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THE SMALL- BUSINESS CONTRACTS HANDBOOK

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THE SMALL-BUSINESS CONTRACTS HANDBOOK

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Lawrence Hsieh, Attorney at Law



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NOTICE TO READERS

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*To my all-star team; wife Janice, and children Jennifer and Jason,
who amaze and inspire me every day.
Thank you to Janice, and to my mom and dad,
for believing in me.*



INTRODUCTION

The Small-Business Contracts Handbook is a resource of first resort to help you, the small-business person and entrepreneur, understand and negotiate a wide variety of legal provisions found in common business contracts. The marketplace is filled with a dizzying array of legal resources, including good books and websites that offer do-it-yourself contract forms for non-lawyers, as well as highly technical treatises and books on the finer points of contract drafting for practicing attorneys and law students. But it occurred to me a few years ago that there are very few resources that actually break down and explain the meaning of common contract provisions (both deal-point and boilerplate) in a way that savvy businesspeople without formal legal training would find useful in their contract negotiations. Enter *The Small-Business Contracts Handbook*.

Non-lawyers are often bewildered by the legal jargon contained in business contracts. I add value by presenting ideas, concepts, and facts that are common knowledge to and used every day by experienced practicing attorneys, but in plain English, in a way that is easy for non-lawyers to understand. This book will arm you with the know-how to enable you to effectively negotiate your transactions, as well as work and communicate more efficiently with your attorney.

While I explain the meaning of many individual contract provisions, I've chosen not to include any complete contract "forms" in the book. Many small businesses purchase or download complete contract forms and use them without careful consideration of all the issues. This one-size-fits-all approach can be dangerous because there are at least two parties with different interests in every business transaction. Furthermore, forms are often passed down from deal to deal and from attorney to attorney. So you may think you're starting off with a bulletproof form (advantageous

to you) when in fact, the form may contain provisions that are very much against your best interests, or in some other way significantly watered down or ambiguous in a way that can harm you.

I will present individual contract provisions (organized by topic), explain their meaning, and offer commonly accepted ways that attorneys leverage the provisions to their advantage.

Chapters include sections on corporate infrastructure (including contract provisions found in shareholder agreements and LLC operating agreements), business transactions (including contract provisions found in agreements for the sale of goods and services, asset purchase and stock purchase agreements for the sale of a business, non-disclosure agreements to protect confidential information, loan agreements, etc.), and contract boilerplate (including contracts provisions found at the end of just about every business contract).

If you have any questions or comments, I invite you to visit my blog, the Contract Adviser, located at <http://contractadviser.com/blog>.

Part I

CORPORATE STRUCTURES





1

BUSINESS ENTITY SELECTION

OVERVIEW

Most readers will already be familiar with the different types of business entities, as well as basic formation documents like a corporation's certificate of incorporation and bylaws. There are plenty of good resources, including free resources on the Internet, comparing the pros and cons of forming one type of entity versus another; for example, a corporation versus a Limited Liability Company (LLC), as well as companies and websites offering the basic formation documents and forms for sale or for free.

While I include a summary of these basic issues in this chapter, I devote the bulk of this section to explaining contract provisions found in the agreements governing the legal relationship between the owners of business entities — the LLC Operating Agreement, and its corporate cousin, the Shareholder Agreement (a.k.a., Stockholder Agreement).

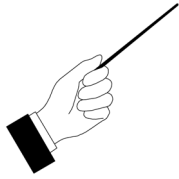
ENTITY SELECTION

The Entity Selection Chart (Table 1) contains basic information comparing the five principal forms of small-business ownership with respect to formation and ownership, liability of owners for business obligations, availability of pass-through taxation, and management/authority to sign contracts. Consult with your attorney and tax advisor on your particular situation, including the availability of methods to convert from one form of business ownership to another.

TABLE 1: Entity Selection Chart

Form of business ownership	C Corporation	S Corporation	Limited Liability Company (LLC)	Limited Partnership	Sole Proprietorship/ General Partnership
Formation/ Ownership	A corporation is a business entity formed by filing a certificate of incorporation (or equivalent document) with the state's secretary of state. For federal income tax purposes, corporations are "C corporations" by default (pass-through tax not available – see discussion below). The owners are referred to as shareholders or stockholders .	A Subchapter S corporation is a corporation that elects pass-through income tax treatment by filing IRS Form 2553 (Election by a Small Business Corporation).	A limited liability company (LLC) is a business entity formed by filing a certificate of organization (or equivalent document) with the state's secretary of state. An LLC is a hybrid entity that offers limited liability to its owners (referred to as members), like a corporation, and pass-through income taxation, like a partnership or proprietorship.	A limited partnership is a pass-through business entity with two classes of owners. The owners consist of at least one general partner , and at least one limited partner .	A sole proprietorship is a business owned and operated directly by one person, but not through a business entity. A general partnership is a business owned and operated by at least two people, but not through a business entity.
Minimum (or maximum, if applicable) number of owners	At least one shareholder.	At least one shareholder, but an S corporation cannot have more than 100 shareholders. They must be natural person U.S. citizens or residents.	At least one member. Members can be U.S. or foreign natural persons or business entities.	At least one general partner and one limited partner.	A sole proprietorship by definition has one owner. A general partnership must have at least two owners.
Liability of owners	The owners (shareholders) have limited liability for the obligations of the business. This means that the shareholders are liable for the debts of the business only up to the amount of their capital contributions. Once that money is gone from the corporation and if there are no other corporate assets, then the creditors cannot go after the shareholders' personal assets. Creditors, however, can hold shareholders personally liable for business obligations if the shareholders run the business "personally" and not through the corporation, for example, by not keeping separate corporate records, commingling corporate and personal funds or assets, or chronically and severely undercapitalizing the company. Basically, if the shareholders disregard the corporation, so too will a court when creditors seek compensation when the company is insolvent.	An S corporation election does not impact the limited liability of the shareholders. S corporation shareholders have the same limited liability enjoyed by C corporation shareholders, subject to the same exceptions.	The owners (members) have the same limited liability as that enjoyed by corporate shareholders, subject to the same exceptions.	The general partners are jointly and severally liable for the obligations of the business. Provided the limited partners do not participate in management, they have the same limited liability as that enjoyed by corporate shareholders.	A sole proprietor is personally liable for the obligations of the business. The general partners are jointly and severally liable for the obligations of the business.

<p>Liability of owners <i>continued</i></p>	<p>A shareholder is also personally liable if, among other acts, he or she commits fraud on behalf of the corporation, injures somebody (a tort) while acting on behalf of the corporation, or affirmatively guarantees the corporation's obligations. The last act, of signing a guarantee, is a way of signing away a shareholder's limited liability by contract.</p>	<p>The default rule for corporations is two-tiered taxation. C corporations must pay income tax on their profits. If the corporation makes a dividend distribution of its profits, then that profit is taxed again to the shareholders. Small business C corporations typically avoid this "double tax" impact by paying its shareholders salary and bonus (which are deductible expenses), rather than dividends (which are not).</p>	<p>The shareholders must affirmatively elect pass-through tax treatment (i.e., Subchapter S status) by filing IRS Form 2553 (Election by a Small Business Corporation). This will enable each shareholder to report his or her share of the business' profits (and losses) on his personal income tax return, even if the shareholder doesn't take any profits out of the business.</p>	<p>The default rule for LLCs is pass-through taxation (see next paragraph) – each member reports his or her share of the business' profits (and losses) on his or her personal income tax return, even if the member doesn't take any profits out of the business. "Check the Box" Rules – The Internal Revenue Service classifies LLCs for tax purposes as a corporation, partnership or sole proprietorship. A multi-member LLC is treated by default as a partnership for income tax purposes (pass-through taxation) unless it elects to be treated as a corporation for income tax purposes by filing IRS Form 8832, Entity Classification Election. A single-member LLC is treated by default as a sole proprietorship ("disregarded entity" with pass-through taxation) unless the owner elects corporate income tax treatment by filing Form 8832.</p>	<p>The default rule for sole proprietorships and partnerships is pass-through taxation. Each owner reports his or her share of the business' profits (and losses) on his or her personal income tax return, even if the owner doesn't take any profits out of the business.</p>
<p>Availability of pass-through taxation</p>	<p>The default rule for corporations is two-tiered taxation. C corporations must pay income tax on their profits. If the corporation makes a dividend distribution of its profits, then that profit is taxed again to the shareholders. Small business C corporations typically avoid this "double tax" impact by paying its shareholders salary and bonus (which are deductible expenses), rather than dividends (which are not).</p>	<p>The shareholders must affirmatively elect pass-through tax treatment (i.e., Subchapter S status) by filing IRS Form 2553 (Election by a Small Business Corporation). This will enable each shareholder to report his or her share of the business' profits (and losses) on his personal income tax return, even if the shareholder doesn't take any profits out of the business.</p>	<p>The default rule for LLCs is pass-through taxation (see next paragraph) – each member reports his or her share of the business' profits (and losses) on his or her personal income tax return, even if the member doesn't take any profits out of the business. "Check the Box" Rules – The Internal Revenue Service classifies LLCs for tax purposes as a corporation, partnership or sole proprietorship. A multi-member LLC is treated by default as a partnership for income tax purposes (pass-through taxation) unless it elects to be treated as a corporation for income tax purposes by filing IRS Form 8832, Entity Classification Election. A single-member LLC is treated by default as a sole proprietorship ("disregarded entity" with pass-through taxation) unless the owner elects corporate income tax treatment by filing Form 8832.</p>	<p>The default rule for sole proprietorships and partnerships is pass-through taxation. Each owner reports his or her share of the business' profits (and losses) on his or her personal income tax return, even if the owner doesn't take any profits out of the business.</p>	<p>The default rule for sole proprietorships and partnerships is pass-through taxation. Each owner reports his or her share of the business' profits (and losses) on his or her personal income tax return, even if the owner doesn't take any profits out of the business.</p>
<p>Management/ Authority to Sign Contracts</p>	<p>Corporations are managed under the direction of the board of directors. Officers, who are elected by the directors, have day-to-day management authority, and can sign contracts on behalf of the corporation.</p>	<p>LLCs can be member managed (managed equally by the owners) or manager managed (managed by the designated owners or third party, similar to the way a corporation would be managed). The managers can sign contracts on behalf of the corporation.</p>	<p>LLCs can be member managed (managed equally by the owners) or manager managed (managed by the designated owners or third party, similar to the way a corporation would be managed). The managers can sign contracts on behalf of the corporation.</p>	<p>Limited Partnerships are managed by the general partner. General partners can sign contracts on behalf of the business. Limited partners enjoy limited liability if they do not participate in management.</p>	<p>The owners manage the business, and can sign (or designate officers who can sign) contracts on behalf of the business.</p>



DBA stands for “Doing Business As.” If a sole proprietor, corporation, or any other business entity wishes to conduct business under any name other than his, her, or the business’s legal name, then he, she, or it must register its fictitious or assumed name with the respective state’s secretary of state.

Keep in mind that only legal persons (individuals or business entities like corporations, LLCs, etc.), may enter into business contracts. A DBA is not a legal entity. So when a business with a DBA enters into a contract, it should sign the contract as “[Legal Name] DBA [Fictitious Name].”



2

ORGANIZATIONAL DOCUMENTS

OVERVIEW

This chapter will discuss selected provisions contained in a corporation or Limited Liability Company's (LLC) formation documents. These include a corporation's certificate of incorporation (or equivalent document), and an LLC's certificate of organization (or equivalent document). These certificates are filed with the secretary of state in the state in which the corporation or LLC is formed.

For small corporations, the **certificate of incorporation** is a relatively short document, typically one to two pages long, because small businesses usually only need to issue one class of common stock. If the corporation plans to issue more than one class of stock, then the certificate will be quite a bit longer because it needs to set forth in some detail the relative rights and preferences of the different classes of stock (see the **Capital Stock Quick Primer** later in this chapter). The certificate of incorporation will contain provisions listing the name and address of the corporation, as well as the name and address of the registered agent who is authorized to receive service of process on behalf of the corporation in a lawsuit.

A corporation's **bylaws** is a private document that is not filed with the secretary of state. While the bylaws establish ground rules for corporate governance (e.g., conduct of shareholder and board meetings, voting, etc.), the bylaws are not a substitute for a well-drafted shareholder agreement. For example, "buy-sell" provisions, which establish the rights and obligations of the shareholders when one of them dies, becomes disabled, or wants to transfer shares, are beyond the scope of the bylaws, and typically are found in shareholder agreements (see Chapter 3 for more about shareholder agreements).

An LLC is formed by filing a short **certificate of organization**, but does not have bylaws. Rather, LLC members may enter into a contract called an **operating agreement** (state law sometimes makes this optional) that contains not only basic bylaw-type provisions dealing with general governance, but also buy-sell and other shareholder agreement provisions. Shareholder agreements and operating agreements are discussed in more detail in Chapter 3.

SAMPLE CONTRACT EXCERPTS

Certificate of Incorporation/LLC Certificate of Formation — Business Purpose

The purpose of the Company is to engage in any lawful act or activity for which corporations [limited liability companies] may be organized under the [insert name of applicable law, for example, General Corporation Law of State of Delaware], as amended from time to time, or any successor thereto.

For most small businesses, it's enough to include something similar to this general purpose provision. In fact, a more detailed purpose provision could hamstring your expansion efforts down the road. Consult with your attorney if you are forming a corporation (typically a Professional Corporation or PC) to engage in professional practice, like law, in which case the certificate of incorporation will need to include a more detailed description of the business purpose. Note that I use the term “Company” throughout the book for consistency. The term “corporation” is typically used to describe the Company in the certificate of incorporation and bylaws.

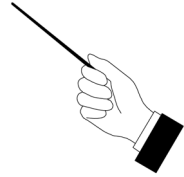
Certificate of Incorporation — Authorized Number of Shares

The total number of shares of capital stock that the Company is authorized to issue is [insert number] shares of common stock, without par value.

The authorized number of shares is the maximum number of shares the corporation can issue. See the Capital Stock Quick Primer later in this chapter for a discussion of frequently used terminology such as authorized, issued, outstanding and treasury shares. Consult with your attorney on the optimal number of authorized shares in your state — the optimal number of authorized shares is often the maximum number of shares you can authorize while paying the minimum incorporation fees, which will vary by state.

What Is Par Value?

Par value is the nominal dollar amount assigned by the corporation to a class of stock. Consult with your attorney as to whether your state mandates or gives a choice of designating par or no par stock. For small businesses issuing only common stock, the notion of par is somewhat dated — shares typically are issued for an amount necessary to adequately capitalize the company, which is usually much greater than the nominal par amount.



Preemptive Rights

No preemptive rights exist with respect to shares of capital stock or securities convertible into or exchangeable for shares of capital stock of the Company, whether now or hereafter authorized or issued.

If the Company is free to issue shares to whomever it wants, it will dilute the ownership of the existing shareholders. Preemptive rights help the existing shareholders maintain their proportionate ownership (and therefore voting power, right to profits, etc.) by entitling the existing shareholders (typically common shareholders) the right to purchase newly issued shares of stock (or securities convertible into shares of stock) before they are offered to third parties. However, such provisions may place the Company at a disadvantage when seeking third party equity financing to grow the Company. Consult with your attorney and financial advisor on whether preemptive rights are appropriate for your situation. State law varies, so consult with your attorney on whether preemptive rights are automatically granted or denied, or must be affirmatively provided for or denied in the company's certificate of incorporation. Note that preemptive rights can also be granted by contract, and may be provided for in the company's shareholder agreement or operating agreement.

Bylaws

Shareholder Vote — Majority versus Plurality

The election of directors is determined by a plurality of the votes cast at a meeting of Shareholders at which the number of Shareholders representing a quorum is present in person or by proxy.

A majority is a situation where over half of the votes are cast for one of usually two choices, whether regarding a vote on a specific issue or the election of directors. A plurality is useful in situations when there are at least three choices (like the provision presented here for the election of directors), and is defined as a situation where one choice receives more votes than any of the other choices.

Shareholder Vote — Cumulative Voting

At all elections of directors duly called and held, each Shareholder entitled to vote has the right to cast as many votes as are equal to the product of the number of

- (i) directors to be elected and
- (ii) shares owned by such Shareholder. Such Shareholder may cast all such votes for a single director or may distribute them among any two or more of them in any manner as he or she may see fit, and the directors receiving a plurality of the votes cast shall be elected.

There are two main voting systems for the election of board members. Let's look at an example — a hair salon business owned by Harry Cutter, Manny Cure, Buzz Barbur, and Aldo Stiles. If they form a corporation with each person owning 25 shares of common stock and a board of four directors, then the outcome of the board elections could differ depending on whether the corporation's bylaws call for statutory or cumulative voting.

In either statutory or cumulative voting, each shareholder would be entitled to one vote per share for each vacant board seat. So in this example, each shareholder would have 100 votes (25 shares multiplied by the four vacant board seats). The difference between statutory and cumulative voting is how each shareholder is able to allocate his or her total number of votes.

In **statutory voting**, which typically controls if the bylaws are silent, each shareholder in the example can only vote up to 25 shares for any one candidate. The likely outcome in a non-dysfunctional business would be that the four shareholders would end up filling the four board seats. Statutory voting favors large shareholders — if Harry owned 51 out of the 100 issued and outstanding shares, he would control who fills each board position, including the ability to bring in an outside director of his choosing.

In **cumulative voting** (see sample contract provision above), however, each shareholder would be entitled to vote his 100 shares any way he or she liked. The shareholder could allocate 25 votes to each of the four candidates, all 100 shares to just one candidate (and not vote for anybody else), or any allocation in between. Cumulative voting helps minority shareholders with fewer votes be able to combine votes to vote for their most favored candidates.

Certificate of Incorporation and/or Bylaws

Exculpation of Personal Liability of Directors

A director or officer of the Company shall not be liable to the Company or its Shareholders for breach of fiduciary duty, except to the extent that exculpation from liability is not permitted under applicable law in effect at the time such liability is determined. No amendment or repeal of this paragraph applies to or has any effect on the liability or alleged liability of any director or officer of the Company with respect to any acts or omissions of such director or officer occurring prior to such amendment or repeal.

Consult with your attorney about the extent to which your state corporate law allows the Company to include exculpatory provisions in the certificate of incorporation that limit or eliminate the personal liability of directors (or even officers, employees, and agents) to the Company or shareholders for damages arising from acts undertaken by such persons on behalf of the Company. Companies often include exculpation (and indemnification provisions, discussed below) in their charter documents to enable them to recruit and retain management. For smaller companies whose shareholders also run the business, these provisions provide yet another layer of personal asset protection.

The sample provision works to insulate the directors from personal liability for acts undertaken on behalf of the Company. Keep in mind, however, that these provisions don't work to protect the directors from personal liability for a director's intentional misconduct, illegal behavior, reckless acts, or omissions, as well as a director's involvement or approval of any deal in which the director gained an improper personal benefit (called Improper Behavior).

Indemnification of Directors

- (a) To the fullest extent permitted by law, the Company shall indemnify, hold harmless, and defend ("indemnification") any person (an "Indemnified Party") who is or was a party or is threatened to be made a party to any threatened, pending or completed claim, demand, action, suit, or proceeding, whether formal or informal, civil, criminal, administrative, or investigative (the "Action(s)"), by reason of the fact that such person is or was or has agreed to be a director or officer of the Company, from and against any and all damages, losses, and liabilities incurred by such person, including, but not limited to, [reasonable] attorney fees and expenses, judgments, fines, penalties, and amounts paid in settlement incurred in connection with any such Action.

Indemnification provisions work hand-in-hand with exculpation provisions (discussed above) to limit or eliminate the personal liability of the directors for acts undertaken on behalf of the Company. Subsection (a) provides the basic framework for the Company's indemnification of past and present directors in the widest range of proceedings.

The provision can also be drafted to include the provisional advancement of litigation expenses such as attorney fees to a director pending the resolution of the Action. Since the advance is provisional, the Company advances the funds regardless of the director's behavior. If it's later determined that indemnification is appropriate, the advance merely becomes part of what would have had to be indemnified anyway. If it's later determined that indemnification is not appropriate (for example, because of improper behavior), then the director has to return the advance.

- (b) Notwithstanding anything herein to the contrary, no indemnification shall be made under subsection (a) above to the extent a judgment or other final adjudication establishes that the Indemnified Party
 - (i) engaged in fraudulent or intentional misconduct or a knowing violation of law, that was material to the Action, or
 - (ii) personally gained a financial profit or other advantage to which he or she was not legally entitled.
- (c) Notwithstanding anything herein to the contrary, no indemnification shall be made under subsection (a) above for any Action initiated by an Indemnified Party unless such Action (or part thereof) was brought to enforce the Indemnified Party's rights to indemnification hereunder.

Subsection (b) works to disqualify Improper Behavior from the right to indemnification. In the sample contract provision, indemnification is limited to the defense of Actions; Subsection (c) excludes an Indemnified Party's counterclaims from indemnification.

- (d) Such indemnification is not exclusive of other indemnification rights arising under any agreement, Director or Shareholder consent, or otherwise. No amendment or repeal of this paragraph shall affect any indemnification of any director or officer of the Company with respect to any acts or omissions of such director or officer occurring prior to such amendment or repeal.

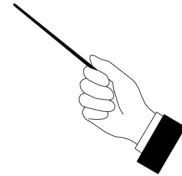
Despite the general statutory authority to include indemnification provisions, the enforceability of these provisions is the subject of much litigation. Hence, the case law in this area is constantly shifting, for example, relating to the indemnification of past directors for acts or omissions that took place before the Company amended its certificate of incorporation or bylaws to eliminate the indemnification provision. Subsection (d) is meant to address this issue, but it may be better for the director to also enter into an indemnification contract with the Company; contracts generally cannot be "amended or repealed" without each party's (including the director's) consent.

Capital Stock Quick Primer

Ownership in a corporation is represented by shares of capital stock. Capital stock consists of common stock and preferred stock. Most small businesses issue only common stock, which typically conveys full voting rights. Preferred stockholders have a prior claim (before common stockholders) on dividends and the assets upon dissolution. Preferred stockholders may have limited voting rights. Then there are the various calls, options, puts, rights, warrants, or other “securities” that entitle the holder to obtain shares of capital stock convertible at some future date or based on some other triggering (financial or other) event.

The certificate of incorporation will list the types, as well as the number, of shares (and other “securities”) the corporation is authorized to issue. The authorized number of shares is the maximum number of shares the corporation can issue. It’s a good idea to issue just a portion of the shares. If a corporation has 1,000 authorized shares, and issues 250 shares to Tom and 250 shares to Josie, then the company has issued 500 shares, with the balance of the shares deemed “unissued shares.” Unissued shares have no impact on percentage ownership. In other words, Tom and Josie each own 50 percent of the company. Think of unissued shares as shares that are held in reserve until the corporation needs to issue more shares. If a corporation issues all of its shares, then if it needs to issue more shares at a later date, it’ll have to engage in the time-consuming and relatively expensive task of amending the certificate of incorporation to authorize the additional shares.

Once Tom and Josie pay the company for the shares, then the shares are deemed to be fully paid and non-assessable. If at a later date, the company repurchases some of Tom’s or Josie’s shares, and then the company holds such shares, it is deemed to hold on to them in the form of treasury stock. Tom and Josie own issued and outstanding shares. Treasury Stock is deemed to be issued shares, but not outstanding shares. If the company decides to repurchase and then retire the shares, then the shares revert back to being authorized but unissued shares.



It’s a little confusing, so remember these formulas:

Authorized Shares = Issued Shares + Unissued Shares

Issued Shares = Outstanding Shares + Treasury Shares

Therefore: Authorized Shares = Outstanding Shares + Treasury Shares +
Unissued Shares