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ATTORNEYS & COUNSELORS

The Foundation: Your Checklist for Creating the Proper Base for Building Your Business

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**Business 3355 –
Entrepreneurship & Venture Planning**



TRINITY
UNIVERSITY



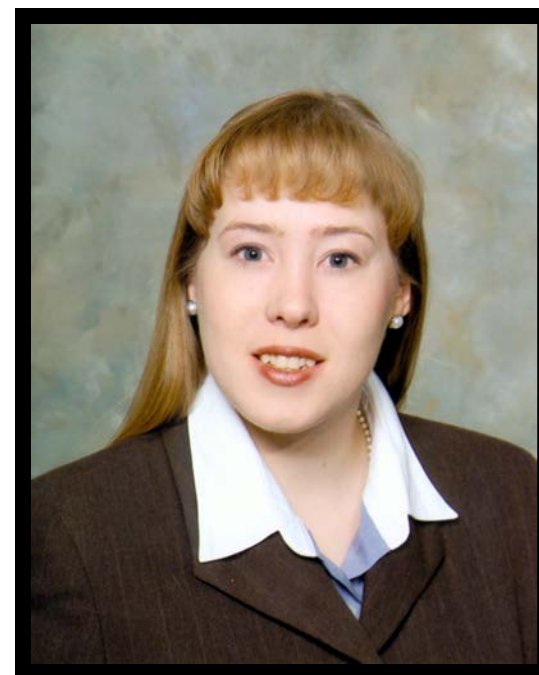
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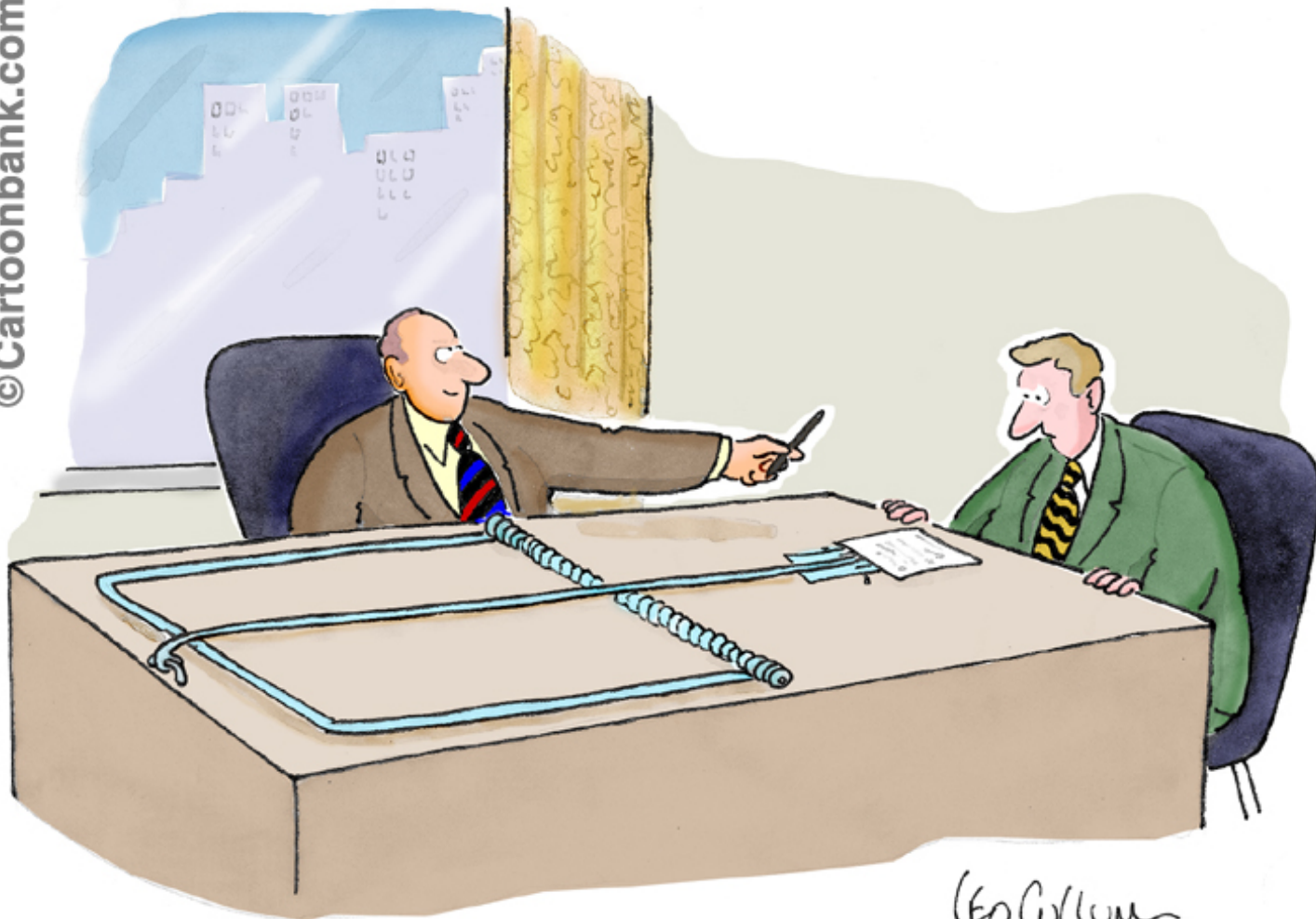
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Geo Allen



Choose the Right Entity

When Should You Formalize Structure?

- ✘ Initiation of Business Operations
- ✘ Asset Protection
- ✘ Invitees
- ✘ Succession Planning
- ✘ Multiple other factors

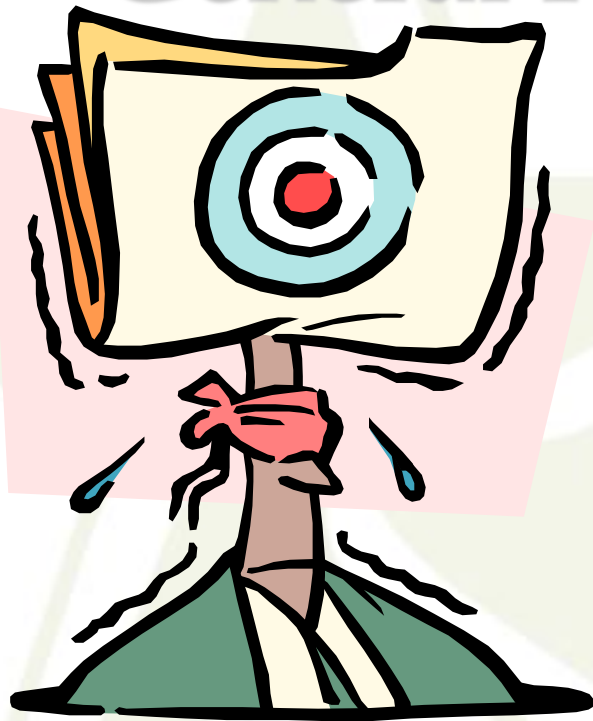


Choose the Right Entity

- **Sole Proprietorship**
- **General Partnership (GP)**
- **Corporation**
 - C-Corp
 - S-Corp
- **Limited Partnership (LP)**
- **Limited Liability Company (LLC)**



Sole Proprietorship General Partnership (GP)

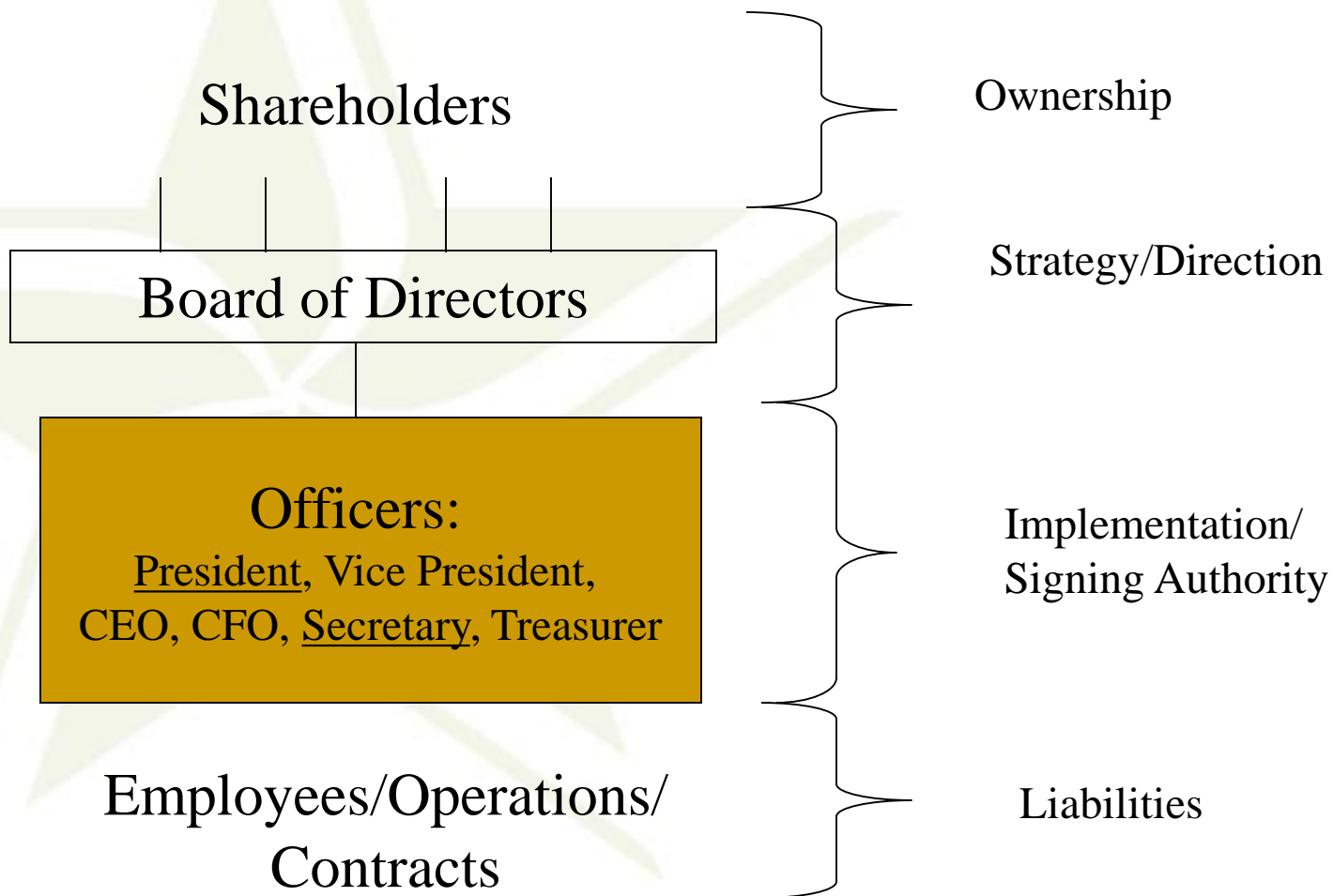


- **Default Entity**
- **No liability protection, partners are jointly and severally liable for all partnership liabilities***
- **The fallacy of a DBA filing county DBAs and State of Texas DBAs**

* Even in Texas your homestead protection is limited to \$30k if single, \$60k if married.



Corporation





Corporation

Pros

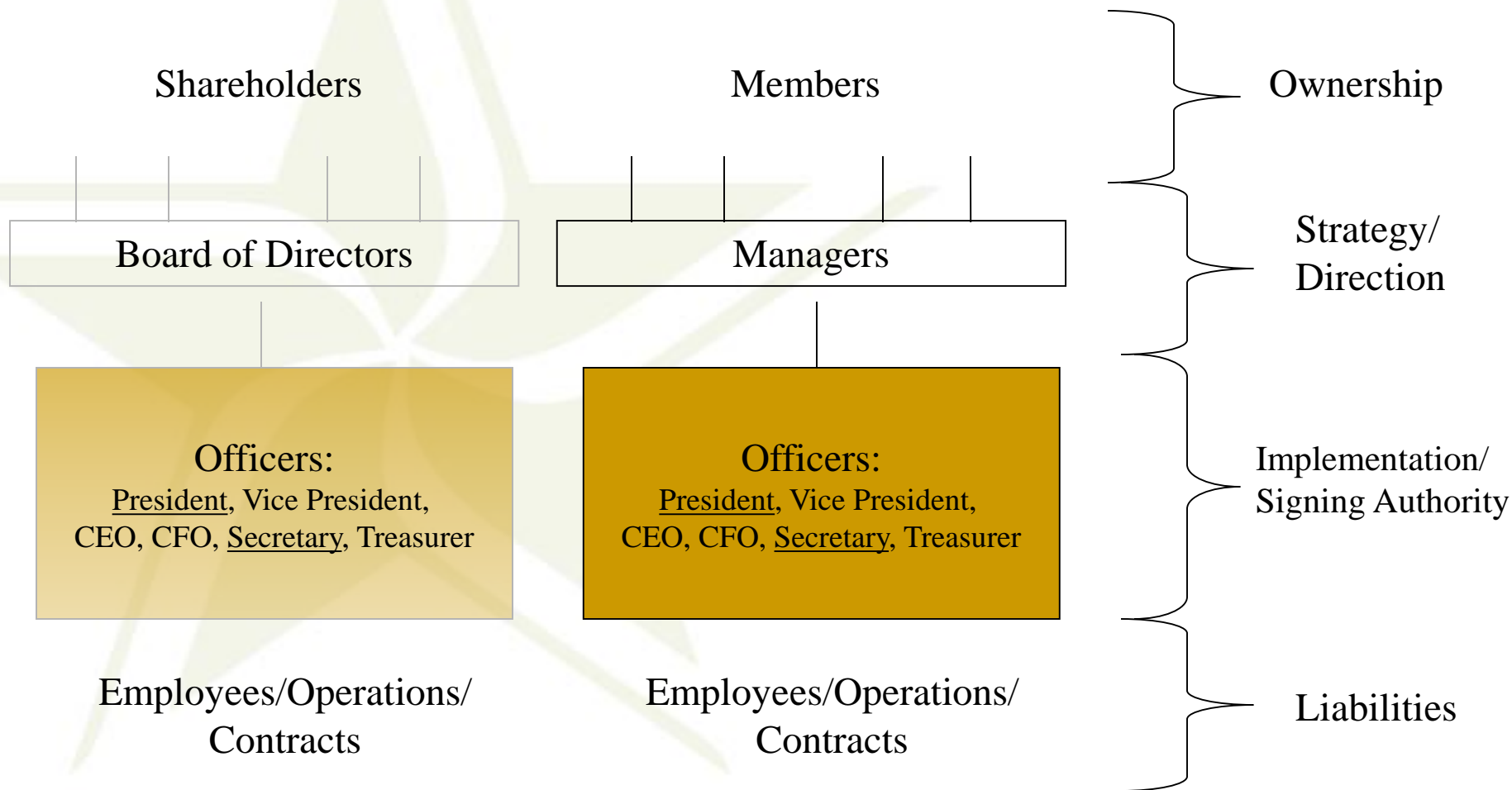
- **Liability limited**
- **Ease of creation**
- **Most common – easily understood**
- **Growth oriented**
- **Centralized Management**

Cons

- **Federal income tax and Texas Margin tax (replaced franchise tax)**
- **S-election restrictions**



Limited Liability Company





Limited Liability Company (LLC)

Pros

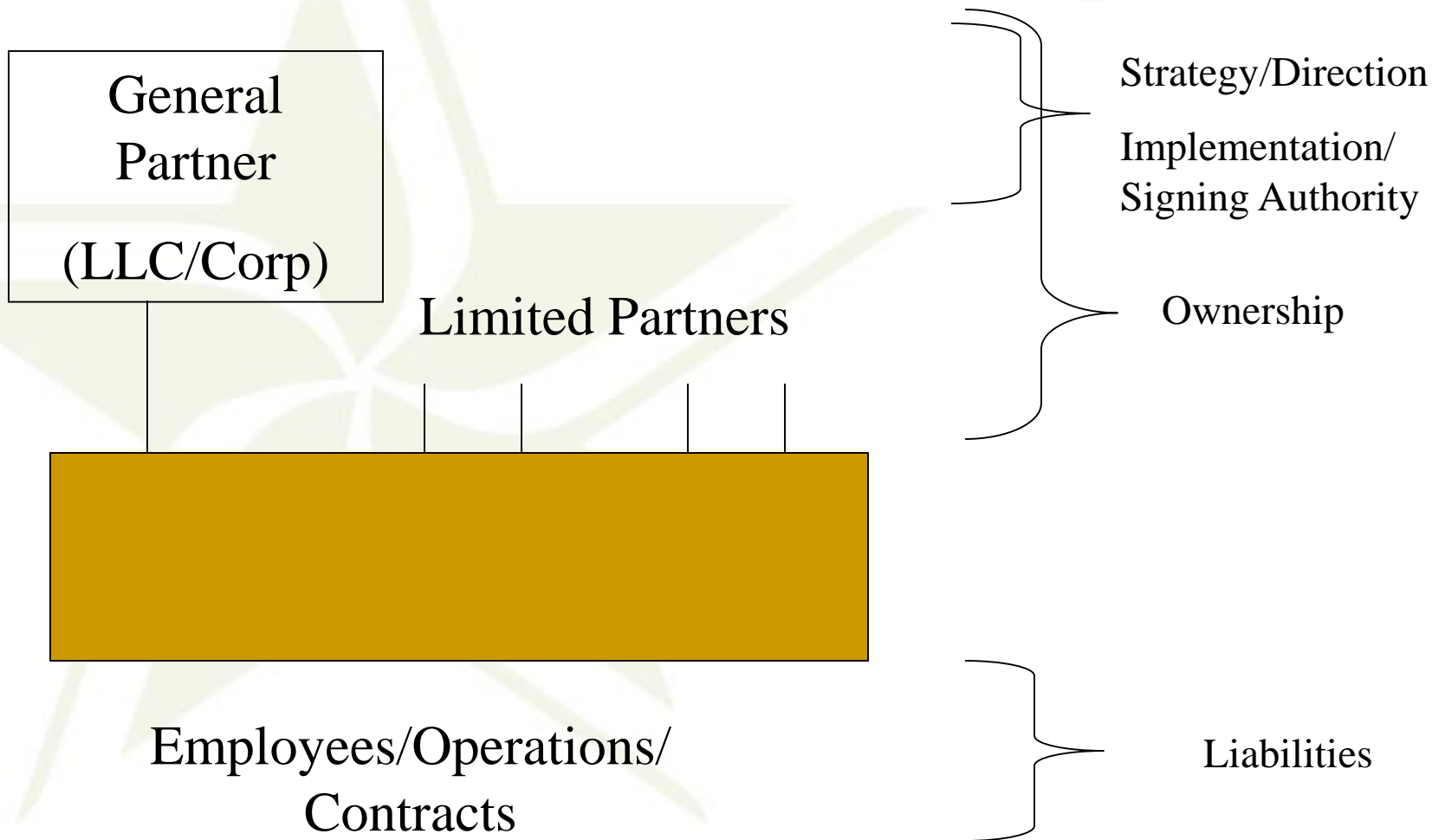
- Can have tax flow through
- Limited liability

Cons

- Federal income tax and Texas Margin tax (replaced franchise tax)
- Different terminology (i.e. Managers and Members instead of Board and Shareholders)
- Minimal uncertainty regarding recognition by other states
 - Limitation of Members' liability
 - How to qualify as a foreign LLC



Limited Partnership





Limited Partnership (LP)

Pros

- Federal Tax flow through
- Liability limited for limited partners

Cons

- Must have a general partner who is liable for all PS obligations
- Limited partners have to agree to no say in management (can be less attractive to investors)
- LPs who participate in management of business become liable as GPs
- Texas Margin tax (replaced franchise tax)
- Expense of maintaining multiple entities



Respect the Entity Form

- Cash Transfers
 - Assets transferred by anyone to the corporation –
Rule: Paper It!!!
 - Do not pay personal bills with corporate checks.
 - Do not pay corporate expenses with personal checks.
 - Assets transferred out of the corporation (*beware of the loans to shareholders problem*)
- Business insurance (e.g. public liability, disability, group medical, hazard) in entity name
- Financing – avoid personal liability through guaranties (*if possible*)



Respect the Entity Form

SIGN PROPERLY:

YOUR PARTNERSHIP, L.P., a Texas limited partnership

By: ABC CORPORATION, its general partner

By: _____
Smart E. Entrepreneur,
the President

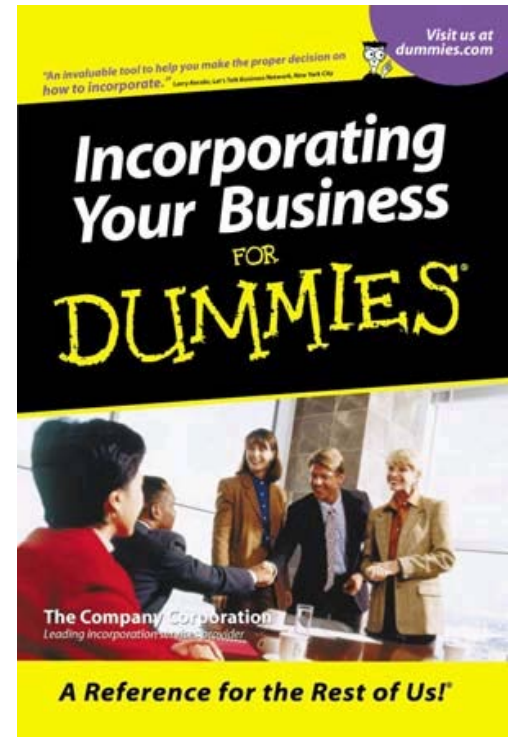


Qualify to Do Business

- Texas v. Delaware v. Nevada
- Texas – Qualified to Business
= \$750 filing fee

“No foreign corporation shall have the right to transact business in this State until it shall have procured a certificate of authority so to do from the Secretary of State”

- TBCA §8.01





Accounting Books ≠ Corporate Records

- Accounting Books: Income Statement, Balance Sheet, etc.
- Corporate Books: Articles of Incorporation, Bylaws, Minutes, Stock Transfer Ledger, etc.



Joint Ownership Issues

- Not only your partner, but ...
- Buy-sell/Shareholders agreements
 - What if I don't want to keep doing this?
 - What if my partner dies? Gets divorced? Files for bankruptcy?
- Issues are always easier to resolve before money is a factor





Types of Intellectual Property

- **Patents** -- gives the inventor the right to exclude others from making the invention
- **Trade Secrets/Know How** -- protection by virtue of secrecy
- **Trademarks/Service Marks** -- identifies a unique source of goods or services
- **Copyrights** -- protects from copying of original works (music, books, software code)



Names and Trademarks

- **Corporate Name/DBA/Domain Name/Trademark – All are EXCLUSIVE**
- **Corporate Name**
 - name on organizational documents
- **DBA**
 - name under which you do business
 - filed at county (individual and entity)/state (entity)
 - can have multiple DBAs
 - does not provide any proprietary rights; only notice filing



Names and Trademarks

● Domain Name

- Internet usage only -
.com, .net, .biz, .org,
.pro, etc.

● Trademark

- Both state and federal
- Federal registrations are preferable

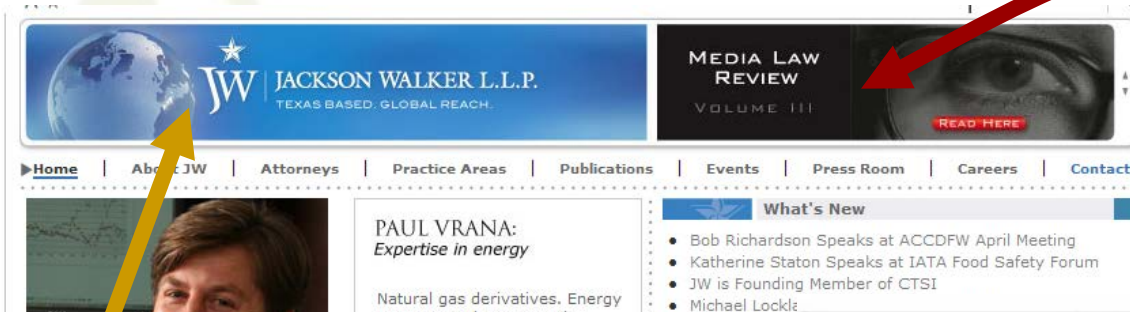




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All Businesses Have Intellectual Property

Example: Ownership of Site Content





Adequately Protect Basic Intellectual Property

- **Confidentiality Agreements and Trade Secret protection**
 - Create a system that will help enforce your rights (manuals, access to information, education)
- **IP Ownership – Beware of the Independent Contractor**



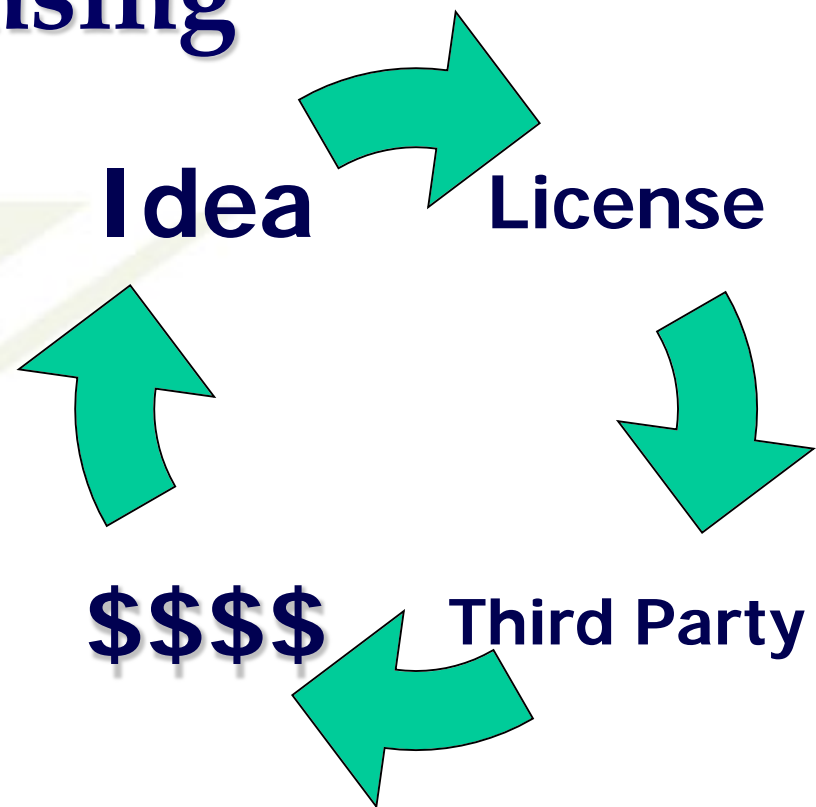
Ownership of Work

- Work for Hire Doctrine (Copyright)
 - Employee works - owned by employer
 - Independent Contractor work - more difficult
- Recommendation: Include “Assignment Clause” and “Work for Hire Clause”



Interesting Model: Licensing

- **Patents** -- gives the inventor the right to exclude others from making the invention
- **Trade Secrets/Know How** -- protection by virtue of secrecy
- **Trademarks/Service Marks** - - identifies a unique source of goods or services
- **Copyrights** -- protects from copying of original works (music, books, software code)





Some Basic Employee Issues

- Application Content - no date of birth, marital status, ethnicity, prior workers compensation claims, existence of disability
- Texas Payday Law - overtime, minimum wage calculations; pay within 6 days of discharge
- 15 Employees - ADA and Title 7(discrimination, sexual harassment)
- Vacation or Sick Pay - follow written policies
- Unemployment - voluntarily resign and misconduct only



READ EVERYTHING ...

- **“Boilerplate” = Most important provisions, do NOT ignore**
- **Don’t assume a provision can’t be changed**
- **Don’t sign contracts until reviewed by a lawyer**





Use of Forms

The parties hereto agree that any disputes or questions arising hereunder, including the construction or application for this agreement, shall be settled by arbitration, in accordance with the **Code of Civil Procedure 1280**. Said arbitration to be accomplished by a single arbitrator appointed by the **presiding judge of the Superior Court of Dallas County Texas**.



Use of Forms

13. Venue. This Agreement and all amendments or modifications hereof shall be governed by and interpreted in accordance with the **laws of the State of Confusion** governing contracts wholly executed and performed therein, and shall be binding upon and inure to the benefit of the parties, their respective heirs, executors, administrators and successors. Jurisdiction for any suit filed to enforce the provisions of this Agreement by either party shall be filed in the federal or state courts of **Mostfavorable District of Confusion in Hitsville, Confusion or Miracle County, Confusion.**



Use of Forms

- ✓ **What is the status of the parties?**
- ✓ **Whose law will govern?**
- ✓ **Who wrote the “form”?**
- ✓ **Why was the “form” created?**
- ✓ **Is this the final draft resulting from negotiation?**



Retain Experienced Advisors

- **Attorneys – Transactional attorneys, litigators and intellectual property attorneys**
- **Accountant –**
 - determine when the corporation's first fiscal year will end
 - what tax elections should or could be made by the directors and/or shareholders
 - matters related to the preparation and filing of tax returns
- **Ask them to work together, meet at least annually**





Taking it further:

Pro's and Con's of Different Entity Forms

- **Sole Proprietorship**
- **General Partnership (GP)**
- **Corporation**
 - C-Corp
 - S-Corp
- **Limited Partnership (LP)**
- **Limited Liability Company (LLC)**



Two Biggest Concerns:

- **How the entity will be taxed**
- **Who will be liable for its obligations**

***The entity itself will always be liable to extent of its assets and so the question is who will be liable, if anyone, if the entity's assets are not sufficient to satisfy all claims.**



Double Taxation

- Personal Tax
- Corporate Tax



Levels of Taxation

- Federal Tax (IRS)
- State Tax (Margin Tax)

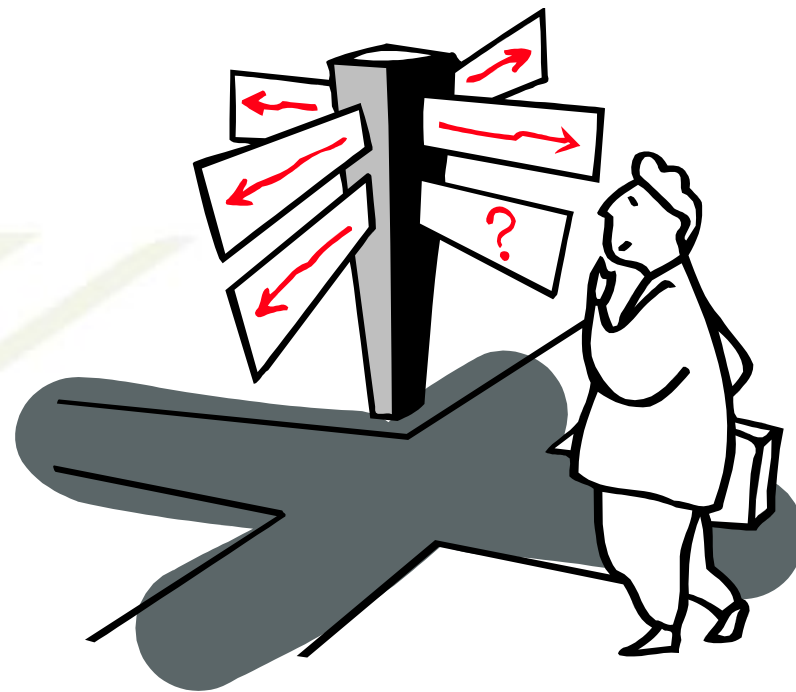
Comparison Chart

Item	C Corp	S Corp	General Partner in GP or LP*	Limited Partner in LP*
<u>Entity Level</u>				
Income	1000.00	1000.00	1000.00	1000.00
Taxable Margin	700.00	700.00	700.00	700.00
Net Income	100.00	100.00	100.00	100.00
Texas Margin Tax (replaced Franchise Tax)*	7.00	7.00	7.00	7.00
Taxable Income Of Entity	93.00	93.00	93.00	93.00
Fed. Income Tax (at 35%)	32.55	0.00	0.00	0.00
Income After Taxes	60.45	93.00	93.00	93.00
<u>Owner Level</u>				
Distribution & Share of Income	60.45	93.00	93.00	93.00
Self-Employment Tax	0.00	2.90#	2.90	0.00
Taxable Income of Owner	60.45	90.10†	90.10†	93.00
Fed. Dividends Tax (at 15%)	9.07	0.00	0.00	0.00
Fed. Income Tax (at 35%)	0.00	31.54	31.54	32.55
Amount Received After Taxes	\$ 51.38	\$ 58.56	\$ 58.56	\$ 60.45



Other concerns

- Capital raising
- Liability Protection
- Management
- Interest transferability
- Continuity of life
- Formation issues such as cost and timing





Capital Raising/Interest Transferability

- **Corporation – Preferred Stock Authorization**
 - ✓ Understood by typical investors – “Can I buy stock in your company”
 - ✓ Voids S-election
 - ✓ Allows for flexibility (redemption rights, conversion rights, preferences)
- **Limited Partnerships for pooling**
- **LLCs for creative rights**



What Types of Interest Can You Sell?

- Common Stock
- Preferred Stock
- Convertible Debt/Bridge Financing

Legal Fees: Up to \$100,000+ (see handout for options for exempt offerings)



Capitalization

<u>Security</u>	Pre- Financing		Post- Financing	
	<u># of Shares</u>	<u>%</u>	<u># of Shares</u>	<u>%</u>
Common – Founders	3,000,000	100%	3,000,000	30%
Common – ESOP	0	0%	1,000,000	10%
Series A Preferred	0	0%	6,000,000	60%
Total	3,000,000	100%	10,000,000	100%



Liability

The entity itself will always be liable to extent of its assets and so the question is who will be liable, if anyone, if the entity's assets are not sufficient to satisfy all claims.

➤ **Owners Liability Limited (Piercing the Veil)**

*exception: watch for guarantees

➤ **Fiduciary Duties**

Directors/Managers; sometimes between partners – Duty of Loyalty, Care and Obedience, Minority shareholders



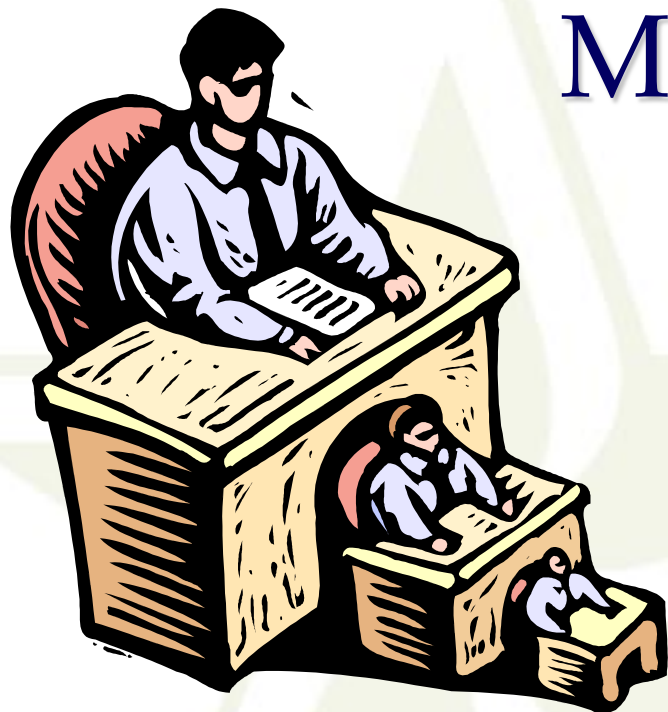


Pay Payroll Taxes

- The corporation must pay all payroll taxes.
- Non-payment may result in personal civil or criminal liability of the officers and directors.
- Unlike other debts of the corporation, officers and directors are individually liable for non-payment and are responsible for paying such payments if the corporation fails to do so.



Management



- ✓ Partnerships and LLCs do "not" have Presidents and Directors
- ✓ Who will have control over what decisions?
- ✓ What will be the extent of Control?

Generalization:

Corporations = defined by law (modified by agreement)

Partnership and LLC = defined by agreement



Continuity of Life

- **Corporations - perpetual existence**
- **LLCs - perpetual existence**
- **General Partnership - partnership continues post-withdrawal until the winding up of the partnership**
- **Limited Partnership - limited life as defined in partnership agreement (or earlier upon agree or by law)**

Formation Cost and Timing

Entity Type	Fees and Other Costs	Timing
Corporation	Filing Fee: \$300 Legal Fees: \$700-\$1200	<ul style="list-style-type: none">• SOSDirect• Basic documents (may also do shareholders agreement)
LLC	Filing Fee: \$200 Legal Fee: \$1000-\$5000	<ul style="list-style-type: none">• SOSDirect• Documents can be complex
Limited Partnership	Filing Fee: \$750 Legal Fees: \$2000-\$5000	<ul style="list-style-type: none">• SOSDirect• Documents can be complex• Requires 2-tier filing



Desire to Deal with Complexity

- ✓ Do you want to live by the terms of the Regulations or Partnership Agreement/ hire someone to assist?
- ✓ Will you earn enough money to justify complex structure (if tax savings \geq filing fees)





Initial Public Offering

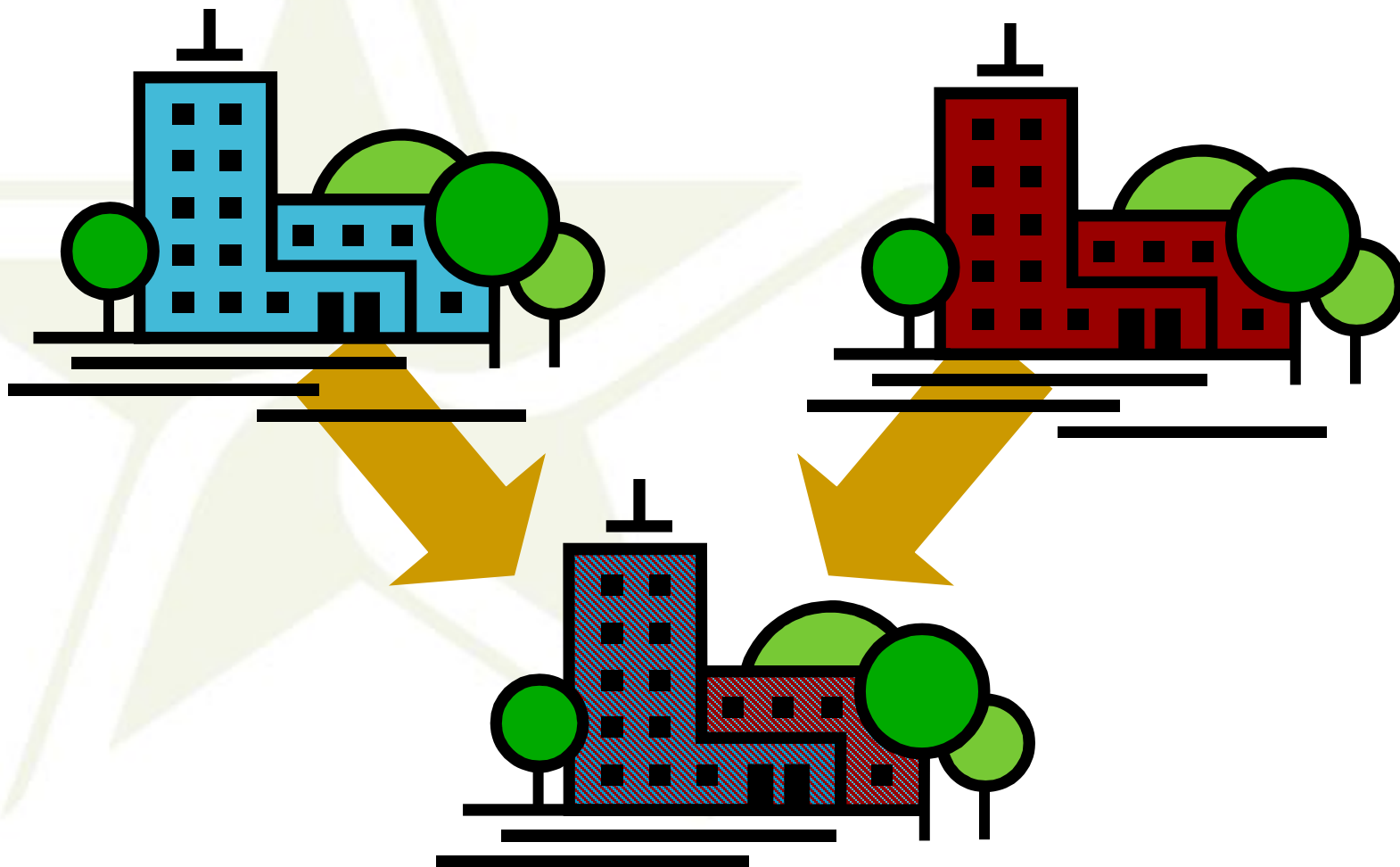
- Registered with the SEC
- Underwritten
- i.e. Google, ...



Invest in Growing Operations and Revenue



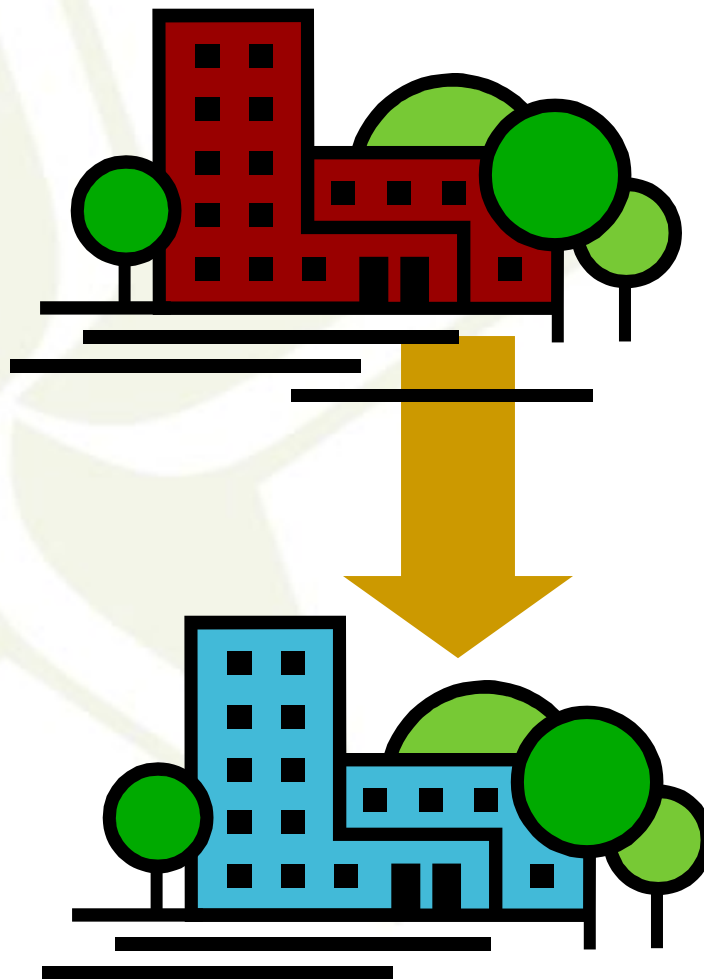
Merger or Acquisition





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Merger or Acquisition





E X I T S T R A T E G I E S

Privately-held businesses

Sale of Company

Advantages

- Complete exit of ownership
- Provides liquidity
- Diversification of wealth
- Avoid family succession issues

Disadvantages

- Difficult transition for long-term owner
- Tax issues
- Continued involvement in management
- Potential need to accept note or stock as part of consideration received

Partial Sales

1. Partial sale
2. IPO
3. ESOP

Advantages

- Liquidity and diversification
- Higher valuation multiples (IPO)
- Retain some ownership
- Capital for growth
- Upside potential

Disadvantages

- Retained interest/ limited exit
- Regulatory/market oversight (IPO)
- Expensive process (IPO)
- Subject to veto power on major decisions
- Accountability to a partner

Transfers to Family/ Estate Planning

1. Family limited partnerships
2. Estate freezes through recapitalizations
3. Gifting

Advantages

- Family retains ownership
- Maintain income stream from family business
- Put growth ownership in hands of heirs
- Transfer significant equity while retaining control
- Plan for transferring control

Disadvantages

- Complex securities
- Retained ownership
- Potential liquidity problems



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