



BE AN UNCOMMON LEADER.®

SMALL BUSINESS TOOLKIT



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NOTICE: The Texas Young Lawyers Association prepared this Tool Kit to help you understand the laws that affect your small business and to help familiarize you with the legal issues that you may encounter during opening and running a small business. Please note that this Tool Kit is solely intended to provide general information only and is not a substitute for legal counsel. The laws outlined in the Guide are subject to change at any time. If you have a specific legal problem, we suggest that you consult an attorney.

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SECTION I. MAKING THE DECISION

Hundreds of thousands of Americans go into business for themselves each year. They are compelled by a variety of factors – downsizing/layoffs, limited opportunity for upward mobility, or dissatisfaction with the job, management, or company. Many seek to avoid the perils of job hunting and crave the rewards of entrepreneurship, such as the scheduling flexibility, freedom of “being your own boss”, and hands-on, direct involvement in all aspects of the business. Regardless of your motivation, entrepreneurship is a life-altering experience that requires full-time commitment and incessant hard work. The anticipated benefits are tempered by financial risk, lack of a steady paycheck and benefits, commitment of time & effort, and sole responsibility for the business’ success. A successful small business is the product of substantial planning and forethought, and this Small Business Tool Kit is presented to guide you through the process and provide insight into some of the questions you should discuss with your lawyer.

A. Are you an entrepreneur?

Starting your own business may be somewhat intimidating, and not everyone is prepared to succeed. Running a small business isn't for the ambivalent or indifferent, and you must have a burning desire and discipline to plan, work, and sacrifice in order to successfully transform your idea into reality. You should carefully consider whether you really want to operate independently, make all the decisions, and shoulder all the responsibility. Are you ready, willing, and able to work harder than you ever have before? Building a successful small business requires self-confidence and discipline – do you have what it takes to make the necessary sacrifices and persevere in tough times? Do you have the sales skills necessary to turn your vision into dollars? If you’ve answered “no” to any of these questions, you may not be ready for entrepreneurship. But if you’re ready to make the commitment, then you’re on the right track.

Successful small businesses generally have the following factors in common: business and industry knowledge, organization and management capabilities, marketing skill, customer/vendor relations, self-motivation, and vision. Business and industry knowledge is vital to the success of any small business. This knowledge can be developed through trial and error, but that high-stakes education could leave your business bankrupt before you’re up to speed. Organization and management are also critical to assessing and meeting the demands of your customers, marketing to potential customers, cultivating and maintaining sound relationships with suppliers and vendors,

ensuring sufficient staffing and efficient business operations, and maintaining compliance with governmental authorities.

It is not uncommon for an entrepreneur to be deficient in one or more of these areas. In reality, most businesses fail due to their own deficiencies, such as weaknesses in management, financial management, or marketing, rather than externally generated problems. If you don't personally have business and industry knowledge, organization and management capabilities, marketing skill, or customer/vendor relations, then you should consider partnering with someone who does.

B. Developing Your Idea

So what's your idea? What's your product? What goods or services are you going to provide to whom, and whose needs are you going to meet? For starters, you should ask yourself "What are my skills, what am I good at, and what do I love to do?"

After making a list of the things you're good at or products you could offer and describing how others would benefit, consider the value of your goods or services. Is there any competition or others offering the same or similar goods or services in the area? Don't be shy about contacting others to learn from their successes and failures. You must carefully weigh the risk involved, and, most importantly, you must believe in what you have to offer.

C. The Business Plan

The next step in developing your idea is to put it in writing. A business plan provides a blueprint for your business and highlights your ideas, strategy, and team; it will be used by you and others, such as banks, investors, and potential partners. Of course, nothing will turn out exactly how you planned it, but you still must plan (see below re: "Adaptability"...). A business plan is a dynamic document, so it will change and adapt as your business evolves to meet the demands of reality. At a minimum, a business plan should include an executive summary, mission statement, and thorough analysis of management, market, product, and financials. Other topics that may be covered in a business plan but must be considered prior to starting a new business are formation and start-up costs, licensing and certification, capital (financial, intellectual, and human), suppliers, equipment, space, technology, advertising, banking relationships, insurance, taxes, governance and compliance, growth, alternative strategies and opportunities, and an exit strategy.

The process of preparing a business plan is perhaps more important than the business plan itself, as it not only brings to light previous unknowns and forces you to consider a multitude of critical issues, but it also compels you to articulate the challenges and anticipate potential solutions. This deep and thorough analysis is vital to the success of your business, both at its inception and throughout its existence.

SECTION II. CHOOSING THE RIGHT BUSINESS

A. Starting a New Business

Now that you've determined that entrepreneurship is (or at least might be) for you, developed your idea, and started preparing your business plan – remember, it's a fluid document – you should consider how to best bring your business to life. Some entrepreneurs share their vision, product, and objectives with an already-existing business. If you fit this description, you should consider teaming up with a business that shares your vision, values, and style. Many entrepreneurs start as franchisees in proven businesses, thus avoiding some of the risks and challenges inherent with starting a new business from scratch. Franchising presents many complex legal issues, and you should consult counsel, at the very least, regarding your prospective franchise agreement.

Is your idea new or novel, or is it an extension or re-direction of an existing business? If so, you should consider partnering with someone already in the industry or perhaps blazing the trail yourself. How your business transitions from idea to operation is the product of many factors, such as your type of business, access to capital and financing, intensity of competition, and many more. Every entrepreneur should know that there's no right or wrong way to get your start, and there are numerous resources available for direction.

B. Purchase an Existing Business

Another alternative is to purchase an existing business. New entrepreneurs, however, should proceed cautiously, as this path does not necessarily offer any shortcuts and can be littered with perils. In purchasing an existing business, you may be able to avoid initial start-up costs, tap into an existing brand and market, and analyze past income and expenses. Even though past performance is no guarantee of future success, it can be useful.

Purchasing an existing business implicates a litany of legal issues, and it is strongly recommended that you seek guidance of an attorney experienced in small

business purchase transactions. When purchasing an existing business, you should first know exactly what you're purchasing. Are you purchasing just the business' assets, or the entire business, including both assets and liabilities? Without proper legal guidance, an acquiring entrepreneur may not be aware that they're also purchasing the business' debt and liabilities, both known and unknown. If making an asset purchase, it is important to set forth in writing the exact terms of the transaction, including the specific assets to be transferred. Err on the side of specificity and include the year, make, model, serial, and VIN numbers, usage metrics, color, size, and other identifiers, where available, to reduce the possibility of future disputes and litigation. Thorough due diligence can help ensure your purchase transaction yields exactly what you're expecting.

A prudent purchaser should also request execution of a non-compete covenant that restricts the seller from opening a similar establishment, using client or customer lists of the established business, hiring employees of the existing business, and/or advising others to operate a competing business.

Entrepreneurs should budget for legal services in opening or purchasing their new business, as the initial time and expense can save hours of time and thousands of dollars in the long run.

SECTION III. CHOICE OF BUSINESS ENTITY

You have a great business idea. You are going to manufacture widgets for use in the newest and fastest growing industry. You could make millions! First question you should ask is how do I protect myself? Should I do this under my own name? What will protect me and at the same time give a more serious outlook to potential investors or even lenders?

This Section will discuss the different choice of business entities you can use for your business and when you should use one or the other. It will also address where you should form such business entity.

A. Common Types of Business Entities

Texas law (and most states for that matter) recognizes several business structures. Below you will find a list and a brief description for each of the most commonly used business entities:

1. **Sole Proprietorship.** A sole proprietorship is when an individual person (if there is more than one owner then it is a partnership as described below) is doing business under his own name (or even under an assumed name). There are no formal organizational requirements to form a sole proprietorship. You simply do business. Similarly, there are no formal management or governance requirements. ***However, there is no limit to liability.*** For this reason, it is ***never*** recommended to do business as a sole proprietor. Under a sole proprietorship, your personal assets are at stake! Additionally, you can only transfer the interests in your business by selling the assets themselves which could mean more tax liability. If you die or something happens to you, the business as presently being done will cease, unlike a limited liability company or a corporation whose life could be for perpetuity. Finally, but not less important, access to capital can be limited. Banks might have an adversity to lending to individuals versus a business entity. From a tax perspective, a sole proprietorship has no entity taxation at either the federal or state level because there is no entity to tax. Earnings are taxed directly to the owner. It should be noted, however, that all earnings are subject to self-employment tax.¹

2. **General Partnership.** A general partnership exists when two or more individuals (or entities) have shared ownership of the business. It has most of the same attributes (and deficiencies) of a sole proprietorship. For instance, like a sole proprietorship, a general partnership has no formal organizational requirements to be formed nor does it have any formal management or governance requirements. This is important because it means that any partner of the partnership can bind or obligate the partnership. This means that a partner can create liabilities for the partnership without other partners being aware.

Also like a sole proprietorship, ***there is no limit to liability for the partners.*** Rather, all liability is shared among the partners equally (what lawyers like to call joint and several liability). For this reason, it is ***rarely*** recommended to do business as a general partnership. Similarly, it has no continuity of life, *i.e.*, the death or withdrawal of any partner terminates the business (but unlike a sole proprietorship it can be reconstituted), you cannot transfer the interests of a general partnership and access to capital might be difficult. A general partnership has what is commonly referred to as full flow through taxation. In other words, the taxes are paid at the individual partners' level

1 Please refer to the IRS for more information regarding self-employment taxation (www.irs.gov). This Section is not intended to provide any tax advice. It is simply a reference tool for you to discuss these issues with an attorney and your accountant.

and not at the entity level. Like a sole proprietorship, general partners (individuals) may also be subjected to self-employment taxes. Additionally, there might be different taxation consequences than a sole proprietorship at the state level (depending on the state).

3. **Corporation.** Under most state laws, there is one kind of corporation. However, from a federal tax perspective there are two: a C-Corporation and an S-Corporation. We give an overview of both below.

i. **General Concepts Applicable to Both.** Regardless of whether a C or S corporation is used, corporations have perhaps the most rigorous management/governance structures. In Texas, in order to form a corporation, a certificate of formation must be filed with the Secretary of State. Such certificate must set forth certain information to put the public on notice about the existence of a new separate entity. Corporations must have at least (1) a registered office and agent for service of process in Texas, (2) at least one director who is in charge of overseeing the corporation's business and (3) at least a president and a secretary as officers.² Additionally, at least one annual meeting of the directors and the shareholders of the corporation must take place to elect directors and officers.³ Sounds like a hassle, so why form one? Unlike sole proprietorships and general partnerships, corporations afford limited liability to its shareholders. Because the corporation is a separate entity, shareholders are only liable for corporate liabilities up to the capital they contributed to the same.⁴

In addition to limited liability, corporations provide for continuity of life regardless of whether you are still around or not. Corporations also provide for free transferability of interests (with the exception of some restrictions applicable to S-Corporations as discussed below). Regardless of the type of corporation used, formalities such as annual meetings, holding corporate assets separate and having arms-length transactions between corporations and shareholders/directors must be followed to maintain limited liability of the shareholders.

ii. **C-Corporation.** C-Corporations are the more flexible type of corporations in that there is no limit in the amount of shareholders they may have.⁵ Similarly,

2 TEX. BUS. ORG. CODE (TBOC) § 21.417.

3 *Id.* at § 21.351 and § 21.401.

4 Easterbrook, F.H & Fischel, D.R. (1985). "Limited liability and the corporation". University of Chicago Law Review 52: 89.

5 Note that we are not addressing state and federal securities issues herein that could affect the status of a corporation.

shares of a corporation can be sold to anyone whether a corporation, individual person or different entities. However, C-Corporations are hit with double taxation. The corporation, as a separate legal entity, pays federal and state taxes (35%) and then individual shareholders also pay taxes on whatever dividends (distributions of earnings) are paid to shareholders (generally 15%). In the event that a C-Corporation is sold, there is a single tax to shareholders if the interests (shares) are sold but there is double taxation if assets are sold as it is deemed income to the entity and then a distribution to shareholders.

Because of the double taxation feature of a C-Corporation, it is generally not a desirable business structure for small businesses. However, sometimes it makes sense. For instance, if you think you might want to take the corporation public at some point in the near or medium future and/or have the equity interests publicly traded or if there is some sort of legal requirement to have a corporate structure, the corporation would be the more appropriate vehicle.

iii. **S-Corporation.** S-Corporations (named as such because of Subchapter S of the Internal Revenue Code) are corporations formed under state law that file an IRS election (Form 2553). From a governance and state law perspective, S-Corporations are essentially the same as C-Corporations. Once Form 2553 is filed, an S-Corporation is viewed as a partnership or sole proprietorship for taxation purposes, depending on the number of shareholders. This means that the corporation itself is not taxed, as C-Corporations are; rather the S-Corporation's profits are passed on to its shareholders, who pay income tax on that money.⁶ In nearly all other respects, though, the S-Corporation is essentially the same as C-Corporations. Most importantly, S corporations receive the benefit of limited liability that goes along with being a corporation. Unlike C-Corporations, however, an S-Corporation is limited on the number of shareholders it may have (75) and on who can be a shareholder.⁷ For instance, corporations or other business entities are not allowed to be shareholders, nor are foreign investors (only US individual persons).⁸ Additionally, S-Corporations may only issue one class of stock.⁹

Although S-Corporations might be preferable from a taxation standpoint to C-Corporations, due to the level of eligibility requirements from the IRS' perspective and the fact that there are other business entities out there that offer the same protection and taxation benefits without so many restrictions, such as limited liability companies

6 26 U.S. Code (IRC) § 1366.

7 *Id.* at § 1361(b).

8 *Id.*

9 *Id.*

(discussed next), it is best to really consider whether it makes sense to form a corporation and make an S election.

4. **Limited Liability Companies.** Limited liability companies (LLCs) are a somewhat recent creation in most states. The intent in creating them was to afford more governance flexibility than corporations but provide limited liability to their members (interest holders). LLCs in most cases may be organized in two ways: (i) member managed or (ii) manager managed.¹⁰ Simply put, a member managed LLC is more like a partnership. The members make the business decisions and run operations of the business. Manager managed LLCs are more like corporations. A manager (or managers) is in charge of running the business, very much the same way directors are tasked in corporations, and members do not have an active role in running the business (like shareholders).¹¹

From a formation standpoint, like corporations, an LLC is formed when a certificate of formation is filed with and accepted by the Secretary of State. In addition to general information required in all certificates of formation in Texas, an LLC certificate of formation is required to state whether the LLC will be manager or member managed and set forth the names of each initial manager (if manager managed) or initial member (if member managed). Like corporations, LLCs have a continuity of life and are very flexible as far as transferability of interests with the exception that LLC interests can not be publicly traded. From an access to capital standpoint, LLCs are more flexible than S-Corporations; however, as a flow through tax entity (as discussed below), it may add complexity to individual investors. Additionally, although allowed, foreign investors create additional withholding requirements on the LLC.

Unlike S-Corporations, LLCs have no limitation on the number or type of members.¹² If an LLC is owned by a single member, for taxation purposes it is treated as a disregarded entity. In other words, a single member LLC owned by an individual is automatically treated as a sole proprietorship for tax purposes. If the owner is a corporation or another LLC, it is treated as a division or branch of that entity. An LLC with multiple members is treated for tax purposes as a partnership. LLCs can elect to be treated as corporations for tax purposes, which is *rarely* recommended. Because LLCs are flow through entities, there is one level of taxation for members

10 See TBOC §§101.251- 101.252.

11 TBOC § 101.252.

12 This is subject to a limitation on being publicly traded. This toolkit does not address restrictions or regulations under federal securities or Blue Sky laws.

(unlike C-Corporations) on distributions of income as well as on the sale of the business, regardless of whether a sale of interests or assets, at the individual members' tax rate. Additionally, if an LLC is a single member LLC, it will have the same taxation consequences as a sole proprietorship, i.e., self-employment tax. From a state law perspective, at least in Texas, LLCs are taxed similarly to C-Corporations.

Because of its flexibility vis-à-vis governance and taxation as well as limited liability, LLCs are the preferred business entity for most small businesses. There are some exceptions that must be analyzed (discussed in Section II below).

5. **Limited Partnerships.** Limited partnerships (LPs) are partnerships where certain partners have limited liability (limited partners) and at least one partner (general partner) has unlimited liability.¹³ Like corporations and LLCs, an LP is formed by filing a certificate of formation with the Secretary of State. Additionally, partners must enter into a partnership agreement.¹⁴ Like LLCs and corporations, LPs provide limited liability for the limited partners and continuity of life. A general partner is usually an LLC or a corporation in order to provide limited liability to those forming it. Like LLCs, interests in an LP are freely transferable.¹⁵ The governance of an LP is very similar to a manager managed LLC. The general partner will make business decisions for the LP and the limited partners will not be involved in the business operations of the same. Like general partnerships, LPs must have more than one partner. From a federal taxation perspective, LPs, are taxed similarly to LLCs. From a state taxation perspective, like an LLC, LPs are taxed like C-Corporations, except where the LP is engaged as a passive entity.¹⁶

B. Which entity do I choose?

As mentioned above, LLCs are usually the preferred business entity to use when starting a new business. They are less cumbersome than corporations or LPs and provide similar protection. Furthermore, LLCs provide the same taxation benefits as S-Corporations or LPs. There are, however, instances where the use of a corporation or an LP might be preferable.

13 TBOC § 3.011.

14 *Id.*

15 Unlike LLCs though, there does exist publicly traded LPs, generally known as Master Limited Partnerships, but since not typical for a small business we will not address them.

16 LPs are passive entities when are they are used to not carry on a business, but rather to hold assets.

You might consider using corporations when some of the following facts apply: (i) there is a large possibility you will go public, (ii) you have foreign investors interested in investing in your business, or (iii) you are in an industry which corporations are the preferable or most commonly used business entity. Remember, S-Corporations are a possibility, but not if scenarios (i) or (ii) apply. If you are thinking of forming an S-Corporation, we would certainly encourage you to reconsider and form an LLC.

In Texas at least, LPs might be a preferable business structure to an LLC if your business will be limited to passive investments or will only hold certain assets such as intellectual property or real estate. Additionally, investors in certain industries, such as oil & gas and real estate are used to LPs as LPs are the business structure that have historically have been used. This is changing, but there are many investors who still prefer an LP.

As mentioned above, sole proprietorships or general partnerships are *never* a recommended option.

C. Where should I form my new business entity?

For the majority of small businesses, incorporating or forming a business entity in your home state, or the state where substantially all your business will take place, is usually the easiest and least expensive option. Virtually every state has laws that require you to register as a foreign entity doing business in such state. However, there are instances where forming your business entity in other states, particularly Delaware or Nevada, might make sense.

Historically, Delaware's business laws have been very pro-business and the judicial system in Delaware has ample experience dealing with legal disputes regarding business entities and structures. For these reasons, it is the state of choice for several of the large corporations and many fast-growing or high-potential companies. Nevada is another state that has become popular for business formation due to its pro-business laws and the lack of an information sharing agreement with the IRS. For this reason, if you are planning to seek investors from many different states and even other countries, Delaware or Nevada might be a good option. Additionally, if you think that your business might move from state to state, or you might relocate the business to a different jurisdiction in the future, Delaware or Nevada might be a good option. Similarly, if you are in a business that might have high growth potential or may be engaged in a risky business, Delaware or Nevada might be a good option.

SECTION IV. FINANCING

So how do you finance your idea? Whether you're starting a new business or purchasing an existing business, it is imperative that you have sufficient ready capital, as well as financial knowledge and planning. Entrepreneurs often fall victim to insufficient funding, over-borrowing, securing the wrong type of financing, and underestimating the cost of debt. All entrepreneurs should understand that there are two types of financing: equity and debt. The debt-to-equity ratio presents the relation between dollars you've borrowed and dollars you've invested in your business. The more money owners have invested in their business, the easier it is to attract financing. If your business has a high ratio of equity to debt, you should consider debt financing; but if your business has a high ratio of debt to equity, you should increase your ownership capital (equity investment) for additional funds. For small businesses, both debt and equity financing often comes from friends, relatives, employees, customers, or industry colleagues, as well as traditional lenders such as banks. Striking the right balance of debt and equity is key to your business' survival and success.

A. Business Plan

Regardless of whether you're seeking debt or equity financing, your business plan is vital to the success of your business. As previously discussed, your business plan highlights your ideas, strategy, and team, for consideration by banks, investors, and potential partners. Your business plan is an invitation for financial support in that it sets forth the blueprint for your business' mission, management, market, product, and financials. Of particular importance is your business plan's executive summary, as most executives and officers won't initially have more than a few minutes to devote to your "invitation."

B. Pro Forma Financials

If your executive summary successfully catches the interest of lenders, investors, and/or partners, they will next turn to the pro-forma financials. The business plan should present a pro forma (projected) cash flow statement, income statement, and balance sheet for each of the first six (6) months, the next six (6) quarters, and the next three (3) years, for a total of five (5) years' projections. Although the financials are generally presented at the back of a business plan, they are critical to determining whether your business idea is viable and whether your business plan can attract the necessary financing.

C. Small Business Loans

Aside from personal investment, banks have traditionally been the major source of small business funding by offering short-term demand loans, seasonal lines of credit, and single-purpose loans for machinery and equipment. Further, the Small Business Administration's (SBA) guaranteed lending program encourages banks and non-bank lenders to make long-term loans to small firms by reducing their risk and leveraging the funds they have available, and the SBA's programs provide necessary funding for thousands of small businesses across the nation. The SBA website (www.sba.gov) provides a wealth of information regarding the SBA's lending program as well as other small business topics.

Financing decision-making also involves many legal considerations, such as sale of equity (and the rights of equity ownership), execution of loan agreements, credit applications, and other documents, and personal guarantees of loans, just to name a few. Again, it's advisable to consult legal counsel before making any formal financing arrangements.

SECTION V. MANAGEMENT

To a great extent, the success or failure of your business will depend on how well it is managed. Business management includes a host of interrelated activities, each presenting their own unique challenges and legal requirements. Being aware of and prepared for these challenges and maintaining compliance with legal requirements will greatly increase the likelihood of the success of your business.

A. Human Resources

Small businesses rarely have Human Resources ("HR") departments, so it will be up to the management of the company to carry out the tasks generally associated with HR, such as recruitment, performance and behavior management, and compensation. While the responsibilities associated with having employees are numerous, some of the most important are listed below.

Before hiring your first employee, the Internal Revenue Service ("IRS") requires you to obtain an employment identification number (EIN), which will be used to report information about your employees to the IRS and state agencies. When you begin the recruitment and hiring process, make sure you don't unfairly discriminate in your hir-

ing policies. Federal law prohibits discrimination on the basis of age, disability, national origin, race, religion, genetics or gender. Once hires are made, it is of great importance to keep complete and accurate wage records for all employees and submit all proper documentation to the proper state and federal agencies, such as the IRS, Texas Comptroller of Public Accounts and Texas Workforce Commission. Visit the websites of these agencies, which have excellent resources for small business owners, at www.irs.gov, www.window.state.tx.us, and www.texasworkforce.org, respectively. Required submissions include Employee Eligibility Verification, Federal Income Tax Withholding forms, state and federal unemployment insurance, and registration with the Texas Workforce Commission, just to name a few of the many reporting requirements imposed on employers. Failure to comply with the rules can result in substantial penalties, so it is best to familiarize yourself with the rules before starting the hiring process.

Once employees are hired, it is important to establish the relationship between management and the team. Whether the worker is considered an employee or an independent contractor can be of considerable importance for federal income tax purposes. Additionally, Texas is an “at-will” state, meaning that employees can quit or be fired at any time, with or without cause. If you hire someone with considerable expertise that is vital to the operation of your business, it will probably make sense to enter an employment contract that sets out the rights and obligations of the parties.

Being an employer also carries with it a myriad of other ongoing responsibilities, such as tax reporting requirements, purchase of workers’ compensation insurance, posting required notices, and maintaining a safe work environment. Consult local counsel and tax professionals if you have any questions as to what your responsibilities as an employer are.

B. Accounting

Many entrepreneurs are risk-takers by design – the kind of people who are excited by the challenge that business ownership provides. Unfortunately, many of these personalities are turned off by the thought of keeping regular and detailed business records. Experienced business owners will tell you, however, that the ability and willingness to keep accurate records are essential to the continued success of any enterprise.

Bookkeeping and accounting are a means of carrying out two basic objectives:

1. To monitor your income and expenses, helping to ensure the profitability of your business; and

2. To collect the information necessary for filing your business's various federal and state tax returns.

The law does not require that you keep business records in a particular way; only that your records accurately reflect the business's income and expenses. Once you devise a system that works for you, stick with it! IRS studies show that poor record keeping – not dishonesty – is the cause for most small business audits, which can lead to substantial fines and penalties.

The basic requirements of small business accounting are (1) selecting a taxable year; (2) choosing an accounting method; (3) keeping a set of account books based on your taxable year and accounting method; and (4) preparing basic financial reports from the data stored in the account books.

Taxable Year. Unless there is a valid business reason to use a different period, or your business is a corporation, your small business must use the calendar year of January 1 to December 31. To use a different period, you must request permission from the IRS. Be sure to use the same taxable year to compute your taxable income and keep your books.

Accounting Method. There are two options here – the cash method and the accrual method. These methods differ in the timing with which transactions are debited and credited to your accounts. Under the cash method – used by the vast majority of small businesses – income is not recorded until payment is actually received, and expenses are not counted until they are actually paid. The accrual method, on the other hand, counts transactions when they are made, not when payment is tendered or received. While the cash method is the more common approach, certain businesses must use the accrual method. Businesses with annual sales greater than \$5 million and businesses that stock inventory and have gross annual receipts over \$1 million must use the accrual method. Other businesses with large year-end expenses may choose the accrual method because it allows them to take greater advantage of tax deductions.

Bookkeeping. This step of the accounting process is three-fold. First, the business owner must keep receipts or other records of every payment received and expenditure made by the business. Second, summarize the expenditures and income records on a daily, weekly, or monthly basis, depending on the nature and volume of the business. Set up a general ledger in which you record all transactions that affect the financial position of the business, with sub-ledgers for specific accounts such as sales and purchases.

This ongoing recording process is called “posting”. Third, use your summaries to create financial reports, such as balance sheets and income statements. The same will indicate the health and growth of the business. These reports will give you greater insight into the condition of your business, and will help you to attract investors or equity partners, should the need arise. If you find the process too daunting, tax professionals can be hired at a relatively low cost. If your business cannot afford the additional expense, there are excellent tax programs available for the small business owner that will do the heavy lifting for you. Whichever path you choose for your business, it is of paramount importance that you have accurate records when tax time arrives.

C. Marketing

Marketing is the process of bringing your product or service to the consumer, and includes several sub-categories such as market research, advertising, pricing and sales. Business activities in these areas are tightly regulated by state and federal agencies such as the Texas Attorney General and the Federal Trade Commission (“FTC”), as well as by state statutes such as the Deceptive Trade Practices Act. Pitfalls abound for the unwary entrepreneur, so it is best to educate yourself in these areas before conducting market research, submitting an ad, or using telephone or email solicitation techniques.

Telephone Solicitation. Sales and market research conducted over the telephone are subject to numerous state law restrictions. In order to legally make a telephone solicitation (“cold call”) in Texas, the seller must register with the Secretary of State and post a substantial bond. Additionally, the seller must make copious disclosures in its registration statement such as the nature of its business, sales information, and the existence of certain legal information such as prior convictions or bankruptcies. Further, the savvy telephone marketer will not run afoul of the “do not call” list, which has been established in all 50 states. Also, new state statutes similar to those imposed on telephone activities regulate marketing carried out over e-mail. The prudent business owner will familiarize himself with the rules that apply to his particular industry before carrying out any marketing activities by phone or e-mail.

Advertising. Ads placed in print, television and web media are subject to intense scrutiny by the FTC and state attorneys general to ensure that the public is not misled by what it sees in newspapers and on television. The penalties for running an illegal ad can be substantial, so be sure your ad campaign complies with state and federal law by following these rules of thumb:

1. Make sure you can substantiate everything your business claims in an advertisement. You must have a “reasonable basis” for objective claims made in the ad before publishing it.
2. Make sure your ad is not deceptive. The FTC defines this term as “misleading in a material respect.” The Texas Deceptive Trade Practices Act defines deceptive advertising as that which “materially misrepresents the cost or character” of the good or service being sold. Ensure your ad does not run afoul of either standard before taking it to market. This is especially important if you are in the business of selling food, drugs, devices or cosmetics.
3. Finally, make sure your ad is not unfair. If the ad could cause substantial injury to consumers that is not avoidable and not outweighed by the benefit conferred, the ad is in danger of being deemed “unfair.” Generally, this finding will be applied when the advert conveys its message in an unethical or unscrupulous manner.

Additionally, be aware of the limitations placed on advertisements within your specific industry. State law imposes a spider web of other marketing regulations on organizations operating certain types of businesses, such as liquor stores, gas stations, and professional services businesses, just to name a few. You will be wise to familiarize yourself with all the regulations that affect the marketing activities of your business.

SECTION VI. BASIC OVERVIEW OF APPLICABLE EMPLOYMENT LAW

As a small business owner, you are tasked with wearing multiple hats, and just one includes that of a HR Director. As previously discussed, it is important to have a basic working knowledge of employer and employee rights and responsibilities so that you can make the best decision for your business when it comes to hiring, firing, promoting, granting leave, accommodating, compensating, and disciplining your employees, just to name a few important issues that commonly arise. Below includes a brief explanation of the various issues and laws that govern the employment relationship, and therefore provide a critical foundation to keep in mind as you grow your business and invest in one of your most important resources— human capital or your employees. This discussion is by no means exhaustive, but is intended to give you a flavor of critical areas of focus related to the workplace.

A. Employee Handbook

The employee handbook is an important tool because you can use it to convey important information to your employees. You may want to convey the goals you wish to achieve through your business model, such as your mission statement, and you may also use this as an opportunity to set forth your expectations for your employees. Various fringe benefits can be included in this resource such as policies related to accrued personal and vacation time, and a list of do's and don'ts in the workplace. It is important to express your desire to have a work environment free from harassment and discrimination and one where your employees treat one another with respect and dignity. You should also include a provision that requires your employees to seek permission from their supervisor before they perform any overtime (work over forty hours in a workweek, which will be discussed further in the *FLSA* section below). Including this instruction can assist you down the road if you should ever have a wage and hour dispute arise due to unpaid wages.

Written representations contained in employee handbooks generally do not give rise to contractual obligations under Texas law, particularly if the handbook contains a disclaimer.¹⁷ So you can maintain an employment at-will relationship as further discussed below, as long as you express your intent to do so in your handbook. Be sure to have your employees sign a written acknowledgement form that they have received and understood the contents of the Employee Handbook, so that you can ensure their commitment to complying with the policies contained in your handbook.

B. Employment at Will

As previously mentioned, Texas is an at-will state, which means that an employee can be terminated for cause, or for no reason at all. Because at-will employment is presumed in Texas, in most cases it is neither necessary nor desirable for an employer to enter into written employment agreements with all of its employees. In fact, written agreements have a number of disadvantages for an employer because they take away the flexibility an employer is granted by not having an agreement. Because the law, employee compensation and job descriptions change frequently, if you do decide to enter into employment agreements with some of your employees, be sure to modify the agreements to account for such changes as applicable.

¹⁷ *Federal Express Corp. v. Dutschmann*, 846 S.W.2d 282, 283 (Tex. 1993).

It is very common to have an employment agreement when the employee is highly compensated, has a unique compensation structure, or occupies a position created for a specific duration that will end upon completion of a project. Such agreements may also include a non-disclosure and/or non-solicitation and non-competition provision which will allow you to protect your business interests and the good-will you have created through your “brand” or services,

If you decide to maintain the at-will relationship (and do not enter an employment agreement), be careful when making oral representations to employees. The courts have had varied holdings regarding the effect of oral promises upon the at-will employment relationship, and as a result, employers should caution supervisors to avoid making oral representations or guarantees regarding the duration or terms and conditions of employment. Should a dispute arise, even if an enforceable contract does not result from the oral representation, a false representation made by a supervisor or business owner could be used as the basis for a claim of fraud, particularly if an employee relies upon it to his or her detriment.

C. Independent Contractors

One of the most commonly litigated employment status issues is whether a worker is an employee or an independent contractor. This legal distinction is important and must be carefully assessed because it dramatically impacts the employment relationship and imposes differing rights and obligations. Generally, the employer-employee relationship has a variety of implications related to labor, employment, tax, and pension laws. Consequently, a misclassification of an employee as an independent contractor can create significant liability for the employer.

It is important to note that the employee/independent contractor distinction is not determined by the label used by the employer and individual performing the work. Instead, there are a number of factors considered depending on who is making the determination. For example, the IRS, Texas common law, and the Department of Labor under the Fair Labor Standards Act, all use differing factors to make this distinction. A common thread that runs through all of the tests is examining the job duties performed and the level of oversight asserted by the employer. It is important to consult an attorney so that you can accurately make this determination.

An individual who is classified as an independent contractor is generally afforded fewer rights than one who is classified as an employee. Various state and federal statutes

protect employees, but not independent contractors. For example, anti-discrimination and labor relations statutes such as Title VII, the Texas Commission on Human Rights Act, the Age Discrimination and Employment Act (further discussed below) specifically protect “employees,” but not independent contractors. Furthermore, independent contractors generally are ineligible to receive employee benefits. For example, if the worker is an independent contractor, the person or entity for whom he or she performs services:

1. Need not pay minimum wages or overtime compensation;
2. Is not obligated to provide unemployment insurance or workers’ compensation coverage;
3. Need not make social security payments;
4. May eliminate many of the administrative burdens associated with recordkeeping and reporting obligations prescribed by both state and federal law with regard to employees;
5. May avoid labor disputes because independent contractors do not have statutory rights to organize and bargain collectively under the National Labor Relations Act; and
6. May avoid most instances of vicarious liability based on the negligent acts of employees.

Generally, employers are liable for the negligence of their “employees” if committed in the course and scope of employment. However, since an independent contractor has sole control over the means and methods of the work to be done, the employing entity generally is not liable for the negligence committed by an independent contractor. Consequently, it is important that you classify the status of your workers correctly, so that you can correctly satisfy the above employer obligations as appropriate.

D. Negligent Hiring

After briefly discussing employer responsibility for the acts of employees, what types of responsibilities do employers have in the hiring process? While the goal for an employer is to hire to fill a specific position or need of the business, employers also need to protect against potential liability that may result from an employee’s harm to other employees or third parties as a result of a negligent hiring claim. Some employees have a heightened duty to third parties because of the type of service the business provides. For example, if your business serves children, you may need to be more cautious in making your hiring decisions to avoid liability to the children you

serve, should wrong-doing by an employee occur.¹⁸ Negligent hiring claims bestow a duty on employers to make informed decisions about applicants.

It is critical for employers to ask for clear and honest answers on a job application for more reasons than one. Not only do employers want to hire who they think they are hiring, but they also may have a defense down the road should a wrongful discharge claim arise if an applicant lies during the hiring process. If an applicant is later found to have lied on his/her application, the employer can use this information as “after acquired” evidence to limit an employee’s later claims for discharge.¹⁹

Some industries have a statutory obligation to run a background check when making hiring decisions, which brings us to another important area in employment law, the Fair Credit Reporting Act.²⁰

E. Background Checks and Credit Reports

If you run background checks or request credit reports prior to making a hiring decision, remember that this practice is governed by the Fair Credit Reporting Act (“FCRA”). This practice is allowed under FCRA, however, employers must first disclose the need for such report conspicuously before the report is obtained.²¹ A perspective employer must also obtain authorization in a document separate from the job application.²² There are specific requirements before an employer can take action against an applicant based on information from a report or the employer may incur civil penalties under FCRA.

The employer must first provide a copy of the report and a copy of their rights under FCRA.²³ The employer must also allow the applicant an opportunity to challenge the

18 *Doe v. Boys Clubs of Greater Dallas*, 868 S.W.2d 942, 950 (Tex. App.—Amarillo 1994), *aff’d*, 907 S.W.2d 472 (Tex. 1994); *Doe v. Taylor Independent School Dist.*, 975 F.2d 137 (5th Cir. 1992) (higher duty in care and education of children harm must be related to job employment).

19 *See e.g. Trico Tech. Corp. v. Montiel*, 949 S.W.2d 308, 312 (Tex. 1997).

20 For example, businesses that employ child care workers can obtain an applicant’s criminal history information regarding certain types of crimes from the Texas Department of Regulatory Services. *See* TEX. GOV’T CODE ANN. §411.114 (Vernon Supp. 1997). An institution of higher education may obtain criminal history information on applicants for “security sensitive” positions. *See* TEX. EDUC. CODE ANN. §51.215 (Vernon 1996); TEX. GOV’T CODE ANN. §411.094 (Vernon Supp. 1997). In addition, an employer who has offered an applicant employment at a residential dwelling used for lodging may obtain the applicant’s criminal history information from the Public Safety Department. *See* TEX. HEALTH & SAFETY CODE ANN. §765.001 (Vernon Supp. 1998).

21 15 U.S.C. §1681a(h), §1681b(b)(2)(a).

22 15 U.S.C. §1681b(b)(2)(b).

21 *See* 15 U.S.C. §1681b(b)(3).

accuracy of the report. So, the employer must make the applicant aware of the report prior to obtaining it, and then a second time, prior to waiting five days before taking any adverse action because of it. The five days allows the applicant to review the report and identify any inconsistencies. Upon taking the adverse action, you must give the applicant the following: name, address, toll-free number of the consumer reporting agency that furnished the report; statement that the agency did not make the adverse decision and it is unable to provide a specific explanation; notice of the consumer's rights to obtain a free copy of the consumer report from the agency within 60 days; and notice of the consumer's right to dispute the information on the report.

It is important to remember that an employer may not use all information reported in its decision to hire or reject an applicant.²⁴ The Equal Employment Opportunity Commission ("EEOC") has issued guidance which restricts the use of information related to arrests and felonies in hiring decisions because it can have a disproportionately negative impact on certain job applicants depending on their race.²⁵ However, the EEOC recognizes that both arrest and conviction records may be justified by business necessity, particularly conviction records. Therefore, it may be a good idea to restrict the information the agency reports to you to avoid any appearance of impropriety.

F. Privacy in the Workplace

A common-law right to privacy exists under Texas law.²⁶ Privacy issues in the workplace are addressed on a continuum, and a constant balancing of employee and employer rights and obligations is necessary. Privacy law generally balances the rights of the employee with the employer's legitimate business purpose. Common examples of these claims arise when there are allegations of invasion of property, eavesdropping, claims based upon employee testing (including AIDS testing, drug testing, pre-employment genetic testing, and polygraph testing, monitoring calls, and employer searches of employee work areas and/or personal possessions).²⁷ It is a

24 See Gregory M. Davis, *Criminal Background Checks for Employment Purposes*, SHRM Legal Report, July/August 2006, at 2.

25 The EEOC has issued Policy Guidance on the Consideration of Arrest and Conviction Records in Employment Decisions Under Title VII (EEOC Compliance Manual Vol. II, 604.013; EEOC Compliance Manual Vol. II, 604.0015 App. A).

26 See *Billings v. Atkinson*, 489 S.W.2d 858, 859 (Tex. 1979).

27 See *Farrington v. Sysco Food Servs.*, 865 S.W.2d 247, 253 (Tex.App.—Houston [1st Dist.] 1993, writ denied) (employee's consent to a drug test negated any claim of invasion of privacy); *Texas Employment Comm'n v. Hughes Drilling Fluids*, 746 S.W.2d 796, 801 (Tex.App.—Tyler 1988, writ denied) (rejecting invasion of privacy claim on the ground the employee impliedly consented to the testing by his continued employment).

good practice to advise your employees in a written policy and in training that they have no right to privacy at the workplace. It is also good measure to get written consent from your employees to avoid later privacy claims, since a privacy claim may fail where a plaintiff has waived that right.²⁸ It is important to remember the following legal parameters with regard to searches, surveillance, and monitoring in the workplace.²⁹

The law governing employer searches of offices and lockers provides a foundation which provides the applicable law for privacy issues.

Key issues often involve:

1. what area is searched (locker, office, file cabinet).
2. the types of items secured in that area (personal only, primarily work-related material);
3. how was the search conducted (with or without permission);
4. did the employee have a method of securing the area (lock or no lock);
5. what prompted the employer's search (wrongdoing or regular monitoring).

Productivity, safety, and loyalty are three concerns an employer can address through the use of surveillance. The decisive issue that typically arises is whether the employer's intrusion would be *highly offensive* to a reasonable person. When assessing the offensive nature of the invasion, courts require the intrusion to be unreasonable, unjustified, or unwarranted to find an invasion of privacy.³⁰ With regard to video surveillance, there are limitations you should be aware of. Even when you own or lease the premises, you have to remember that your employees have rights too. While common areas are typically open to surveillance, restrooms, locker rooms and areas that common sense tells us are private should not be under surveillance.

On a similar note, employers can monitor phone calls with clients or customers for quality control. However, when an employer realizes a call is personal, the employer must immediately stop monitoring the call. It is noteworthy that if the employee was told not to make calls from a specific phone, then the employee takes the risk that calls from that phone may be monitored and the reasonableness of an expectation of

28 See *Polansky v. Southwest Airlines Co.*, 75 S.W.3d 99, 105 (Tex.App.—San Antonio 2002, no pet.).

29 See *McLaren v. Microsoft Corp.*, 1999 WL 339015, at *4 (email privacy case relying on *Trotti* Locker search case).

30 See *Billings*, 489 S.W.2d at 860.

privacy becomes questionable.³¹ Moreover, under these same statutes, employers can monitor email and internet use in the workplace. However, when employees access personal email accounts or social networking sites where they have not provided the employer with their password, the law tends to weigh in favor of the employee.

G. Various Federal and State Statutes

A basic working knowledge of some of the various federal and state employment law statutes can help you to be more conscious of asking the wrong questions during interviews, as well as make you more cognizant of the potential pitfalls you may encounter when monitoring your employees for performance and potential termination. It is critical that you accurately document the performance of employees, so that if you ever have to defend against a lawsuit related to a termination and failure to promote, you will have the documentation to back-up your decision and a jury will stand behind your decision.

Note the following statutes not only protect against discrimination and provide various rights to employees, it is also important to note that if an employee is protected under the below statutes, and makes a complaint of discrimination, an employer is also prohibited from taking adverse action against them, which is referred to as retaliation.

1. **Title VII of the Civil Rights Act of 1964** (“Title VII”)³², prohibits employment discrimination, including termination, on the basis of an employee’s race, color, national origin, religion, or sex. Title VII also prohibits discrimination based on pregnancy, and sexual harassment or other workplace harassment based on a protected characteristic. Title VII applies to employers with **fifteen or more employees**.^{33 34}

31 Electronic Communications Privacy Act of 1986 (ECPA), 18 U.S.C. §§2510, 2511; Tex. Civ. Prac. & Rem. Code § 123.002.

32 42 U.S.C. §2000e *et seq.* The Texas statute that follows Title VII is TCHRA. TEX. LABOR CODE §21.001 *et seq.* (Vernon 1996).

33 An unsettled issue of law is whether employees from joint employers may be aggregated to reach the 15-employee threshold under Title VII (or any other employment statute’s minimum employee requirement).

34 Note, a recent area of focus by the EEOC involves family responsibility discrimination. For example, do not ask questions during hiring about whether the applicant cares for children or an aging parent at home. These types of questions can lead to discrimination claims if a dispute ever arises.

2. **Age Discrimination in Employment Act** (“ADEA”),³⁵ prohibits age discrimination in all terms, conditions, and privileges of employment. The ADEA protects employees 40 years of age and older and applies to employers **with twenty or more** employees.

3. **Family and Medical Leave Act** (“FMLA”),³⁶ mandates unpaid leave in the event of birth, adoption, or serious illness. The FMLA requires employers to grant twelve weeks of unpaid leave to an eligible employee (i) for the birth or adoption of a child, or (ii) to care for oneself or a child, spouse, or parent suffering from a serious health condition. The FMLA also requires that the employer restore the employee to the same or an equivalent job upon his or her return to work. To be eligible for FMLA leave, an employee must have been employed for at least twelve months and must have worked at least 1,250 hours during the twelve months prior to the leave. Employees at **work locations with less than fifty employees are not eligible** for leave unless the employer has fifty or more employees employed within seventy-five miles of the work site. An employee may take twelve weeks of FMLA leave once every twelve months; employers may adopt a policy defining the applicable twelve-month period. Note that the FMLA was recently amended to include special leave related to those in the military.

4. **Americans With Disabilities Act** (“ADA”),³⁷ prohibits disability discrimination in all aspects of employment and requires an employer to make reasonable accommodations to employ a disabled person. The ADA defines a disability as a physical or mental impairment that substantially limits a major life activity. A disabled individual is otherwise qualified to work if he or she can perform the essential functions of the job, with or without reasonable accommodation provided by the employer. The ADA applies to employers with **fifteen or more** employees. It is important to note that the ADA was recently amended under the ADAAA, which gives employees broader rights in this area. Remember, employers have an obligation to accommodate an employee who

35 29 U.S.C. §621 *et seq.*

36 29 U.S.C §2601 *et seq.*

37 42 U.S.C. §12101 *et seq.*

asks for a reasonable accommodation that can help them to perform the essential functions of their position. It is a good rule of thumb that any testing you require of your potential and current employees is based on the *specific job duties* that the employee performs, i.e. lifting a certain weight. It is important to link all testing to the job duties and job description of that employee, instead of making overbroad job requirements which tend to discriminate under these statutes. Lastly, any testing should be performed after a conditional offer of employment.

5. **Fair Labor Standards Act** (“FLSA”),³⁸ establishes the national minimum wage and sets standards for overtime pay. The FLSA prohibits an employer from retaliating against an employee for filing a complaint with the Department of Labor or complaining to his or her employer about a wage and hour violation. The minimum wage was recently increased to \$ 7.25 per hour. The critical area of focus for compliance with the FLSA relates to classifying your employees as exempt or non-exempt. One the most common misconceptions is that if an employee is salaried, the employer does not have to pay the employee overtime wages for hours worked over forty hours in a given week. **This is incorrect.** The FLSA provides specific classifications referred to as “exemptions” for employees that determines eligibility for overtime. If the employee fits within one of the exemptions, then overtime pay is not due, and the employee is paid according to his/her salary. Alternatively, if the employee does not fit within this specific exempt status, then an employee must be compensated for any hours worked over forty in a workweek at a rate of time and a half per hour. It is important that you correctly classify your employees in this manner, otherwise business owners may face investigation by the Department of Labor, and liability for significant back wages and penalties for incorrectly classifying an employee.

Remember, employers have an affirmative obligation to keep accurate time records for non-exempt (non-salaried) employees, so be sure to have these procedures in place. In addition, an

38 29 U.S.C. §201 *et seq.*

important legal component to unpaid wages, is whether the employer had any knowledge of the work being performed. So, always require non-exempt employees to ask for permission to work overtime so that you can accurately document and pay wages that are due.

6. **Texas Payday Act**,³⁹ provides that an employee who is exempt (from overtime/salaried) under the FLSA must be paid at least once a month. All other employees must be paid at least twice a month. This Texas statute also provides that an employee who has been terminated from employment must be paid in full within six days (not “workdays”) after the employee is discharged. Payment must include vacation pay and sick pay pursuant to any written agreement or written company policy.⁴⁰ An employee who quits his or her employment must be paid in full on or before the next regularly scheduled payday. Wages paid on commission and bonuses must be paid in a timely manner as agreed by the employer and the employee, or according to the terms of a governing collective bargaining agreement.⁴¹

H. Defamation

Defamation claims can arise in a variety of employment contexts including reviews, intra-company communications, investigations of employee conduct, discipline and termination meetings, and post-employment references. The most common statements complained of involve alleged illegal drug or alcohol abuse, dishonesty, fraud, incompetence and, increasingly, sexual harassment. Be very careful to only share the details of investigative reports of wrong-doing with the “need to know” supervisors and employees, and you will likely maintain an investigative privilege that will protect you against liability for defamation. It is a good idea when giving job references after termination to only give a name, job title, and date of employment.

39 TEX. LAB. CODE §61.001 *et seq.*

40 40 TEX. ADMIN. CODE §821.25(a).

41 40 TEX. ADMIN. CODE §821.26.

SECTION VII.⁴² CONTRACTS

You have formed your business, have financed it and have started growing rapidly. Quickly you realize that since inception, every stakeholder for your business has thrown a contract your way and you feel overwhelmed because you have no idea what you are reading. This Section will address contracts generally. It is imperative that you contact an attorney when reviewing contracts, particularly those that might have an economic detriment for you. Every contract is different so it is impossible to summarize what should be in one but below are some general concepts you should look for.

A. General Terms of Understanding

All agreements, regardless of the nature of the same will (or should) have a section that deals with the general business points between the parties. This section must include all terms and conditions negotiated. A contract should state who is doing what, how long they are doing it for, what each person is getting in return, who assumes risk of what, what happens if someone does not do what they agreed to do and any other terms that is industry specific. For example, if the contract is for the sale of widgets, the agreement must contain provisions regarding how many widgets you will sell, for how long, where the widgets will be placed or picked up, how will be responsible for shipping and risk of loss, how you will get paid for those widgets and what happens if the widgets are defective. If you are buying a service from a service provider, be specific about what services you are purchasing, for how long, how much you will pay for them, where the services will be provided and what happens if the service is not provided to satisfaction.

As a general rule, the more specific a contract is the better. The more you leave for interpretation, the higher the likelihood a judge will end up interpreting the contract in the future in a lawsuit. Judges will look at the “four corners” (or the entirety of a written contract) of a contract. This means that judges will review the terms of a contract and where specific will enforce the same. Trouble arises when there is uncertainty in the terms and conditions agreed upon or when the contract is silent as to certain agreements.

⁴² This Section will not address lease agreements or partnership agreements. For an overview of each please refer to Sections 3, 8, and 11. Similarly, this Toolkit does not address asset or stock purchase sales or other exit strategies; rather it is a guide for day to day operations of a business.

B. Representations and Warranties

Most contracts will have some sort of Representations and Warranties section. Representations are statements of past or existing facts.⁴³ One party represents to the other that what they are saying is true as of the date of the agreement. Warranties on the other hand, are promises that existing or future facts are or will be true.⁴⁴ Although different, representations and warranties are generally lumped together in most agreements and therefore we will refer to them herein as “**Representations.**” Representations generally reflect certain concerns of the parties. For instance, if a particular industry you are doing business in requires certain permits or licenses from a governmental authority by one party, it is a good idea to have that party represent that it has such permits or licenses and that they are current as of the date of the contract. It is also a good idea to make sure that they will promise, i.e., warrant, that the permits and licenses will remain current for the life of the contract. Similarly, compliance with say food and drug laws would be addressed in this section if in the food or drug industry.

Typical representation provisions found in contracts deal with (i) the parties having authority to execute the agreement, (ii) that the terms of the agreement are enforceable against each party, (iii) that there are no laws or rules that prohibit the parties from complying with the agreement, (iv) that the parties contain all permits, licenses and other requirements to do what they agreed to do, (v) that the party who is providing the widgets actually owns the same or has the right to market, sell, etc... the same, among others. Depending on the type of contract being drafted, Representations can be the bulk of the contract. Again, as discussed above in Section A, the more specific, the less likely that there might be misinterpretations in the future.

It should be noted that when the contract is for the sale of goods or services, warranties become very important. Most contracts for sale of goods or services will include a limitation of some sort as to what the goods or services are good for. Warranties as to merchantability provisions need to be reviewed carefully as they will differ from good to good, particularly if what you are selling is perishable.

⁴³ See generally Howard O. Hunter, *Modern Law of Contracts*, Chapter 9 (rev. ed. 2008).

⁴⁴ *Id.*

C. Covenants.

Like warranties, covenants are promises of one party to the contract to another. Covenants can be positive (I agree *to do* something by x date), or negative (I agree that I *will not* do something). It is important to remember that covenants apply only to actions or circumstances that are within the control of the parties. Thus, when reviewing covenant provisions, it is important to think what you can actually control. For example, if you have agreed to be the exclusive distributor for say, Best Widget Ever in Texas, you might be asked to covenant that you will not, sell any competing widgets to the Best Widget Ever. That is within your control. However, you cannot promise that the competing widget will not be sold in Texas period. You can't control that. Billy Bob might have a similar arrangement for Lame Widget, a direct competitor. Similarly, it is within your control to promise that you will do everything you can to produce Best Widget Ever with the same quality throughout the agreement, but you can't promise that it will be the best widget forever since someone else might create Most Awesome Widget that blows Best Widget Ever out of the water.

When negotiating covenants in your contract, make sure that you promise to do or not to do things that are within your control and as mentioned before, be as specific as possible.

D. Indemnification Provisions

Indemnification provisions are one of those provisions that many overlook but are very significant. Typically (and depending on the contract) parties to a contract will agree to indemnify each other (and their representatives, officers, agents, etc...) from claims by third parties brought against the other party due, either directly or indirectly, to the actual contract or the provisions in it. When reviewing this provision, make sure that you feel comfortable that the other party is indemnifying you in the substantially the same manner you are indemnifying them. Think about whom might actual have a claim against you because of entering into this contract and see whether it makes sense to expand that section. If there is a specific person or party you are worried about, make sure to mention it.

Another thing to watch out for is carve outs to the indemnification. For example, your contract might say something like "...no indemnification shall be made for negligence or willful misconduct of the parties." Make sure you are protected as much as possible. Anything more than negligence, such as gross negligence and you might be

in for a lot of trouble. Be sure to ask a lawyer specifically whether an indemnification provision protects you as much as possible.

E. Boilerplate – Standard Provisions

Every contract has them. Most people don't read them. *You should.* Standard provisions address very important terms of a contract. For example, if there is a dispute will you go to court or arbitration, what law will govern, what court will hear the case or whether you can have a jury or not. It will also contain where you will receive or send notice of a breach or claim under the contract and whether the contract can be assigned or not. Generally, the drafter of the contract will provide Boilerplate that is best suited for him or her. Think carefully when reviewing them as to whether they work for you or you need to negotiate them. For example, if you are in Texas and all the business will be in Texas, do you really want to court in Florida and have Florida law apply. That might cost a lot of money. Another provision that is often overlooked is the "Force Majeure" or "Act of God" provision. A "Force Majeure" is a provision by which a party is released from complying with his or her commitments in the contract. Make sure that such provision is reasonable. They should truly be "Acts of God" or major forces at play to not enforce the contract.

As you can see, negotiating, reviewing or drafting a contract can be very cumbersome. If you take three lessons from this Section, they should be (1) be specific, (2) review carefully and (3) ask your attorney for help.

SECTION VIII. LEASE AGREEMENTS

A. Triple Net and Gross Leases⁴⁵

There is a variety of commercial leasing arrangements, and you should first determine whether your lease is a gross lease, triple net lease, or a combination of both. Gross leases require the tenant to pay only the rent that is stated in the lease, with the landlord paying all the operating expenses. While this type of lease creates a more "fixed" type of rent, it is difficult to predict what the landlord's true cost of maintaining and providing the property will be in the future. Therefore, this type of lease may be better suited to a short-term lease. Further, the landlord may be more

45 "Triple Net Leases, Gross Leases and the Apples to Oranges Problem," Kent Newsome, State Bar of Texas 28th Annual Advanced Real Estate Law Course, June 29-July 1, 2006, San Antonio, Texas

sophisticated in real estate transactions, and may therefore overestimate a tenant's rent when drafting a gross lease. In this situation, an attorney and/or experienced broker may be able to negotiate a lower rent for you.

Under a modified gross lease or semi-gross lease, the tenant pays the stated amount of rent and also shares the operating expenses with the landlord. Additional rent provisions in the lease provide for a pass through of certain operating expenses to the tenant. These expenses may include the tenant's pro rata share of real estate taxes, insurance premiums, and common area maintenance costs.

A triple net lease requires the tenant to pay the rent set forth in the lease plus its pro rata share of all operating expenses. These expenses include costs of repairs and maintenance, insurance premiums, real estate taxes, and costs of utilities. The landlord passes 100% of the operating expenses to the tenants on a pro-rata basis, and retains the responsibility for the mortgage, ground lease, or other debt service payments. Modified net leases include limitations to the pass through operating costs, and are also very common.

A majority of business leases in Texas are hybrid, either semi-gross or modified net leases. Such leases provide for base rent in addition to a portion of the operating expenses of the landlord. Make sure you understand the provisions relating to your rent to determine which type of lease you are negotiating, and which form would be most beneficial for you and your business.

B. Understanding a Commercial Lease Agreement⁴⁶

Although you may decide legal representation in a commercial lease transaction is best for you, it is possible to secure such a lease once you have answered some basic questions and have a general understanding of what you and your business require.

1. Have you met with a CPA and discussed your business? Make sure you have enough financing for start-up and go over the forecasting and budgeting with your accountant.
2. Do you have a contractor for the finish-out? Can you get everything built for the budget? Is the contractor reputable?

⁴⁶ "Practical Ways to Represent the Small Tenant in a Retail Lease Transaction," Kevin M. Kerr, State Bar of Texas 27th Annual Advanced Real Estate Law Course, July 7-9, 2005, San Antonio, Texas.

3. What is the timing on ordering inventory and/or fixtures for your business?
4. Do you have quotes on insurance premiums?
5. Will you require a loan and if so, have you started that process?
6. Are you going to be raising money from investors? If so, have you started that process?
7. Have you obtained all the necessary permits or licenses required, if any, by the City for your type of business?

C. Letter of Intent⁴⁷

A Letter of Intent is a document that you will negotiate with the landlord or landlord's broker that incorporates the basic terms of your lease. When deciding whether to enter into a lease agreement, it is important that you verify the following about the Letter of Intent:

1. Does it accurately reflect the business deal you believe you agreed to?
2. Are there any significant business points that were not addressed? For example:
 - a. Have you reviewed the detail of the common area maintenance (CAM) charges for the Center?
 - b. What about an exclusive in the Center? Are there any restrictions in the Center now?
 - c. Does the Center expect signage on the pylon, and if it isn't available, can they have a "next use" right in the lease?
 - d. What about a "no build" area? Can you protect visibility in the event a new building is constructed in the parking lot?

⁴⁷ *Id.*

- e. Are you going to use the roof for any dish or antennae?
- f. Do you need reserved parking restrictions in the front of your store?
- g. Do you need to ask for leasing restrictions in the Center? (Such as no “long term users” like restaurants or health clubs next door, or no sexually oriented businesses or sexual ads visible from the windows).
- h. Do you have a concern about the personal guaranty? Can you ask for a limitation of the amount (such as 20% of the unpaid rents) or for time (such as Tenant performs for the first two years then the guaranty goes away)?

D. The Lease Clauses⁴⁸

Below are some typical lease clauses as well as suggestions for additions or changes that you may want to consider depending on your business. This list is not exhaustive, and you may wish to seek legal advice when negotiating the terms of your particular lease.

1. Tenant’s Permitted Use

Does the permitted use completely cover the business you intend to operate? If you anticipate your business may change or be modified in the future, can you add that possibility into the lease now? You may also want to consider adding a provision that in the event the business fails, you may make a change of use to allow for other specified uses.

2. Exclusive Use Protection

This clause may be critical if you are trying to prevent a tenant with a similar business from moving into the Center. You must first determine if this type of clause is necessary, as many landlords resist this restriction. If the landlord will not grant an all-encompassing exclusive, ask for one for your primary line of business (so as to limit competitors), the primary use of your business, or an exclusive in a limited area of the Center.

48 *Id.*

3. Restrictions on Uses

A tenant has many restrictive clauses on what they may or may not do, so you may want to consider asking for a limitation on the landlord that no part of the Center may be leased, sold, or used by certain types of businesses. For example, if operating a family restaurant, you will not likely appreciate an adult video store occupying space in the same Center. Alternatively, try to limit any potentially detrimental tenants to moving in next door to your business.

4. Parking

If your business requires fast in and out parking, try to ask for a provision in the lease from the landlord. However, landlords are often unwilling to enforce any parking restrictions, so you may want to ask for the right to paint the curb and place parking signs on certain spaces. You may also want to request that a restriction be placed on other tenants in the center from utilizing spaces around your business if necessary.

5. Non-Disturbance

A landlord generally will not want to worry with a Non-Disturbance Agreement from its lender unless the loan documents require it, but if you are expending significant funds for your finish-out, you may want to make this a condition of the lease or ask the landlord to use its “best efforts” to obtain the Agreement. You should also be prepared to pay the lender costs for the Agreement.

6. Permits/Inspections/Licenses

Make sure you investigate the permit and licensing process before executing the lease! You should make sure you give yourself the right to terminate the lease in the event the landlord disapproves of your final plans and specifications, or simply does not approve in a timely fashion.

7. Franchises

If you are a franchisee, speak early with the franchisor and find out if they require lease approval. If so, you must ensure the landlord is willing to accept them.

8. Substitution of Space

Almost every lease gives a landlord the right to relocate tenants from their space to another within the Center. However, you may want to add a clause to exclude a particular area in the Center that is unacceptable to your business.

9. Operating Expenses

These expenses are detailed in the lease regarding the common area maintenance. Some clauses need to be limited in nature to save your business additional expenses. For example, you will want to try to eliminate landlord employee expenses to those employees that are assigned to work on the property, not office personnel. Try to put a maximum number on any management fees and costs that can be charged by the landlord. Also, try to remove general provisions that provide that you are responsible for expenses to comply with all laws. This would potentially make you responsible for the landlord's necessary changes to handicap ramps or upgraded fire protection.

Simply striking some items in these provisions may not necessarily remove your responsibility for paying them later, so read the lease carefully! You will want to make sure you are not responsible for the leasing commissions, finish-out, or any other expenses or costs related to any other tenants in the Center as well. Another consideration is to write a provision giving you the right to audit the landlord's books with respect to the common area maintenance charges incurred throughout the year.

10. Gross Sales

Make sure you understand the definition of "gross sales" in the lease and have an accounting system to track your numbers.

11. Landlord's Lien

A lease will likely contain provisions regarding a landlord's security interest, which allows the landlord to secure its payment obligation and have a way of disposing of property left after a tenant moves out. If your business requires financing, consider putting in language in the lease that provides that any of the landlord's liens will be subordinate to the security interest of your business's lender. Further, provide that the landlord execute a subordination document incorporating this provision. Additionally, if your business has private property (such as medical records for its patients or

property files if it is a real estate brokerage firm), make sure that the landlord agrees that it will not claim any lien or rights to such property.

12. Obligation to Operate

Most leases contain a covenant to operate if the tenant is committed to paying percentage rents. However, you may want to consider tying this provision to a formula for overall occupancy in the Center or have the provision conditioned upon an active and operational anchor store.

13. Assignment/Sublease

The ability to assign your lease may be a very important exit strategy for your business. Therefore, try to add a provision that you may assign or sublease upon written consent of the landlord, and that in the event the landlord declines a proposed transferee an opportunity to assume your lease, then you may give notice and terminate the lease.

14. HVAC Maintenance

If the HVAC unit exists when the lease commences, landlords frequently are willing to allow a pro rata cost of the replacement to the system as an additional term of the lease. You may want to add this provision as well as review your duty to maintain and replace very carefully.

15. Legal Fees

Some leases do not contain language providing for the recovery of attorney's fees for the prevailing party in the event of a lawsuit between you and the landlord over the lease. You may want to make sure this provision is included.

16. Landlord's General Representations

A general clause for the landlord is helpful to add to most leases and is not typically objectionable. It also helps to somewhat equalize the risks between the landlord and tenant. An example clause follows:

“Landlord represents and warrants to Tenant that: (a) to Landlord’s actual knowledge, the Shopping Center complies with all applicable laws, rules, and regulations; (b) it is the owner of the real property and improvements in the Shopping Center; (c) it has the full right and authority to enter into the Lease without any subsequent action and the execution of the Lease, and the performance of Landlord’s obligations therein, do not violate any agreement binding on the Landlord; (d) that as of the date of the Lease, there are no restrictions (including pre-existing lease exclusives) except those disclosed in writing to Tenant prior to the date of the Lease that would prevent Tenant from operating within the Leased Premises.”

17. Visibility

You may want to add a provision providing that the landlord will not allow any action that would materially obstruct the visibility of your premises or its signs from certain vantage points.

18. Tenant Improvement Costs

Older centers sometimes require updated improvements. If you are moving into such a center, consider adding a provision that the landlord is responsible for all upgrades to the exterior of the premises, and not you.

SECTION IX. TAXES

The great jurist Oliver Wendell Holmes, Jr. said, “Taxes are what we pay for civilized society.” From the small business owner’s perspective, however, taxes are paid not out of a sense of civic pride, but to stay in compliance with the law, retain entity existence, and to help state and federal governments keep track of the wages paid to employees. Business owners are wise to report early and often, maintain meticulous records, and stay current on obligations owed to state and federal governments. Penalties for failure to abide by these principles are substantial, and could mean the death of your small business. The main taxes that the Texas small business owner will be subject to are the federal income tax, federal self-employment tax, state and federal unemployment tax, state real property and business personal property tax, state franchise tax, state and federal excise tax, and state sales and use tax. The registration, reporting and compliance requirements for each are outlined below.

Federal income tax. As a starting point, a business must have a taxpayer identification number so the IRS can process its returns. If your business is a single-person sole proprietorship, you can use your social security number. However, you must apply with the IRS for an employer identification number (EIN) if you: (1) have employees; (2) have a qualified retirement plan; (3) operate as a corporation, partnership or LLC; or (4) file returns for employment or excise taxes. Refer to the IRS small business site at www.irs.gov/businesses/small for application requirements. Additionally, if you have employees, you must obtain a social security number for each of them, and use the identifier when completing forms.

Most businesses are required to make estimated tax payments on a quarterly basis throughout the year. (Failure to do so will result in penalties). At the end of the company's taxable year, all businesses except partnerships must file an annual income tax return, at which time the business will be responsible for any tax liability not paid through estimated tax payments. (Partnerships are required to file an information return which detail the amounts paid to partners). The type of form your business is required to file will depend on the choice of entity the business employs. To determine the right form for your business, refer to the IRS small business site at www.irs.gov/businesses/small.

To reduce your tax liability at the end of the taxable year, you are allowed to deduct from income "ordinary and necessary" business expenses. An "ordinary" expense is one that is common and accepted in your industry, and an expense is "necessary" if it is beneficial and appropriate to your business. An expense does not have to be indispensable to be considered necessary. Common deductible business expenses include start-up costs, ongoing expenses such as rent and utilities for your business location, vehicle expenses such as gas and maintenance, and depreciation of business assets such as vehicles, equipment, furniture and buildings. If you run your business out of your home, you may be qualified to deduct expenses related to that part of your home used for business purposes, but only if your business use of the home is exclusive and regular, and only if your home office is either a separate structure, your company's principal place of business, or a place where you regularly meet with clients or customers. Consult with a local tax professional if you are unsure whether you qualify for a specific business deduction.

Federal self-employment tax. The self-employment tax is a social security and Medicare tax levied on individuals who work for themselves. A self-employed individual is liable for the self-employment tax and must file a Schedule SE with their individual tax return if:

1. Their net earnings from self-employment were \$400 or more; or
2. They had church employee income of \$102.28 or more.

One-half of self-employment taxes paid are deductible as an adjustment to income on the self-employed's individual tax return.

State and federal unemployment tax. The federal unemployment tax is required to be paid by all businesses that have employees under the Federal Unemployment Tax Act. These taxes contribute to the payment of unemployment benefits to workers who lose their jobs. Employers must report federal unemployment tax based on a formula set forth by the IRS. If your business has employees, refer to Publication 15, Schedule E, Employer's Tax Guide, available at www.irs.gov/publications/p15/ar02.html.

In addition to the federal tax, the State of Texas also levies an unemployment tax. Generally, an employer is liable for this tax if it acquires a business that is liable for the tax or if it pays at least \$1,500.00 in wages in a calendar quarter or has at least one employee during twenty different weeks in a calendar year. There are additional ways to qualify for this tax, so consult rules promulgated by the Texas Workforce Commission. If your business is subject to the tax, you must register with the TWC within 10 days of becoming subject, post required notices at your place of business and file quarterly reports stating the taxable wages of your employees. For more information on the Texas unemployment tax, visit the Texas Workforce Commission website at www.texasworkforce.org.

State real property and business personal property tax. The state has jurisdiction to tax all real property located within its borders, and that includes property owned by businesses. For purposes of the Tax Code, "real property" includes lands, improvements, mines, timber and minerals. The tax assessor/collector that taxes real property is generally the county in which the property is located, though the county may collect for agencies in the municipality in which the property is located. There are numerous specific exemptions to the real property tax available to the business owner. These are generally limited to businesses engaged in religious, educational, charitable or nonprofit pursuits, though other narrow exemptions exist for such land uses as agriculture and historic sites, and for land held by disabled veterans and other specific groups. Generally, the real property tax will only be assessed against the fee owner of the land, though in some limited circumstances a lessee of land could be subject to the tax. Additionally, most lessors will pass a portion of the tax along to the lessee as a part of its contractual obligations. Real property tax is an *ad valorem* tax, meaning it is

assessed against the value of the land as appraised by the central tax appraiser each year. Generally, real property taxes are billed in October of the taxable year and are due on January 1st of the following year. The tax liability becomes delinquent and subject to penalties on February 1st.

In addition to the real property tax, business owners are liable for a tax on the business personal property located within the real property and improvements, such as equipment, machinery and office furniture. The entity that owns such property is required to file an annual “rendition” with the central appraisal district of the county in which the property is located which states the estimated value of the property. Failure to file such a rendition will result in the central appraisal district taxing on an estimated value of the property, and a 10% penalty on the tax will be assessed. Forms and instructions for filing a rendition can be found on the state Comptroller website at www.window.state.tx.us/taxinfo/taxforms.

State franchise tax. The Texas franchise tax applies to all businesses except those set up as sole proprietorships or general partnerships. Every taxable entity that is organized in or doing business in Texas is subject to the tax and is required to file a franchise tax report with the Texas Comptroller of Public Accounts. The tax rate is 1% for most entities and 0.5% for qualified retailers or wholesalers, and the applicable rate is applied against the total in-state revenues of the business, less the cost of goods sold. However, most small businesses are not liable for the franchise tax because the first \$300,000 of revenues is exempt from the tax. All businesses, even if they do not owe the tax, are required to file a franchise tax report, however. The initial report is due one year and 90 days after the formation date of the taxable entity, and an annual report is due every year thereafter by May 15th. For instructions, see the Comptroller’s website at www.window.state.tx.us/taxinfo.

State and federal excise tax. Whereas most taxes are assessed against the value of the property or payment taxed, excise taxes are taxed on a unit basis. Excise taxes only apply to businesses selling certain products and carrying out certain activities. Examples of the most common excise taxes are assessed against such products and services as fuel, motor vehicles, tobacco, fireworks, and hotel rental. Consult local counsel to determine whether your business is subject to any excise taxes.

State sales and use tax. The Texas Sales and Use Tax is imposed against all retail sales, leases and rentals of most goods, and some taxable services. Varying by city and county, the sales and use tax can be as high as 8.25%. Generally, a small business must

obtain a sales permit from the Texas Comptroller of Public Accounts if it is engaged in business in Texas and it is selling tangible personal property or providing taxable services to Texas customers. This requirement applies to both wholesalers and retailers. When the business sells taxable items, it must collect the sales tax in the amount applicable in the local jurisdiction in which the business operates. Depending on its sales volume, the business must file sales tax reports monthly, quarterly, or annually, on forms that will be sent to you by the Comptroller. In order to maintain compliance with the Rules, business owners dealing in products or services subject to sales tax should familiarize themselves with Texas Administrative Code Rule 3.286, Seller's and Purchaser's Responsibilities.

SECTION X. PROTECTING YOUR IDEAS AND GOODWILL

When starting your business, it is important that you take the steps necessary to protect your ideas, whether that includes a licensing agreement, confidentiality agreement, or even a trademark. The following will give you some information on how to protect your ideas, and ultimately, your business.

A. Trade Secret

A trade secret is a process or device for continuous use that is used by a business owner to give him an advantage over his competition, and may include anything from a formula for a chemical compound, to a process of manufacturing, treating, or preserving materials, to a pattern for a machine or other device, to a list of customers. In Texas, customer lists, pricing information, client information, customer preferences, buyer contacts, blueprints, market strategies, and drawings have all been recognized as trade secrets.

To be protected under Texas law, a trade secret must (1) be secret; (2) be used in the owner's trade or business; and (3) give the owner a competitive advantage over persons who do not know or use it. Secrecy is of primary concern, and there are several ways to protect your trade secret. One way is by patent. But beware of the expiration on the patent, at which point others can freely duplicate your work. Even if the patent expires, you may be able to apply for another patent in the event the design of the invention is modified or changed.

Another way to secure your trade secret is by copyrighting your work. The Copyright Act permits copyrights on works that are unpublished as well as published.

Pursuant to the Copyright Act, a publication refers to the “distribution of copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental lease, or lending.” You may limit, restrict, or make other conditions of confidentiality for distribution or publication of a copyrighted work.

Secrecy does not have to be absolute to establish a trade secret. There may be a limited disclosure of a trade secret to others, especially under obligations of confidentiality. However, you must take reasonable steps to protect your trade secret. Courts consider the following factors to determine whether such reasonable steps were taken: (1) nondisclosure agreements; (2) plant security; (3) access to the information; and (4) other confidentiality measures. These measures must have been in effect when the matter was alleged to have been secret. For example, when selecting employees for your business, have you made sure that those who will be exposed to your trade secrets have signed a nondisclosure or confidentiality agreement, and did you provide consideration for same? You may also want to consider restricting the information only to those employees with a “need to know” in your business.

Customer lists may be protectable, but it is a difficult area as well. Generally, unless otherwise agreed, after the termination of employment the employee has a duty to the employer not to use or disclose to third persons in competition with, or in a way that will injure, the employer, trade secrets, *written* lists of names, or other confidential information given to the employee solely for the employer’s use or acquired by the employee in violation of the duty of confidentiality. Courts have protected those customer lists protected by contractual provision, by nondisclosure agreement, and under a sale of business covenant not to compete.

A business owns the rights to any trade secrets developed in the scope of employment by an employee who was specifically hired to invent, develop, or devise improvements for the employer. Likewise, an employer is considered the author and owner of any copyright in an employee’s work product so long as that work was done by the employee within the scope of employment. Anything outside an employee’s scope and purpose of employment belongs to the employee. Further, if a person is employed to do non-inventive work and there is no agreement to the contrary, that employee is entitled to ownership of any inventions and patents that are the result of the employee’s invention, created through knowledge learned on the job. Trade secrets may also be acquired from another source, such as an asset sale, merger, or other change in ownership, but it must be transferred as any other property right, and the owner must be able prove ownership by these means.

B. Trademarks

A merchant has a right to identify its goods and services with a name, symbol, logo, or unique packaging or product design to signal to the public that its goods or services come from one source. By trademarking, a dual purpose is served of protecting the consumer against confusion and protecting the merchant's investments in the names and marks in which he has earned goodwill. While a patent protects the substance of a product, the structure of a device, or the method used to accomplish a task, a trademark protects a product's configuration or appearance, and only protects the decorative, nonfunctional elements intended to reveal the product's origin. Trademark rights are grounded under the Texas Trademark Act or the Federal Trademark (Lanham) Act.

A "trademark" is a name, symbol, word, device, slogan, or any combination of these used by a person to identify the person's goods and to distinguish them from the goods of others and to indicate the source of goods, even if the source is unknown. A "service mark" is a name, symbol, word, device, slogan, or any combination of these used by a person to identify the person's services and distinguish them from the services of others even if the source is unknown. A "trade name" is an individual name, surname, firm name, corporate name, or lawfully adopted name or title used by a person to identify a business, vocation, or occupation. The term "trade dress" means the total image or overall appearance of a produce, and often includes features like size, shape, color, color combination, texture, advertising materials, graphics, sales and marketing techniques, and layout or floor plans.

The law only protects those marks that are deemed "distinctive", and does not protect every name, logo, design, or symbol. Ownership rights in a trademark are acquired by (1) adopting and using a mark in trade or business in such a way that the public associates or identifies the owner of the mark or as the source of the product or services, or (2) by acquiring ownership or title to the mark from another trademark owner. Trademark rights are limited in scope to the territory in which they are used. The exclusive right to use a mark comes from exclusive use in commerce, in connection with an existing business, enterprise, or activity. You must file an intent-to-use application to register a trademark under the Federal Trademark Act, which constitutes a constructive use of the mark, conferring a right of priority, nationwide in effect, or in connection with the goods or services in the registration. Trademarks may also be assigned, transferred, and licensed.

SECTION XI. STRATEGIC ALLIANCES

At some point during the life of your business, different opportunities might arise to form strategic alliances with other individuals for mutual benefit. These alliances might come in way of partnerships (or even when you have multiple members in an LLC), joint ventures, mentor/protégé arrangements, distribution arrangements or even you acting as a sub-contractor. Below, we will provide you a brief description of each and what to look for.

A. Partnerships. Regardless of the business entity (whether a partnership or an LLC) when you have more than one person forming a business it is a partnership. Each person involved in the business has something to contribute and a unique quality that makes them a good fit. In most instances, partners in a business have know each other for a while, might be friends, even family members. As with any relationship, the best way to keep it intact is to set forth clear rules from the beginning. For that reason, whether a partnership agreement or a Company Agreement for an LLC (or Operating Agreement if formed in Delaware) it is vital to clearly set forth the economics and responsibilities of each party. Such an agreement should always (i) what each party is contributing, (ii) what percentage of the business each party will have, (iii) how income will be distributed (if differently than by the percentages each has), (iv) what each party can do or not do without the other, (v) how the partnership terminates and (vi) who gets what when it terminates.

Most partnership agreements will have all of the provisions set forth above and will also contain provisions regarding taxation of the business. When one person owns 51% and another 49% it is important to consider whether minority protection provisions are important. The minority partner will want as much control as possible of the decisions made. There is a balance to be made so as to not strain relationships. Similarly, many agreements will address provisions regarding death of a partner and whether a partner may buy another out among others. There are many other provisions that may be included but a priority should be placed in what you brought in, what income distribution you get, if any, and what you get when and if the business is sold or terminated. Another issue to consider, which can be a big hassle in the future is what happens if you each own ½ the business and disagree on a decision, i.e. a stalemate. Consider drafting provisions regarding stalemates so that the business may go on in the meantime. Finally, there might be some provisions that are state law specific, such as indemnity and release of liability of partners, officers, managers, etc...Review those carefully and make sure that they apply to your business and that they comply with the law of the state where the business was formed.

B. Mentor/Protégé Agreements. Mentor/Protégé arrangements have existed since the middle ages (or even farther back, The Stone Age perhaps!). For a long time, this type of arrangement was informal in nature, an apprenticeship of sorts. Today, you might have mentorship programs among business. A large company might take a small company under its wings and provide management and technical assistance. This helps the small business develop skills to become competitive, stay alive in the marketplace and even provide assistance with successful exit strategies, i.e. sell the business. Before entering into these types of arrangements remember, it's all about profit! Analyze the business that will be your mentor carefully. Research their history and background, what services and products they provide, whether their business fits in your market segment, whether they have capital to offer and perhaps most importantly what they are asking for in return. Mentor/protégé arrangements can be a great way for a small business to develop a new market, get access to capital, technical assistance and even subcontracting or new contract opportunities. It can also provide access to a new network of potential investors or clients.

Most recently, Mentor/protégé arrangements have been developed in connection with minority owned businesses and the Small Business Administration (SBA) 8(a) program.⁴⁹ A formal Mentor/protégé agreement should be executed that sets forth what the parties expect from each other, how long the arrangement will last and how it can be terminated. From the mentor's perspective, it may provide access to government contracts with set asides for small disadvantaged businesses (business owned and operated by disadvantaged minorities, women and Native Americans). From the protégé's perspective, it will provide all the benefits we mentioned above.

C. Joint Ventures. A joint venture (JV) is different from a partnership in that a partnership generally involves an ongoing, long-term business relationship, a JV on the other hand, is when a group of persons or businesses get together for a specific business undertaking or purpose, i.e. a single undertaking.⁵⁰ It might be to develop technology to create the Best Widget Ever, develop a website or other web based product to target a specific audience, to develop some oil and gas properties, etc... Generally, these arrangements last for so long as the specific business undertaking does. A JV might be beneficial if you want to reduce the risks of entering into a certain

49 See the U.S. Department of Commerce Minority Business Development Agency website for more information regarding mentor/protégé arrangements. www.mbda.gov.

50 See generally, Practising Law Institute (PLI). 1996. *Joint Ventures: Practices in Search of Principles*, by Stephen V. Bomse. January–February. Corporate Law and Practice Course Handbook series, PLI order no. B4-7134.

business or you lack knowledge of a local environment or for an opportunity to share in technology you would not otherwise have access to.

When entering into a JV, a contract that sets forth the parties' mutual responsibilities and goals must be drafted. The contract should set forth (i) what each party will contribute (both in terms of equity and know-how), (ii) what each party will get in return of such contribution, (iii) who will be responsible for what (iv) who will make what decisions (who will control) and (v) what each party will get upon termination of the JV. If, for instance, you are providing an invention or some sort of intellectual property that you want to retain, it should be clearly stated that all the IP contributed by you to the JV remains your sole property and that you will take it with you when the JV is terminated. Additionally, although not necessary, you should always consider setting forth a date certain or a certain event for the termination of the JV. Unlike a partnership, a JV is for a specific purpose and should be terminated when that purpose is fulfilled.

D. Subcontracting. More recently than not, small businesses are too small to compete for large projects. Rather, they might be able to get pieces of projects if they act as sub-contractors of general contractors. A sub-contractor is a business or person that is hired by a general contractor to handle or do a specific part of a larger project.⁵¹ A good example of sub-contracting is a building construction project. A general contractor will get a contract to build a building. The general contractor will need help with carpentry, drywall, electrical installations, etc...Generally, the general contractor will subcontract the work out to smaller business that do a specific type of work.

When acting as a subcontractor on a project make sure that the terms and conditions of your arrangement with the general contractor are clear. Certain provisions that you should look for are and negotiate effectively are (i) what exactly you need to do, (ii) by when do you have to do it, (iii) what if any assistance will the general contractor provide, (iv) how will you get paid and when will you get paid, (v) what happens if you can't complete your part of the job due to another subcontractor's or the general contractor's fault, among others. When being a subcontractor, there are many things that are out of your control, for instance payment. Most general contractors will want to subject payment to them being paid. For this reason, it is important to make sure that a general contractor has a payment bond in place to guaranty payment. Additionally, timing might be out of your control. There might be other parts of the

51 Waxman, Shelly. All Anybody Needs to Know About Independent Contracting. iUniverse, 2003.

project that need to be finished before you can start your project. Make sure that is contemplated and that you are not penalized for not finishing within expected time if outside of your control.

Like mentor/protégé arrangements, subcontracting has become particularly profitable when it comes to federal and state contracting. Generally, the Small Business Act and several states' laws have created set asides for contractors who use small disadvantaged businesses as subcontractors.⁵² The rules for the SBA programs are very specific and quite complicated, but if followed appropriately, a small business could have a very lucrative business.

Regardless of the Strategic Alliance chosen to further grow your business, be sure to know who you are doing business with, do your due diligence, and be clear about what you and they expect to get out of the arrangement. Again, the more specific, the less likely a judge will be reviewing your agreement in the future.

SECTION XII. RESOURCES

- A. Your local Chamber of Commerce
- B. Lone Star Community College
- C. Small Business Minority Group
- D. www.EEOC.gov
- E. www.dol.gov
- F. One-stop business assistance center -City of Houston
- G. El Paso Community College Small Business Development Center
- H. Dallas Small Business Development Center
- I. University of Texas at San Antonio Small Business Development Center
- J. www.sba.gov
- K. Federal Trade Commission www.ftc.gov
- L. www.irs.gov
- M. www.window.state.tx.us
- N. www.texasworkforce.org
- O. www.mbda.gov

52 See generally 13 CFR Part 120 et al.

SECTION XIII. CONCLUSION

We hope you have found this Toolkit helpful. Remember, the decision to open your own business is one that you should make only after gathering all of the necessary information. Many small business owners find owning a business to be extremely rewarding, and it is critical that you seek the advice of counsel when making your goal a reality. We hope this Toolkit will assist you in asking the right questions so that you can achieve the success you deserve.

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