

# Legal Issues 101

Operating a Successful Consulting Practice

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# Introduction

Operating a successful business requires selecting the right form of business entity to accomplish your new ventures financial and business objectives. The business entity options available to entrepreneurs thinking of starting a new company in California include sole proprietorships, partnerships, limited partnerships, limited liability partnerships, corporations, and limited liability companies. When you evaluate what type of business entity will best suit your new venture keep in mind a few key issues, including the following: (1) ease with which the business entity is formed, (2) extent to which the entity protects you and your co-founders from personal liability, (3) whether the management structure of the new entity suits your business objectives, (4) how easy or difficult it is to raise money to fund the new business, (5) how easy or difficult it is to sell or otherwise transfer ownership of the business to new owners, (6) terminating the business entity and winding up its affairs, and (8) the tax treated afforded the new business entity state and federal tax law. The presentation that follows provides you with insights and answers on each of these issues for each of the business entities identified above.

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# Introduction

All successful businesses must enter into contracts to conduct business. A contract is a legally enforceable oral or written promise. Oral contracts are difficult to enforce so make sure your contracts are in writing. Without contract law, entrepreneurs would create new technological goods and services for clients, but would not know for sure who owns the intellectual property rights embodied in those goods and services. Without contract law, entrepreneurs would also have a difficult time getting paid. Understanding the basic principles of contract law enables you to: (1) better understand the terms and conditions in the agreements offered by vendors and that you offer to clients, (2) identify key issues in an agreement that requires your careful attention or your attorney's attention, (3) improve your chances of being paid in full for your goods and services, (4) protect the intellectual property your company owns and will use for the clients, and (5) shift risk to the other parties to the contract.

Exact contract terms vary by transaction. Every contract you enter into should, at a minimum, include clear and concise provisions that cover the following subjects: (1) establish the parties and their intent to enter a contract, (2) set forth all of the contract terms, including delivery and payment, clearly and concisely, (3) establish important timing issues and clear deliverables, (4) specify ownership of intellectual property, (5) specify which party bears certain risks of the transaction, (6) include comprehensive dispute resolution provisions, (7) include an attorneys' fees clause and other so-called boilerplate provisions, and (8) ensure signatories have authority to bind the parties to the agreement.

If after reviewing this presentation you have further questions about the topics covered in the presentation, please contact Finkel Law Group at (925) 274-9600 or [info@finkellawgroup.com](mailto:info@finkellawgroup.com).

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# Choosing a Form of Business Entity for Your Consulting Business

- The first question you and your partners should ask when starting a new business:
- Given our business objectives what is the best form of business entity to operate the new venture?

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# Choosing a Form of Business Entity for Your Consulting Business

## Options

- Sole Proprietorship
- Corporation
- Limited Liability Company
- Partnership
- Limited Liability Partnership
- Limited Partnership

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# Sole Proprietorship

## Definition

- A natural person who directly owns the business and is directly responsible for all of its debts and liabilities.
- Simplest form of entity to conduct business accompanied by the greatest risks.
- Not a separate legal entity like a corporation.
- Avoids many of the formalities and reporting requirements of business entities.

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# Sole Proprietorship

## Formation

- Anyone can form a sole proprietorship, including business consultants.
- Involves no registration with any government agency.
- Should obtain a local government business license and possibly a fictitious business name (i.e., “doing business as” or “DBA”).
- If a DBA is used, you must file with the county recorder in the county where the proprietorship's principal place of business is located.
- When using a DBA, the owner's name is public record.
- Filing fees are modest; periodic renewals of registrations are required.

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# Sole Proprietorship

## Personal Liability

- All the profits belong to the business owner and all the losses do too.
- Owner has unlimited personal liability for the debts and obligations of the business.
- Owner puts his or her entire personal assets and wealth at risk in a sole proprietorship.
- If the owner is married, he or she puts the community property at risk as well.

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# Sole Proprietorship

## Management & Control

- Owner has total management authority, but may act through agents.
- The actions of agents can increase the owner's risk of incurring personal liability for the agent's actions.

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# Sole Proprietorship

## Working Capital & Securities

- A sole proprietor funds the business either out of personal funds and property or with borrowed funds.
- Owner is personally liable to repay borrowed funds.
- Sole proprietorship issues no stock, bonds or other securities to evidence ownership of the business

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# Sole Proprietorship

## Change of Ownership

- If a sole proprietor ceases to operate the business, it terminates.
- Alternatively, assets and liabilities can be sold to a buyer, at which time the business terminates.
- If a new owner is added, the business becomes a partnership.

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# Sole Proprietorship

## Termination

- Sole proprietorship terminates when the owner discontinues the business.
- Must wind up any pending obligations, contracts, and registrations such as business licenses or permits.
- Must complete all required tax filings regarding income, employees, and related matters.

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# Sole Proprietorship

## Taxation

- Income and expenses of a sole proprietorship are reported as personal income and expenses on Schedule C of the owner's federal and state income tax returns.
- Sole proprietor must pay employment taxes and workers' compensation insurance on employees' wages.
- Does not provide tax advantages for estate planning purposes.

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# Corporation

## Definition

- A corporation is a limited liability entity in which the owners, called *shareholders*, are generally not liable for the corporation's debts and obligations solely by reason of their status as shareholders.

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# Corporation

## Formation

- One or more natural persons, partnerships, associations or domestic or foreign corporations may form a corporation.
- Professionals, like attorneys, accountants, dentists and architects can form professional corporations.
- Create the corporation by filing articles of incorporation with the Secretary of State and paying a filing fee.

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# Corporation

## Formation

- Bylaws must be adopted to establish corporate housekeeping rules.
- Organizational resolutions must be adopted to establish management, basic operating requirements, issuance of company stock and similar matters.
- Shareholders may enter into a “buy-sell” agreement that restricts the sale of shares and sets a formula to value shares upon transfer.

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# Corporation

## Personal Liability

- Shareholders are not personally liable for corporate debts and obligations unless they:
  - Personally guarantee corporate debts or obligations;
  - Engage in tortious conduct;
  - Receive improper distributions;
  - Subject to “alter ego” claims for commingling personal and corporate matters; or
  - Breach duties to other shareholders or the corporation.
- Shareholders’ names are not a public record, but other shareholders may obtain the names from corporate records.

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# Corporation

## Management & Control

- Incorporator appoints initial directors unless they are named in the articles of incorporation.
- Shareholders annually elect a board of directors who set policy for the corporation.
- The Board elects officers to manage the day-to-day affairs of the corporation, including a president, secretary and treasurer.
- Shareholders exercise no management functions. If they do, they risk losing their limited liability protection.
- Names of officers and directors are public record.

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# Corporation

## Working Capital & Securities

- Shareholders contribute cash or property to the corporation in exchange for stock.
- Corporation can issue one or more classes or series of common or preferred stock with full, limited, or no voting rights and with other rights, preferences, privileges and restrictions.
- At least one class or series of stock must have voting rights and unlimited dividend and liquidation rights.
- By varying the rights of different classes and series of stock, certain shareholders can gain superior rights on voting control, distributions, and other aspects of corporate control.

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# Corporation

## Working Capital & Securities

- Shares of stock are issued to evidence ownership.
- Stock must be registered in each state, and with the Securities and Exchange Commission, where it will be offered for sale unless the transaction or security is exempt from registration.
- Regulatory filings are sometimes required to register a stock offering or get an exemption from registration.

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# Corporation

## Change of Ownership

- Shareholder may transfer stock to a new owner, subject to restrictive agreements among shareholders, restrictions in the articles or bylaws, and compliance with securities laws.
- Change of ownership does not dissolve or terminate a corporation.

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# Corporation

## Termination

- Corporation usually has no fixed termination date.
- Can be dissolved by action of 50% or more of the voting power of the corporation's shareholders and filing a certificate of election with the state.
- Dissolution can be judicially supervised or not.

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# Corporation

## Taxation

- Corporation is formed under state law and taxed under IRC Subchapter C unless election under Subchapter S.
- Net income of a C corporation is taxable by the federal and state governments at corporate tax rates.
- When a corporation issues a dividend to its shareholders, the shareholders report the dividend as income and must pay federal and state income taxes on the dividend.
- This is “double taxation.” The corporation's net income is taxed at the corporate level and again at the shareholder level.

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# Corporation

## Taxation

- Double taxation can be minimized by
  - (1) paying wages to shareholders who are employees,
  - (2) paying fair market rents to use assets owned by a shareholder, or
  - (3) paying fair market interest on a debt owed to a shareholder.
- Corporation that retains most of its income as capital reinvestment in the business may benefit from the corporate tax structure because marginal corporate rates may be lower than the marginal individual rates.
- California corporations pay a minimum \$800 franchise tax for the privilege of doing business in California.
- Corporations must also pay employment taxes and workers' compensation insurance on employees' wages.

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# S Corporation

## Definition.

- Same as a C Corporation, but the shareholders may elect that the corporation be taxed under IRC Subchapter S.
- To qualify as an S corporation, the company cannot:
  - Have more than 100 shareholders,
  - Have a shareholder other than an individual, estate, a tax exempt organization, or certain qualified trusts,
  - Have a shareholder who is a non-resident alien;
  - Have more than one class of stock,
  - Be an insurance company;
  - Be a foreign corporation; or
  - Be a domestic international sales corporation.
- S corporation status may be inadvertently terminated at any time if it fails to meet any of the above requirements.
- Once the S election is terminated, whether inadvertently or intentionally, the corporation may not normally make another S election for 5 years.

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# S Corporation

## Formation

- Create an S corporation the same as a C corporation, plus . . .
- Shareholders elect S corporation status.
  - File IRC Form 2553 with the IRS
  - File Form 100S with the FTB
  - There is currently no fee to file the form with the IRS.
- IRS provides simple method for taxpayers to request relief for a late S corporation election and a late corporate classification election.

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# S Corporation

## Taxation

- Certain advantages over a C corporation.
- S corporations net income, losses, and tax credits are “passed through” to the corporation’s shareholders without being taxed at the corporate level under federal and California tax codes.
- Double taxation is largely eliminated, but California imposes a 1.5% tax on S corporation income.
- The tax result is similar but not identical to that of a partnership.
- In all other respects, an S corp is operated like a C corp with regard to corporate governance by a board of directors and management by officers.

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# Close Corporation

## Definition

- A corporation with no more than 35 shareholders, who agree in writing to relax various corporate control and operating requirements otherwise required by state law.
- Shareholders can change default governance rules under Corporations Code, except
  - Number of shareholders,
  - Disclosure of rights, preferences, privileges and restrictions on stock certificates,
  - Conditions under which dividends may not be paid,
  - Approval of reorganizations,
  - Requirements governing dissolutions,
  - Recordkeeping and reporting requirements, and
  - Rights to inspect corporation's records
- Otherwise a Close Corporation is operated just like a C or S corporation.

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# Close Corporation

## Formation

- Formed the same as any “for profit” corporation with additional specific wording required in the articles of incorporation regarding
  - election of close corporation status,
  - placement of a legend on the stock certificates to that effect, and
  - a written agreement among the corporation and its shareholders specifying the corporate formalities to be relaxed.
- Existing corporation can elect close corporation status by amending its articles of incorporation to add the required wording.
- Amendment must be approved by all shareholders.

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# Close Corporation

## Termination

- Terminated in the same manner as any other corporation.
- Without terminating its existence, a close corp can elect to become a regular C corp by amending its articles of incorporation to delete the provisions electing close corporation status.
- Can do so with approval of affirmative vote of 2/3 of each class of outstanding shares.

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# Limited Liability Company

## Definition

- Limited liability company is a non-corporate business organization with one or more owners (called *members*) who normally do not have personal liability for the debts and obligations of the LLC.
- An LLC combines several of the best qualities of the other types of business entities:
  - a hybrid of a corporation (offering limited liability for members)
  - with the tax attributes of a partnership (eliminating double taxation on the entity's income as well as on distributions to the members) and
  - the flexible management structure of a partnership.

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# Limited Liability Company

## Formation

- LLC is created by filing executed articles of organization on Form LLC-1 with the Secretary of State and paying a filing fee.
- Members enter into an operating agreement to establish managerial, operational and financial rules to govern the LLC's day-to-day operations.
- An oral operating agreement among the members is legally sufficient, but a written agreement is recommended for certainty of the terms intended.
- One or more individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, LLCs, or other entities may form an LLC.

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# Limited Liability Company

## Personal Liability

- Members of an LLC are not personally liable for debts and obligations of the LLC, unless the members:
  - Personally guarantee debts of the LLC,
  - Participate in tortuous conduct,
  - Receive improper distributions, or
  - Are subject to “alter ego” claims for commingling personal and LLC matters.
- Members who serve as managers may have additional liability due to the additional control they have over LLC matters.
- Names of LLC managers are public record due to filings with the State.
- Members names are not public record.

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# Limited Liability Company

## Management & Control

- LLCs have flexible management structure.
- Can vest management in one or more managers, who may but need not be members.
- Can consolidate all aspects of LLC's management, operations and finances in a single document called an operating agreement, which should be in writing.
- If permitted by the operating agreement, an LLC's managers may for convenience in dealing with third parties have officer titles such as president, secretary and treasurer, and may also have a board of directors.
- Alternatively, the LLC can be managed by one or more general managers (i.e., partners).

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# Limited Liability Company

## Working Capital & Securities

- Fund the company through members' capital contributions of cash and property, and loans from members and third parties.
- In exchange for capital contributions members receive LLC membership interest.
- In exchange for loans, members or third parties get promissory notes.
- Unless the articles of organization or the operating agreement provide otherwise, members are not required to contribute funds in addition to their original capital contributions.
- Varying the rights of different classes of membership, may allow certain members to have superior rights with regard to voting control, distributions, and management.
- Memberships are securities so the company must comply with all securities laws.

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# Limited Liability Company

## Change of Ownership

- If a member transfers his membership interest to a third party, the transferee becomes a member only after the affirmative vote of a majority in interest of the other members.
- If a transferee is not admitted as a member, he holds only an “economic interest” in the LLC.
- He is entitled to share in the income, gains, losses, deductions, distributions and other economic aspects of the LLC.
- He has no voting or management rights and only limited rights to information about the LLC’s business and affairs.
- Operating agreement may provide for the termination of a member’s interest in the LLC, but the provision must be reasonable at the time the agreement was made.
- If a member's economic interest is terminated, he is entitled to his contribution back.

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# Limited Liability Company

## Termination

- LLC is dissolved and its affairs wound up at a time or upon the occurrence of certain events set forth in the articles of organization or the operating agreement
- LLC can also be dissolved by an affirmative vote of a majority in interest of the members.
- When dissolution occurs, the managers file a certificate of dissolution with the Secretary of State.
- The LLC's business and affairs are wound down, with creditors paid first and members receiving the remains.

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# Limited Liability Company

## Taxation

- Like a partnership, an LLC is generally not subject to federal or California income tax, unless it elects to be taxed as a corporation.
- California permits the formation of single-member LLCs, which is treated as a sole proprietorship for federal and California income tax purposes unless the LLC elects to be treated as a corporation.
- An LLC must pay a minimum annual franchise tax of \$800 to the State of California's Franchise Tax Board.
- Plus a statutory fee of an additional \$900 or more for any year in which the LLC's total income from all sources derived from or attributable to California is \$250,000 or more.

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# Partnership

## Definition

- A general partnership is an association of two or more persons to conduct business as co-owners regardless of intent to form a partnership.
- Individuals and entities may be partners in a general partnership.
- A partnership is an entity distinct from its partners and may be formed by written, oral, or implied agreement.
- An oral agreement is legally sufficient, but a written agreement is strongly recommended for certainty.

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# Partnership

## Formation

- Two or more individuals, corporations, estates, trusts, partnerships, limited partnerships, LLCs, associations, joint ventures, governments and other legal or commercial entities may form a general partnership.
- Creating a general partnership requires no filing with the Secretary of State or any other governmental authority.
- A general partnership may file a statement of partnership authority with the Secretary of State's office along with a filing fee.

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# Partnership

## Personal Liability

- General partners are jointly and severally liable for all debts and obligations and most wrongdoing of the partnership.
- A judgment against a partnership may not be satisfied from a partner's separate assets unless there is also a separate judgment against the partner individually.
- All partners have fiduciary duties of loyalty and care to each other.
- Names of general partners are public record only if a statement of partnership authority or a fictitious business name is filed.

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# Partnership

## Management and Control

- General partnerships do not have a board of directors or officers like a corporations, but instead are managed and operated by the partners themselves.
- Partnerships may have employees.
- Each partner is an agent of the partnership and can bind the partnership in the ordinary course of business.

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# Partnership

## Working Capital & Partnership Interests

- A partnership's working capital comes from partners' contributions of cash and property or from loans from partners or third parties.
- A general partnership is not attractive investments to passive investors because of personal liability for partnership debts and obligations and difficulty transferring partnership interests.
- Unless otherwise provided in the partnership agreement, each partner is entitled to receive an equal share of the partnership profits and losses in proportion to the partner's share of profits.
- Ownership interest in a partnership is usually not a security because the partners are involved in management of the business.

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# Partnership

## Change of Ownership

- All partners must agree to the admission of new partners.
- Unless the partnership agreement states otherwise, a partner may assign its economic interest in partnership.
- Assignee is only entitled to an economic interest and does not become a partner.
- Such an assignment does not by itself cause the dissolution of the partnership or the dissociation of the assignor partner.

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# Partnership

## Termination

- Dissociation of a partner (through withdrawal, retirement, or death) does not necessarily result in dissolution and winding up of a general partnership.
- A partnership for a specific term or purpose is dissolved and wound up on dissociation of a partner unless a majority in interest of the remaining partners agrees to continue the partnership.
- A partnership at will is dissolved on a dissociation only on the affirmative vote of at least half the partners.
- A partnership agreement may vary these provisions.
- On dissolution, all the partners may agree to reconstitute as a new partnership to carry on the business of the dissolved partnership.

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# Partnership

## Taxation

- A general partnership is generally not subject to federal income tax or California income or franchise tax.
- Partnership's net income and losses are reportable on partnership's tax return and shares allocated to each partner are reported on each individual partner's personal income tax return.
- Employment taxes and workers' compensation insurance must be paid on employees' wages.

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# Limited Partnership

## Definition

- Limited partnership is a partnership formed by two or more persons and having both of the following:
  - one or more general partners who engage actively in the management and control of the business and have unlimited personal liability for the partnership's debts and obligations, and
  - one or more limited partners who are not personally liable for the partnership's debts and obligations unless they participate in the control of the business.

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# Limited Partnership

## Formation

- One or more individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, LLCs, or other entities may form a limited partnership.
- A limited partnership is formed by the partners signing a Certificate of Limited Partnership, recording it with the Secretary of State, and paying a filing fee.
- An oral partnership agreement is legally sufficient, but a written agreement is recommended for clarity.

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# Limited Partnership

## Personal Liability

- General partners of a limited partnership are jointly and severally liable for partnership obligations to the same extent as a general partner of a general partnership.
- Limited partners are not personally liable for partnership debts and obligations, unless they participate in control of the partnership business.
- If the limited partnership operates outside California, the laws of other states may apply in determining a limited partner's liability.

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# Limited Partnership

## Management and Control

- General partners manage the business of a limited partnership and may receive a salary or other payment for doing so.
- Limited partners engaging in management of the partnership risk losing their limited liability protection.

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# Limited Partnership

## Working Capital & Partnership Interests

- Partners contribute cash and property to the limited partnership in exchange for their ownership interests.
- Because of limited liability and pass-through tax treatment limited partnership interests are attractive to passive investors (e.g., real estate).
- Because limited partners can't participate in management without risking general partner liability, it is usually unattractive to venture capitalists.
- General and limited partnership interests can be issued in more than one class, with the partnership agreement establishing the rights, powers and duties of each class.
- By varying the rights of different classes of partnership interest, some partners may have superior rights with regard to voting control, distributions, and other aspects.
- Limited partnership interests are generally characterized as securities.

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# Limited Partnership

## Change of Ownership

- A limited partnership interest is personal property assignable in whole or part.
- Assignment does not dissolve a limited partnership or entitle the assignee to become a partner or exercise any rights of a partner.
- A general partner has the power to dissociate at any time, a limited partner does not.
- A new general partner is admitted in accordance with the partnership agreement or with the consent of the limited partners.
- A new limited partner is admitted in accordance with the agreement, as the result of a conversion or merger, or with the consent of all the partners.

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# Limited Partnership

## Termination

- A limited partnership dissolves and its activities are wound up only on the occurrence of the following:
  - An event specified in the limited partnership agreement,
  - The consent of all general partners and of limited partners owning a majority of the rights to receive distributions, or
  - On departure of a general partner, depending on the circumstances.

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# Limited Partnership

## Taxation

- A limited partnership is not subject to federal or state income tax at the entity level unless it elects to be taxed as a corporation.
- Unlike a general partnership, a limited partnership is subject to an annual franchise tax of \$800 paid to the State of California's Franchise Tax Board.
- Employment taxes and workers' compensation insurance are required on employees' wages.

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# Limited Liability Partnership

## Definition

- An LLP is a form of general partnership with some limited liability protections permitted for the partners.

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# Limited Liability Partnership

## Formation

- Use of an LLP is restricted to certain licensed professionals, specifically attorneys, accountants and architects.
- Form a limited liability partnership (LLP) by executing and filing a form LLP-1 with the Secretary of State with a fee.
- An LLP must provide security for claims against it through either insurance, bank deposits or meeting certain net worth requirements.
- A legal services LLP (i.e., law firm) must also register with the State Bar of California.

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# Limited Liability Partnership

## Personal Liability

- LLP is a form of general partnership in which a partner is not liable for the debts and obligations of the LLP or the tortious conduct of other partners, if all the following true:
  - LLP is registered as an LLP,
  - If it is a law services LLP, the LLP is registered with the State Bar of California, and
  - Certain security requirements are met.
- A partner may not limit liability for its own tortious conduct, but is protected from vicarious liability for the acts of his or her partners.

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# Limited Liability Partnership

## Management and Control

- An LLP is managed by its partners.
- The names of the partners of LLPs are public record.

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# Limited Liability Partnership

## Working Capital & Securities

- Owners of an LLP fund the business either with personal funds and property or with borrowed funds.
- The LLP's lenders may require personal guarantees from the partners.
- Because LLPs are a form of general partnership ownership interests in an LLP are usually not securities.

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# Limited Liability Partnership

## Change of Ownership

- Transfer of LLP interests may be made only to licensed professionals.
- LLP interests otherwise have the same restrictions and requirements as other securities.

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# Limited Liability Partnership

## Termination

- An LLP continues in existence until a notice of cessation is filed with the Secretary of State or until the LLP has been dissolved and finally wound up.

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# Limited Liability Partnership

## Taxation

- A California LLP is generally treated as a partnership for federal and California income tax purposes.

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# Contract Law for Consultants

## Introduction

- A contract is a legally enforceable oral or written promise.
- Oral contracts are difficult to enforce. Put your contracts in writing.
- Without contract law, technical consultants like you would create new technologies for clients, no one would know for sure who owns the intellectual property rights in those products, and you would not get paid.
- Understanding the basic principles of contract law enables you to:
  - better understand terms and conditions in agreements offered by clients,
  - identify key issues in an agreement that require careful attention,
  - improve your chances of being paid in full for your services, and
  - protect the intellectual property you already own and will create for the client.

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# Contract Law for Consultants

## Advantages of Written Contracts

- A written contract prevents misunderstandings by forcing the parties to articulate their specific intentions, needs and desires for the transaction at the time of the deal.
- Drafting a written contract identifies misunderstandings and clarifies ambiguous points that may exist between parties.
- Signing a legally enforceable written contract focuses the mind.
- A contract can take any form so long as it contains essential terms (i.e., identity of the parties, subject matter, basic terms, and signature of person against who enforcement is sought. The court will fill in the rest!
- Make sure to include all aspects of the agreement you believe are truly important to the needs of your business and the transaction.

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# Contract Law for Consultants

## Checklist of Contract Terms

- Exact contract terms vary by transaction, but every contract you enter into should cover the following terms:
  - Establish the parties and their intent to enter a contract
  - Set forth all of the contract terms clearly and simply
  - Establish important timing issues and clear deliverables
  - Specify ownership of intellectual property by contract
  - Specify which party bears certain risks of the transaction
  - Include comprehensive dispute resolution provisions
  - Include an attorneys' fees clause
  - Ensure signatories have authority to bind

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# Contract Law for Consultants

## Identify Parties and Their Intent to Contract

- Start each contract with explicit statements identifying the parties and summarize their intent to form a contract.
- State the names and addresses of the parties.
- State the date of the agreement, which is typically the date it's signed.
- Use recitals to provide the background of the agreement, state the purpose of the agreement, and frame the facts and issues to advance your interests.
- Facts recited in a written agreement are conclusively presumed to be true.
- If the operative words of a grant are doubtful, recitals may be used to assist in its construction. Make sure they are accurate.

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# Contract Law for Consultants

## Defined Terms

- Use defined terms to create short-form references for names, terms and concepts repeated throughout the agreement.
- Defined terms improve readability, assure consistency, and focus the mind on important points of the agreement.
- Definition section should define every word critical to understanding and enforcing the agreement. Helps avoid disputes over whether a word is interpreted in its normal, technical, legal, trade or local sense.
- Definitions are particularly important when the subject matter of the agreement is technical in nature (i.e., agreements to create IP).
- If a definition is clear and unambiguous, a court will apply it to interpret the agreement. Otherwise, the general meaning will prevail which may not be your intention.

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# Contract Law for Consultants

## Defined Terms

- Examples of critical terms that should be defined include
  - Property
  - Territory
  - Intellectual Property
  - Confidential Information
  - Payment (i.e., gross profits, net sales, purchase price)
  - Parties (i.e., employees, contractors)
- Make sure each term is defined only once and use consistently throughout the contract.
- Do not define terms that are not used, and do not use terms that are not defined.

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# Contract Law for Consultants

## Set Forth Terms of Agreement Clearly.

- Set forth the essential terms of the transaction clearly and simply.
  - Parties and performance obligations
  - Subject of matter of the contract (i.e., goods, services, license grant)
  - Payment, royalties, and terms
- Clear and explicit language should govern the contract. Ambiguous terms lead to litigation to determine the meaning of those terms. The court, rather than the parties, decide the scope of the contract and parties' obligations.
- Include representations and warranties essential to the transaction's successful completion:
  - Payment upon receipt of goods or services
  - Software works in accordance with accompanying documentation
  - Intellectual property rights owned by consultant or licensors

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# Contract Law for Consultants

## Set Forth the Terms of Agreement Clearly.

- Party's performance can't be conditional on an event exclusively within that party's control because the promise may be illusory and the contract invalid.
- Negotiate in advance all performance requirements, delivery instructions, installation directions, risk allocation, and procurement of insurance.
- Include payment terms that specify (1) when payment will be made, and (2) in what form payment will be made.
- When installment payments are made include acceleration and interest clause in the event of late payments to encourage the buyer to pay installments on time.
- When measure of performance is subjective, include provision that requires written notice for failure to comply and opportunity to cure before default.

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# Contract Law for Consultants

## Establish Key Timing Events: Commencement

- Contract begins on the effective date. The date the contract is signed. If different parties sign on different dates, the contract becomes effective on the last date signed.
- A clear term provision reduces risk the contract is construed as terminable at will which could lead a court to find an illusory promise and no contract.
- Unclear term provision presents problems because business can be disrupted if a party can terminate the contract for any reason or no reason at any time.
- Include specific dates by which services must be completed or goods delivered. If performance must be completed at a specific time state it in the contract (i.e., time is of the essence).

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# Contract Law for Consultants

## Establish Key Timing Events: Extensions

- Contracts for a fixed term allow for extensions or renewals of the contract. Consider the following basic issues before preparing an extension clause:
  - Is the extension conditional on the occurrence of some event? Performance?
  - Can the contract be extended by actions one party or must all parties agree?
  - Is the right to extend available to both parties?
  - Will the contract be extended “unless” an action is taken (no notice required) or “only if” action is taken (notice required)?
  - Will any contract provisions change as a result of the extension (e.g., deliverables, contacts, payment terms, reporting)?

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# Contract Law for Consultants

## Establish Key Timing Events: Extensions

- When drafting extension provisions, specify any notice periods, type of notice required, and any other steps necessary for effective extension.
- No one should be taken by surprise at the expected end of the term.
- You can prepare and attach notice forms to the contract to aid in compliance with extension requirements.
- Set a deadline for execution of the extension agreement to encourage the parties to focus on the extension issue before the contract expires.
- The parties to the contract should calendar any significant dates to avoid an inadvertent failure to extend or not extend.

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# Contract Law for Consultants

## Establish Key Timing Events: Termination.

- Termination of a contract occurs when a party ends the agreement pursuant to authority in the contract or under law.
- Contracts often allow termination before expiration of the term on the occurrence of certain events (e.g., breach, fulfillment of agreement, etc.)
- A terminating event can result in automatic termination or give one or more parties the right to terminate.
- Always include a termination procedure to reduce disruption. It should include written notice of an intent to terminate within a certain time.
- Require advance notice of termination to minimize disruption caused by sudden termination (e.g., 30 days prior written notice of intent to terminate).

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# Contract Law for Consultants

## Establish Key Timing Events: Effect of Termination.

- Specify the consequences of early termination. Address the following questions:
- Do any rights or obligations survive?
  - Payment
  - Confidentiality
  - Property rights
- How should the parties treat previously exchanged consideration?
  - Repayment
- How should the parties treat previously exchanged information?
  - Retain
  - Return
  - Destroy

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# Contract Law for Consultants

## Consideration for the Contract

- To be enforceable, a contract must be supported by consideration.
- Consideration consists of any benefit conferred or prejudice suffered, or agreed to be conferred or suffered, as inducement for a promise that is not legally required.
- Consideration comes in a variety of tangible forms:
  - Current cash and cash equivalent payment.
  - Letter of credit.
  - Deferred money payment (e.g., promissory notes)
  - Performance of services.
  - Shares of stock.
  - Transfer of assets or rights.
  - Assumption of liabilities.

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# Contract Law for Consultants

## Ownership of Intellectual Property Created Under Contract

- Initial ownership of IP is always determined by statute not by contract.
- Ownership depends on the status of person who created IP and type of IP created.
- Does the law view the person who created the IP as an employee or consultant?
- What type of IP did the person create?
  - Patentable subject matter
  - Copyrightable subject matter
  - Trade secrets

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# Contract Law for Consultants

## In the Case of Employees

- **Copyrights.** If an employee creates a work of authorship within the scope of his employment it is a “work made for hire” and the copyright belongs to the employer.
- **Patents.** If an employee creates an invention in the scope of his employment, he is the inventor.
- Ownership of the invention passes to the employer when the employee expressly agrees to assign his rights to his employer by contract.
- Ownership of the invention passes to the employer through the “hired to invent” doctrine if at the time of invention the purpose of the employment was to invent.
- The “shop right” doctrine grants the employer an implied license to use its employee’s patented invention in its business without infringing the patent. Title remains with the inventor who is free to grant other licenses or assign his rights.
- **Trade secrets** generally follow patent rules.

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# Contract Law for Consultants

## In the Case of Consultants

- **Copyrights** vest in the consultant without a written agreement because the consultant is the author under copyright law.
- **Patents** vest in the consultant without a written agreement because the consultant is the inventor under patent law.
- **Trade secrets** generally follow the patent rules.

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# Contract Law for Consultants

## Solving the Ownership Problem by Contract

- Prepare well drafted agreements between consultants who develop patentable or copyrightable materials and their client companies.
- The agreements should allocate ownership of the IP created by the consultant for the company.
- Skilled consultants have developed a body of intellectual property before a company hires them to develop a technology product.
- When the consultant works for a company she uses some of the IP she has already developed, and develops new IP specifically for the company that hired her.

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# Contract Law for Consultants

## Solving the Ownership Problem by Contract

- A well drafted consulting agreement will include a license grant to the hiring party to use pre-existing IP and a license grant or assignment to the hiring party for newly developed IP created by the consultant under the agreement.
- If there is an assignment from the consultant to the hiring party there will frequently be a license back to the consultant that allows him to use the newly developed IP in the consultant's future business engagements.
- The license back may be subject to certain restrictions, like field of use restrictions that limit or prohibit future licenses to competitors of the hiring party.

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# Contract Law for Consultants

## Example: Balanced Cross License Grant

- “Consultant hereby grants to Company an irrevocable, perpetual, fully paid-up, royalty-free, worldwide, nonexclusive, personal and non-transferable right and license under any patent rights or trade secrets owned by Consultant, or licensable by Consultant without the payment of royalties to a third party, to make, use, disclose, import, offer to sell and sell the Deliverables.”
- “Company hereby grants to Consultant an irrevocable, perpetual, fully paid-up, royalty-free, worldwide, nonexclusive right and license, with the right to sublicense, under any copyrights owned by Company, or licensable by Company without payment of royalties to a third party, to use, reproduce, copy adapt, prepare derivatives, distribute, display and perform Deliverables.”

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# Contract Law for Consultants

## Example: Consultant Favorable License Grant

- “Company acknowledges and agrees that all work product, materials, information incorporated within, developed, generated or produced by Consultant pursuant to, resulting from or in connection with a work order including, but not limited to, all Deliverables, Documentation, computer software, copyrightable processes, technical information, trade secrets, flow charts, diagrams, specifications, reports, documentation, information and data along with all Intellectual Property Rights arising therefrom or related thereto shall be the sole and exclusive property of Consultant, subject to the following nonexclusive license granted to Company.”
- “Consultant hereby grants Company nonexclusive, nontransferable license without rights to sublicense to: (i) install each Deliverable on Licensee Hardware; (ii) allow Company employees and contractors to use the Documentation and Deliverable on Licensee Hardware or through the Licensee Network solely for Company’s internal business purposes at the Installation Site, and for no other purpose, including but not limited to distribution to third parties; and (iii) reproduce the Documentation and Deliverables solely as necessary to support the permitted use by Company.”

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# Contract Law for Consultants

## The Bottom Line on Intellectual Property Rights

- From the consultant's point of view, at the end of the transaction the consultant either wants to own the work product or have a broad license to continue to use it in future transactions.
- From the hiring party's point of view, it does not want to spend a lot of money developing a product and then have the consultant retain the right to sell it to its competitors for a fraction of the cost paid.
- The hiring party needs to make sure there are enough restrictions (i.e., field of use, etc.) in the agreement to protect against this risk.

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# Contract Law for Consultants

## **Specify Which Party Bears Certain Risks of the Transaction.**

- Decide what events would relieve either or both parties of their contract obligations (i.e., breach, government action, force majeure events).
- An event can excuse a party's performance if it makes performance impossible or commercially impracticable.
- Include an exculpatory clause that designates each of the potential events that could prevent a party's performance.
- Require one party to secure insurance against certain losses.
- Require either or both parties to indemnify the other for certain events arising under the contract.

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# Contract Law for Consultants

## Include Comprehensive Dispute Resolution Provisions

- Include a mandatory mediation clause that requires the parties to participate in good faith mediation before resorting to arbitration or litigation.
- Include an arbitration provision to avoid the time, expense, tension, distraction, delay, unpredictability and publicity of public litigation.
- Include a provision that allows a party to seek injunctive relief from a court of competent jurisdiction to protect certain intellectual property rights. Critical for the owner of intellectual property.
- Include an attorneys' fees clause that awards the prevailing party reasonable attorneys' fees and costs. Otherwise each party pays its own way.

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# Contract Law for Consultants

## **Makes Sure Signatories Have Authority to Bind.**

- When a contract is entered into with a business entity, make sure the person who signs the contract has the authority to do so.
  - Sole proprietor signs for himself and is personally liable for the contract.
  - A general partner generally authority to bind a partnership.
  - A manager or managing member has authority to bind an LLC.
  - An authorized officer (i.e., president) has authority to bind a corporation.
- For each type of business enterprise there may be statutory or contractual reasons that limit a person's authority to sign on behalf of the entity (i.e., partnership agreement, operating agreement, bylaws, etc.).
- Verify authority by including a provision that affirmatively states the signatory is authorized to execute the contract on behalf of the business.

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# Contract Law for Consultants

## Don't Forget the Boilerplate

- Include a **notice** provision to ensure communication: How, where, when & who.
- Include an **amendment** provision to specify how the contract can be modified.
- Include a **merger** provision to ensure finality.
- Include a **severability** provision to prevent a court from declaring the entire contract invalid because of a single, invalid provision.

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# Contract Law for Consultants

## Don't Forget the Boilerplate

- Incorporate **exhibits** by reference into the contract.
- If **time is of the essence**, put it in the contract.
- Include a **survival** provision to protect IP and confidentiality.
- Include an **ambiguity** provision to protect drafting party.
- Include a “**necessary acts**” provision to require a party to perform an act or sign an instrument not specifically required by the contract.

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# Legal Issues 101

Operating a Successful Consulting Practice

Lonnie Finkel, Esq.



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