

# High-touch Legal Services® for Startup and Early-stage Companies

## Top Ten Legal Tips for Independent Contractors

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Working as an independent contractor can be exciting, challenging and gratifying, all at the same time. Yet, as they proceed down that path, individuals should make sure that they are not exposing themselves to legal risks unnecessarily. The following summarizes some of the most important risks and how they can be avoided.

### 1 Choose the right type of legal entity for your business

The quickest, easiest, least expensive approach is to do business as a sole proprietor (no separate legal entity). The major disadvantage: Unlimited personal liability for business debts and obligations.

If a separate legal entity is desired to limit personal liability, the choice is between a corporation and a limited liability company (LLC). A corporation has greater compliance obligations (see below) but is perceived as more substantial by some prospective clients. Nolo Press ([www.nolo.com](http://www.nolo.com)) publishes books that describe and explain the process of forming a corporation or LLC.

Input from a tax advisor is important to decide whether a corporation or LLC should be taxed separately from the individual owning it. Any type of entity can do business under a fictitious business name by filing a statement with the county where the business is located.

### 2 If you choose a corporation or LLC, comply with applicable formalities

A corporation or LLC will limit personal liability only to the extent that business is conducted as an entity separate from its founder. So, for example, the entity must have its own bank account and must be sufficiently capitalized to meet expected financial obligations, and contracts must be entered into by the entity rather than by the individual (who signs as the entity's president or manager). Corporations (but not LLCs) need to hold annual shareholder and board meetings and prepare minutes of those meetings.

### 3 Buy the right types and amounts of insurance

Insurance exists not only to pay specified liabilities if they are incurred; it also covers legal expenses

associated with those liabilities. Most important are commercial liability, automobile and, in some instances, errors and omissions (professional liability) insurance.

Many large companies require that their independent contractors maintain at least these types of insurance, usually with specified levels of coverage, typically in the range of \$1-5 million.

### 4 Identify and protect your intellectual property

Independent contractors' intellectual property often includes:

- Original works of authorship, copyrights for which can be registered with the U.S. Copyright Office.
- Trademarks or service marks, which can be registered with the appropriate state office and/or the U.S. Patent & Trademark Office.
- Trade secrets (information that provides an economic advantage and is not generally known to others), which are protected by nondisclosure or confidentiality agreements (discussed below).

Novel, non-obvious inventions that merit patent protection are far less common.

All agreements with clients and subcontractors should be examined carefully to ensure that rights to intellectual property are not lost or compromised.

### 5 Use your form of client agreement whenever possible

Every independent contractor should have a standard-form agreement to present to a prospective client as a starting point for negotiation. That agreement will include business terms that are appropriate for the contractor's services and important legal protections, such as limitations of liability and protection of intellectual property.

Many clients (especially large companies) will insist on using their form of independent contractor

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agreement. In this case, by referring to his or her own form of agreement, the contractor will have some idea of how the client's agreement should be changed to offer adequate protections.

## **6 Be careful when assigning or waiving intellectual property rights**

Clients' standard-form agreements typically say, in effect, "Everything that the contractor produces for this project, and all intellectual property rights therein, will be owned by the client, and the contractor hereby assigns or waives all rights therein." This approach is dangerous if the contractor has existing intellectual property, because his/her rights to that property can be lost unless there is a separate provision that expressly maintains the contractor's rights in that property.

## **7 Be careful when collaborating or subcontracting**

If parties work together in an arrangement under which they split the profits of their efforts, they may find that they have unintentionally created a partnership. For example, under California Corporations Code Section 16202(c)(3), subject to certain exceptions (see the next paragraph) "[a] person who receives a share of the profits of a business is presumed to be a partner in the business". A partnership – especially if unintended – can be undesirable because any partner can subject each of the partners to unlimited liability for partnership obligations!

One of the exceptions is that an independent contractor who receives a share of the profits in payment for services is *not* presumed to be a partner. So if you collaborate with or subcontract to a third party, be sure to enter into an agreement that clearly establishes an independent contractor relationship.

## **8 Be careful with nondisclosure / confidentiality agreements**

Differences among nondisclosure agreements (NDAs) usually are small – they tend to cover the

same territory in similar ways. However, NDAs from large companies often contain what I consider a most pernicious provision: A "residuals" clause, which excludes from confidentiality obligations information that the recipient's personnel retain in their memories.

The problem is that the clause gives any recipient with a good memory the right to use your trade secret information and reveal it to third parties! If the company will not remove the residuals clause, try to negotiate limits on its effectiveness (for example, by excluding trade secrets from its scope).

## **9 Avoid oral agreements whenever possible**

An oral agreement is a problem waiting to happen. If an agreement is not reduced to writing, it is too easy for the parties to have different understandings of the agreed-upon terms, setting the stage for a dispute. Furthermore, if a dispute does arise, the parties' recollections of the terms almost certainly will differ, meaning that any court decision likely will be based on an educated guess as to what the parties intended.

It makes no sense to incur these risks when a written agreement can be prepared quickly and easily.

## **10 Understand what distinguishes independent contractors from employees**

Large companies usually develop procedures by which they can obtain the services of independent contractors in compliance with applicable laws. Small companies, however, in an effort to conserve cash, may call personnel independent contractors when they really are working as employees.

If the Internal Revenue Service or the applicable state agency determines that an individual alleged to be an independent contractor really is an employee, both the employer and the employee are likely to be unhappy when they are subjected to taxes and other deductions, not to mention any interest or penalties that may be assessed.

Anyone who takes these steps will have a solid foundation for running a business as an independent contractor.

*The information in this article is not intended as legal advice and does not establish an attorney-client relationship. If you need legal advice on a matter, please contact an attorney directly.*

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