

LEGAL ISSUES FACING THE NEW BUSINESS

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Introduction

A couple of years ago, it occurred to me that some of my new or prospective business clients would benefit from a written discussion of the basic issues they should consider. After looking around for a book or pamphlet I could buy, I finally decided to just do it myself. **Please note that the law applicable to these topics is subject to change as new legislation is passed and judicial decisions are rendered.**

You must also understand that **nothing in here should be considered legal advice**, or relied upon as such. This was never intended to be an in-depth legal treatise, and answers to your specific problems may involve considerations not covered here. My simple goal was to educate the reader enough so that he or she could start asking the right questions about how the law applies to their particular circumstances. If you want help finding the answers to those questions, talk to a lawyer.

You should also recognize that the practice of law is more art than science. Anyone searching for "the answer" to a legal question will often be frustrated by the inevitable response: "Well, it depends ...". What is best in one instance may not be best in another, making strict rules difficult to apply. Even so, working through the issues to find a less-than-perfect solution is far better than ignoring the issues completely.

Diving into the exciting entrepreneurial world is risky enough; don't make it worse by ignoring the "fine print" in life. If you are going to build a business, do it right. Good luck!

John Crane
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1 Market Identity

To many businesses, positive public recognition is a precious asset. Protecting that goodwill from appropriation is important. Unfortunately, many business owners do not understand how rights to the business identity are acquired in the first place.

Tradenname

To maintain exclusive rights to any business name, the name must be *used*. Indeed, it is the use of the name that establishes the rights. Conversely, if it has not been used, or is no longer being used, there probably are no exclusive rights to it.

The first thing many entrepreneurs do when they think of a new idea for a business is file an assumed name certificate with their local county clerk. This is not a bad idea, since Texas law requires anyone doing business under a name other than their own to file such a statement identifying the real owners. However, many have proudly carried that certificate out of the clerk's office thinking they had snared the business name as theirs exclusively.

Filing an assumed name certificate gives you no rights to the business name! If you used the name first, and have not stopped using it, you can probably exclude others from using it. If someone else has been using the name longer than you, then they probably can stop you from using it. At best the fact that you filed an assumed name certificate can be some evidence of the date you started using the name, if there is a question about who was first.

Note that if two different names are deceptively similar in sound or spelling, then the older business can often still force the newer one to change. In other words, do not think that you are safe just because you made minor deviations to the spelling or pronunciation of a name to differentiate it from a competitor's.

The law tries to stop a newer business from trading on the goodwill established by an older business. The question of whether or not two names are deceptively similar will often turn simply on whether a likelihood of confusion exists. A judge or jury will answer that question, after the considerable expenditure of your time, money and aggravation. In short, research other names in your market and be careful in selecting a name.

Trademarks

Look at any product on a store's shelf and analyze what sets it apart from the other products. Is it the name? A distinctive logo? Its shape? Its color? Any of these things can constitute that product's trademark. If you doubt the value of a product's trademark, try copying any these distinctive features and see how long it takes to receive a threatening letter from that company's attorney.

Like a name, a business has no rights in a trademark unless that mark is in use. Use of the mark establishes the right to continue using it. Stop using it, and all rights to it may be lost.

If you have been using a trademark and another business infringes upon it, the remedies available depend upon whether or not you have registered the mark. Without registration, you only have the right to stop the infringement. You cannot collect any damages or attorneys fees for your trouble.

By registering your trademark with the U.S. Patent and Trademark Office, you add strength to your arsenal. In a suit for infringement of a registered trademark, the plaintiff can recover damages (such as lost profits) and attorneys fees. Registration can also have the effect of deterring infringement by placing your trademark in a national registry. By searching the registry, new businesses can avoid inadvertent infringement on a mark that is already in use.

Fanciful marks are the easiest to register and protect. KODAK is an example of a purely fanciful mark. I have been told that the Eastman Company literally created the word, which otherwise has no meaning, after considerable market research. Over time, they changed the company name from Eastman to Eastman-Kodak, and finally to KODAK as the public's recognition of their trademark increased.

Many entrepreneurs want their trademark to be descriptive of the product's function or appeal. Trademarks that are merely descriptive, however, will often be denied registration and are difficult to protect. Furthermore, words in common usage will be excluded from protection, even if the rest of the mark is accepted for registration.

Some marks become so popular that they are deemed "generic" and exclusive rights are lost. Aspirin is an example of a trademark that was so successful it became known as the generic term for acetylsalicylic acid and is no longer protected.

2 Type of Entity

A fundamental and potentially confusing decision facing every new business is the choice of entity in which to do business. Increasing the confusion is the addition within the last decade of new types of entities to the traditional list of choices. Too many entrepreneurs fail to spend the time necessary to understand the pros and cons of each choice.

The types of entities discussed below are: sole proprietorship, partnership, limited partnership, registered limited liability partnership, corporation and limited liability company. Of these, all except sole proprietorships and partnerships are creatures of statute, meaning that they would not exist had the legislature not created them. Consequently, in considering any particular feature, one should always remember this general rule: what the legislature giveth it can taketh away.

There can be many factors to consider in deciding which is best. Ultimately, these factors usually involve the owner's desire to reduce liability exposure and tax burden.

Sole Proprietorships

The entrepreneur who does nothing but hang a sign on his hotdog cart is a sole proprietor. One person owns the business. At the end of the year, that individual pays tax on any profit from the business at his or her individual tax rate. In many respects, sole proprietorships are the simplest business form.

Sole proprietorships offer no liability protection, however. Every nonexempt asset owned by the individual, whether used in the business or not, can be applied to payment of business debts. Consequently, if the hotdog vendor sells a defective hotdog, the sick customer that sues and wins can collect on the judgment by seizing and selling the sole proprietor's non-business assets.

Partnerships

When two or more individuals go into business with an agreement to share profits, losses and management, they are considered partners. Although the partnership files a federal income tax return, it pays no income tax because it is not a taxable entity. Like a sole proprietorship, profits and losses are "passed through" to the individual partners, who pay taxes on their respective shares of profit at their personal rates.

Also, like a sole proprietorship, each of the individual partners is liable for partnership debts to the full extent of their nonexempt personal assets. As a general rule, any partner can bind the partnership and, therefore, each individual partner.

Limited Partnerships

A limited partnership allows certain owners of the business to limit their risk of liability to their investment only. At least one general partner is required. That general partner is responsible for managing the business and is fully liable for partnership debts. The remaining owners of the business are limited partners. The limited partners have no right to participate in the management of the business, but they are personally shielded from liability for partnership debts.

As with general partnerships, income and loss from the business passes through to the owners. Unlike general partnerships, limited partnerships only exist upon filing a certificate of limited partnership with the Texas Secretary of State. At \$750.00, the filing fee is high when compared with the other liability-limiting entities. Limited partnerships are often popular choices because they are not subject to the Texas franchise tax, although at least one Texas legislator has suggested that this exception be reconsidered.

Registered Limited Liability Partnerships

In 1991 the Texas Legislature created the registered limited liability partnership ("LLP"). Under this form of partnership, all partners are free to participate in the management of the business, and each is shielded from personal liability for another partner's negligence. An LLP is really a general partnership with the aspect of full partner liability removed in most circumstances.

Of course, no partner in any type of partnership is free from liability for his own acts. For example, the LLP is probably most popular with law firms (for reasons discussed below). The LLP does not protect the individual lawyer/partner from liability for malpractice. It can, however, protect the other partners' personal assets from liability for his or her mistakes.

For the most part, only professional service partnerships, such as lawyers and accountants, use LLPs. Most other businesses will find another type of entity more suitable. Those who find it appropriate must pay an annual fee of \$200.00 per partner, and must maintain liability insurance of at least \$100,000.00.

Corporations

Perhaps the most common way to limit the liability of business owners is to incorporate. Corporations have been around for decades and are a recognized entity in every state. The courts have addressed most of the issues arising from their formation and operation. As a result, owners of corporations often enjoy more certainty in their rights and obligations.

Unlike sole proprietorships and partnerships, corporations are taxed on their income. A corporation files its own income tax return with the Internal Revenue Service and pays tax on any profit according to the corporate rate schedule.

A particularly distasteful feature of corporations is the principle of double taxation. It is the effect of this feature that many small businesses try their best to avoid. To explain, assume first that a corporation with only one shareholder shows a profit of \$10,000.00 at the end of the year. It pays tax on that profit at a particular tax rate. If the corporation then distributes the remaining after-tax profit to its shareholder as a dividend, that individual shareholder pays income tax on the distribution. In other words, the \$10,000.00 profit was taxed twice.

A common method of eliminating this double-taxation effect is to expense out as much of the corporation's profit as possible. To accomplish this, corporations will often pay year-end salary bonuses to key people, particularly shareholders active in the business. By increasing its salary expense, the corporation reduces its profit and, therefore, its income tax liability. Of course, the corporation must take into account the increased payroll taxes resulting from the bonuses.

The IRS offers relief to some corporations from this double taxation effect. Under Subchapter S of the Internal Revenue Code, certain corporations can elect to be taxed like a partnership. An electing corporation, commonly known as an "S Corp," files a tax return showing its income, but pays no tax. Instead, the shareholders pay tax on their respective shares of profit.

S Corp taxation is not available to all corporations. Some restrictions are:

- * the total number of shareholders must be 75 or less
- * all of the shareholders must generally be individuals or qualifying trusts (e.g., no corporations can own stock)
- * all shareholders must be U.S. residents

The costs of incorporating begin with \$300.00 that must be paid to the Secretary of State when the articles of incorporation are filed. The Texas franchise tax, equal to the greater of .25% of taxable capital or 4.5% of net income, is another

feature of corporations that many find unattractive. Corporations with gross receipts less than \$150,000.00, however, are not subject to the franchise tax.

Usually, a corporation is managed by directors elected by the shareholders. In turn, the directors hire the officers to run the day-to-day operations of the business. Those owned and operated by a small number of shareholders are called "close" or "closely held" corporations. Actually, Texas law provides that a corporation can avoid many corporate formalities by designating in its articles of incorporation that it is a close corporation. Texas courts, however, have used the designation to refer generally to small shareholder-managed businesses, whether formally designated as such or not.

Limited Liability Companies

Along with LLPs, in 1991 the Texas Legislature followed other states in creating the limited liability company ("LLC"). This development excited many in the business community, and rightly so. It offered liability protection to businesses that could not qualify as S Corps, while also offering considerable flexibility in management structure.

In many ways, LLCs are hybrids of partnerships and corporations. If they want centralized management, the owners, called "members," can elect a board of "managers" to be the functional equivalent of a corporation's board of directors. If they require less formality, then the members can agree to handle management themselves.

Like a corporation, the LLC pays franchise tax to the State of Texas annually on its income. The filing fee is \$200.00 and, typically, the owners organize the LLC so that it passes profits and losses through to the members. Some advantages an LLC may offer over a corporation include the ability to share profits at a different ratio than losses and lack of restrictions on the type and number of members.

3 Co-Owner Agreements

Any time two or more individuals go into business together, they should set out their respective rights and obligations in writing. Yet, many intelligent entrepreneurs, who take great pride in their ability to negotiate deals with strangers, refuse to talk plainly with their prospective partners. Perhaps you have heard comments such as:

"We've been friends for years. We don't need anything in writing."

"If I felt like I needed some document to cover me, then I wouldn't want to be in business with the guy anyway."

Trust between partners is essential, but the courthouses are full of former partners who confused trust with blissful ignorance. The time to think about all the problems you could have with your co-owner is *before* you go into business with that person. If they are not willing to give serious attention to the issues, it may be time to think twice about the venture.

The following is a list of topics to consider that is in no way intended to be exhaustive:

- A. What will be the value and nature (cash, property or labor) of each owner's initial contribution to the business?
- B. Will any additional contributions be required?
- C. If more contributions will be required, will the contributor receive equity or a note?
- D. Who will have control?
 - * Will minority owners be protected against dilution?
 - * Can other owners be brought in without your agreement?
 - * If two owners have equal control, what happens if you disagree?
- E. What restrictions, if any, will be placed on an owner's ability to transfer his or her interest?
 - * Can an owner sell out to anyone he or she pleases?
 - * Will the business, or other owners have a right of first refusal to match any purchase offer received by an owner?
 - * If an owner dies, what happens to his or her interest? Will the owner's heirs inherit the interest and be entitled to all rights and privileges?

* If an owner divorces, can the ex-spouse receive all or part of the owner's interest in the business, and the accompanying rights, as part of the property settlement?

* If an owner quits working in the business, can he or she maintain ownership while pursuing other (possibly competing) interests?

* If an active owner becomes disabled, can he or she maintain their equity indefinitely?

F. Assuming you decide to restrict the transferability of ownership interests, how do you propose to value the interests for buy-out purposes?

G. What will be the business name?

H. Who will be the officers, and what will be the authority/responsibility of each key player?

I. Will anyone be entitled to draw money from the business initially, whether as salary, capital draw, dividend, loan repayment or otherwise?

J. Do you want the ability to remove any officer, director, or shareholder for cause?

K. Under what circumstances can the business be dissolved and its assets liquidated?

Whether the business is a partnership, corporation or limited liability company, these and any other relevant issues should be dealt with in writing *before* business is commenced.

4 Employment Agreements

Among all business assets, human capital is usually the most valuable. Talented people create the other tangible and intangible assets of the business. Unfortunately, when those talented people change jobs, they can devastate their former employer by taking valuable knowledge with them.

Employment agreements serve many purposes. At a minimum, they should define the employee's responsibilities, compensation and length of employment. In certain instances, they should also protect the employer against injury by a departed employee.

Term of Employment

In Texas, employees who are not under contract for a specified period of time are considered "at will" employees. The employee is free to quit at any time. Conversely, the employer can fire the employee at any time for any lawful reason, or for no reason.

In many instances, it may be of benefit to both parties to agree to a specific period of employment. During that period, the employer cannot fire the employee except for cause, and the employee cannot quit without being liable to the employer.

Restrictions Against Competition

An employer may want to use the employment agreement to restrict a valuable employee's ability to shop his or her services to the competition. Such "noncompete" provisions typically prohibit the employee from accepting other employment that directly or indirectly competes with the employer's business.

To be enforceable, noncompete provisions must be ancillary to an otherwise enforceable agreement and be reasonable in scope and duration. The law does not favor restricting a person's ability to earn a living.

If a widget salesman is prohibited from selling widgets for any other company anywhere in the free world for ten years, a judge is not likely to enforce the agreement. If the widget salesman is prohibited for six months from selling widgets within the same area in which the former employer sells widgets, the prospects for enforcement improve.

The provision must also be supported by "consideration," a legal term of art meaning essentially that the employee must receive something of value in exchange for his or her promise not to compete. A noncompete provision that is part of an enforceable employment contract, or a separate agreement that is executed at the same time as the main employment agreement, is presumed to be supported by consideration.

Furthermore, the promise of continued "at will" employment is not consideration, since it is an illusory promise – the employer could still fire the employee at any time. The promise to provide specialized training, however, may well suffice. Telling the employee, "Sign this and you get to keep your job," will not.

If a noncompete provision is unreasonable, the judge may choose to enforce it only to the extent necessary to protect the former employer for a reasonable period of time. In any litigation over the agreement, the judge can also award the prevailing party its attorneys fees and court costs.

Trade Secret Protection

Whether or not the employer is concerned about competition from former employees, it should always be concerned about losing trade secrets. Every employment agreement should provide that all trade secrets of the business always be held in strictest confidence, even after employment is terminated.

The courts are generally more willing to protect a business from loss of trade secrets than from competition by former employees. Even in the absence of written employment agreement, an employer can often enjoin a former employee from taking those secrets to a competitor.

It is usually helpful if the employer will take reasonable steps to identify the material it deems confidential. Keeping files in safe locations, marking documents "CONFIDENTIAL," and including in the employment agreement a general description of the types of property that is confidential, will make it easier to prove their sensitive nature later.

5 Hiring a Lawyer

First and foremost, entrepreneurs should try to find a lawyer upon whom they can rely. Why pay money to any professional for advice that will be ignored? Usually the best way to find a lawyer is to ask for a personal referral from someone who has been satisfied with their counsel.

Of course, the lawyer should be competent in the field. Competency requires a certain amount of experience and training. Do not be afraid to inquire into a lawyer's background. Ask what kind of clients he or she has represented in the past.

Even if competent, a lawyer may be a bad fit for a client if personalities do not mesh. Rendering proper legal advice can often require considerable time spent discussing the circumstances of the business. The effectiveness of that time will diminish if the parties do not communicate well.

Conflicts of Interest

For businesses with two or more owners, a problem in retaining common legal counsel is the inherent conflict of interest that arises. Too many owners do not pay attention to this conflict. Sadly, too many lawyers fail to adequately identify the conflict and explain it to their clients.

An attorney is required to be impartial, loyal and free to exercise independent judgment with regard to the client's needs. When representing multiple parties to a business venture, the lawyer owes certain fiduciary obligations to each party. The lawyer cannot promote the interest of any client to the disadvantage of another. The lawyer cannot keep secrets told by one client from another involved in the venture. An attorney may act as the common representative for the group only after fully advising all involved of the conflict, and obtaining their informed consent to the joint representation.

Each co-owner has their own interests to consider in any venture. Even if those interests may not appear adverse initially, there is always the potential that differences may develop. While each may own an equal interest, each owner usually brings something different in terms of expertise to the company. They may have different ideas about how that expertise is to be used in the operation of the business.

Conflict often arises in discussion of the written agreement between co-owners. Owners may argue about what rights the corporation or other shareholders should have upon death or divorce. Certain tax planning decisions may have different consequences among various owners. There may later be conflict over the amount of

money that can be taken out of the corporation by each owner, whether as a salary, loan repayment or profit distribution.

All of these examples simply emphasize the ultimate point: each co-owner should consider seeking the advice of independent counsel who can focus his or her loyalties upon them alone. No lawyer with a brain and conscience should represent both sides against the middle. Only if the nature of the conflict has been fully explained and the multiple parties have waived any objections can the individual lawyer represent all of them.

Fees

An oil filter company has used a series of television advertisements that offers an apt analogy. A mechanic would hold up a new oil filter and, pointing to a broken-down vehicle, say "you can pay me now or pay me later." Some entrepreneurs simply cannot bring themselves to pay a lawyer for advice in the early stages of their business. As a result, many wind up paying much more to extract themselves from problems that could have been avoided.

In Travis County, Texas, hourly rates for attorneys range from \$125.00 to over \$300.00. The median rate is probably around \$200.00 per hour. It should come as no surprise to learn that any lawyer can charge whatever that lawyer thinks he or she can get. The value of the legal expertise does not necessarily rise or fall with the hourly rate charged.

Hiring the cheapest lawyer to be found may work well for certain basic matters. Of course, if it takes an inexperienced \$125.00/hour lawyer ten hours to complete a project that a seasoned \$300.00/hour lawyer could accomplish in two, what has been saved? The hourly rate is an important factor, but should not be the determinative factor.

Many projects lend themselves to a flat fee arrangement. Much of the work involved in forming new business entities is often handled on such a basis. Again, many entrepreneurs will shop for the cheapest flat fee and sometimes that will suffice. If all a business needs are articles of incorporation filed with the Secretary of State, then lawyers with even minimal experience in business matters may be perfectly competent to handle the job. If the issues are more complicated, however, then the entrepreneur might do well to look beyond the initial fee to consider the quality of representation available after business is commenced.