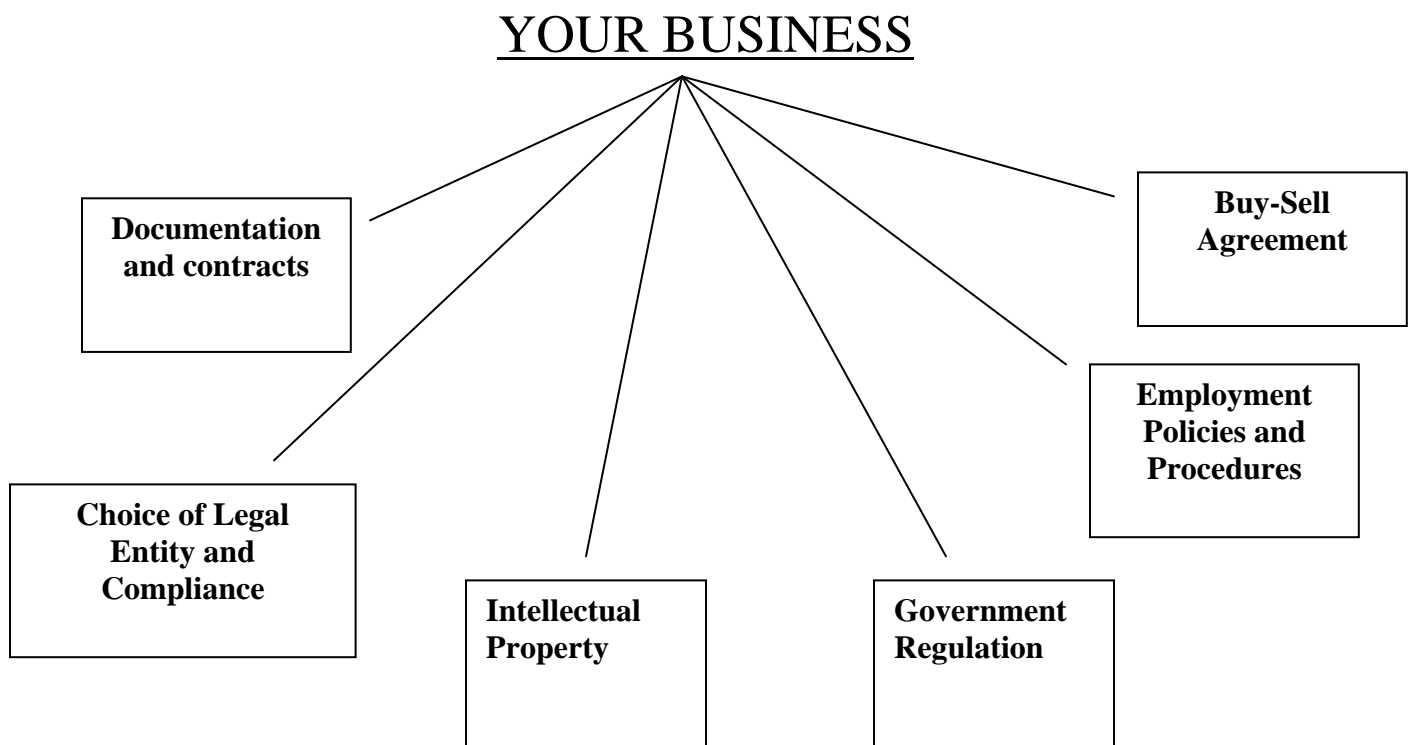


# BUILDING YOUR LEGAL INFRASTRUCTURE

in•fra•struc•ture *n.* 1. An underlying base or foundation especially for an organization or a system.



# Legal Entity

**1. Sole proprietor** – This is the default form of doing business for individuals. **Advantages** -- Simplicity; no paperwork and no expenses of setting up a corporation or limited liability company. All revenues and expenses show up on the individual owner's personal tax return. **Disadvantages** -- A Sole Proprietor is personally responsible for all liabilities of the business, including those not covered by insurance. Take the example of John Smith Consulting. John owns and operates this business as a Sole Proprietor, which means that HE is the business. There is no legal entity separate and apart from John. A customer who is unhappy with advice that John has given sues "John Smith Consulting" and obtains a judgment against John, personally. The customer uses the court's decision to obtain a lien against John's personal residence: he then forecloses on the lien and John's house is sold to satisfy the judgment.

**2. General Partnership** – John Smith Consulting now takes on two new consultants who are also co-owners of the business. Still, there is no separate legal entity. This is the default form of doing business for two or more individuals. **Advantages** – Simplicity; the only added paperwork is a partnership agreement that states how profits/losses are divided. All profits and losses are allocated among the partners and reported to the IRS on each partner's individual tax return. **Disadvantages** -- Now, not only is each partner personally liable for his or her own conduct, each is also personally liable for the conduct of the other partners. In many ways, this is even worse than a Sole Proprietor, from a liability standpoint.

**3. Corporation** – John and his partners decide to form a corporation called "John Smith Consulting, Incorporated." As a result, the owners now own shares in a separate legal entity that operates the business and is responsible for all liabilities of the business. **Advantages** -- As long as the corporation is properly formed and maintained, the owners are not personally liable; instead, creditors' claims can only be satisfied from the assets of the corporation itself. Also, because the owners have elected to be treated by the IRS as a "Subchapter S" small business corporation, all profits and losses are allocated directly to the stockholders, and the corporation itself pays no income tax. **Disadvantages** – Specific set up tasks are required.

**4. Limited Liability Company** – John and his co-owners decide to form a separate legal entity known as a "limited liability company" or "LLC". **Advantages** -- An LLC has the flexibility of a partnership to divide profits and losses between the partners (for instance, since John Smith contributed most of the "sweat equity" to get the business going, he is entitled to a slightly larger piece of the pie). By contrast, corporations generally must divide profits based on the relative share ownership of each stockholder. Also, *members* of an LLC (that's what owners of an LLC are called) are insulated from personal liability for business-related activities, just like a corporation. Finally, all profits and losses are allocated directly to the members, and the LLC itself pays no income tax. **Disadvantages** -- Specific set up tasks are required.

## Compare an LLC to a Subchapter S corporation

<i>LLC</i>	<i>SUBCHAPTER S</i>
<ul style="list-style-type: none"> <li>• double taxation avoided</li> <li>• limited personal liability</li> <li>• fewer structural/hierarchy formalities (but need for Operating Agreement)</li> <li>• unlimited number of members; no restrictions on membership</li> <li>• can have multiple classes of stock; flexibility in distribution</li> <li>• can have subsidiaries</li> <li>• Perpetual existence</li> <li>• earnings taxed whether or not distributed</li> <li>• each member files an individual tax return; multi-member LLCs also file partnership tax return</li> <li>• health insurance for &gt; 2% member is partially tax deductible</li> <li>• employed member pays self-employment tax</li> <li>• creditors may charge LLC interest of member/debtor (but not force a sale)</li> <li>• unrestricted transferability of interests (subject to Operating Agreement)</li> <li>• An LLC is owned by Members who can either serve as day-to-day managers or appoint a Manager</li> </ul>	<ul style="list-style-type: none"> <li>• double taxation avoided</li> <li>• limited personal liability</li> <li>• must follow state corporate law formalities (e.g., annual meeting, election of directors)</li> <li>• limited to 75 members; generally, only individuals may be stockholders</li> <li>• limited to one class of stock (but can have different voting rights); proportionate distributions</li> <li>• can have subsidiaries</li> <li>• Perpetual existence</li> <li>• earnings taxed whether or not distributed</li> <li>• each stockholder files an individual tax return</li> <li>• Health insurance for &gt; 2% stockholders is partially tax deductible</li> <li>• employed stockholder pays Medicare, FICA, FUTA, WC, State Unemployment</li> <li>• creditors may attach shares (but are subject to Stockholder Agreement)</li> <li>• unrestricted transferability of interests (subject to Stockholders' Agreement)</li> <li>• A corporation is owned by Stockholders, who elect Directors, Officers handle day-to-day management</li> </ul>

# Buy-Sell Agreements

**1. Shareholder Agreements (corporation); Operating Agreements (LLC) --** Essentially contains the same types of provisions, regardless of the type of entity. However, one size generally does not fit all.

**2. Voluntary Transfers --** The primary goal of any buy-sell arrangement is to control the transfer of shares. In the absence of an agreement, only applicable securities laws restrict transfer/sale of shares. Here are some typical control provisions:

- No transfers other than pursuant to the Agreement
- Right of First Refusal to other owners (funding?)
- Right of First Refusal to company (funding? statutory limitations? )
- Permitted Transferees (e.g., family members, trusts)

**3. Death and Disability Transfers –** What happens to the shares of an owner who dies? What if the owner works in the business and becomes disabled?

- Shareholder "Put"
- Company "Call" provisions
- Life insurance funding
- Determination of "disability" (employed by company?)

## **4. Other Important Provisions**

- Tag along with majority selling shareholder
- Majority selling shareholder "drags" along minority shareholders
- Voting rights
- Future Shareholders
- Valuation of shares (agreed, 3<sup>rd</sup> party, book value)

# Documentation and Contracts

## 1. Statute of Frauds -- certain contracts MUST be in writing

- Contracts for the sale of goods > \$500
- Contracts to be performed over > one year
- Contracts involving the sale of land

## 2. Oral or Written Contracts

- What is a contract?
- Oral Contracts aren't worth the paper they're written on .....
- Problems of proof
- Gentlemen's Agreements -- Gentlemen are an endangered species

## 3. Implied Warranties

- Merchantability
- Fitness for a particular purpose
- Disclaimer or exclusion of implied warranties

## 4. What should you document?

- Relationships with professional advisors
- Relationships with key customers and suppliers
- Key employees
- Business partners

## 5. Document Retention Practice

# Intellectual Property

## 1. Trademarks

A trademark includes any word, name, symbol, or device, or any combination, used, or intended to be used, in commerce to identify and distinguish the goods of one manufacturer or seller from goods manufactured or sold by others, and to indicate the source of the goods. In short, a trademark is a brand name.

When used in connection with a service such a mark is called a service mark. Rights in a trade mark or a service mark can be created either by use, or by use and registration with the state or federal government. Ultimately, however, the mark must be used in commerce. Until the mark is federally registered (if ever), the party using the mark should display the symbol <sup>TM</sup> next to the trademark or service mark, to show the world that the owner claims rights in the mark. After federal registration is granted, the owner may use the symbol ® next to the mark. Federal registration has certain specific benefits to the owner, one of which is to potentially add to the value of the product by strongly identifying the source. Trademark protection lasts as long as the mark is in use.

## 2. Copyrights

Copyright is a form of protection provided to the authors of “original works of authorship” including literary, dramatic, musical, artistic, and certain other intellectual works, both published and unpublished. The 1976 Copyright Act generally gives the owner of copyright the exclusive right to reproduce the copyrighted work, to prepare derivative works, to distribute copies or phonorecords of the copyrighted work, to perform the copyrighted work publicly, or to display the copyrighted work publicly.

Copyrights protect the expression of an idea (not the idea itself), and gives the owner the exclusive right to copy and license the work. For example, a description of a machine could be copyrighted, but this would only prevent others from copying the description; it would not prevent others from writing a description of their own or from making and using the machine. Copyrights exist as soon as a work is created, and can include words, images, sounds, or any original work reduced to a tangible medium. Copyright can also be claimed through federal registration, pursuant to specific procedures administered by the Office of Copyrights: *there is no state copyright law*. The use of the symbol © [**name of author, year**] indicates a claim of copyright. The duration of a copyright is the life of the author plus 50 years. To show copyright infringement, the owner must show copying: Copyright does not protect against the

independent creation of the work by a third party. Photocopying and unauthorized use of copyrighted software and music are two major areas of copyright infringement.

### 3. Patents

A patent for an **invention** is the grant of a property right to the inventor, issued by the U.S. Patent and Trademark Office. The term of a new patent is 20 years from the date on which the application for the patent was filed in the United States or, in special cases, from the date an earlier related application was filed, subject to the payment of maintenance fees. US patent grants are effective only within the US, US territories, and US possessions.

The right conferred by the patent grant is, in the language of the statute and of the grant itself, “the right to exclude others from making, using, offering for sale, or selling” the invention in the United States or “importing” the invention into the United States. What is granted is not the right to make, use, offer for sale, sell or import, but the right to exclude others from making, using, offering for sale, selling or importing the invention.

A patent is obtained by filing a patent application, multiple drawings and a technical statement with the U.S. Patent and Trademark Office, where an examiner compares the invention with known references, or "prior art" to determine whether the invention is in fact original. The words "patent pending" may used while the application is in process. A patent prohibits any unauthorized manufacture, use or sale of the devices or processes embodying the invention -- even if innocently infringed, independently discovered or discovered by reverse engineering.

# Employment Policies and Procedures

## 1. "At Will" Employment

- Employee's freedom to quit
- Employer's freedom to fire, **except**
  - for race, religion, sex, national origin, handicap, age
  - in violation of public policy (e.g., "Whistleblower")
  - in retaliation for filing a WC claim
- Termination for "cause" may still allow a claim for unemployment

## 2. Major Laws Affecting Employers

- Civil Rights Act of 1964 (discrimination and sexual harassment)
- National Labor Relations Act (NLRA)
- Age Discrimination in Employment Act (ADEA)
- Americans with Disabilities Act (ADA)
- Family and Medical Leave Act (FMLA)
- Occupational Safety and Health Act (OSHA)

## 3. Employee Documentation

- Employee handbook/policy manual (including sign-off)
- Employee file (including disciplinary records)

## 4. Confidentiality and Non-competition Agreements

- Purpose
- Scope
- Enforceability

**Government Regulations  
and Taxation**

**1. Licenses and Permits**

- Business License
- Occupancy Permit

**2. Taxation**

- Income/Self-Employment Tax
- Worker's Compensation Fund
- Retail Sales Tax Number

**3. Other Important Areas of the Law**

- Immigration
- Fair Labor Standards (Minimum Wage Law)
- Occupational Health and Safety (OSHA)
- Environmental
- Worker's Compensation