-

Guide
to
Starting and Operating
A Business

Attorney At Law
70 Walnut Street
Wellesley, MA 02481-2102
Telephone: (617) 928-3677 • Fax: (617) 249-1527 • E-Mail: stankay@kaylaw.net
Web Site: http://www.kaylaw.net

STANLEY B. KAY

Mr. Kay is an experienced corporate attorney who represents entrepreneurs and emerging growth companies in the following areas:

- Securities compliance, including SEC and Blue Sky registration and reporting
- Private placement of securities and venture capital financing
- Senior and subordinated loan financing
- Mergers and acquisitions
- Strategic alliances and joint ventures
- Technology development and licensing agreements
- International business transactions
- General business agreements concerning employment, consulting and marketing and distribution matters

Mr. Kay was previously General Counsel to a $200 million high technology business of the Northrop Grumman Corporation, a major advanced technology and aerospace company. He has also been the principal lawyer for other high technology, manufacturing and energy companies on a variety of domestic and international matters. Mr. Kay has law degrees from Georgetown University and the University of Texas, where he was a law review editor and a National Moot Court winner. He is also a graduate of the University of Pennsylvania's Wharton School of Finance, and he attended the London School of Economics.

Mr. Kay is active in numerous professional and business organizations, including the American, Massachusetts and Boston Bar Associations, and the Smaller Business Association of New England. He has written and spoken extensively on corporate law subjects.

GENERAL CONSIDERATIONS TO STARTING AND OPERATING A BUSINESS

Business Plans

Starting a new business is an exciting, but complicated process. The exciting part is giving birth to a new idea or concept. The complicated part is all of the legal, financial, and business issues that go into carrying out that idea or concept. A good entrepreneur will manage to balance all of these issues to create a successful venture.

The key to balancing the business issues is to develop a solid business plan. Every successful business is based on a solid business plan or road map that clearly articulates the opportunity available to the business and the strategy for pursuing that opportunity. Although most business plans are physical documents, many are simply a collection of plans, procedures, and ideas. Whatever the format, a solid game plan is the key to a well organized and successful business. The business plan should not be a static or rigid document: it is a snapshot of the founders' intentions when prepared, and should be a reflection of the company's present and future opportunities and risks. If the new company is to survive, the founders must adapt their business plan to the ever-changing environment for start-up ventures.

The business plan serves another function as the core of the disclosure document to be used to issue securities to raise equity capital. This disclosure document, usually in the form of a private offering memorandum, is prepared principally by the company's lawyer, or under his or her guidance, to ensure that full disclosure is made in compliance with the federal and state securities laws. The business plan provides the basic information concerning the company's business, products, technology, markets, marketing strategy, management and financial projections.

Some commentators recommend that a business plan be based on the following factors:

1. The People. The men and women starting and running the venture as well as the outside parties providing key services or important resources for it, such as its lawyers, accountants, and suppliers.

2. The Opportunity. A profile of the business itself-what it will sell an to whom, whether the business can grow and how fast, what its economics are, who and what stand in the way of success.

3. The Context. The big picture the regulatory environment, interest rates, demographic trends, inflation, and the like - basically, factors that inevitably change but cannot be controlled by the entrepreneur.

4. Risk and Reward. An assessment of everything that can go wrong and right, and a discussion of how the entrepreneurial team can respond.

Another document, the executive summary, is different from the business plan and the private offering memorandum. Its purpose is to present a concise summary of the business plan to venture capital sources or investment bankers as an introduction to the venture.

It is not a substitute for the private offering memorandum, and should not be used to sell securities, which should be effected only by the private offering memorandum.

Self Assessment

As part of your business planning, you should conduct an honest assessment of your stengths and weaknesses for your new business. Here is a checklist that you can use. Examine each of the skills areas listed in the chart. Ask yourself whether you possess some or all of the skills listed in the parentheses. Then rate your skills in each area by circling the appropriate number, using a scale of 1-5, with 1 as low, 2 as between low and medium, 3 as medium, 4 as between medium and high, and 5 as high.

Skills	Rating low		medium		high
Sales • pricing • buying • sales planning • negotiating • direct selling to buyers • customer service follow-up • managing other sales reps • tracking competitors	1	2	3	4	5
Marketing • advertising/promotion/public relations • annual marketing plans • media planning and buying • advertising copy writing • marketing strategies • distribution channel planning • pricing • packaging	1	2	3	4	5
Financial planning • cash flow planning • monthly financial • bank relationships • management of credit lines	1	2	3	4	5
Accounting • bookkeeping • billing, payables, receivables • monthly profit and loss statements/balance sheets • quarterly/ annual tax preparation	1	2	3	4	5
Administrative • scheduling • payroll handling • benefits administration	1	2	3	4	5
Personnel management • hiring employees • firing employees • motivating employees • general management skills	1	2	3	4	5
Personal business skills • oral presentation skills • written communication skills • computer skills • word processing skills • fax, e-mail experience • organizational skills	1	2	3	4	5
Intangibles • ability to work long and hard • ability to manage risk and stress • family support • ability to deal with failure • ability to work alone • ability to work with and manage others	1	2	3	4	5
Total					

After you've rated yourself in each area, total up the numbers. Then apply the following rating scale:

• if your total is less than 20 points, you should reconsider whether owning a business is the right step for you

•if your total is between 20 and 25, you're on the verge of being ready, but you may be wise to spend some time strengthening some of your weaker areas.

• if your total is above 25, you're ready to start a new business now.

<u>Which Business Should You Choose?</u>

The following chart is designed to help you choose the business that's right for you. To fill it out, follow these three steps:

(1) In the far left-hand column, list the business ideas you're considering by order of interest. So, in the top left-hand blank space, put the idea you think you're most interested in. Underneath it put the next idea and so forth until you've listed all of your possible ideas down the left side of the chart.

(2) Now take each idea and rate it on a scale of 0-3 in each of the areas listed. Use the following rating system: 0-none, 1-below average, 2-average, and 3-above average.

Here's a look at each of the categories and some of the things you should consider when rating them:

Your knowledge of the business. How much do you know about the area? Will you have to spend extra time and money teaching yourself the business? Will you have to take on a partner because you don't know the business well enough?
Rating: 0-no knowledge of the business; 1-some indirect knowledge of the business; 2-limited knowledge; 3-working knowledge.

Your experience in the field. In some cases, you may have a lot of knowledge about the subject, but not much experience. Have you ever owned or worked in this type of business before? To what extent is hands-on experience crucial to the business?
Rating: 0-no experience; 1-indirect experience; 2-limited experience; 3-familiar with the business.

Your skills. Ignore, for now, those skills that might be common to each of your ideas, and try to concentrate on skills that are unique to that business. To what extent do you possess those skills? If you lack them, how difficult will it be to acquire them?
Rating: 0-none; 1-limited skills; 2-some skills; 3-extensive skills.

Ease of entry. Think both of the costs of entering the business and of the competitive barriers that might exist. For example, a service business that you can run from your home might be relatively inexpensive to start, but if several others are already providing that service, entry in the field may be difficult.
Rating: 0-crowded field, very difficult to enter; 1-limited entry available; 2-mix of large and small competitors; 3-virtually unrestricted entry for any size business.

Uniqueness. Uniqueness does not necessarily mean that literally no one else is providing the same

product or service; it can mean that no one else is providing the product or service in the same way you intend to provide it, or it can mean that no one else is providing that product or service in your area. You're looking for some way to distinguish your product or service from others who are already in business.
Rating: 0-your product or service widely available; 1-a few to several others offering your product or service; 2-only one or two others; 3-no others providing your product or service.

Business idea	Your knowle	Your experienc	Your skills	Ease of entry	Uniqueness	Total

(3) Now total up the numbers. Here are some tips for making sense of the numbers and for narrowing your list of business possibilities:
• eliminate any of your ideas that scored less than a total of 10
• eliminate any idea that did not score at least a 2 in every category
• eliminate any idea that did not score at least a 3 in the uniqueness category

How many ideas are left? If the answer is "none," then you need to use the list to identify where you need to improve and you need to develop a strategy for raising the "1's" to "2's" or "3's." If the answer is "more than one," you have a pleasant dilemma: a choice of which business to start. If the answer is "one," you may have just found the business that's perfect for you.

Business Advisors

The best way to manage the legal and financial issues related to the organization of a business is to hire or work closely with lawyers, accountants, and other trusted advisors. Some sources note that the number one reason most businesses fail is that they fail to hire professional advisors. A good advisor will understand the goals and objectives articulated in a business plan and recommend a structure consistent with those goals and objectives. When there are several options and strategies available to the entrepreneur a good advisor will present each option and help the entrepreneur weigh the relative costs and benefits of each option. In the end, the entrepreneur will be able to make an informed decision based on well thought out advice.

Business Organizations

The first decision an entrepreneur must face after developing a sound business plan is choosing the type of entity from which to pursue the business objective. Today, there are several forms of entities to choose from when forming a business organization including: Corporations, S-Corporations, Sole-Proprietorships, Partnerships, Limited Partnerships, Joint Ventures, and other types of organizations depending on the state of organization. Some states (including Massachusetts) have also authorized the creation of Limited Liability Companies and Limited Liability Partnerships.

A. **C-Corporation** Unlike sole-proprietorships and partnerships in which the owners control and run the business, a corporation has separate ownership (stockholders) and control. This is accomplished by creating a fictitious entity that controls the business. This fictitious entity is responsible for the liabilities that may arise in operating the business, thus giving the owners (stockholders) limited liability. Because a fictitious entity is created, corporations must observe "corporate formalities" and control the business by a separate legal entity.

1. Corporate Formality. "Corporate formality" takes many forms and is evident in every stage of starting and operating a corporation. The single most basic "corporate formality" is management of the corporation through a board of directors (instead of management by the owners). In a small and medium size corporation, the directors are often the stockholders, causing one individual to wear several hats and reinforcing the need for corporate formalities to separate these roles. "Corporate formality" also requires documenting major decisions of the corporation through resolutions by the directors and maintaining records with the state.

2. Limited Liability. A corporation offers its owners/shareholders limited liability with respect to their investment in the corporation. The only amount of capital that remains at risk is typically the amount of money or other capital contributed to the business. As long as the corporate identity is maintained, there is no personal liability for individual shareholders.

3. Corporate Veil. If the corporate identity or "veil" is broken or "pierced," however, individual shareholders may be subject to personal liability. Lack of corporate formality such as failure to maintain corporate books and records, or failure to maintain separate bank accounts, are a few grounds for piercing the corporate veil. The officers and directors of the corporation should also take special care to enter into contracts or agreements on behalf of the corporation and not individually. Each major action of the corporation should be reviewed with counsel to determine the need for formal approvals of the board of directors or shareholders.

4.Tax Matters. The major tax consequence of the corporate structure is that the organization is treated as a separate entity for income tax purposes. The corporation pays corporate income tax on all income derived much like each individual pays personal income tax. When the corporation distributes dividends to shareholders, the shareholders then pay tax on the dividends at their respective individual income tax rate. This results in a negative double taxation of the income that the business generates.

5. Articles of Incorporation. A Massachusetts corporation may be formally organized by filing Articles of Incorporation ("Articles") with the Secretary of state. The Articles contain information with respect to the corporation's name, purpose, registered agent, capital structure, initial directors, incorporators, and other information concerning the rights and preferences of shareholders. While some provisions of the Articles contain general information, other provisions contain critical information for which careful consideration must be given.

6. By-Laws. In addition to filing the Articles, other important documents and issues must be addressed during the incorporation process. Each corporation must have a set of by-laws that govern the internal rules and regulations of the corporation. The by-laws typically provide for

matters such as the election of officers and directors, time for annual meetings, indemnification of officers and directors, and other internal rules of the corporation. The "bylaws" are an exhaustive set of rules and information that define the corporations basic structure and internal procedures of operation. A set of bylaws will define the board of directors and delegate who has authority and contain many more intricate matters that will impact of daily operations.

7. Organizational Meetings. All organizational procedures and actions taken by the initial incorporators, directors, and shareholders must be adequately reflected in the minutes of the corporation. These actions are typically summarized in resolutions, memorandums, and consents which are signed and acknowledged and then inserted in a corporate record book. Such meetings begin with a meeting of the stockholders to elect directors who will manage the fictitious entity. This election is documented through "resolutions" or "minutes" of the meeting. The directors then have an initial meeting to address initial management issues such as bank accounts and tax elections and elect officers who will run the daily operations of the corporation. This initial meeting is also documented through resolutions that are generally drafted by an attorney.

8. Corporate Record Book. To memorialize all "corporate formalities," and conclude the organizational process, the corporation should develop a corporate record book. This record book will contain the recorded Articles of corporation, bylaws, all minutes of meetings, all resolutions, and records of stock ownership, directors and officers and is generally maintained by the corporations attorney. With respect to "piercing the corporate veil," failure to maintain a corporate record book would be much like failing to keep receipts of the business for tax purposes. Once the final step of organizing a corporate record book is accomplished, the corporation is fully organized and operational; however, "corporate formalities" must be carried forward.

9. Shareholder and Director Actions. "Corporate formalities" are carried forward by conducting regular and special meetings of the shareholders and directors so that business issues are addressed and resolved through the proper governing bodies. Because shareholders do not manage a corporation, shareholder meetings generally occur only to replace directors, issue stock, amend articles or bylaws, and take other vital actions. Director meetings may be viewed as an opportunity and forum to keep the business organized and focused and may involve an attorney to counsel the board of directors on agendas and actions. A special meeting of directors may address an immediate, major action of the corporation such as pay out of dividends, purchase of assets, employment of officers, issuance of stock and raising capital. Depending on the extent of the business of the corporation, the regular meeting may occur anywhere from monthly to annually. A regular meeting of the board of directors would address on-going actions of the corporation and major actions that occur near the time of the regular meeting. All meetings are memorialized by minutes or resolutions which are then placed in the corporate record book. Shareholder and director action also may involve formal notice procedures to convene a meeting, but for small corporations, most actions can be taken unanimously, without having to follow notice procedures.

10. Subscription Agreements. A corporation is founded by one or more people dedicating services or money to organize the corporation. This is often accomplished formerly by a binding "subscription agreement" wherein the soon-to-be stockholders pledge their services or money in exchange for stock of the to be created corporation. The subscription agreement not only binds those who are forming the corporation, but may also be used to establish the basic management and financial structure of the corporation by adopting the articles of incorporation, bylaws, shareholder agreements, employment agreements and any other appropriate matters the subscribers wish to lay out before forming the corporation. Upon its creation, the corporation as

well as the subscribers have the power to enforce the subscription agreement.

11. Stock Matters. The subscription agreement generally provides for the issuance of stock certificates. Preparation and issuance of stock certificates does not require an officially licensed agency. However, there are certain state laws to adhere to when issuing stock, much like laws regarding the preparation of deeds. Stock certificates represent ownership in a company and serve as the shareholders' record of ownership. The corporation maintains its official record of ownership in its corporate record book. When creating stock, certain issues may be addressed such as transferability, voting, preferred dividends, and convertible options. Depending on the type of corporation and the corporation and investor's preferences, stock characteristics may be modified to make an investment more attractive. If stock attributes are not addressed prior to organizing the corporation, then upon creating various classes of stock the Articles and registration with the state must be amended.

12. Securities Compliance. A share of stock typically represents a security interest. The sale of securities is regulated by the Securities Act of 1933 (a federal statute) and state securities laws. Every sale of a security must comply with securities laws or fall within a multitude of exemptions.

13. Annual Reports. State laws require annual reporting to maintain a corporation in good standing. Such reports require reporting new capital and registration of the directors and principal officers. Failure to maintain a corporation in good standing with the state is another rationale for piercing the corporate veil.

14. Business Registrations. As is the case with any form of entity, most states, counties and cities require some form of business registration for entities operating within their boundaries. Certain types of organizations are also regulated by the federal government and require separate filings with the appropriate federal agency.

B. **S-Corporation** The primary difference between a C-Corporation and an S- Corporation is that for federal income tax purposes, an S-Corporation is not treated as an entity; and thus double taxation is avoided. All profits and losses of the organization flow through to individual shareholders in accordance with their percentage ownership. For state income tax purposes, an S-Corporation may or may not pay some income tax. All other general rules applicable to C-Corporation also apply to S-Corporations.

In order to become an S-Corporation, a person or group must first organize a regular C-Corporation as discussed above, and then promptly file an election to become an S-Corporation with the Internal Revenue Service (Form 2553). The time for filing is generally two and one-half months from the earliest of the date of organization, the date the corporation first had shareholders, the date the corporation started doing business, or the date it first had assets. A corporation may also file for an S-Election at the beginning of any tax year, generally through mid-March.

An S-Election is not automatically granted by the IRS. In order to qualify to be an S-Corporation a corporation must have no more than 100 shareholders, none of which can be partnerships, corporations, or nonresident aliens. In addition, an S-Corporation can only have one class of stock (although certain differences in voting rights are permitted). An S corporation can own 80% or more of the stock of another corporation in years beginning after 1996.

If these basic requirements are met and maintained then a corporation will more than likely qualify to be an S-Corporation. If at any time a corporation does not meet these requirements, then it will lose the tax treatment afforded to S-Corporation and will be taxed as a C-Corporation.

It is often advantageous to begin corporate existence as an S corporation, with a C corporation conversion at a later time.

C. **General Partnership** A general partnership is an association of two or more people with a profit motive. A partnership agreement generally spells out the relationship among partners, although it need not be a written agreement. The default rules of law for most partnerships are governed by the each state's version of the Uniform Partnership Act. If no formal agreement speaks to an issue concerning the partners, then these default rules will govern the outcome of the issue.

The down side to most partnerships is that each partner is jointly and severally liable for the affairs of the business and the actions of the other partners. The up-side is typically the favorable pass-through tax treatment that partnerships receive. A partnership is not taxed as an entity for federal income tax purposes and all profits or losses pass-through to the individual partners in accordance with the terms of the partnership agreement. Another up-side to partnerships is that the financial and managerial relationship among partners can be spelled out with greater specificity and flexibility than other more rigid corporate organizations.

A joint venture is another common term used to define a partnership relationship between two or more people or organizations. A joint venture, however, may also be a simple contract between two or more parties. This type of joint venture does not amount to a formal organization and merely spells out the obligations of each party to the agreement and the relative economic benefits to each party.

If the association of two or more people or entities amounts to a partnership, very little has to be done to acknowledge the organization of the partnership. A formal partnership agreement, however, is highly recommended, if not essential, to most businesses who plan to operate under a partnership structure. If the partnership operates under a name different than the names of the partners, then an assumed business name must be filed with the appropriate county where the business is operating.

D. **Limited Partnership** A limited partnership is much like a general partnership in that it maintains pass-through tax treatment of profits and losses. The difference between the two entities is that certain partners, the limited partners, maintain limited liability with respect to their investment in the partnership. The other partners, the general partners, remain personally liable for all debts and liabilities of the business.

The limited liability/pass-through tax treatment aspects of a limited partnership make it a prime vehicle for capital raising. A person or entity can organize a limited partnership and offer limited liability to investors along with pass-through tax treatment. Several common structures include a corporate general partner to further limit the liability of the general partner.

To organize a limited partnership a person or entity must file a certificate of limited partnership with the Secretary of state. Annual filings with the secretary of state, as well as other business registrations also apply to limited partnerships.

E. **Limited Liability Company** A limited liability company is a new form of entity that is recognized in many states (including Massachusetts). This structure typically offers limited liability to all owners of the company along with pass-through tax treatment. Some states, however, allow limited liability companies to be treated as corporations for federal income tax purposes. With the promulgation of the IRS's "check the box" rules, it is now relatively easy to make a choice between a corporation and a partnership without having to meet certain former rigid requirements that governed taxability previously.

Limited liability company statutes refer to the owners of the organization as "members" instead of "shareholders" or "partners". Instead of a "board of directors" managing the company, a limited liability company may call for a "managing member". The managing member can be a corporation, individual, or some other form of entity. The organizational document that must be filed with the Secretary of state is called Articles of Organization. The primary agreement or document for a limited liability company is the Operating Agreement. This document serves as the partnership agreement or by-laws of the entity.

The primary advantage of limited liability companies lies in the flexibility of ownership issues. Virtually any person, entity, or organization can be a member of a limited liability company. Unlike an S-Corporation, there are no rigid requirements for membership. Unlike limited partnerships and general partnerships, there is limited liability available to every member of the organization. In states that permit them (including Massachusetts) limited liability companies are ideal for closely held organizations that are looking for limited liability for all members along with pass-through tax treatment.

Notwithstanding these advantages, however, there are clear risks for a business to organize as a LLC, including:

1. LLC agreements tend to be more complicated than corporate agreements and take longer to negotiate and draft. For this reason, it may be better to choose a corporation over an LLC if the tax results will be similar (especially since an S corporation provides comparable benefits). The LLC agreements tend to be complicated for several reasons, i.e.:

a. Owners want complex management procedures because the operating rules can be open-ended. On the other hand, the rules for management in a corporation are defined with considerable specificity by statute and court precedents.

b. The tax rules that apply to partnerships and LLCs are very intricate. Drafting provisions that comply with these rules can be difficult. This is especially so where the owners want to take advantage of the flexibility of the rules. For example, they may want to provide that even though they contribute to the LLC equally, one owner will receive more of the profits for a certain period of time.

c. Even where matters are kept as simple as possible, various lengthy provisions are often included in LLC agreements to comply with the tax law. These usually deal with the maintenance of capital accounts for the purpose of calculating how much each owner will get if the LLC is liquidated. They typically are boilerplate, but can still add to the complexity and cost of the agreement.

d. The tax rules also add to the complexity because they can produce surprising results in the future. For example, if an LLC sells some appreciated property, owners who have contributed equally to the LLC may assume that they will each recognize an equal amount of gain on the sale. However, if the property was originally contributed to the LLC by one of the owners, all the gain may be charged to that owner. Determining the likely tax results in the future is time-consuming for the client, the lawyer and the accountant.

e. The tax rules can also add to the cost of an LLC because of additional record-keeping and accounting work that is needed later on to comply with them.

2. With an S corporation, owners will not pay self-employment tax on dividends. They only pay the tax on amounts distributed to them as salary (as long as they receive "reasonable compensation" for their services). The extent to which LLC members must pay self-employment tax is unclear, but it appears that they generally will pay more tax than they would in an S corporation. .

3. There is still virtually no case law on any of the legal issues that may come up with an LLC. Probably the most critical issue is when the LLC "veil" can be "pierced" so that liability is imposed on LLC members. Although the test may be the same as it is for corporations, it is not yet clear, especially for one-member LLCs.

4. Owners of a C corporation can deduct the cost of health insurance and other fringe benefits they get from the business from their personal income. LLC owners can deduct only 30% of these benefits. (Owners of an S corporation can deduct only 30% as well, unless they own less than 2% of the business.) This factor can be decisive in choosing a C corporation over an LLC if the business is small and its health plan will be the sole source of the owners' health insurance,.

5. When a corporation is acquired by another corporation, there generally is no tax on the ransaction if stock is traded for stock (under § 361 and § 368 of the Code). However, an LLC that has elected to be treated as a partnership cannot use this technique. This is a factor that should be considered by a new business that expects substantial growth and hopes to be acquired in few years. However, if a business is expected to be sold in an asset sale, this technique will not apply.

6. Some states still prohibit one-member LLCs, and five other states don't clearly allow them (Massachusetts allows them). It is likely that a business person will not want to form a single member LLC in any of those states because the LLC's liability protection may not be enforced. Additionally, there is a chance that if an LLC is formed in another state but does business in one of these states, its liability protection will not be enforced.

7. State taxes can also create problems in certain jurisdictions. Currently, significant state taxes are imposed on LLCs in California, Florida, Pennsylvania, and Texas. The states take a variety of approaches. For example, Florida has a 5.5% "artificial entity tax." Texas has a "franchise tax" of .25% of an LLC's "capital" and 4.5% of its "earned surplus." Also, some states impose initial and annual fees amounting to several hundred dollars, which may be significant to a very small business.

Another problem is that it is not clear whether all states will apply the IRS's new "check-the-box" rule (which allows businesses to choose whether to be taxed as a partnership or a corporation simply by checking a box on a form) for purposes of the state income tax. Indeed, some states, including California, will continue to apply the IRS's old, stricter "four-factor" test.

8. C corporations can sometimes save taxes by reinvesting their profits in the company, rather than distributing them to the owners. Consequently, the immediate tax on the profits consists only of the corporate tax. In a small business, that rate may be much lower than the owners' personal rates. Also, if the company is ultimately liquidated, the profits will be subject to capital gains tax, which is likely to be lower than the tax on ordinary income. With an LLC or an S corporation, this technique cannot be used, since all profits are taxed immediately as personal income.

9. C corporations can compensate employees with stock options, and if certain requirements are met, no tax is paid until the stock is actually sold (under § 422 of the Code). LLCs do not have this opportunity. (S corporations may not have it either, although this is not clear.)

10. Owners of certain types of C corporations -- mainly manufacturing and sales companies -- can exclude 50% of their gain on the sale of "original issue" stock if they have held the stock for more than five years (under § 1202 of the Code). Owners of LLCs do not have this benefit.

F. **Limited Liability Partnership** Another new form of entity in some states is a limited liability partnership. This entity is a general partnership with limited liability of its partners. All of the pass-through tax advantages of a general partnership apply to limited liability partnerships.

The principal organizational document typically must be filed with the Secretary of State. The primary document for purposes of defining the relative rights and obligations of each partner remains the partnership agreement.

G. **Sole Proprietorship** If liability is not an issue for a business venture and simplicity and low cost are a must, then a sole-proprietorship would be an appropriate means of organizing a business. A sole-proprietorship is a one person show. The profits and losses associated with the business are all reported on the individual owner's personal tax return. Other than filing an assumed business name application, when applicable, there are no formal steps required to organize the business. All other regulatory filings and registrations, however, apply equally to sole-proprietorships.

II. **Raising Capital**

The type of entity formed will depend largely on the amount of capital necessary to fund the proposed business. The goal of any capital structure is to match the needs and desires of the investor with the needs and desires of the company. The corporate structure offers several options for raising capital such as the sale of stock, and debt. A general partnership, on the other hand, has very few capitalization options. Each type of entity has relative advantages and disadvantages to the each type of investor.

A. **Choice of Security: Debt or Equity?** The most common security interest in most corporations is, of course, common stock. Most corporations are organized with only common stock. To raise capital a company may sell its common stock to investors. Often times, however, the proposed risk associated with the investment requires another means of investment involving additional terms. An investor, for example, may want to be the first to be paid back from the profits of the venture, or the first to be paid in the event of a dissolution or liquidation of the venture. Preferred stock of a debt instrument is a security interest that would accomplish these objectives. In the case of preferred stock and debt the investor stands in front of all common stockholders.

The variations of preferred stock and debt that are available to satisfy an investor are virtually limitless. Warrants or options to purchase stock are often added to spruce up a particular debt or preferred stock instrument. This gives the investor an added incentive to participate in more than one particular instrument.

A"Unit"is a term that is typically used to refer to an interest in a limited partnership interest or general partnership. Each Unit represents some percentage ownership of the partnership just like a share of stock represents a certain percentage ownership of a corporation.

Debt instruments, unlike shares of stock, do not confer ownership in a company.

A fundamental choice for any financing will be whether to choose to finance through debt or equity. Additionally, there may also be the possibility of choosing hybrid instruments that include both debt and equity, such as debt instruments with a right to participate in equity (e.g., warrants, options or other stock rights). Each has its advantages and disadvantages, some of which are summarized as follows:

1. **Debt**.

a. Advantages.

(1) Interest is typically a known cost (although this advantage is diminished where the debt has variable interest rates and is without a ceiling).

(2) Normally debt confers no claim on the future earnings of the company.

(3) Interest is tax deductible, which may provide for a lower effective cost to the borrower.

(4) Debt involves no dilution of stockholder interest.

b. Disadvantages.

(1) Interest is a fixed cost which will increase the break-even point for the company. Debt could exacerbate a downturn.

(2) Repayment increases the cash outflow of a company, which may have to be considered in future plans.

(3) Debt is not permanent capital with an unlimited life; provision must be made to refinance or repay.

(4) Debt instruments (e.g., loan agreements, bond indentures) typically include covenants or restrictions affecting control of the business.

2. **Equity**.

a. Advantages.

(1) No fixed cost. Frequently its costs will depend on the future value of the company, and whether it can afford to pay dividends. (Of course, this advantage is reduced if preferred stock is used where the payment of dividends will be required).

(2) A higher equity base can permit greater leveraging of the capital base to obtain debt financing.

(3) Stock and other forms of equity can provide permanent capital with no required payback.

(4) If the new equity is preferred stock, dilution of the current owner's equity and value does not occur.

b. Disadvantages.

(1) Dilution can be significant. The more that equity that is given up to outsiders at the beginning, the more that future growth of investment capital may be limited.

(2) Because of the prospect of dilution, equity - not being tax deductible when repaid in the form of dividends or liquidation - typically has a higher real cost than does debt.

(3) Equity provides the investor with an element of control over your business. How much control depends on the terms that you obtain, but the loss could be significant even for minority shareholder.

B. **Sale of Securities.** Corporations typically raise capital by the sale of securities. As a general rule, all securities must be either registered with the appropriate state and federal agency or be exempt from registration with the state and federal government. The registration process is a time consuming and expensive process. Fortunately, there are several exemptions from registration which are available to small businesses. A small business, however, should not assume that a proposed sale of a security will be exempt from the registration process. Every sale of any security in a business should be reviewed carefully to ensure that an exemption is available or that registration will be completed.

The penalties for failure to comply with the securities laws are extremely severe and may even result in criminal liability. In addition to complying with the registration or exemption provisions of the securities laws, an issuer of securities must also comply with the anti-fraud provisions of the law. These anti-fraud provisions are extremely broad provisions that are meant to penalize any misstatement or omission of a material fact in connection with the sale of any security. Full compliance is the only means of avoiding risk and liability associated with the sale of a security.

C. **Private Placement of Securities** A private offering (i.e., placement) of securities involves the non-public offering of securities to individuals or organizations for a price. The offering is considered an exempt offering because it is a private offering and not a public offering. Most private offerings are limited to a small number of investors and are sold through non-public means of solicitation. For example, a private offering is not advertised in newspapers or on television. Individual sales to investors are the most common form of private offering.

A "private placement memorandum" is prepared for a private offering for the purpose of disclosing all material risks associated with the proposed investment. This fulfills the technical purpose of the document which s to comply with the anti-fraud provisions of the securities laws. The other purpose of the memorandum serves to explain the business concept and the proposed terms of the investment. Information concerning the officers, directors, or partners in the venture are set forth in the memorandum along with the proposed sources of the capital being raised in the offering.

If a memorandum is not used in connection with a private offering, then care must be taken to disclose all material facts and circumstances surrounding the prosed investment. All investment documents should clearly set forth the anticipated risks associated with the proposed investment. The goal of securities laws is to make sure that and investor is fully informed of the risks and liabilities associated with the proposed transaction.

D. **Venture Capital**. Venture capitalists as a source of financing will involve extensive documentation, and may involve more than one type of security (e.g., common stock, convertible preferred stock, convertible debt, or some other form of convertible security). The following issues will almost always be important to venture capitalists:

1. Control. They will likely want the right to replace management and make major decisions concerning the business if they feel that their investment is jeopardized. Major changes in the articles of incorporation will frequently require their consent.

2. Anti-Dilution. Entrepreneurs frequently want to issue additional stock to their employees and other investors. Venture capitalists will seek anti-dilution provisions whereby the conversion ratio will be adjusted to give them more shares of common stock if the company sells common stock at a price lower than what the venture capitalists paid.

3. Registration Rights. Venture capitalists will want to have their stock registered with the SEC and state agencies as part of a public offering of a stock so that they will be able to sell it eventually. Issues - differences of opinion - will arise between them and the entrepreneur concerning the timing of such registration, and the costs associated with them.

D. **Mezzanine Financing**. When a company is too mature for a venture capital offering, but is not ready to go public, companies will sometimes seek they type financing. Convertible preferred stock will typically be offered with documentation similar to that in venture capital offerings. Pricing is usually established by reference to an expected public offering price in 12 to 18 months.

E. **Public Offering**. "Going Public" is a dream that many entrepreneurs have as a final recognition of the success of their company. A public equity offering may be accomplished at a higher valuation of the company than a private placement. The increased liquidity and value of publicly traded stock provides important benefits to the company's founders, management and principal stockholders. Additionally, publicly traded stock at high market valuations may enable the company to obtain additional private financing based on the future potential of the publicly traded stock; and it may allow the company to make future acquisitions without a depletion of its cash.

However, entrepreneurs should also consider the many ways that the operation of a public company will differ from a private company, including the various filings that federal and state securities regulators will require, and the greater disclosure of company information that will be necessary. This added disclosure could give valuable information to competitors, or adversely affect the market price of the company's stock. Additionally, the control of founders and principal stockholders could be diluted by successive public offerings.

The greater costs of going public should also be considered. Underwriting discounts and commissions usually run to about 10% of the gross offering amount. Legal costs can run between $125,000 and $200,000 or more; accounting costs (if there are no prior audited financial statements) can cost up to $100,000 or more; printing expenses can range between $50,000 and $100,000; and blue sky and other expenses can range between $25,000 and $50,000; all for a total (in addition to underwriting) range between $300,000 and $450,000. Additionally, once public, the SEC reporting requirements can involve additional legal and accounting expenses of between $30,000 and $100,000 annually. Additionally, there are costs of transfer agents, printing ad mailing of proxy statements and annual and quarterly reports to shareholders, and fees to financial and public relations consultants.

F. **Corporate Partnering**. A method of equity financing that is being used with more frequency is called "corporate partnering" or "strategic alliances," an arrangement between a large company, with substantial financial, managerial and marketing resources, which provides capital to a small company where there is a common interest in a technology, market or product. This trend has been motivated, in part, by the recognition of larger companies that smaller companies may have more innovation, flexibility and initiative. The small company is usually driven by a need for venture capital, whereas the larger company is usually motivated to obtain access to a new technology or market. In many cases, a marketing or licensing agreement is signed concurrently with the investment which allows the large company a defined market or field of use for a technology. In other cases, the large company may act as a supplier or distributor of the products being developed by the small company. In all cases, however, multiple agreements for the investment and the business relationships (e.g., joint R&D, marketing or technology exchange) must be carefully created to define all aspects of the relationship.

III. Financing That Does Not Involve Securities Law Issues.

A. **Supplier Financing**. Your suppliers can be a source of financing if they are persuaded that they will have a long term and profitable relationship with you. Depending on the supplier, they may loan hardware and skilled personnel; provide software development in exchange for royalties; co-op advertising; lease and flooring plans; warranty service.

B. **Customer Financing**. Many customers will provide advance payments of all or part of the price of products or services, depending on the nature and quantity of the product or services to be sold. This advance funding is frequently used where the customer will fund the development of a particular product, such as a unique piece of software. Extra care needs to be applied to define the milestones and performance criteria, including acceptance procedures. Additionally, in the case of the development of a product for a particular customer, the customer's and your rights to manufacture and sell the product, and to share in the royalties from such sales should be specified.

C. **Commercial Bank Loans**. Banks will typically use their own forms as a basis of negotiating loans. It is important to have your attorney carefully review the terms and conditions of those forms, which will typically give the banks broad discretion in deciding whether to advance further funds or to declare defaults. In particular, careful attention should be paid to so-called "affirmative covenants" by which you may have to satisfy financial and business criteria throughout the term of the loan. Failure to meet these covenants could lead the bank to call the loan. Note that banks will also make asset-based loans, as described below.

D. **Asset-Based Lending**. Lenders who specialize in this type of lending will provide loans which are secured by accounts-receivable, inventory and similar assets. Asset-based loans may sometimes be available to you even when you may not be able to comply with the terms and conditions of a commercial loan; however, the rates are likely to be higher for this type of lending, reflecting the increased risk to the lender and the higher cost of monitoring the loans.

E. **Equipment Leases**. Equipment leases are typically referred as either "leveraged" or "non-leveraged". Leveraged lease are complicate transactions involving the transfer of tax advantages (i.e., investment tax credit and depreciation) from an equipment user to one or more lessors. These types of leases typically involve a variety of parties (i.e., lessor, lessee, lender, brokers and trustee, as well as separate lawyers for each party), and complex documentation. The costs, including legal fees, tend to be high, and time-consuming.

Non-leveraged leases are much more straightforward. The leasing company typically retains the investment tax credit and depreciation, but may be willing to negotiate the transfer of these benefits for a higher rent. The transactions costs of these lease are much lower and less time-consuming.

IV. **After You Establish Your Business.**

There are many additional legal services that a corporation or other business entity may require after its inception. Contracts and agreements serve as a vehicle to enforce rights and as an instrument to prevent litigation. This is accomplished by a well drafted agreement that clearly defines the parties, the scope and the terms of an agreement. Moreover, by addressing these issues, the contracting parties will have a mutual understanding of the expectations of each party.

A. **Commercial Real Estate Services**. Depending on a business' circumstances, the business may want to lease or buy real estate. When purchasing commercial real estate, there are a seemingly overwhelming number of issues that should be addressed by a purchase contract. As such, it is not advisable to merely enter any contract. Before entering a contract to purchase, a business should be assured that the agreement contemplates the intended use of the property and that the agreement protects the purchasers through proper contingencies and representations. Moreover, prior to taking title, the purchaser should be assured that the title is free and clear of all liens and is otherwise good marketable title.

A more common practice is to lease commercial real estate. Because a business' location is often intricately related to its identity, a commercial lease is not to be taken lightly. Almost every aspect of a commercial lease may be negotiated. Moreover, due to the binding nature of a lease, the lease should be carefully examined to assure that it is fair and functional with respect to the business purposes. Some issues that should always be carefully examined are term, rent, improvements, signs, repairs, use, services, assignments, casualty, default, security deposit treatment and relocation of tenant.

B. **Licensing Agreements**. Many businesses must acquire permission, or grant permission to others, to use property and ideas. Without having the proper permission through a licensing agreement, a business would be flirting with potential business ending litigation for infringement or conversion. A license agreement clearly defines the property to be acquired, which can include patents, rights, trademarks, equipment, know how, and technical assistance. A license agreement also defines the compensation to be paid for the property, which can take the form of royalties, consulting fees, up front payments, and other fee arrangements. In addition, a license agreement should address modifications to the property (who owns improvements), quality control, assignment, default, outside infringements, indemnifications and the nature of the interest (whether its exclusive, revocable, etc.).

C. **Trademark and Patent Registration**. Businesses develop many types of protected interests that if copied would be extremely detrimental to the business. But merely developing a product, system or unique work does not make it protected. To properly protect a name, process or design, a business must apply for letters of patent or properly register the interest. Depending on the nature of the interest, this can be done on a state, federal or international level.

D. **Stock Sale Agreements**. A stock sale agreement is a detailed agreement that protects a purchaser and seller by making certain covenants and warranties so that securities laws are not violated and clearly defining the stock to be transferred and the sale terms. Voting trusts and proxies are binding agreements that allow stock owners to confer voting rights of stock to a trustee or person for a specific or general voting purpose.

E. **Asset Purchase Agreements**. Much like a real estate agreement, an asset purchase agreement serves to define the property to be transferred, the method of transfer, and the price. Having a written agreement spelling out the transaction in detail serves to protect those involved and creates a binding, enforceable instrument.

F. **Franchise Agreements**. Franchising encompasses a broad scope of business arrangements. It was initially meant to address basic systems of similar product distribution but now addresses all forms of business enterprise. A franchise agreement is essentially an agreement granting the right to use a business concept, trademarks, know-how, products and format. In addition, the franchisee utilizes the existing product distribution system built by the franchisor.

The benefits to a franchisor are from the sales of the franchise businesses, royalties, and requirements to use the distribution system. The benefits of a franchise to a franchise purchaser come from using existing name recognition, proven marketing concepts and established reputation. Nonetheless, to purchase a franchise, a business usually must pay a substantial price and continue to pay fees. Moreover, because a franchise involves maintaining particular formats and using certain distribution systems, the franchise agreement should be examined in great detail in order to ensure a fair and realistic arrangement that all parties understand.

E. **Employment Agreements**. Small and medium size businesses are generally operated by shareholders or other types of owners, thus making the owners the employees. A written employment agreement avoids disputes over authority and actions by outlining an employee's obligations, responsibilities and authority with respect to the business. Without such an agreement, there can be confusion as to who is responsible for what tasks and who is the ultimate decision maker regarding certain decisions. Having such an agreement will allow for objective performance evaluation and enable the business to operate efficiently.

Employment agreements help to define compensation as well. Employment agreements serve to tie performance to incentives in order to reward employees for contributing to the business, and they serve to legitimize compensation for tax purposes. Moreover, employment agreements can include non-compete clauses and confidentiality agreements. These protect the business' good will and investment in training an employee by creating enforceable rights to enjoin a person from using business information or competing with the business.

F. **Shareholder Agreements**. A shareholder agreement is an agreement between all or some of the shareholders of a corporation that addresses transferability of stock, key man insurance, buy-sell agreements, or other matters shareholders choose to agree on. The two basic reasons for a shareholder agreement are that without an agreement, shares of stock can be freely transferred to outside ownership through sale, gift or devise (possibly resulting in an unwanted business colleague or loss in control), and having such an agreement creates a market for otherwise unmarketable shares of stock. A market is created by a shareholder agreement by providing that upon death or disability or before a transfer can be made, the shareholder's stock must be offered to the corporation or to the other shareholders. This also restricts who may purchase the stock by giving the corporation and other shareholders a first option to purchase. The agreement further specifies a formula to calculate a price, or in the event of death or disability, the agreement provides for insurance proceeds to be used for the purchase of the stock. Such an agreement can also protect the balance of power when a stock transfer is made by granting prorata acquisition rights to all shareholders.

There are many stockholder agreements but the basic model sets up a purchaser, execution terms, valuation, payment terms and funding. A shareholder agreement can also ensure board membership by certain people by containing an agreement to vote shares certain ways. A company should consider a shareholder agreement whenever there is more than one shareholder.

G. **Confidentiality Agreements**. Many intangible assets of a business are not formerly protected by instruments such as patents and trademarks. A few such items are business plans, ideas, systems, lists, reports and financial data. However, businesses face many situations where such materials must be revealed to third parties (e.g., when seeking financing). A confidentiality agreement is a contractual agreement that acknowledges one party's protected right in the asset, and therefore confers a protected right in assets not otherwise protected under the law.

H. Manufacturer's Representative, Distributor and Dealer Arrangements

An essential part of the emerging growth company's business plan will be the marketing and distribution arrangements for its products or services. As your company progresses in stages from design to product development to production, it will be well advised to begin early to plan its marketing and distribution strategy and organization. Depending on the types of products and the distribution channels that are planned, there are several types of relationships and related agreements that will apply:

1.Manufacturer's Representatives. A manufacturer's representative, or rep, is an agent which sells the goods of a manufacturer or supplier within an assigned territory. The manufacturer's rep has limited authority as to the terms of sale, including pricing, and usually takes orders subject to acceptance by the manufacturer. The manufacturer's rep's territory may be exclusive or nonexclusive. Manufacturer's reps usually carry a line of related but noncompeting items. A manufacturer's representative neither has possession nor title to the goods that he or she sells.

2. Distributors and Dealers. A distributor or dealer is a sales representative which purchases the goods from the manufacturer and resells them at a marked-up price. A distributor or a wholesaler usually resells the goods to dealers throughout the distributor's territory, and the dealer in turn sells the products to the ultimate customers. Distributors and dealers both have possession and title to the goods, the distributor taking possession and title from the manufacturer, and the dealer taking title and possession from the distributor.
A distributor may also be a franchisee. Distributors and dealers usually operate on an exclusive basis within an assigned territory.

3. Consignees and Commission Merchants. Consignees and commission merchants are selling agents with which the manufacturer places possession of, but not title to, products, for ultimate sale by the consignee, but as the property of the consignor. The consignee usually does not have control over the sale of the goods, and the consignor usually approves the terms of the sale and bears the risk of loss. The consignee may return unsold goods to the consignor. The commission merchant is also a consignee, in that it holds only possession, and does not purchase the goods. However, a commission merchant has some degree of control over the goods and the terms of sale, and may sell in its own name as well as that of the consignor.

4. Value Added Reseller ("VAR") Agreements. In the computer industry, it is common for a hardware or software producer to sell its hardware or software product to another company which integrates the producer's product hardware or software products of its own and resells the integrated product. Such agreements usually provide for the VAR to receive a mark up of the price on the original product as well as profit on the VAR's product; but are generally structured to the particular application. Accordingly, they have a variety of designations such as VAR Agreements, Bundling Agreements, Developing Distributor Agreements, etc., based on the particular industry and the type of VAR being utilized to distribute the company's products.