

# Chap 13. Legal Structures for Businesses

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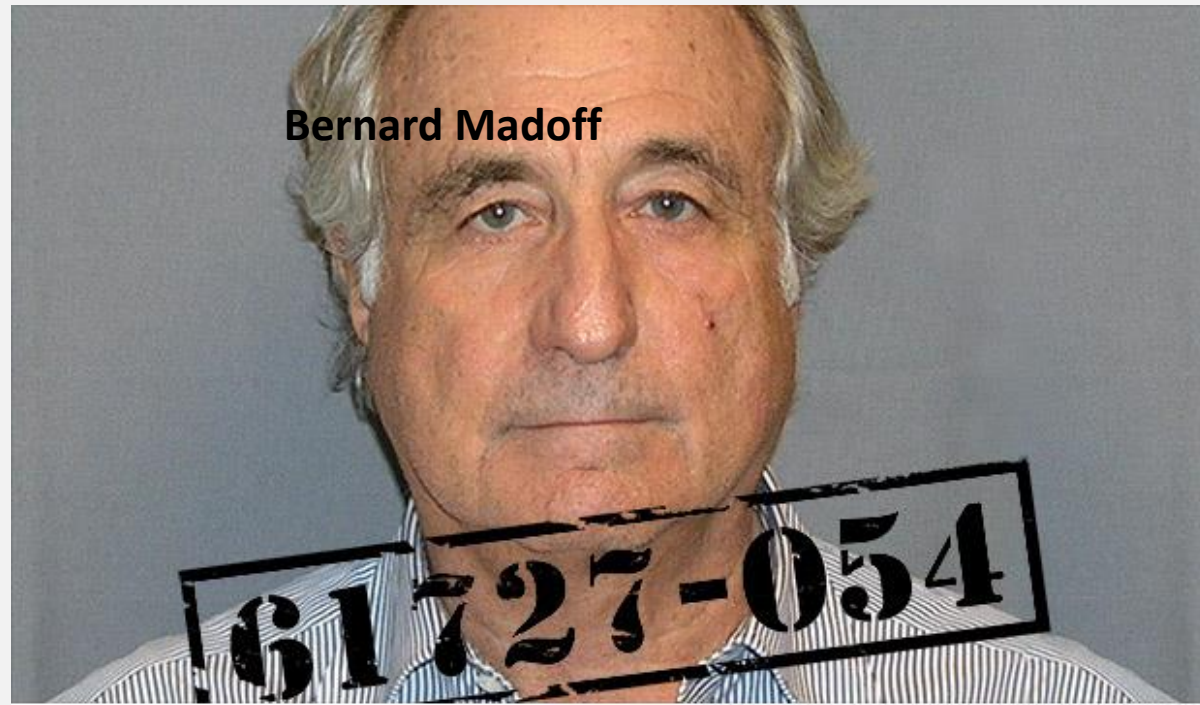


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# Good Legal Advice

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- Hire attorney with relevant experience
- Use this expensive resource wisely and sparingly
  - Group legal matters for consultation –not one by one
  - Prepare materials yourself prior to consulting the attorney, and then offer help in preparing final documents.
  - Many ventures bring attorney onto their Board or their advisory board. The attorney essentially trades current services for later compensation often through a small share in the equity of the venture.
  - Use other professionals that may be less expensive than attorneys. Some possibilities include
    - management consultants
    - Tax prep services
    - Insurance agents

# Using legal advice wisely and conservatively –an ILinc story.

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While founding ILinc we had one co-founder who was addicted to attorneys! In the division of labor, he had been asked to do the initial leg work on setting up the founder's agreement and the eventual incorporation. Once we realized how much he was spending on attorneys, we decided to take this on as a collective task and we did much of the legal work ourselves, but took each final document to the attorneys for review.

The climactic moment leading to that decision came when our co-founder invited us all to join him for a meeting with the attorneys in their luxurious offices downtown. We sat around a conference table in the elegantly paneled board room while the attorneys presented a range of legal options for us, and then a wide ranging discussion ensued. I could see that he was enjoying the give and take, but I was stewing and had visions of a cash register with the price rolling up unstopably. Eventually I (somewhat rudely) insisted that we needed to go and stood up and thanked them and left with one co-founder looking relieved while the other looked perplexed.

As we left the offices the perplexed co-founder blurted out "Aren't they great guys!" Unable to contain my irritation I retorted that "They can afford to be nice at \$400/hr."

Collectively, with help from legal information available on the internet, we drafted a founders agreement and eventually the articles of incorporation. Once we were satisfied that the documents met our needs, we took them to the attorneys for review. They made very few suggestions for revision, but those they made were helpful. After that, we adopted this as our modus operandi through three rounds of venture capital and eventually acquisition.

Legal advice is imperative, but it should be used sparingly and when it is most critical. Never ask attorneys to do routine work that you could do yourself.

# Founders Agreement

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Most ventures that include more than one founder need to start with the creation of a founders' agreement. Preparing for the creation of this document demands that the founders engage in some serious discussion about how they envision the company operating and what each of the founders wants to get out of the company.

- Shareholders agreement
- Specifies legal form (LLC, LLP, Corporation)
- Divides the Equity: what is the share of ownership for each founder?
- Defines how equity acquired; cash, sweat equity, IP
  - What resource of value does each co-founder bring to the firm. In some cases the founders may bring cash to help start the company. In other cases one or more of the founders may not bring cash, but bring skills that will be needed in founding and operating the venture. The founders agreement may then specify that these co-founders earn their equity over time through their own efforts. Other co-founders may bring valuable intellectual property (IP) to the company through patent's copyrights, or other IP.
- Defines initial operating capital
- Defines vesting process
  - Frequently the agreement specifies a vesting period to ensure that the involvement of the co-founders takes place as needed and expected.
- Provides a process for exit of founders through voluntary departures, involuntary separation, acquisition, or IPO.
  - Buyback clause: You need to ensure that the control of the company does not pass into un-involved hands. If a founder leaves –either voluntarily, involuntarily, or through death or disability you need to specify what happens to that founder's equity. Often there is a provision in the agreement that specifies that the other founders have the right to buy back the departing founders equity at a fair market price. Failure to do that could mean that a death, divorce, or disability could leave the venture with a new partner whose goals, abilities, and desires are at variance with the others.
  - Determining the fair market price can be a difficult process for new ventures and often leads to disputes.

# The Exit Strategy

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- Why is it that when people are entering into new ventures, they often do not take the time to think of how the venture might end?
- The first step is to have a conversation about the ultimate goal of each founder of the venture. What do they want to get out of the venture and how do they see themselves in relation to the venture in a decade? For some founders, the creation of a new venture is a lifestyle decision and they envision themselves running this venture throughout their careers. The typical aspirations of founders are often described by these categories:
  - Salary Substitute Firms
    - Restaurants, convenience stores, dry cleaners, etc.
  - Life Style Firms
    - Indulge a persons passion, hobby or desire for a particular lifestyle
    - Marina owner I met in Tortola was a former Wall Street Executive
  - Entrepreneurial Firms
    - Private Firms –the stock is closely held and not offered to the public.
    - Public firms - the stock is offered to the public under the usual legal requirements of the Securities and Exchange Commission (SEC), and state and federal governments.
    - Exit Strategies –what are the strategies for exiting entrepreneurial firms?

# Exit Strategies for Entrepreneurial Firms

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- As we have seen, if the new venture intends to raise money from investors then the investors need to see a clearly agreed upon path to a substantial return on their investment. In general this means that they expect the new venture to either do an IPO or be acquired within a reasonable time frame –often 5 years.

# Avoid Legal Disputes

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Here are a few things you should be considering when launching and operating your new venture

- Meet all contractual obligations
- Avoid under-capitalization-lack of resource has doomed many ventures.
- Put everything in writing –avoid misunderstanding
- NDA –Use non-Disclosure agreements to protect your intellectual property and your plans.
- Non-compete agreements –these ban a former employee from joining and/or helping a competitive firm.
  - “A covenant not to compete is enforceable only if it is necessary to protect a legitimate business interest, reasonably limited in time and space, and consonant with the public interest.”
  - Must be reasonable and not overly broad to be enforced
  - California bans almost all non-compete agreements
  - Virginia is very limited in its enforcement
  - Massachusetts allows non-compete agreements, but several efforts have been made by the tech community to ban them.
- Set high standards in every aspect of your business –from ethics to operations.
- Use mediation to settle disputes to avoid costly legal proceedings.

# Business Licenses and Permits

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When starting a new venture, you should take the time to discover what permits and licenses will be required by federal, state, and local authorities. Some examples include:

- Business License
  - Obtained locally for sole proprietorship
  - May require home occupation business license
  - State license if one has employees or is an LLC, LLP, or Corp.
  - Potential sales tax license?
  - Other special licenses
- Federal employer identification Number (EIN)
- Other Business permits
- DBA-Doing Business As –fictitious business name permit.
- Use the SBA website for a guide to licenses and permits



# Form of the Business

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- There are several legal forms that a new venture may consider including.
  - Sole Proprietorship
  - Partnership
  - Corporation
  - Limited Liability Company
- These forms differ in how various issues are handled and may offer different advantages and disadvantages to a venture. Considerations include:
  - Cost of formation
  - Liability protection
  - Tax
    - does the entity get taxed itself or does it pass profits through to the owners for taxation. In the former case, the owners will still have to pay taxes on any profits distributed. This is often termed double taxation.
  - Types and numbers of investors
  - Liquidity

# Sole Proprietorship

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- Advantages
  - Easy and inexpensive to create
  - Owner retains complete control and keeps all profits
  - The owner can deduct any losses against other owner income
  - Is **taxed only once** to the owner
  - Easy to dissolve the business
- Disadvantages
  - **Unlimited liability** to owner
  - Very reliant on skills, abilities, and dedication of owner
  - Can be difficult to raise capital
  - Loss of owner to death or disinterest terminate the business
  - **Low liquidity** of the investment

# Partnerships

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- General Partnership- with partnership agreement
  - Advantages
    - Easier and less expensive than a corporation or LLC
    - Pools several persons skills and resources
    - Can be easier to raise funds than a sole proprietorship
    - Business losses are deductible to partners against other income
    - Taxed only to the partners and not to the company
  - Disadvantages
    - Unlimited personal liability
    - Relies on small number of people
    - Difficult to raise capital
    - Disagreements among partners are common
    - Unless a partnership agreement provides differently- the partnership ends at death or withdrawal.
    - Liquidity of the investment is low. It is hard to cash out any owner.

# Partnerships

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- Limited Partnerships
  - often have both general and limited partners
  - General partners are liable for debt, but the limited partners are limited to the amount of their investment
  - Limited partners do not share in control (or jeopardize the limited liability)
  - This is common in real estate development, oil and gas exploration, motion picture venture.

# Corporations

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- There are two slightly different types of corporation termed **C Corporations** or **S Corporations**
- **C Corporation** – allows both preferred and common stock
  - The preferred has special rights over common stockholders for dividends and liquidation.
- Must file **articles of incorporation** with the Secretary of State (SOS) in the state of incorporation that give:
  - Name, purpose, number of shares, classes of stock, other items
  - Corporations must file annual papers with S.O.S. and pay annual fee.
  - Provides protection against personal liability
    - Piercing the corporate veil – in some cases, especially if malfeasance or malicious behavior can be shown, the directors may be held personally liable.
  - Profits are taxed to the corporation and then taxed again to the stockholders -if distributed to stockholders through dividends
    - This is often called **double taxation**
    - Many owners prefer to profit through stock appreciation rather than through dividends because capital gains are generally taxed at lower rates and do not have to be paid until the stock is sold. Taxes on dividends received must be paid in the year received.

# Sub-Chapter C Corporations

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The C corporations can be of several varieties.

- Public Corporations
  - Stock is listed and traded publically on the stock exchanges.
  - It is very liquid –allowing stocks to be sold or bought at will.
- Private corporation
  - In a private corporation the stock is held very closely and not traded publically. It is very illiquid because buying and selling ownership cannot be done on exchanges.
- Closely held corporation
  - In a closely held corporation the stock is infrequently traded among a small group even though the stock may be available publically. It is somewhat illiquid.
- Stock options are often issued to reward employees.
  - The right to buy stock at some set price.
  - If stock appreciates, then one can buy -then sell and take the profit.
  - Links success of employee to success of firm. Can also handcuff the employee or keep them working at the firm in order to obtain vesting of stock options.

## Sub-Chapter C Corporations

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- The C-Corp has both advantages and disadvantages:
- Advantages
  - Protection from liability
  - More ways to raise capital –easier to do so
  - No restrictions on the number of shareholders
  - If traded, then very liquid
    - Private->Public=IPO –initial public offering
  - Can Offer stock options.
- Disadvantages
  - Requires more work and legal advice to set up.
  - Cannot deduct business losses against your personal income.
  - Double taxation –at corporate and at shareholder level
  - Small shareholders have little influence in management

# Sub-Chapter S Corporations

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The S-Corp has some aspects of a partnership but is an incorporated public corporation.

- Most notable the S-Corp does not pay taxes. It files an information return and passes the profits/losses to the stockholders for their personal tax returns. (This tax treatment is similar to partnerships)
- The S-Corp provides protection from liability like the C-Corp (with the same caveat that the corporate veil can be pierced legally under some circumstances making the owners personally liable)
- Only actual salaries are subject to Self Employment tax –not passed through income to shareholders
- Requirements for an S-Corp
  - It cannot be subsidiary of another corporation.
  - The shareholders must be US citizens and cannot be partnerships or corporations
    - They can have no more than 100 ownership units (husband-wife is one unit)
    - All shareholders must agree to the formation of an S-Corp
  - There is only one class of stock –either preferred or common



# Limited Liability Company (LLC)

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- The LLC Originated in Germany. Wyoming was the first state in US to allow LLCs.
- All the members (similar to partners or stockholders) have limited liability –this is similar to corporations
- It must be a private business and not a publically traded company
- The income is passed through to owners for taxation
  - No double taxation
  - Can be split any way they wish
- It is more flexible than S-Corp on number of members and tax-related issues
- The LLC introduces new terminology to describe owners and the type of Ownership.
  - Stockholder → “members”
  - Owning stock → “interests”
- If the LLC wants to “go public,” and sell their shares publically then they must convert to a C-Corp.

# Non-Profit Legal Organizations

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- Many forms of social entrepreneurship are accomplished through non-profit ventures and these are often organized into 501c(3) corporations that must be focused on one or more of these charitable public purposes:
  - charitable, religious, educational, scientific, literary, testing for public safety, fostering amateur sports competition, or preventing cruelty to children or animals.
- The key provision is a complete prohibition on “**self inurement**” –or using the profits or assets of the non-profit organization to provide any private benefit to any person who is in a position to control or influence the non-profit. In fact, there is never a profit. There may be a surplus of revenues over expenses, but it cannot be distributed to those operating the non-profit or used for purposes other than the charitable purposes for which the non-profit was chartered.
- Non-profit corporations do not pay taxes unless they engage in some unrelated business. Then they must pay taxes, called the unrelated business income tax (**UBIT**), on the unrelated income.
- Donations to legally chartered 501c(3) corporations are generally tax exempt, although any portion that returns benefits (dinners, entertainment, etc.) to the donor is non-deductible.

# Non-Profit Organization

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- In order to become a non-profit organization, one must first be chartered according to state law –usually requiring articles of incorporation that set out the charitable or other non-profit purpose, specify how it will be governed, and other items.
  - Example from Massachusetts:  
<http://www.sec.state.ma.us/cor/corpweb/cornp/npfrm.htm>
- The organization can then apply to the IRS for the 501c(3) designation.
  - <http://www.irs.gov/pub/irs-pdf/p557.pdf>
- Each year the organization must file a “Return of Organization Exempt From Income Tax” (Form 990 ) and must keep proper accounting and governance records.
  - <http://www.irs.gov/pub/irs-pdf/f990.pdf>
- The organization cannot use its resources to lobby for political issues or to support political organizations or individuals. A very small percentage of annual expenses may be spent on lobbying (generally less than 5%), but if that is exceeded then the organization may have its non-profit status revoked.

# Other kinds of non-profits are defined under federal law

- 501(c)(1) — Corporations Organized Under Act of Congress (including Federal Credit Unions)
- 501(c)(2) — Title Holding Corporation for Exempt Organization[2]
- 501(c)(3) — Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations
- 501(c)(4) — Civic Leagues, Social Welfare Organizations, and Local Associations of Employees
- 501(c)(5) — Labor, Agricultural and Horticultural Organizations
- 501(c)(6) — Business Leagues, Chambers of Commerce, Real Estate Boards, etc.
- 501(c)(7) — Social and Recreational Clubs
- 501(c)(8) — Fraternal Beneficiary Societies and Associations
- 501(c)(9) — Voluntary Employee Beneficiary Associations
- 501(c)(10) — Domestic Fraternal Societies and Associations
- 501(c)(11) — Teachers' Retirement Fund Associations
- 501(c)(12) — Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, etc.
- 501(c)(13) — Cemetery Companies
- 501(c)(14) — State-Chartered Credit Unions, Mutual Reserve Funds
- 501(c)(15) — Mutual Insurance Companies or Associations
- 501(c)(16) — Cooperative Organizations to Finance Crop Operations
- 501(c)(17) — Supplemental Unemployment Benefit Trusts
- 501(c)(18) — Employee Funded Pension Trust (created before June 25, 1959)
- 501(c)(19) — Post or Organization of Past or Present Members of the Armed Forces
- 501(c)(20) — Group Legal Services Plan Organizations
- 501(c)(21) — Black lung Benefit Trusts
- 501(c)(22) — Withdrawal Liability Payment Fund
- 501(c)(23) — Veterans Organization (created before 1880)
- 501(c)(24) — Section 4049 ERISA Trusts
- 501(c)(25) — Title Holding Corporations or Trusts with Multiple Parents
- 501(c)(26) — State-Sponsored Organization Providing Health Coverage for High-Risk Individuals
- 501(c)(27) — State-Sponsored Workers' Compensation Reinsurance Organization
- 501(c)(28) — National Railroad Retirement Investment Trust
- 501(c)(29) — Qualified Nonprofit Health Insurance Issuers (Created in section 1322(h)(1) of the Affordable Care Act)

# Ethics and the “Tone From the Top”

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- Recent years have provided some chilling examples of ethical lapses many of which have gone far enough to be serious legal lapses.
  - Bernie Madoff and his investment Ponzi scheme defrauded hundreds of investors and lost between \$18 and \$65 billion of their investments.
  - Enron collapsed leaving investors and employees holding the bag while many of the officers went to jail.
- Tone From the Top means to lead by example
- Establish a Code of Conduct (Code of Ethics)
  - Google adopted the mantra of **–Don’t be evil!**
    - They backed this up with a full code of conduct, and still find themselves criticized from time to time on ethical issues.
- Implement an Ethics Training Program
  - Ethical Dilemma    Good for organization or self  $\leftrightarrow$  unethical?  
There is often a choice between doing something that is good for the individual and what is good for the organization. A clear code of ethics supplemented by employee training can help guide an employee through those dilemmas.

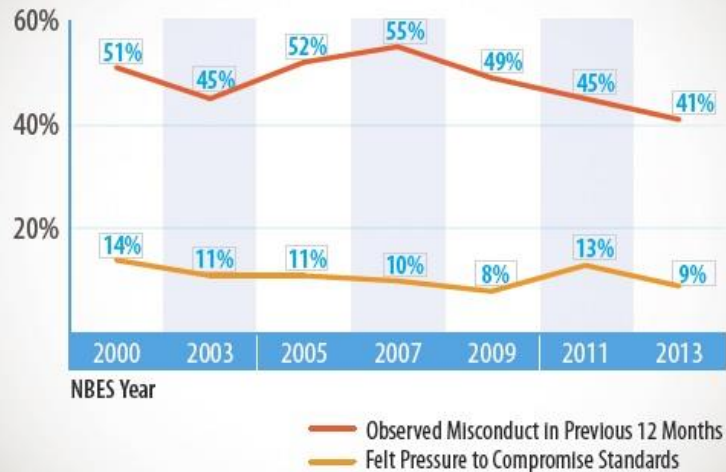
# Ethics

Survey of Fortune 500 company employees by the Ethics Resource Center in 2013.

- <http://www.ethics.org>

There is some good news in an overall decline in misconduct, and confirmation of the effectiveness of setting clear standards and providing employee ethics training.

Observed Misconduct Continues to Decline, At Historic Low



OBSERVED MISCONDUCT	2011	2013
OVERALL	45%	41%
Abusive behavior or behavior that creates a hostile work environment	21%	18%
Lying to employees	20%	17%
A conflict of interest – that is, behavior that places an employee’s interests over the company’s interests	15%	12%
Violating company policies related to Internet use	16%	12%
Discriminating against employees	15%	12%
Violations of health or safety regulations	13%	10%
Lying to customers, vendors, or the public	12%	10%
Retaliation against someone who has reported misconduct	10%	x
Falsifying time reports or hours worked	12%	10%
Stealing or theft	12%	9%
Violating employee wage, overtime, or benefit rules	12%	9%
Delivery of substandard goods or services	10%	9%
Abusing substances, such as drugs or alcohol, at work	11%	9%
Breaching employee privacy	11%	8%
Improper hiring practices	10%	7%
Sexual harassment	11%	7%
Breaching customer or consumer privacy	7%	5%
Violation of environmental regulations	7%	4%
Misuse of company’s confidential information	7%	4%
Violating contract terms with customers or suppliers	6%	4%
Falsifying invoices, books, and/or records	x	4%
Accepting inappropriate gifts or kickbacks from suppliers or vendors	5%	4%
Offering anything of value (e.g., cash, gifts, entertainment) to influence a potential/existing client or customer	5%	4%
Falsifying expense reports	5%	4%
Falsifying and/or manipulating financial reporting information	5%	3%
Improper use of competitor’s proprietary information	5%	3%
Offering anything of value (cash, gifts, entertainment) to influence a public official	4%	2%
Making improper political contributions to officials or organizations	4%	2%

<http://www.ethics.org/downloads/2013NBESFinalWeb.pdf>

# Reasons to create a code of conduct

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- Avoid fines or other civil/criminal complaints
- Decrease vulnerability
- Improve Customer loyalty
- Improved Employee Commitment
- Improved Brand Reputation
- Better Access to Capital