

**Legal Risk Management Tip**  
**September 2016**

**CONSIDERATIONS WHEN FORMING A NEW BUSINESS**

You're walking down the street one day when it suddenly hits you – the perfect idea for a mobile application (“app”). This is the app that’s going to change everything. This app is straightforward, user-friendly and something that everyone wants and needs. After frantically searching every corner of the internet to check if something like this is already in the market, and finding nothing, you decide it’s time for you to start a business around this great idea. Having never owned or operated a business before, you start wondering what you should be thinking about when getting your business off the ground. This article will help summarize some of the more immediate items you should consider when setting up your business.

**A. Choice of Entity**

You have the idea, you even thought of a great name to call yourself, now you need to think about which entity structure should house your new business. There are several entity structures available to you for review – the most common types being a sole proprietorship, limited liability company (“LLC”) or corporation. It is important to note that entity choices are state specific in that entities are not governed at the federal level, but rather you organize at the state level. Each state has its own laws that govern the actions an entity may perform. Thus, you should carefully review the laws of your home-state to ensure your new entity is in compliance with applicable state law. Some of the more pressing matters to consider in choosing your entity should include, but are not limited to, the following:

**1. Liability Protection**

Certain entity structures, such as LLCs and corporations, provide their owners certain protections pursuant to a principle referred to as “limited liability.” Generally, the principle of “limited liability” provides that the owners of a business (such as “members” in a LLC or “shareholders” in a corporation) cannot be held personally liable for the debts, obligations and other liabilities of the entity itself, or for the acts of any other owner, agent or employee of the entity.<sup>1</sup> Thus, an owner’s financial liability for the company’s debts is generally limited to the value of the owner’s interest in the company (i.e., the amount the owner paid to obtain ownership in the company), but does not extend to the owner’s personal assets. In contrast, the owners of businesses that do not provide limited liability protections, such as sole proprietorships and the partners of general partnerships, are personally at risk for the liabilities of their businesses. These protections are extremely important to help ensure that a business owner is only taking on risk in the business, and are not jeopardizing their personal assets should the business falter. As a point of clarification, however, it should be noted that owners are still liable for their own actions as the limited liability principle does not protect owners from their own bad acts such as negligence, malpractice and other errors and omissions.

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<sup>1</sup> See <http://www.businessdictionary.com/definition/limited-liability.html>.

## **2. Tax Considerations**

There are no requirements that a business be housed as an entity. Those who operate a business as a sole proprietorship for instance, without forming an entity, will be directly taxed on the business income and gain via their personal tax returns. Conversely, should you choose to utilize an entity structure for your business, different tax structures apply to different entity types. For instance, corporations may be classified as C corporations or S corporations. As a general rule, C corporations are taxed twice on business income - once when earned by the corporation, and again when that income is distributed as a dividend to the shareholders. Conversely, income and gains earned by flow-through entities, like S corporations (and typically LLCs, unless elected to be taxed otherwise), are generally taxed only once - to the owners when earned. Beyond the method of taxation itself, other tax considerations need to be reviewed when choosing an entity. For example, there are differences between entities and the types of pension benefits or medical benefits which may be deductible and available to owners of the company. Further, owners of the business that also serve as employees may have income and capital gains taxed differently to the benefit of the owner. As such, it is important to consider how you anticipate your business to operate, and find an entity whose tax structure best aligns with the business.

## **3. Capital Raising**

In all likelihood, your new business will need to secure outside capital in order to cover expenses before your product hits the market and becomes profitable. There are two primary ways of obtaining such capital – debt and equity. Debt is obtained when the company borrows capital with the promise of returning that capital in the future (such as with a bank loan, bridge loan or promissory note). Equity financings occur when a business is not promising to return the capital; rather, the capital is going towards purchasing ownership interests in the company (such as selling shares of a corporation or membership interests in a LLC). The type of entity selected can help facilitate these investments by others, while others have certain restrictions that may limit or prevent certain investors. For instance, as a general rule, any person or entity can be a shareholder of a C corporation. However, S corporations have certain limitations placed upon them by the Internal Revenue Service (“IRS”) as to the types and number of investors.<sup>2</sup> Additionally, certain types of investors (such as venture capitalists<sup>3</sup>), while permitted to be LLC owners, may be reluctant to invest directly in an LLC taxed as a partnership without additional tax planning, or additional safeguards included as part of the LLC’s operating agreement.

## **B. Intellectual Property (“IP”) Considerations**

Your ability to have your ideas recognized as your own, and retain sole ownership over that idea, is what will (at least initially) generate the core value of your business. Intellectual Property (“IP”) refers to creations of the mind, such as inventions; literary and artistic works; designs; and

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<sup>2</sup> Pursuant to the IRS, to qualify for S corporation status, the corporation must meet the following requirements: (i) be a domestic corporation, (ii) shareholders must only be comprised of individuals, certain trusts and estates, (iii) no more than 100 shareholders, (iv) only one class of stock is permitted, and (v) cannot be an “ineligible corporation” as defined in <https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations>.

<sup>3</sup> A venture capitalist is an investor who either provides capital to startup ventures or supports small companies that wish to expand but do not have access to equities markets. For more information, *see* <http://www.investopedia.com/terms/v/venturecapitalist.asp>.

symbols, names and images used in commerce.<sup>4</sup> There are various laws designed to protect differing types of IP, such as trademarks, service marks, patents, copyrights and trade secrets. The general idea behind all of these legal structures is the same – to try and protect the innovation of an idea, process or item. Therefore, it is important to recognize the IP inherent to your business, and keep in mind that all aspects of the business – including employees, processes, thoughts, concepts and ideas, can potentially be included as part of your company’s IP in one way or another. When protecting your IP, some of the factors to keep in mind include:

### **1. Timing**

Before spending resources on efforts to sell your product, you want to first register and secure your IP rights. Timing is important in protecting these rights as you want to be able to prove that you conceived the idea, and the processes by which it operates, prior to anyone else. As such, early capital should be designated to help evaluate and protect your company’s IP rights. You should also keep thorough books and records of such things as the date of creation, any iterations and steps you have taken to protect your IP in order to assert your rights and defend any infringement accusation that may arise in the future.

### **2. Jurisdiction**

Depending upon the type of IP you are seeking to protect, you may need to register your IP at the state or federal level, or both. Further, if you are planning on operating outside of the US, you must register your IP in foreign jurisdictions as well. Working with a professional familiar with the laws of the appropriate jurisdiction is strongly recommended to ensure your IP is protected.

### **3. Partnering with Service Providers**

It’s not impossible that you alone have everything necessary to operate your business, including superior technological skills, marketing experience, contacts with distributors and a source of sufficient capital to initially operate your business. However, in all likelihood, you are going to need to partner with certain service providers (such as attorneys and accountants), investors and a slew of other strategic partners to get your great idea to market. As such, it is critical how you approach these relationships. Your ability to profit from your idea resides in your ability to keep your idea your own. As such, be sure that prior to working with any service providers you have agreements in place to protect your confidential information and intellectual property. Simple “hand-shake” arrangements are insufficient. This is especially important for service providers you may partner with early in the business’ life-cycle, when your intellectual property may not yet qualify for protection.

## **C. Growing Your Business – Marketing and Manpower**

It is important to remember that you are in control of your business. You need to decide where you want the business to go, and how you’re going to get there. While this sounds like a simple concept, it encompasses a vast array of considerations for you to consider. Paramount to any business succeeding are the concepts of who will be assisting in your efforts, and how you will find customers.

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<sup>4</sup> See <http://www.wipo.int/about-ip/en/>.

## **1. Employees Versus Independent Contractors**

Whether you decide to start your business as a solo practice, or partnering with others, a time will undoubtedly come when you will need additional assistance in operating the business. The question that is often asked is, “should I hire someone as an employee, or an independent contractor?” This is a complex concept that can have broad financial, tax and legal repercussions to the business and its operations. It is recommended that you thoroughly vet the type of association you wish to encourage for your business, and what steps will need to be taken to ensure that your business is compliant with relevant law.

## **2. Marketing Efforts**

Letting others know about your business is oftentimes the most significant hurdle any business will face. As the business grows, how, where and when the business conducts its marketing efforts will change. It is important to note, however, that, while most view marketing as a creative endeavor, there are important legal considerations that should be examined as well. For example:

- When should you begin to market and what should be distributed? As discussed above, you want to be mindful of your firm’s IP protections – even when marketing. Enabling Public Disclosure (“EPD”) is a legal term that means you have had non-confidential communication with others, or publicly shared enough about your product to allow an appropriately experienced individual (a person having ordinary skill in the art) to reproduce your product.<sup>5</sup> Thus, it is important to be sure that any marketing efforts do not destroy IP rights to which you may be entitled.
- How can you find and contact potential clients? Before you send marketing collateral via email or direct messages, you need to collect the contact information of your potential customers. However, the process of collecting and using this information is immersed in privacy, non-solicitation and other legal considerations. Such rules are typically promulgated by each individual state.<sup>6</sup> Before performing such targeted marketing efforts, you should be familiar with rules governing data collection processes and methods of use.
- What should you say in your marketing materials? The Federal Trade Commission (“FTC”) enforces regulations governing truth in advertising.<sup>7</sup> Depending upon your business type, additional rules governing what can be said, what needs to be disclosed and proof of licensure may also be required. Before disseminating any marketing materials, it is important that the content be reviewed both in a general context, as well as specific to industry regulations that may be applicable to the business.

## **D. Conclusion**

As evidenced above, there are multiple considerations when starting a business; and the ideas expressed herein only scratch the surface. Importantly, even if you have operated your business for a significant amount of time, these and other considerations must be weighed. Whenever your

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<sup>5</sup> See [https://en.wikipedia.org/wiki/Public\\_disclosure](https://en.wikipedia.org/wiki/Public_disclosure).

<sup>6</sup> For example, the California Online Privacy Protection Act requires certain disclosures be made, including but not limited to: (i) the kinds of information online marketing tactics collect, (ii) how the information may be shared, (iii) the effective date of your policy, and (iv) processes customers can follow to obtain or limited the information you may have on them. For more information, see <http://www.leginfo.ca.gov/cgi-bin/displaycode?section=bpc&group=22001-23000&file=22575-22579>.

<sup>7</sup> See <https://www.ftc.gov/tips-advice/business-center/guidance/advertising-marketing-internet-rules-road>.

business expands, changes or launches a new product or service, new legal and regulatory considerations become applicable. Each entrepreneur should carefully review his or her own business to identify those areas that need to be addressed in order to promote a long and profitable enterprise.

For more information on these and other considerations, please contact us at [info@jackolg.com](mailto:info@jackolg.com), or (619) 298-2880. Also, please visit our website at [www.jackolg.com](http://www.jackolg.com).

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