOW TO HIRE A FINANCIAL ADVISOR

With so many moving parts in running a business, it is not uncommon to miss opportunities to maximize wealth. So start by selecting the right advisor and advisory firm that will best serve

Several years ago, I was introduced to a scrap metal business owner who was in his early 50s and in need of someone to manage his company's retirement plan and his personal funds. I found it strange to hear that someone who was earning $700,000 a year was just putting away funds now for retirement. I couldn't imagine how he could have spent all that money and had none in savings until now--until we had this conversation. He explained that he had been making between $500,000 and $700,000 year for the last 15 years. The business had been growing and expanding, and he put all his time into those efforts. He didn't seem to have expensive tastes. Instead, he led a simple life and just kept sending his broker his excess cash. His broker was his college roommate and had worked for one of the major, well-known brokerages. He trusted this guy like he was part of the family. It turned out this broker had been embezzling the business owner's money for the last five years. The brokerage finally discovered the fraud, but it was after most of this customer's assets had been spent. In an effort to recoup his assets, he sued the brokerage, but he only recovered a portion of his assets. Yes, the broker was caught, fined and jailed, but there was little left of this business owner's savings. It is rare that someone who has been defrauded didn't say, "But I trusted him (or her) like they were my family."

The two key avoidable mistakes the business owner made were:

1. He didn't monitor his broker's work by reviewing the brokerage statements.
2. He hired a friend. When you hire friends, it is hard to ask the difficult questions, and hold him or her accountable.

your interests and structure a relationship where standards and expectations are set in advance and regularly monitored. I will discuss how to set expectations in advance and how to simply monitor the results.

Advisors come in many different makes and models, so select one who is going to take an interest in your overall well-being, not just someone that is interested in making money on your assets.
You know that you don't have the time to constantly monitor your investment advisor, so here are some practical suggestions to properly set up your relationship with your advisor and put in place the "checks and balances" so that you know that you are being properly taken care of. These are items that most advisors put in place on your behalf so you shouldn't have to be asking for this service.

- All assets should be held with a reputable custodian such as Charles Schwab, Ameritrade or Fidelity, to name a few. If you are writing a check to a small independent firm and the check is to be written in their name, then you may be taking on additional risk and will need to do additional homework as to the credibility of the firm.
- You should have a direct link to your accounts at the custodian and where the custodian sends you statements monthly. Statements from your advisor are fine only if you are also getting them from the custodian, and the values at the end of the month match. The key item here is "custodian." Once every quarter, look at the custodian's statement and match it with the advisor's statement. If they don't match, and the difference is more than a rounding error or of concern, contact the management of the advisory firm that you are working with.
- Your advisor should suggest but if they do not, require your advisor to create an investment policy statement (IPS). This statement lays out your financial situation, potential need for emergency funds, objectives for the growth of your assets and other goals you want to accomplish. For the advisor, it also sets up investment parameters in terms of ranges in each asset class that is determined based on your risk tolerance and objectives for those funds. Asset classes can include U.S., international, and emerging market stocks and bonds. The IPS may also allow for and include alternative investment types if you are inclined. An IPS spells out and makes clear how much risk you are willing to take and how your funds are to be invested.
- Require the advisor to provide you with quarterly reporting that shows account performance relative to a benchmark that you mutually agreed upon. For example, if your account is going to be invested in 35 percent U.S. stocks, 15 percent non-U.S. stocks, 20 percent bonds, 25 percent alternatives and 5 percent cash, the performance benchmark should provide a weighted index of corresponding indices.

You are not expected to come up with this benchmark; your advisor should do this for you.

- Avoid working with an advisor or firm that has conflicts of interest that could interfere with making the right investment choices on your behalf. Further explanation of the issues associated with conflicts of interest, and the differences between brokers, registered investment advisors and banks is below.

HOW TO DECIDE WHETHER TO HIRE A FINANCIAL PLANNER, INVESTMENT ADVISOR, OR BOTH

In most cases, I recommend hiring someone who can provide financial planning **and** investment advice as you probably won't have the time, inclination or knowledge to do it all yourself or juggle two additional professionals in your life when you can have just one. This person or team understands all of your financial needs, so they coordinate for the best approach to help you with your finances.

To make the right decision, it helps to understand some of the common industry credentials. For example, a financial planner often has obtained the designation of CFP (Certified Financial Planner) and can do the following for you (source-Financial Planning Association):

- Set realistic financial and personal goals;
- Assess your financial health by examining your assets, liabilities, income, insurance, taxes, investments and estate plan.
- Develop a realistic, comprehensive plan to meet your monetary goals by addressing financial weaknesses and building on fiscal strengths.
- Put your financial plan into action and monitor its progress.
- Stay on track to meet changing goals, personal circumstances, and stages of your life, products, markets and tax laws.

A good planner will liaise between you, your estate planner and accountant to ensure all aspects of your plan are coordinated, and you are getting the maximum benefit. With a busy schedule, you will most likely want one person who understands all of your finances and can triage on your behalf with your estate planner and accountant. Ask your accountant or tax advisor for a referral, or go to the National Association of Fee Only Financial Planners at www.NAPFA.org to locate a planner.

WAYS TO PAY AN ADVISOR: FEES OR COMMISSIONS

In selecting your financial team, you should also consider how he/she is compensated. This often directly influences his/her business processes.

Financial planners charge in one of two ways: fee-only and commission. Fee-only financial planners charge a fee for the job they complete for you. Most often, it is hourly, on a project basis or on a percentage of the assets they manage for you. The fee can run from $1,000 to $10,000 depending on the scope and complexity.

Commission-based financial planners, also known as brokers or advisors, earn commissions on the investments and or insurance products they sell you. Some advisors work on both fee and commission. I recommend staying clear of anyone who charges commission. Here is an example of why:

When I started my first business in 1990, I interviewed an experienced decorator to decorate the office and give it the professional look it needed. I gave her an idea of a budget, which was really a wild guess, as I didn't know the cost of furniture and window dressings. When I asked her how much she would charge me for the job, she indicated she would build her commission into the purchases of the furnishings and invoice me for a single amount. In other words, I would not be given a break out of costs or see any receipts. Because of my lack of knowledge about the costs of decorating and furniture, she could build in just about any commission she wanted, and I would not know if I were being charged a fair rate or not. It was clear to me, if her fees had to be hidden, there was something she did not want me to see. Perhaps she was a responsible, honest professional, but there was clearly a conflict of interest in the way she charged her fees. We never did work together.

Many brokers work this same way. While the fees are generally disclosed, they are difficult to find in the small type and thick prospectuses the brokers give clients. To avoid this, think of the decorator analogy when hiring a financial advisor.

I have seen numerous instances where someone has hired a financial planner who works on a commission basis, and I have to question the level of objectivity used by the planner. Clients face two issues when hiring someone who works on commission.

1. It should be noted that the higher the commissions, the weaker the ability for the investment to produce returns commensurate with risk for the client. For example, if your advisor puts $20,000 of your money in an investment that pays him or her a 5% commission, then only $19,000 ($20,000 x 5 percent = $1,000) is invested. You have

to earn a return of 5.26% before you are back to even on your $20,000, and you have taken market risk just to break even.

2. An advisor or planner working on commission will be prone to selling a higher commission product or one that is not appropriate for the situation because of a better commission. These may not be the best or most appropriate products for you, and depending on your financial knowledge, you may never be the wiser.
   - For example, in many cases, a family may need life insurance. I have found that in most cases, a simple, low-cost term-life policy works well for a family that is able to save as at some point the members will have enough assets to support the spouse should the breadwinner pass away. Due to the expense of insurance, this is often far more cost effective than a whole life policy, which does not expire. However, an advisor who works on commission is often licensed to sell insurance and may prefer to sell a family an expensive whole life policy as these policies pay out hefty commissions. Chances are, most buyers do not catch on that they bought an inappropriate product until much later in their lives or careers. There will also be no recourse on the buyer's end, because if sold to you by a broker, rather than a Registered Investment Advisor, then he or she is legally allowed to put his or her interests ahead of yours.

THE TAKEAWAY ON CHOOSING A FEE-BASED FINANCIAL PLANNER OR ADVISOR VERSUS A COMMISSION- BASED ADVISOR

Advisors come with a lot of titles and descriptions. My recommendation is to hire an advisor on a fee-only basis, which means essentially you are paying him or her on a percentage of assets under management so his or her incentive is to grow your account's value, not incur transactions that generate commissions.

HOW TO WORK WITH AN ADVISOR WHO IS A BROKER OR A REGISTERED INVESTMENT ADVISOR

You also have a choice between hiring a broker or registered investment advisor. You may feel these differences are inconsequential, but they are not and can cost you tens of thousands of dollars in excess fees and poor investments. So it is best to understand these differences.

"*In 2006 and 2007, Goldman Sachs Group peddled more than $40 billion in securities backed by at least 200,000 risky home mortgages but never told the buyers it was secretly betting that a sharp drop in U.S. housing prices would send the value of those securities plummeting.*

Goldman's sales and its clandestine wagers, completed at the brink of the housing market meltdown, enabled the nation's premier investment bank to pass most of its potential losses to others before a flood of mortgage defaults staggered the U.S. and global economies.

Only later did investors discover that what Goldman had promoted as triple-A rated investments were closer to junk." – McClatchy Newspapers, November 2009 "How Goldman Secretly Bet on the U.S. Housing Crash"

A broker's responsibility is to recommend only *suitable* investments for a client, but those need not necessarily be the best investments. A brokerage firm can recommend investments it is holding as a firm and no longer wants in its portfolio. As described above, this was exemplified in 2008 when Goldman Sachs' staff sold the firm's subprime mortgages to its retail clients.
What they were doing was not illegal but arguably highly questionable. Most of the big Wall Street firms are brokers. (A few of you might be familiar with are Goldman Sachs, Morgan Stanley-Smith Barney, Bank of America-Merrill Lynch, Credit Suisse and William Blair.)

On the other hand, registered investment advisors are required to act as a fiduciary, which means they must heed a higher standard and recommend investments that are in the client's best interests. That's not to say there aren't many good brokers. It is, however, important to understand your advisor's responsibility to you under the law.

WHEN INTERVIEWING AN ADVISOR, WHETHER IT BE AN INVESTMENT ADVISOR, FINANCIAL PLANNER OR SOME COMBINATION, HERE ARE A LIST OF QUESTIONS TO ASK AND ITEMS TO LOOK FOR:

- How long has he or she served as an investment advisor? Experience through several market downturns can be valuable.
- What are the advisor's plans for retiring from his or her career?
- How is the advisor compensated: commission or percentage of assets?
  - If commission, do you feel comfortable knowing some investments will pay him or her more than others? How much is the broker or advisor earning on your account?
- If the advisor is paid by fee only (or a percentage of assets), how much is that fee or percentage?
  Common fee levels are:

- Up to $250,000 (1.5% or less);
- $250,000 – $1.2M(1.25% or less); and
- $1.2M – $2M (1% or less).

- What kinds of services does the advisor provide? Options include:
  - Comprehensive financial planning;
  - Investment advisory-investing assets; and/or
  - Insurance (potential conflict of interest).
- How often will the advisor meet with you to discuss your portfolio and/or financial plan?
- Where will your investments be held (preferably with a known custodian such as Charles Schwab, TD Ameritrade or Fidelity, etc.)?
- How would the advisor invest your portfolio across asset classes? It is reasonable to ask for a broad asset allocation plan in advance.
- Where do you fit among the advisor's clientele in terms your portfolio's size? Are your assets the largest or smallest client account?
- Ask for the Form ADV, which the advisor must file with the U.S. Securities and Exchange Commission, (a legal filing document), and read for a full understanding of fees, conflicts of interests, services that the firm provides and history of infractions or citations from regulators. It was often said that if someone had taken the time to read the ADV of Bernie Madoff's firm, they would have noticed the inconsistencies in his company's services so as to indicate that there may be a problem with the firm's offerings.
- Get copy of the advisory or brokerage agreement in advance and read it. Understand what you are going to pay and how, what they are responsible for doing for you, and how you can terminate the agreement.
- Obtain two references from individuals who are similar to you in age and assets. Call and ask about their relationships with the advisor, how well the advisor has done for them, and about any issues they may have with the advisor.
- Run an online search on Google regarding the individual you are working with and his or her firm. Find out as much as you can.
- Go online to FINRA.org, and key in the advisor's name. You will be able to find out if there are any sanctions against that advisor.
- Evaluate whether this individual is interested in your well-being; will he or she listen when you express your needs and concerns? Is this someone who will look out for your best interests?
- Ask what types of investments are commonly included in a client portfolio. Investments such as stocks and bonds are common, but you will want to know what

other investments such as closed end or unlisted funds or investments and the use of options and leverage to name a couple. These are not necessarily bad investments but do carry a higher level of risk to your principal and you should be fully aware of those risks.

- Is the advisor capable of tax-sensitive management?

BEWARE OF:

- Promises of specific returns on your portfolio;
- Urgency for you to invest now, or you will miss a great investment;
- Requests to make your check to the firm or the advisor when investing (you want to write your checks to the custodian);
- Reluctance to provide their ADV, which is a disclosure document that must be provided to a client in advance per the SEC and the state where the advisor is registered; and
- Hiring friends. When you are working with a friend, you cannot ask the tough questions and demand performance from a client service and investment perspective.

Investing for your future, your retirement, understanding the rules of the game.

HOW TO MAKE THE MOST MONEY POSSIBLE IN THE LEAST AMOUNT OF TIME

You want to maximize your returns, but it is difficult to put a significant amount of money away when you are starting your business. Hopefully your planner, advisor, and estate attorney have told you to leave your retirement assets alone, because in the case of bankruptcy or some type of litigation, they will most likely be exempt from creditors.

As you have figured out by now, in working with any professional you hire, you need to know something about what you are hiring them to do, so you can ask the right questions and can monitor their work for you. Whether you have taken my advice and hired an advisor to help with your personal finances or decided to go at it alone, you should review and keep in mind the following.

There are four key elements to remember when you are looking to maximize your returns:

- Invest early in your earning years;
- Minimize taxes;
- Minimize fees; and
- Diversify your investments.

INVEST EARLY

If you invest $10,000 a year for 20 years at 7%, you will have $410,000. If you wait 10 years and want to reach the $410,000 level, then you need to put away about three times as much even though you are only investing for half as long. That comes to $30,000 a year. That's $200,000 over 20 years, or $300,000 over 10 years!
This example shows the benefits of long-term compounding if you start to save early. It also demonstrates the financial pain of waiting until later to save.

MINIMIZE TAXES

Taxes play a big role in your overall returns. If you have a $500,000 portfolio that is actively traded, which means that securities bought are often sold in less than a year, then you are going to give up a significant amount of return to taxes. For example, let's assume you have a realized gain in your portfolio of 10% or $50,000, and you are in the top federal tax bracket of 39 percent. Then $19,500 goes to pay taxes on those gains. So instead of a 10% return, you end up with a 6.1% return.

You can maximize your returns and pay less in taxes just by making some simple adjustments. It is generally tax favorable to put your high turnover investments or taxable income-producing investments, such as bonds and actively managed stocks, in your tax-deferred account, such as a 401(k) plan or IRA. A good advisor will do this for you.

This leads to the discussion of whether to invest in tax-deferred investments such as IRAs or 401(k) plans. Many people ask if they are better off paying taxes now on their money and investing it "after tax" rather than putting the money in a tax-deferred account, such as a retirement plan or IRA.

The answer is generally to defer taxes through some sort of retirement plan, because you will most likely be in a lower tax bracket in retirement. Personally, I like to see some balance of taxable and tax-exempt funds in a client's portfolio. If you have accumulated too much wealth in tax-deferred funds, you may find yourself under the required minimum distribution (RMD) rules of having to take more out of these funds than you actually need to live on and being subject to a higher tax bracket. However, if you are in a lower tax bracket now than you will be in retirement, it may be beneficial invest after-tax dollars.

To review this topic correctly and discuss the benefits and considerations, it would take many more pages and detail than one probably wants to digest. If you have a knowledgeable advisor who is doing their job, he or she can help guide you through this decision.

MINIMIZE FEES

Fees on your investments come in a variety of forms, in addition to the fee you are going to pay your advisor. You may pay other fees including the following:

- Custodian fees;
- Trading fees; and
- Fund management fees.

Each time there is a buy or sell in your account, you may be charged a trading fee by the custodian, which can range from $5 to $25. Generally there are no other custodian fees unless you have your funds with a trust company where there may be additional account fees.

Fund management fees are incurred on mutual funds and exchange-traded funds. These fees are embedded in the mutual or exchange-traded funds (ETFs), so the management and administrative fees are not visible. Management fees on no-load funds or index-type products such as ETFs range from a low of 0.20% to a high of 2%. If you are paying your advisor on a commission basis, then you may be paying an additional 3-4% in fees.

As you can see, these fees can add up and can be excessive. Over the life of your investments, high fees will reduce your portfolio's return.

I had a new client come to me and explain he was not really very excited about investing in the stock market, because in the last 10 years his broker was investing for him, his investments never grew. When I asked him how he was paying his broker and what percentage, he had no idea. I went back and looked at the 10-year return for the S&P 500 through Dec. 31, 2009, and the average annual return was 3.02%.

Chances are, his portfolio's return was diminished by fees and possibly some bad investment decisions. Remember, overall expenses should be in line with the size of your portfolio; the larger the portfolio, the lower the overall fees.

Here is a broad outline of what a reasonable amount of fees should be, based on the size of your investment portfolio.

- A portfolio of $500,000 may incur total fees- custodial, transaction and management fees of 2%;
- A $3M portfolio should be as low as 1.25%;
- At $5M, total fees should be below 1%.
- If you have less than $500,000, most advisors will not work with you on a fee basis, as there is not enough money in fees for your account to be worth their time. I generally recommend when assets are below $500,000, a client should open up a Vanguard account and ask the firm to recommend an asset allocation plan suitable to the situation. Vanguard's staff gives good general advice, and most of the firm's investments perform well and charge low fees.

THE IMPORTANCE OF DIVERSIFICATION

Studies have shown that over time a portfolio of stocks and bonds, or a portfolio of stocks and bonds and alternatives, have outperformed a portfolio of only stocks. In addition, by diversifying your portfolio, the intent is that your portfolio will not be subject to as dramatic swings in value as one that was invested solely in stocks.

When discussing the proper allocation for a client, I generally start with a portfolio of 1/3 stocks, 1/3 bonds and 1/3 alternatives. From there, I adjust those ratios based on a number of factors, including, but not limited to, age, risk tolerance, other assets the client has, such as real estate, and the risks associated with the client's business.

My client in the scrap metal business owns a significant amount of real estate, and his income is dependent on the commodity business. As a result, he has a high personal allocation to alternatives (metals and real estate). Therefore, I consider this allocation an alternative and split his personal investments between only stocks and bonds.

In contrast, another client of mine is an entrepreneur and is comfortable taking large bets on new companies, which means we don't know whether the direction is going to be "boom" or "bust" at any one time. I counter the volatility in his business by keeping his personal assets well diversified in low-risk, high-quality investments, such as large capitalization stocks of companies with strong balance sheets and bonds from similar high-quality companies. I also keep a higher-than-usual level of short-term cash investments available should he need the funds to hold him over until he has another success.

As you can see, each person's individual situation is different and should be managed as such. If you feel that you are getting a "cookie cutter" approach and the investments have not taken into account your particular situation, then you may want to contact another advisor and get a second opinion. Most firms will provide a "second opinion" at no charge.

Chapter 32 | Choosing a Consultant or Professional

Joel N. Goldblatt

Business owners know they need expert advice and outside skill sets from time to time. Entrepreneurs, especially successful ones, also know they must delegate and cannot address every issue that arises in the formation of and continued operation of a business. Inevitably outside expertise is required in the form of attorneys, accountants, insurance agents, and computer consultants, just to name a few. The quandary that arises is how to find good people and how to know whether or not you, the business owner, has chosen wisely. This chapter contains some tips and questions to use when selecting a consultant, professional or outside expert.

A starting point in seeking and obtaining outside expertise is a referral from a valued friend or business associate who knows the party or company being referred and has conducted business with them. In the past this was the means to obtaining outside expertise in almost all cases. With the advent of the internet this is not as certain a practice as previously existed. Now quite a bit of information can be obtained from the web, both helpful and that which can be misleading or completely inaccurate. As a result it is wise to know that you do not know what you don't know and as such your process can greatly assist in getting you and your business to the right resource.

A good process would include the following steps:

1. Get at least two names from respected sources. When doing so ask whether your referral source has worked with the party being referred, how long, what they liked and did not like, their perception of the strengths and weaknesses of the person or party they are referring and the nature of any services rendered for them by such third party consultant.

2. Use the web to gain more information about the suggested consultant or professional being referred to you. Go to the company or individual's web site. See if articles come up mentioning the individual or company referred or any other information concerning them. Where professionals are involved use state licensing web sites to determine the status of their license and whether there is any disciplinary record. States license attorneys, accountants and insurance brokers as well as many other types of commercial activity and there is often a wealth of objective useful information available.

For attorneys, often the state's Supreme Court oversees licensing. For accountants often Departments of Professional Regulation over see such practitioners. For insurance brokers either a Department of Insurance or Department of Professional Regulation may have oversight responsibility.

3. Reach out to the party referred and if possible meet in person. Regardless of whether you meet in person or not ask the following questions and listen carefully to the answers:

   a) How long have you been in business?

   b) What licenses and or extra levels of training have you achieved?

   c) How do you charge and if applicable what is your hourly rate?

   d) Describe your typical client and what do your typical clients look like from a demographic perspective, e.g. size of company in sales, locations, types of business number of employees, industry?

   e) Ask why they got into the business or profession?

   f) Ask how they like to communicate with clients?

   g) Ask what their expectations of clients are? [And you in turn communicate your expectations of them and ask what if any problems they have with that?]

   h) Ask what types of matters and or projects are they most familiar with?

   i) Ask what if anything related to your business would they feel uncomfortable handling?

   j) Ask what questions would they ask if they were hiring someone in their line of work?

   k) Ask what issues should you be cognizant of in selecting someone who does what they do for a living?

   l) Ask whether they have a problem with you getting a second quotation? [If they do, run do not walk away. This is not the same as the party responding they do not negotiate price. Hard working knowledgeable skilled professionals routinely will not compromise their rate. Having said that, many professionals are flexible on hourly rates and or flat fees.]

   m) Ask whether they have a problem with you seeking a second opinion? [If they do, run do not walk away.]

n) If the party is a commissioned earner for the services in question find out how they are compensated and how much and whether percentages change for various different products or companies offering similar products. Ask if one product was suggested what their commission is and whether or not there are hidden fees or overrides for volume they do or for reducing or eliminating claims- this is particularly true with insurance agents and financial brokers and those administering qualified employee retirement funds.

o) Find out about some aspect of their personal life, are they married do they have children what town do they reside in what are their hobbies or charitable activities?

p) Ask if they have ever been disciplined or had their licensing threatened or suspended.

q) Find out if they practice in a niche or have a practice expertise they routinely deal with?

r) Ask why you would benefit from having an association with them?

s) Ask them to describe a client experience with them over the course of a year or two.

t) Ask how many clients do they have that look like your business.

u) Ask how long they plan to be in the business or profession they are in.

v) Ask if they have ever filed for bankruptcy?

w) Ask if they have ever been sued.

x) Ask for what kind of back up they have and other expertise or partners or associates involved in their practice or business.

y) Ask what other resources they can provide to you and your business?

z) Ask if they would make referrals to you and your business if that is appropriate and find out how they network to obtain business.

Be curious and alert and compare at least two similar service providers to one another as this will assist in learning the area the provider is involved in and will better educate you to your unique issues. A good process will cause you to be better able to evaluate expertise and fit for your company's needs. Using the same questions on two potential sources permits an "apples to apples" comparison. No one answer to any question set forth above is necessarily determinative of who you should choose. Rather it's the totality of the answers and the comfort they bring to you that should be focused upon to select the outside expertise you will invariably require in setting up, running and operating a business.

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Chapter 33 | Franchising

Meg Schmitz

So here you are, at the final chapter of ***The Book: By Entrepreneurs, For Entrepreneurs***. You may be asking what a chapter on franchising is doing here. Some people think the two worlds are mutually exclusive. I am here to argue that they are not exclusive at all; there is, in fact, a huge justification for you to consider applying your skills and talents in the franchise realm. My point of view comes from 20 plus years of personal investment of my time and money into the creation of new ventures, and as the owner of franchise locations, and another 11 years of consulting experience in the franchise industry.

As I view the business landscape in the U.S., there have been some extreme shifts over the last 40 years. Some businesses barely survived the last few recessions, some tanked, while others were able to thrive. When considering those that were able to thrive versus those that failed, I had to step back and wonder why; what were the common threads that joined the winners (or the losers) together? I can answer the question in the franchise realm: so many of the brand names you recognize, and probably consume, have the infrastructure and leadership in place to adapt to changes that come with up or down markets. **Franchises are built, generally, to survive and adapt.**

As an entrepreneur, what I would like you to do is to think like a franchise, because whatever your business may be, there may be direct competition from franchise. It's amazing how widespread and varied the industries are that franchising has delved into. Most people think of food, or automotive, but where there is demand from a consumer population, there probably is a franchise to fulfill that need.

There are really two paths I would like to explore. One is to create a concept that is replicable, and the other is to dovetail your experience and skill sets into something that already exists. Both avenues allow you to call the shots and control the course of business every day. I work with people every day who want to be entrepreneurial but don't have all the resources to make it work. My specialty is franchising, but I am also an entrepreneur. Like you, I tweak and tune my thinking to create new business concepts, or new delivery methods, based on what I see as a problem that needs to be solved or where there is a gap or "white space" in the consumer arena. The goal is to succeed, and that is usually measured by one's ability to monetize the business model.

I am continually amazed that The American Dream is alive and kicking, especially after our last recession. The desire to create is evidenced by the comrades I meet in the many entrepreneur think-tanks I contribute to. We live in a country that rewards the "can-do" spirit. I don't need to tell you how great it feels to watch the seedling turn into the mighty oak, and to say "I did that." We create new businesses to solve people's problems, to make life better or easier. We also act in a capitalistic way, the end goal of which is to make more money out of the money we invest, to live a better life, and know that we put our own stamp on everything that comes from our endeavors.

While it's great fun to create and germinate a business plan from a seed of an idea, for me, the hard part is getting it launched and sustaining it. I am challenged to think and act fast enough to stay on top of the ever-changing dynamics in the marketplace. As a solo practitioner, no one has my back; they are all aiming at my back! Keeping up with the market changes and competition requires a scope of vision and a plan of attack that I just don't have the energy to sustain. I have been far more financially successful, and remunerated many times over, in the franchise world. (I would even tell you that I have been more personally rewarded, and more ego-gratified, in my franchise work than anything else I've done.)

The fact of the matter is that it's hard out there, and education and technology move the needle faster than ever. Then there are detours, like stock market blow-ups, seismic economic shifts, competition getting ahead of me, and consumers changing their habits. I don't like surprises anymore; it was okay when I had more money to burn and more energy to draw upon to correct miscalculations or mistakes, but perhaps my age and a few hard knocks have changed things. Now, I want a clear path to success, and I want it to be big and satisfying and free from distractions. Let me do what I am good at; everyone else can then fall into line, do a job that's well defined, and we all get paid.

Maybe you are an exceptionally gifted pioneer with clear vision, focus, and confidence. Maybe you have an idea that, once grounded and established, you believe would be a phenomenal business opportunity to expand in your community, or across the country, perhaps even around the world. You have read through this book, and the "fire in your belly" is growing into a blast furnace, and now you can't wait for that new idea to go viral. For some of you, you have an idea that merits that kind of planning, and there is a place for franchising in your world. Should you come to the realization that you have a business model that could be replicated or knocked off (imitation IS the sincerest form of flattery), stick with your idea, and let's talk about how to license and sell it. That's franchising: letting other people's money build YOUR brand by providing a product or service that is commonly needed coupled with a process that delivers it. I would love to talk to you about your vision, discuss the foundation needed to grow it big, and explain how your business can be groomed and converted into a franchise system. You can contact me through LinkedIn.

For others of you, franchising may be the furthest thing from your mind. You may only be interested in creating a niche offering and keeping it small. You may already be successfully running your own business and simply reading this book for fine-tuning. You are the pioneers I admire and respect, and I applaud your conviction to stay the course. Creating a franchise means getting the idea out of your head and converting it into a tight system that can be replicated, controlled, delivered uniformly, measured, and monitored. Not all businesses are formatted for large-scale growth, and not all business owners are terribly thorough in their planning and execution. Being a solo act is challenging enough, let alone having to come up with rules and regulations for everyone else to follow.
As an idea generator and business creator, there are specific areas on which you need to focus. Each chapter in this book helps you set that foundation so that you are ready to launch. Logo, check; website, done; legal affairs in order, got it; marketing, it's out there. From the inception of your business, you are the Master of Your Universe, from getting your employees motivated, creating a deliverable product or service is crystal clear in everyone's mind, and then gearing up for all those customers who are going to beat down your doors.

But what happens after those portals or doors open? Assuming that you have thought of everything, how do you stay on course, ahead of the competition, delivering an exceptional experience to the consumer, not just this year, but next year, adapting and repositioning for tomorrow, and all the other tomorrows of the next 10 years? Unless you have something that is truly unique, you will compete with a franchise in some aspect of your business, and you will be challenged in the marketplace to do your "thing" just as well, if not better.

Let's assume that your business has employees, a location that people visit, and a consumable that entices the customer to come back. In addition, let's agree that you have a branding strategy that defines what you offer, that you have a targeted and specific consumer population, and that there is an employee population to serve those customers. What are your top challenges in year one, five, or 10? The answer will be different for each phase of your growth.

In creating a business, there are many elements to align. You should consider price, perceived value, competition, employee attentiveness/engagement, customer loyalty, brand continuity, and creative modifications or enhancements. I would also challenge you to consider how you are going to do all of this, or who you will surround yourself with, so that you don't run through your creative juices and burn out in the first 18 months.

If you are a true entrepreneur and you are confident about your ability to execute and succeed, then you have my complete admiration and respect.

There is another group I want to address: those who have an idea but question whether they have the resources to make it work. I have been around entrepreneurs long enough to know that there are those of you who read this book and are already exhausted with all the moving parts. I only ask you to be realistic; some of you are overwhelmed by the time and money required and the demands that will make you choose between this fledgling business and other important aspects of your life. I have lived through the experience of having to ignore my life and family to make my entrepreneurial dreams come true. Maybe you are an intrepid idea-generator, but you aren't that comfortable with all the risks. Maybe you would really like to have a little support and not go at it completely alone. For those who sense that they need a little guidance, I suggest plugging in your considerable talents and becoming just as successful as any other business person.

I call franchise ownership "independence with a safety net." Many entrepreneurs, myself included, have benefitted tremendously from the systems and mechanisms world-class franchisors put in place. As the day-to-day owner of many franchise businesses, I love the fact that if I have a question, they have an answer. Another aspect of this is that if I follow the system, it <u>works</u>. In saying "it works," I mean that I successfully bring in revenue, know what my essential expenses are, and make a profit that supports my lifestyle. I'm still calling the shots, but I have that right to make decisions within the support and framework of a proven system. Safety!

With gold-standard franchises, what is bought is a time-tested system with a specific methodology and procedures that are easy to follow. The mechanism to deliver the product or service is refined, perfected, and streamlined. A franchise owner's mission is to deliver an experience that is predictable and reliable, with a 100% satisfaction guarantee. We are entrepreneurs who buy licenses from other entrepreneurs who had a vision, created a system, and have convinced others to share that same vision. We are **frantrapreneurs** who want to own a business with a safety net and without recreating the wheel.

I would even defend the notion that nothing really is new, we're all just finding interesting ways to repackage existing solutions. Take a little from here, borrow a little from there, and you have a "new" platform from which to launch a new business. Instead of figuring out how to be unique, how to stay ahead of the competition, or how to guarantee longevity (i.e., avoid obscurity), I find it extraordinarily enjoyable to use my time and money to achieve financial success with a proven idea and a tested delivery method while still putting my own individual stamp on my employees' and customers' experiences.

I don't know about you, but my entrepreneurial excitement has been tempered by the challenges of getting to market. "THINK! Predict! Do your pro formas, and double check with your trusted advisers (that inner circle whom you know won't steal your idea and one-up you). You must project your sales, anticipate costs, over-runs, losses, and those unexpected cross-hits by the competition who are looking for the same revenue dollars you are. You must have game, and it better sustain you through a fantastic, or more realistically adequate, launch period. Refine, redefine, reenergize."

Think through the financial aspects of your start-up endeavor, from the back of a napkin to the product being put in front of a consumer (be Steve Jobs for a second, back in that dorm room). What will it cost you to leverage the money so you can produce the idea, make something that works, and then replicate it? Market it? Deliver it? Maybe you are delivering a service, like a lawyer or a dentist who wants to expand into a second location; how do you identify your customers? How much will they pay? When do you break even after getting your degree and then building your practice? How do you make real life work until you make real money?

In the franchise world, much of this is predictable. We collect data points so we know how to spot the important markers on the path to success. It isn't so easy to put it all together in the real world. Frankly, no one I work with gets into business to lose money, but lots of people quit before they realize the financial rewards, and the true ego benefits, of their efforts. It takes time and infrastructure to create a business that really pays off.

In short, franchising provides:

- A proven model
- Comprehensive training
- Operations and training manuals
- Business management software
- Established web presence
- Technical support/intranet
- Marketing tools and techniques
- Branding methodology and name recognition
- Identifiable expenses
- Group buying power
- Intelligence on competition and the marketplace; industry statistics
- Research and development for constant improvement
- Grand-opening marketing
- Customer and employee acquisition and retention
- Annual conferences, regional meetings
- A network of owners just like you

Many of these points are intuitive, and you can figure out why they would simplify your business operations. After all, you are also a consumer living in the U.S.; without even being aware of how often you purchase something from a franchise, you know that you frequent certain businesses because you leave happy, you got what you wanted, and it was the same great experience as the last time. Wouldn't it be great to know that all you have to do is build brand loyalty and equity, knowing that someone else is doing all of the background work? I know I am over-simplifying, but wouldn't it be nice simply to *execute*?

Alright, franchising isn't quite that simple. Every day there are new challenges, which tend to relate to a few common things: employees, customers, and fulfillment. Why isn't the phone ringing? Where are your customers? How focused are your employees on customer satisfaction? How is your company culture? Is there consistency? There are a myriad moving parts, and you need to be able to identify and rectify problems as they arise.

As a franchise owner, I find my greatest sense of peace comes from the fact that someone else has already thought of these things and figured out how to work through them. If you are a solo act, you may not know how to address and rectify them. When I don't know why my franchise business isn't growing, I have historical metrics and experienced professionals to identify the shortcomings and help me to implement corrective measures.

Yes, it costs you something to get all this infrastructure. The licensing fees and royalties are line-item expenses that you probably don't have in your independent business. But you might kick around a long time trying to identify who to hire to take care of these issues, while a franchisee is up and running with a well-oiled machine behind his/her every move. The license pays for the program or operating system (have you ever thought about how long it would take to write all the programs for Microsoft Office before you could get any real work done? That's the value of a great operating system), and royalties cover the cost of building the team that supports you, from training and operations to marketing and R&D.

Who does the best at franchise ownership? From my experience, it could be anyone who understands that there are short and long-term benefits to following a system, playbook, or recipe. You don't have to think of everything, you just have to **execute** on a proven strategy. Some of my most financially successful placements came from corporate, family business, and non-business backgrounds. They have been corporate executives looking to be "The Man" versus working for him; they have been successful military leaders; high profile athletes who know what it takes to win a championship ring; they have been Domestic Engineers who understand that a great meal is produced quickly and successfully when following a recipe. These people do well in franchising because they understand teamwork, leadership, and how to win by following a proven system. They have learned that uniformity delivers a predictably successful outcome. They know that championships are won by individuals working as a team toward a common desirable goal. And let's face it, on your birthday, the German chocolate cake is far better when you add the right ingredients, bake it properly, and smother it with frosting!

Now, think about your experiences with franchises. I'll do a little name-dropping. Your Chevrolet dealer is a franchise location. Your favorite professional sports team is a franchise. At McDonalds, don't you expect the same taste experience each time you get your Big Mac whether you are in San Diego or Milwaukee? When you get your haircut at Great Clips, you expect to visit your favorite stylist who happily checks you in and gives you a great haircut each and every time. Meineke should service your car the same way from location to location, and Molly Maid should clean your house in a predictable fashion at the same time every other week. You keep going back because of the uniformity of the experience time and time again. The value is generated from the *predictable satisfaction* you get from excellent execution of systems.

The mechanism for delivering this uniformity comes from a very strong legal prospectus called the Franchise Disclosure Document (FDD). In this document, you will find everything about that franchise spelled out in layman's terms. The business model is clearly spelled out, from the founder's background and executive leadership team to litigation, marketing, cost to open, income projections, current owners' contact information, and information on those who have exited the system. This FDD is required from every franchise company by the Federal Trade Commission, and most states have their own rules and regulations about how that franchise operates in each state. One good read through the FDD and you will see that a great franchise system is thoroughly planned and presented.

If you want to be the next Steve Jobs or Bill Gates, use this book and all the professional resources you can find. If you want to be the next Phil Jackson, join a franchise; follow a proven methodology and create your own culture. Demand impeccable implementation. And put your own indelible stamp on YOUR employees, your customers, and your business every day. Plan for success, and you have reasonable shot at winning.