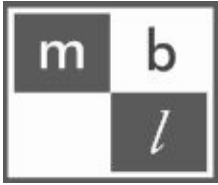




Think of Everything, Act Accordingly.

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The Startup Issue!

Starting a Business? This issue focuses on things you need to know before you get up and running. Not starting a business? Don't worry, it also contains useful information for those who already own or manage successful businesses.

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The information presented in this newsletter is not meant to be and does not consist of legal advice. Your legal situation turns on specific facts, and to take this information as advice could have serious negative consequences. If you would like to speak to an attorney, please contact Madison Business Law.

Arranging your Business from a Legal Standpoint: Entity Selection and Structuring

So you've decided to start your own business? Congratulations! While you focus on perfecting your product or service, finding distribution channels, and devising a marketing strategy, you could be missing important legal issues that must (MUST!) be dealt with as soon as possible.

because doing business as a general partnership is dangerous, plain and simple. By rule, every partner in a general partnership is responsible for all debts of the partnership, including debts that the partner doesn't know about and debts arising from torts in which the partner was in no way at fault.

Perhaps most importantly, you and your attorney need to think about your choice of entity or entities. If you are opening up shop with equity and/or sweat investment from other people, you have created a general partnership, whether you wanted to or not. While general partnerships have been recognized as a business entity for over 100 years, they have fallen out of favor with attorneys and business owners alike. This is

The simple solution is to form an LLC. This is true even if you're starting the business by yourself. The LLC designation costs \$130 to file in Wisconsin, plus \$25 each year to file an annual report. These expenses are miniscule compared to the protections those three letters provide. Say, for example, that your partner embezzles money from one of your clients. Without the LLC designation, a judgment

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would leave you liable to the aggrieved party to the full extent of their damages, even if your partner were available and able to pay. Organizing as an LLC protects your personal assets, so that only the money you have directly invested in the business is vulnerable. To be clear, the LLC designation would not protect your partner in this situation, nor would it protect you if you were involved in the scam or knew that it was happening.

I'd like to illustrate with another example. If one of your employees commits a tort on the job, your business is liable for any and all damages (you can require your employee to indemnify your business for things like this, but that's another topic for another day). Say he was texting his friends about fantasy football while delivering your product to vendors, wasn't paying attention and wrecked an ongoing construction project. There were no injuries, but the multiple judgments against your business has maxed-out your insurance coverage.

As long as you've been complying with simple requirements, the limited liability status will protect your personal assets from these judgments. However, a skilled attorney can help your business survive this incident as well, even as the LLC through which it operates is wiped out. Of course every situation is different, but it may be

possible to keep your vendor and supplier contracts, good will and intellectual property by validly transferring these rights and responsibilities to a new LLC.

By now, the advantages of limited liability entities should be obvious. However, the LLC is not always the best form to choose for your new business. If you plan to raise a lot of equity capital, you're better off forming a corporation (\$100 to file, \$25 each year for the annual report). Angel and venture investors will often only invest in corporations, as they value the ability to take the company public, which can realistically be done only with corporations. In addition, corporations may reward employee excellence with stock options, while LLC's cannot. Perhaps most importantly, the corporation form allows you to pay yourself and your partners a salary and count all additional earnings as distributions of profits, which are exempt from the 15.3% self-employment tax. And as long as the IRS continues to allow corporations to check-the-box to file as an "S-Corp," corporations can be exempt altogether from the corporate income tax (this advantage exists only if there are fewer than 100 shareholders, each of whom is an actual person).

When counseling your business on its initial choice of entity, a good lawyer will often find that it makes sense to organize or incorporate multiple business entities to be run

in conjunction with one another. Revisiting the example from before: I may have set up your business as a corporation owning a number of LLC's- one to operate the production business, one to operate the delivery business, and one to own the real estate. As long as each LLC were in compliance with state reporting laws and properly managed - with separate, adequately capitalized bank accounts - a civil suit for damages against the delivery LLC would have serious difficulty "piercing the corporate veil." Thus, your business' production operations and real estate holdings would be well protected.

Taking it one step further, you could have segregated delivery operations into an LLC staffing the drivers and separate LLC's for each delivery truck. This would leave only the staffing operation (with its few assets) and the truck involved in the accident accessible to judgment creditors (Bonus: if the company were to lease the trucks it would have even less to lose). Wisconsin courts have not yet developed this area of law, but at worst these protections would likely reduce any settlement your business may have to pay.

Of course, a good lawyer will get to really know your business to determine whether the protective benefits of defensive entity structuring would outweigh its additional legal and accounting costs and administrative burden.

If you're just starting your business, or think that some of the strategies discussed in this article may help protect your business assets, please don't hesitate to give Madison Business Law a call.

That's not Fair! The Perils of Sharing Profits Equally

When you and your partners start your business, it may be tempting to say that you'll just split everything equally- it's easy, it's fair and it just seems right. While the egalitarian approach might seem like your best course of action, it is ripe with problems that run deep, and could sink any business. Unless you've known your partners for many years and would trust them with your life, you may wish to proceed with caution when trusting them with your livelihood.

So what are the negative effects of splitting profits* equally among the partners? Worst of all, this

arrangement can breed apathy. Imagine a new business with three partners, each splitting profits equally. The simplicity of this arrangement is undermined by the way it has disconnected each partner's earnings from their productivity. Two partners are pounding the pavement, working nights and giving their all to the business and the third is giving literally nothing to the business. That third partner will still share equally come distribution time. Is that what you envision for your business? As if this situation weren't bad enough, as time goes on it will become more difficult for the two other partners to keep up their hard work. Eventually, the business starts to really suffer because nobody's giving a hundred percent. Before you know it, it's time to liquidate, dissolve and hope your personal liability isn't too deep.

"Unless you've known your partners for many years and would trust them with your life, you may wish to proceed with caution when trusting them with your livelihood."

Of course, nobody thinks this is going to happen- they wouldn't go into business with someone they know to be lazy. But it happens more than you'd like to think, and you may only get one chance to prevent it from ruining your career dreams.

Even if you and your partners continue to work hard and you grow a successful business, an equal profit sharing arrangement could leave your most productive partner (you, of course) feeling slighted. Whether you're working harder, understand the business better, bring in more clients or are just better at what you do, you've done more for your partners than

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Madison's Olbrich Gardens, photo: E. Schwarz

**Please note: In this article I don't use the textbook accounting definition of the word "profit." Instead, I use it to mean all of the money that partners earn from the business. I also use the word "partner" in lieu of "member," "shareholder," "unit-holder" and other more technical terms.*

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they've done for you and you should have the right to be compensated for that. Unfortunately, you probably won't be able to count on your partners to realize your superior contributions. People can be pretty touchy when money is involved (and especially so when you're telling them that you deserve more of it than they do).

Lastly, though this happens much less frequently than the underachiever and overachiever problems described on the previous page, splitting profits equally leaves much more wiggle room for a dishonest partner to steal from the business. This is because the dishonest partner will be stealing from a bigger "pot" of money. Let's hope this will never be an issue for you.

So what terms can a good lawyer put in your partnership agreement to better align partners' payouts with the value they bring to the business?

If your business has established a consistent cash flow, one simple way is to pay each partner an hourly wage. This will ensure that nobody can fully reap the benefits of the business without actually *working for the business*. You could be more specific, setting different wages for different types of work and setting a minimum number of hours each partner must work and a maximum numbers of hours each partner can be paid for, and even set minimums and maximums for

each type of work. Remember, as a partner sharing in the profits of the business, you are considered management and your work and payment are outside the scope of state and federal employment laws.

Even if your business has not established a steady cash flow, you could put in wage provisions that will kick in after certain time or revenue milestones, and can even include provisions for back pay.

If you run a service business in which each dollar of revenue can be attributed directly to work performed by a partner, it makes sense to tie each partner's share of profit to the work they complete. In this situation, you have to be careful to fairly distribute the risk of a client's non-payment among the partners. Otherwise you may be basing a portion of each partner's compensation on luck alone.

I recently organized an LLC in which each partner was paid 70% of the time they bill, with the remaining payments going 20% to the business to pay expenses and 10% as a finder's fee to the member or members who brought in the work (even if it was the same member who did the work). This is a rather extreme example, but it works well for a group who view their business primarily as a synergy of their own individual services.

If your business requires multiple partners to work collaboratively on project or product development and you are averse to paying yourselves a wage, you and your



photo: WI Dept. of Natural Resources

partners can implement a "scoring system." This arrangement asks each partner to rate each other's contributions at intervals throughout the project. The advantage, of course, is that everyone continues to have a reason to impress their partners with their work. However, careful planning will be necessary to prevent alliances from forming and funneling profits to certain partners.

There are many ways to structure your partnership's profit sharing, with different levels of risk and reward. It's important that you and your attorney think hard about what will work for your business and discuss it at length. There are many important decisions to make in your partnership agreement, but this provision will almost definitely be the most important.

Madison Business Law is happy to help you and your partners figure out what works best for you.

There are many important decisions to make in your partnership agreement, but earnings distribution will almost always be the most important.

Starting with a Clean Slate: the Importance of Knowing Your Contractual Obligations

If you want to start a business similar to one you've recently worked for, you may run into problems with a non-competition agreement. Many businesses require their employees to sign these, which prevent the employee from engaging in competitive enterprise during and for a period after their employment. These agreements typically include provisions requiring confidentiality, protection of trade secrets, and non-interference with the employer's ongoing business.

Though Wisconsin courts have viewed these agreements unfavorably, they will be enforced if they are necessary for the employer's protection and require only reasonable restriction of the employee's conduct. These restrictions must not be overbroad

in terms of time or location and must not prevent the employee from earning a living. Also, they must be supported by consideration- meaning that the employer must give something in return for the employee's promise.

Most companies have retained good counsel to draft these agreements so that they are enforceable. Therefore, it is important that you review these agreements with counsel to determine their enforceability and applicability to you.

If you move forward with your business in a way that breaches these agreements, you could be looking at a nasty set of damages, such as an injunction preventing you from developing your new business and liability for any losses

your former employer can attribute to your actions (including costs of hiring, lost profits and anything else they can make a case for) including their attorneys' fees, which can quickly run over \$10,000.

New businesses are often started on a shoestring budget, with partners worrying about their living expenses in addition to their business costs. A "damn the torpedoes" attitude towards restrictive covenants that you've signed might let you build your business how you want to in the short run. However, no matter how big you can grow it, a business built on shaky foundations can crumble, leaving you with a heavy debt load and stinging regret. A small consolation: at least you'll know to do it right next time.

Editor's Desk: A Letter to the Business Community

Dear Friends:

I became a business lawyer because I love to negotiate tough issues and draft contracts. What I didn't realize until I started practicing solo is that the most rewarding aspect of my job is not the time spent at the negotiating table or poring over a Word document, but instead the knowledge that my work saves my clients time, money and sometimes even their reputation. Ok, you got me- I never thought time spent going through a Word document would be the most rewarding part of the job (though I really do enjoy it).

In the time I've been a solo practitioner, I've had the opportunity to meet hundreds of great people, with interesting ideas and a strong commitment to success and a better community. I continue to look forward to helping these people bring their ideas to fruition and protect their interests so that their hard work can build their business, employ more people and make the Madison area an even better place to work and live!

Here's to your success!



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