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Selecting a Business Entity – A Pivotal Decision in Starting a Business *by Mark S. Dessauer*



When starting a business, many decisions must be made before getting the business “off the ground.” Perhaps the most important decision is what form of entity will be used to operate the business. Tennessee has seven major entity formations, each of which has its own benefits and drawbacks.

Sole Proprietorship

Sole proprietorships are owned by one individual and do not require any formalities or filings, making them both simple and inexpensive. Profit or loss of a sole proprietorship is reported on the owner’s individual tax return. A disadvantage is that the owner is personally responsible for all the debts and liabilities of the business, including liabilities in tort.

General Partnership

A partnership is an association of two or more persons carrying on as co-owners a business for profit. No formal filings are required, but parties generally utilize a form of partnership agreement to set forth the business terms and conditions of the parties’ arrangement. The tax and liability issues are similar to sole proprietorships in that the profits and losses pass through to the partners and the partners are jointly and severally liable for the debts and obligations of the partnership, meaning that the personal assets of the general partner are at risk.

Limited Partnerships

A limited partnership is comprised of a general partner and one or more limited partners. Limited partners have limited liability – their liability is generally limited to the amount of their investment in the business – but they cannot participate in the operation of the business. The general partner is liable for the debts and obligations of the partnership and controls the operation of the partnership’s business. This liability is unlimited. Both limited partners and general partners share in the profits and losses of the limited partnership to the extent of their ownership interests, and limited partnerships are pass-through entities for purposes of federal income tax.

Limited Liability Partnerships

The limited liability partnership (LLP) is a variation of an already existing general partnership. The principal advantage of an LLP is that an obligation of the partnership is solely an obligation of the partnership. A partner is not personally liable for such an obligation solely by reason of being a partner, unless the liability was a result of his or her personal negligence. The major drawback to an LLP is that the limited liability is only available while the partnership is a limited partnership. Thus, if the LLP fails to renew its annual registration, then its limited liability shield lapses.

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Words of Wisdom from Vanderbilt Dean Jim Bradford

by Matthew H. Wimberley and Mary Ellen Miller

Jim Bradford is Dean of the Owen School of Management at Vanderbilt and a former Partner with Hunter, Smith & Davis. He has served as General Counsel and then President and CEO of AFG, an international glass manufacturer in Kingsport. He was the keynote speaker at the May 24 Hunter, Smith & Davis employment and business seminar at MeadowView. The *All Things Legal* editors spoke with him via telephone prior to his visit to Kingsport.

Q *How does your management style differ as a dean coming from the business world?*

A It doesn't. You just be yourself. You can't change your management style based on the environment. The same processes apply. Value base management with transparency and honesty is key. Empower your people and hire those that are smarter than you are. Make sure those closest to the decision make the decision. In the for-profit companies there is a common system of measurement. With education there are lots of different constituencies.

Q *We've read that you tell your students to do things so that "your grandmother would be proud." Would you elaborate on that?*

A Well if you can't print it on the front page of the newspaper you don't want to do it. Lead by example. Whether as a parent, an employee or a volunteer your actions speak louder than words. You are setting examples. Now that I'm a grandparent I see the three year old modeling the parent. We respond to the examples set for us. In the classroom I say "do things the right way so that you can sleep at night."

Q *It is graduation time. Do you have words of wisdom for those coming out and those who are already in the workforce?*

A Many people coming out of graduate school think the first job you get is everything. They focus on the wrong thing. You really want to know if it's the right culture- if you can trust the people, if you'll be challenged and if there are opportunities ahead.

No business plan comes out exactly as you would like because life doesn't work that way. I succeeded for two reasons:

- 1) I am a very hard worker. I was not the brightest bulb but I worked hard.
- 2) I said what I thought politely. I had a grandmother!

People work best when they are challenged in every way. People ought to choose employment that sometimes is not the most money or the most prestige but where there is the most opportunity. Ed Norris (a now deceased Partner at Hunter, Smith & Davis) made such an impact on me while I was at Hunter, Smith & Davis. I went to work because of the example Ed set for me and the incredible opportunities that Hunter, Smith & Davis gave me.



Q *How did the practice of law prepare you for academia?*

A Well, Chancellor Gee calls law "the last renaissance degree." They can't really teach you law in law school, it's far too complex. But law teaches you to be analytical and curious. It teaches you how to take apart and classify things; the deductive reasoning process. It teaches you to look at the bigger picture. Resolution conflict doesn't mean you attack the person. It served as a great education for what I'm doing today.

Q *Do you use the skills you used as a practicing lawyer?*

A Well, I learned to take my legal hat off when I was CEO (at AFG). The law sensitizes you to other people's rights and privileges and procedural issues. We have an appellate procedure at Vanderbilt outside the confines of school and the law gave me an appreciation and understanding of that. I don't dig out a legal textbook anymore but I'm still counsel to my children.

Please save the date!

Navigating Treacherous Legal Waters —Litigation Issues

A Lunch and Learn for Adjusters

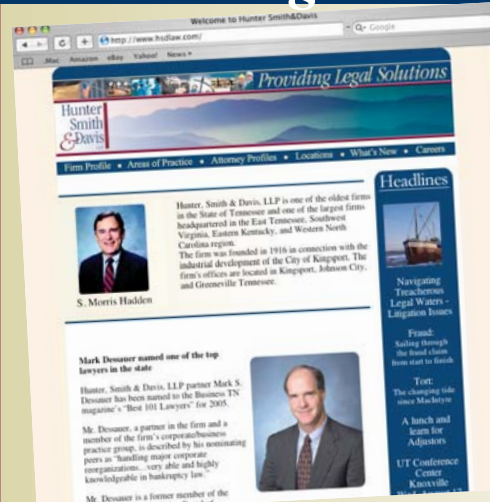
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Electronic Discovery — How it Impacts Business *by Jody P. Mitchell*



The Federal Rules of Civil Procedure may be undergoing a 21st Century change in the months ahead. The proposed rules, which would not take effect earlier than December of 2006, are to bring needed clarity and guidance in the realm of electronic discovery (E-Discovery). The passage of these rules would have an immediate impact on attorneys as well as businesses involved in litigation.

The proposed rules would address the following “E-Discovery” concerns:

1. Reasonably Accessible Data. Under the proposed rules, the requesting party can only discover relevant and “reasonably accessible” electronic data. The real issue turns on which type of information is reasonably accessible. For example, if a company employee departs the business and the information stored on his computer hard drive is systematically wiped out, is the erased information reasonably accessible? Granted, the information could be recovered, but doing so would take time and money. Interestingly, proponents of the rules identify information that is reasonably accessible by pinpointing information that is not reasonably accessible, namely legacy data, deleted data, and inactive data stored for disaster recovery. Usually, legal sparring over issues involving nebulous terms such as “reasonably accessible” must be judicially determined. As a consequence, it is probable that by the time a court determines whether information is “reasonably accessible” it could have disappeared.

2. Privilege Concerns. The proposed rules attempt to give ammunition to the producing party so that it can produce relevant information without waiving any privileges that may apply. Parties frequently attempt to minimize costs and delay of exhaustive searches for privileged information by agreeing to protocols that minimize the risk of waiver. These arrangements are called “Quick Peek” and “Claw Back” agreements. These agreements allow parties to turn over documents without review; thus allowing the producing party to retrieve any information that turns out to be privileged. The proposed rules state that a producing party who provides privileged information, without intending to waive the privilege, may, “within a reasonable time,” notify the recipient who would then have to “promptly return, sequester, or destroy the specified information and any copies.” In a perfect world, the rule’s added security seems comforting. However, the proposed rule does not address the Pandora Box problem: even if no waiver occurs, and the information is returned, the adversary has looked at information that may help them and hurt you.

3. Safe Harbor Provision. Sometimes a court will sanction a party for failing to turn over requested information. However, businesses routinely update and delete programs and, in turn, cause otherwise discoverable information to be extinguished. Does this mean that an attorney or a business can be sanctioned for updating its information? The proposed rules envisioned such an issue and created a safe harbor, which protects a party that “took reasonable steps to preserve the information after it knew or should have known the information was discoverable . . . and the failure resulted because of the party’s routine operation of the party’s electronic system.”

The proposed rules and other issues associated with electronic discovery affect more than attorneys and curious legal scholars. In fact, most often, it

is the business or company the attorney represents that is most affected by electronic discovery. A corporate defendant is typically responsible for searching its own electronic archives for information relevant to the litigation, and courts frequently order the producing company to foot the bill for finding information for its adversary. These expenses have the potential to be enormous for large companies that would have to search/produce thousands of documents.

Nevertheless, one way that a company can remedy the costs associated with electronic discovery and efficiently handle such requests, is via a comprehensive record retention policy. A record retention policy should be geared towards clearing out unnecessary information, albeit in a responsible and legal manner. Some methods for maintaining such a policy are as follows:

1. Maintain a Central Corporate Repository. (Electronic information should not be spread across servers, backup tapes, etc. Maintaining a central repository reduces overlap and duplication of electronic data).

2. Maintain a Corporate Document Management Policy. (Storing electronic data and records should have some organized principle. Issues arise where company employees save any and all documents with no organizing method. This increases discovery costs because someone may have to sift through irrelevant documents to recover discoverable information).

3. Decrease Intermingling of Critical and Less Critical Documents. (It is important to have some distinguishing means between the relative importance of stored information).

4. Decrease Intermingling of Business and Private Use. (If the company is able to keep its employees’ private information separate from company data then no one will have to separate the two types of information during discovery).

5. Distinguish between Disaster-Recovery Backup and Business Archiving. (Companies should be cognizant of the different information needed for disaster recovery and its long-term business archive. Generally, companies save too much unnecessary information, for too long, which creates inefficiencies during the discovery process).

6. Backup Systems that Can Easily Be Restored. (It is important that companies are cognizant of their existing backup collection when updating software and hardware. In the event a company is required to recreate or restore data from a legacy system, the method could take months and generate hefty expenses).

Because electronic discovery is becoming more prevalent in the 21st Century, it is only logical that the law keep abreast of the new methods of discovery. In addition, it is also logical that the main targets affected by the rules’ change, namely companies and businesses, have advanced preparation to efficiently and effectively deal with electronic discovery requests if and when the issue arises.

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Selecting a Business Entity, *cont'd.*

Limited Liability Companies

The limited liability company (LLC) is formed upon filing articles of organization with the Tennessee Secretary of State and upon the adoption of an operating agreement (except for single member LLC's). Members of an LLC have limited liability, and normally are not personally liable for an obligation solely by reason of being or acting as a member. The obligations of an LLC are solely the obligations of the LLC. LLC's are classified for federal income tax purposes as general partnerships, unless the LLC elects to be classified as a C corporation for tax purposes. LLC's have the most flexibility of all entities, having the fewest absolute rules regarding internal owner relations.

C Corporations

C Corporations are regulated entities and annual filings are required with the Tennessee Secretary of State. Corporations consist of: Shareholders (the technical owners of the business); Board of Directors (the governing body of the corporation); and Officers (charged with the day to day management of the business). The benefits of a corporation are primarily limited liability and flexibility. Generally, owners can only be held liable for the operations of the business to the extent of their investment, and there is generally no limit on the number of shareholders, class of shareholders or type of entity that can own shares in a corporation. The C corporation carries with it the major disadvantage of being subject to a corporate level tax on its earnings. Corporations are subject to federal income tax, and if the corporation's earnings are then distributed to its shareholders as dividends, the earnings are taxed again at the shareholder level.

S Corporations

S corporations were developed mainly to provide tax benefits to smaller businesses pursuant to § 1362 of the Internal Revenue Code. The shareholders of S corporations have the same limited liability as shareholders of C corporations. However, the S corporation passes its income through to the shareholders and the corporate level tax does not apply. However, an S corporation cannot have more than 100 shareholders, all the shareholders must be individuals who are citizens and residents of the United States, estates, or certain types of trusts, and S corporations can only have one class or stock. This limits the ability to attract investors through the issuance of preferred stock and excludes corporations, partnerships, and limited liability companies from investing in S corporations.

Consideration of the above issues should help guide the choice of entity decision by all business owners. This article is not intended to be legal advice.

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Hunter, Smith & Davis Partner Bill Argabrite, second from right, shares a light moment with (L-R) Steve Dennis, ETSU John H. Poteat Chair of Banking; Frank Nothaft, Chief Economist of Freddie Mac; Larry Mote, Economist, Office of the Comptroller of the Currency; Kevin Lavender, Commissioner, Tennessee Department of Financial Institutions and David Berson, Chief Economist, Fannie Mae. Hunter, Smith & Davis is a sponsor of the East Tennessee State University "Issues in Banking" Lecture Series.