

CHAPTER TWELVE

Forming and Operating a Small Business

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Introduction

This chapter deals with the legal and other issues that have to be resolved when forming and operating a small business. It contains six sections. The first section discusses issues that are common to all small businesses, regardless of their legal structure. Section two explores the various types of business organizations that exist in the United States, comparing their strengths and weaknesses and discussing the taxation of each type of business organization. Section three discusses the considerations that must be taken into account when selecting a form of business organization. Section four examines the steps that must be taken to get a new business organized. Section five explores the legal problems that commonly arise during the life cycle of a business, such as changing the legal format or otherwise reorganizing the business and buying, selling or liquidating the business. Section five also provides a brief summary of what happens when a business experiences financial difficulty or becomes involved in bankruptcy proceedings. The sixth and final section explains where you can go to get help and additional information about your business.

The material in this chapter is written from the perspective of a small business, such as one owned and operated by you and a few other family members or other individuals. The rights of the employees and customers of the business and transactions with your business by third parties, such as landlords or banks, are considered only with respect to the impact they have on the legal structure of the business and your exposure to personal liability for claims they may have against the business. The rights of employees, customers and third parties are dealt with in more detail in other chapters of this book. See the chapter on "[Law and the Workplace](#)" for more information on employer/employee rights and responsibilities. The chapter on "[Contracts and Consumer Law](#)" includes details on customer rights, seller responsibilities, and warranties.

Getting Started

This section deals with some of the major issues that you must resolve before becoming involved in owning or operating a small business.

Q. What are the first steps that should be taken?

A. There are four preliminary steps that should be taken before deciding to start or buy a business: development of sound business ideas, market research, financial planning and deciding whether to have co-owners.

GETTING A SOUND BUSINESS IDEA

A sound business idea is a venture that makes economic sense, generally based on your experience and background. You will generally want to choose a type of business with which you are familiar and have some experience. It would not be advisable, for example, for an individual who has no experience in food service operations to open up or buy a restaurant. Because operation of a successful business requires hard work and expertise, prior experience in the same or a similar business will save you the time and expense of developing the background and knowledge of what the particular business requires to be successful.

Q. How can market research help?

A. Because the failure rate for new business is so high it is important to determine whether a market exists to purchase your service or product, and, if so, the best way to sell it. One important issue to be decided is the location of the business. You may not want to open up a greeting card shop across the street from another greeting card shop in a small town. But two greeting card stores located in a different part of a major shopping center might both be successful. In addition, if your market is specialized or has particular needs, market research will help you to understand what your buyer wants and how to communicate that your business can meet that need.

Q. How do I develop a financial plan?

A. Inadequate or unwise financing is one of the principal reasons why so many new businesses fail. The financial requirements of businesses vary greatly. Trade associations are often a good source of information about the capital needs of a particular business. The local office of the federal Small Business Administration (SBA) and the equivalent state offices can also assist with financial planning for a new business. If the business is going to be run as a franchise operation, the franchiser will probably have a great deal of useful information about the financial resources the franchisee will need. Franchise operations will be discussed in more detail later in this chapter. Finally, banks and private business consultants can help with financial planning. Once you have gathered this information, you are in a position to develop a financial plan.

Q. How do I secure financing?

A. There are, as a general rule, three potential sources of capital for a new business:

1. contributions made by the investors who will be actively involved in the management of the business;
2. banks and other financial institutions; and
3. capital raised from other individuals and institutions.

Capital contributions from the management investors will frequently be insufficient to meet the needs of the business. Loans from financial institutions are a possibility for additional working capital, though the long-term effect of paying off the debt has to be taken into account. Most rates of profit are under 10 percent, making the assumption of an interest-paying burden a severe strain on a beginning business.

If you do decide to borrow capital, the business must have collateral to secure the loan. Financial institutions will also generally require personal guaranties and collateral from the owners of the business, which means that you might have to risk losing your home or other valuable property to get funding. The federal Small Business Administration has loan and lease guarantee programs that are designed to encourage banks and other financial institutions to lend money to small businesses. Many states also have special loan or guaranty programs or financial assistance packages and tax relief plans for small businesses. Information about these programs can be obtained from the local SBA office or the office of the equivalent state or local agency charged with the responsibility of assisting small businesses.

Q. What are consequences of bringing others into the business?

A. The fourth preliminary step is to decide whether you are going to own the business by yourself or have other investors who will have an ownership interest in the business.

The decision to bring others into the business can affect its legal structure. For example, you must have two or more owners to operate a business as a partnership. Partnerships and the other legal forms of business will be discussed in section two of this chapter. The decision to have-owners can trigger the applicability of federal and state securities laws, if the-owners are not going to be actively involved in the operations of the business.

Obtaining capital from other individuals and institutions is a possibility but, because of the potential applicability of federal and state securities laws, must be pursued with caution. The securities laws apply to the sale of any ownership interest in a business where the profits are expected to come from the efforts of others. Under this broad definition, virtually all types of equity or debt ownership interest in a small business sold to persons may be securities. For this reason, you should not contact anyone about investing in a business without fully reviewing your investment plans with a securities lawyer. This includes stock, debentures, and other similar corporate debt instruments, limited partnership interests, and even general partnership interests, where one or more of the general partners does not have the expertise (or authority) to participate in the management of the business.

Assuming a particular type of ownership interest is a security, the anti-fraud provisions of the securities acts automatically apply. In addition, unless an exemption is available, a prospectus, which is a very technical and complex disclosure document, must be prepared and the securities must be registered with the federal Securities and Exchange Commission and the equivalent state administration office in every state where the securities will be sold. Failure to comply with the prospectus and registration requirements will trigger a variety of administrative and private remedies, including money damages, and, in extreme cases, criminal sanctions.

In most cases, the particular ownership interest will qualify for an exemption from federal and in some cases state registration requirements. An exemption is a statute or regulation that says certain types of securities can be sold to the public without the expense of a prospectus, so long as other specific requirements are met. There is an exemption from federal registration requirements, for example, for a company issuing securities all of which are sold to persons in one state. There are also several exemptions designed primarily for small businesses. These exemptions, many of which are incorporated into what is known as Regulation D, have limitations on the number of purchasers or the total dollar amount of the offering. These exemptions restrict or prohibit advertising of the offering and also restrict resales of the acquired securities. Another complicating factor is that the applicable state securities laws are frequently inconsistent with the federal securities laws, and compliance with both is required.

Needless to say, no one should attempt to issue any securities without the assistance of a lawyer, accountant and other experts. All the exemptions, however, have very technical requirements with which you must strictly comply. Compliance is also expensive, although complying with the exemptions is less expensive than complying with the full registration requirements.

Q. Besides these four steps, what other issues need to be considered before going into a new business?

A. The remainder of this section will discuss issues other than the legal format of the business. These include the location of your business, insurance, various licenses and permits,

tax identification numbers and tax registration, protection of any patents, trademarks and copyrights that will be owned or licensed by the business, whether to operate your business as a franchised operation, and employer-employee problems.

It is important that you carefully review all of these issues, even if it ultimately turns out that some of them are not applicable to your particular business. Some businesses, for example those that are involved in health care or food service, are subject to complex regulation by numerous federal, state and local agencies. Other businesses, on the other hand, may only be subject to minimal regulation. The size of the business can also affect the extent of the regulations. The laws of most states, for example, exempt businesses with fewer than four or five employees from having to carry workers compensation insurance covering injuries to employees.

Even if your business is exempt, you might still decide to carry workers compensation insurance because of the protection it would give both you and your employees in the event one of your employees is injured while working in the business.

Q. Why is the location of a business so important?

A. There is an old adage that goes something like this: What are the three most important reasons for the success of a business? The answer is location, location and location. The location of the business vis a vis your competitors has already been discussed in connection with the need to conduct market research for your business. Location is important for other reasons as well.

Q. What are these other reasons?

A. One is the necessity of being located in an area that is convenient for your customers and clients. Your market research should help you to find a suitable location for your business; but that's not the only decision you have to make. Another important decision is whether to own or lease the building where the business is to be located.

BUY OR LEASE YOUR PLACE OF BUSINESS?

Unless you already own a suitable building, this can be a difficult decision. Buying or building a new building generally involves a larger capital outlay than a lease, but if the building is mortgaged, the term of the mortgage will frequently be longer than the term of a lease of similar space. On the other hand, commercial leases are generally much longer and more complex documents than residential leases and should be reviewed by your lawyer before you sign the lease agreement. Your lawyer should, of course, also review all the documents involved in the purchase or construction of any building you buy or build.

Q. What are some of the most important issues involved in a commercial lease?

A. A detailed discussion of commercial leases is beyond the scope of these materials, but four important issues to look for should be mentioned-the amount of the rent, an option to renew, an option for additional space and protection against competitors.

Q. How do you determine the rent?

A. In most cases the rent in a commercial lease will be expressed as so many dollars per square foot. This is the annualized price for the unit, so the monthly rent is determined by multiplying the rent per square foot by the total number of square feet in the unit and dividing by twelve months. For comparative purposes with other suitable rental units, you need to know whether the rent includes or excludes taxes, insurance on the building, and utilities. To the extent it excludes them, you will have to pay these items in addition to the rent.

Sometimes rent escalation clauses permit the owner to raise the rent because of inflation or when taxes or utilities go up during the year. Finally, many retail and restaurant leases will include clauses that require the tenant to pay either a flat monthly rental or a rental based on a set percentage of sales in the store or restaurant, whichever is higher.

Q. What is an option to renew?

A. A second important issue in commercial leases involves an option to renew the lease at the end of the lease term for an additional term. Without an option to renew, you may be forced to move or to pay an extraordinarily high rent to remain where you are just at the time the business is becoming very profitable. To provide maximum protection, the rent, or at least a formula for determining the rent during the renewed period, should be specified.

Q. What is the significance of an option for additional space?

A. A third issue that needs to be investigated is an option to lease additional space and the rent for that space. That option allows the new business to lease only the amount of space it needs, with the protection of being able to increase the amount of space when and if it is needed. The advantage of an option is that you are not obligated to rent the additional space unless you want to.

Q. Can the lease protect my business from competitors?

A. A fourth issue involving commercial leases that can be important in some types of business is a provision prohibiting the lessor from leasing space to a competitor, or if the lessor will not agree to this, a provision stating that space leased to any competitor must be located on a different floor or in a different wing of a shopping center.

Q. What about operating a business out of my home?

A. For some types of businesses, especially those where you visit your customers rather than being dependent on their coming to your place of business, this is fine. In some situations, you may be able to deduct the value of the space you use for your business operations on your income tax return. To qualify for the deduction, however, your home office must, as a general rule, be your principal place of business (i.e., your main location for administrative/management activities) and be regularly and exclusively used by the business.

One of the most prevalent types of businesses operated from homes is a day care center. Many states have special license requirements for day care centers. In some states the licensing and other requirements for day care centers in private homes having only a few children are less rigorous than larger group day care centers. Finding out what regulations apply is important for this and every type of business.

Q. What types of licenses and permits are required for a business?

A. It depends on the type and location of the business. All states have statutes and regulations that require tests, proof of financial responsibility and compliance with other requirements to obtain a license to engage in a particular business or profession. A state license to operate a day care center is one example. Doctors, lawyers and even barbers have to be licensed by the state before they can practice their profession. The types of businesses subject to these licensing requirements vary from state to state.

Some businesses exempt from state licensing regulations are required to obtain a license or permit from a county or city to perform certain operations. Building contractors, for example, have to get a city or county building permit to build a house or commercial building.

Most cities and many counties require businesses located in their jurisdiction to have a business license. In reality, this is a tax based generally on the gross receipts of the business rather than a regulatory license designed to protect the public against shoddy work and incompetence. Avoiding this tax can be an important factor in choosing the location of a business.

Q. What kinds of insurance will I need?

A. As is the case with most of the other issues discussed in this section, it depends to some degree on the type and size of the business. The exemption from workers compensation insurance for small businesses with very few employees is an example of this principle. Another is employee fidelity bonds, which is a form of insurance to protect against embezzlement. Some businesses are required to have fidelity bonds for employees such as bookkeepers who handle money. Most businesses, however, can choose whether to bond all or some of the employees.

Some of the other types of insurance a typical small business will want to consider include:

- business interruption insurance (often referred to as business continuation insurance) to offset losses if the business is forced to shut down for a substantial period because of a fire, flood or other catastrophe;
- liability insurance, including product liability insurance, to protect against damage claims filed by third parties injured on the premises, by delivery trucks or other company vehicles, or by a product produced by the business;
- malpractice and errors and omissions insurance for professional businesses;
- director and officers (D & O) liability insurance to pay the expenses and damage awards against corporate executives as a result of suits filed against them by shareholders of the corporation;
- medical insurance covering the owners and the employees of the business;
- disability insurance, which pays a portion of the salary of an employee or owner who has a long-term disability and cannot work;
- life insurance that will provide a death benefit to the families of the owners and the employees and possibly provide funds to compensate the business for the loss of one of the owners (often called "key man" insurance) and funds to purchase the equity interest of a deceased owner;
- unemployment insurance, which is really a tax based on the payroll of a business used to pay benefits to all long term unemployed workers in a state.

Q. What tax registration and identification numbers, tax forms and the like are required for a new business?

A. There are several federal and state requirements. The Internal Revenue Service (IRS) publishes a pamphlet entitled "Your Business Tax Kit," which is available at any IRS office or on the Internet at www.irs.ustreas.gov. It contains a great deal of helpful information on the various federal taxes that apply to a business. Many state tax commissions have similar publications describing the state taxes that apply to a business. Both types of publications contain samples of the tax registration and other forms that must be filed.

All businesses must obtain a Federal Employer Tax Identification Number before beginning to operate. Each state also requires tax registration by a new business. In most cases the state will use the Federal Employer Tax Identification Number (see insert below). All states that have sales taxes also require any business that is not exempt from the tax to register with the appropriate state agency. The business is required to collect and remit to the state on a regular basis (monthly or more frequently) the applicable sales tax.

Every business is required to withhold from employee wages federal and state income taxes and FICA (social security and Medicare) taxes and regularly remit these funds to the IRS (in the case of federal withholding and FICA) and the applicable state tax agency. Businesses whose total federal payroll tax liability for the prior year is \$50,000 or less must deposit payroll taxes in a special account once a month. Businesses whose payroll taxes for the prior year exceeded \$50,000 must deposit the tax money two times each week. The total deposits must then be paid to the IRS at the end of each quarter. The state requirements may or may not be the same as the federal deposit requirements. It is important to know the requirements and follow them, as there may be heavy penalties for late payment.

Most states require registration or at least periodic filing with the state agency that administers the state unemployment insurance tax, which is a tax based on the businesses payroll. A business must also pay the federal Unemployment Insurance Tax, which is also based on its total payroll, on a periodic basis.

In addition, all businesses must file annual federal and state income tax returns. The applicable forms vary with the type of business. Partnerships, "S" corporations, limited liability companies and other businesses that as a general rule pass the tax consequences of their operations to their owners file a different type of return from that of businesses that are operated as "C" corporations. The differences in the way various types of business organizations are taxed will be discussed in the next section of this chapter. "S and "C" Corporations are terms that are applied to different types of corporations for tax purposes. The characteristics of these designations are described later in this chapter.

GETTING AN EIN

The EIN, as it is known, is obtained by filing an IRS form SS4, which can be obtained from any office that has IRS forms or online from the IRS website--www.irs.ustreas.gov. If the form is mailed, the EIN will be issued in four to six weeks. Alternatively, the SS4 can be faxed to 816-926-7988 and the number will be issued within 24 hours, or the applicant can call direct (816-926-5999) and receive the EIN number verbally. If the latter method is used, the applicant must place the number on the SS4 and mail the to the IRS for processing.

Protection of Patents and Other Intellectual Property Rights

Q. How can patents, trademarks, trade secrets, trade names, and copyrights owned or licensed by an investor or a business be protected?

A. These types of property are generally referred to as intellectual property rights. Each type is subject to special legal and tax rules, which will be briefly described below. Because of the highly technical nature of intellectual property rights, it is essential that competent legal counsel be consulted as soon as possible once it becomes evident that such a right exists, in order to maximize the protection of the developer or owner of the right.

Q. What kinds of inventions are patentable and what is the advantage of obtaining a patent?

A. Not every invention is patentable. By statute, the invention must fall into at least one of four classes: process (for example, manufacturing of chemicals or treating of metals), a machine, an article of manufacture, or composition of matter (for example, mixtures of chemicals). In addition, based on existing technology (known technically as prior art), the invention "would not have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains." This is usually referred to as the "unobviousness" test. Not only must the invention meet the foregoing criteria, it must have some utility and not be frivolous or immoral, and there must be proof that it can be made operative. Moreover, a patent will not be issued if the invention has been described in any printed publication anywhere in the world or was in public use or offered for sale anywhere in the United States for more than one year prior to the time an application for a United States patent is filed. Assuming all these conditions are met, the patent may still not be issued because of existing valid conflicting patents. Even if it is not possible to obtain a patent, however, it may be possible to provide basic protection for the owners of the invention through the trade secret doctrine, or in the case of a design invention by means of a trademark or copyright. These and other possibilities, such as an unfair competition claim against unauthorized users of the invention, should be explored with the client's patent counsel.

The application for a patent is filed with the Patent and Trademark Office in Washington, D.C. You can contact them at U.S. Department of Commerce, Crystal Palace Building, 2121 Crystal Drive, Arlington, VA 22202; telephone, 800-786-9199; web address www.uspto.gov. The grantee of a patent has non-renewable exclusive monopoly in the United States to use or assign rights to use the patent for seventeen years from the date of issue. A patent issued in the United States does not provide any protection in another country, however. For such protection, additional patents must be obtained. In order to have maximum protection in all other countries that are signatories to various treaties and conventions establishing reciprocal priority rights, foreign patent applications must be filed in this country. Since patents in many other countries are subject to onerous taxes and in some cases compulsory licensing within the country, it is often advisable not to seek foreign patents, or to seek them only in countries where it will be economically worthwhile to do so.

The time involved in pursuing all the procedural steps in obtaining a final decision on a patent may take several years. Since the seventeen-year life of a patent begins to run only from the date of issue and an infringement claim can cover the period between the filing of the application and the issuance of the patent, however, the inventor's rights are not prejudiced by

the delay, assuming a valid patent is ultimately issued.

USING A PATENT TO GENERATE INCOME

An inventor can maintain total control of a patent and manufacture and market goods employing a patent as a sole proprietorship. Alternatively, the inventor can sell or license the patent to others on an exclusive or non-exclusive basis in return for a payment called a royalty. One option is for the inventor to sell or assign the invention to a new or existing business in which the inventor is an investor with the expectation that the business will develop and market the patented product. These various methods of marketing a patent have different tax consequences.

Q. What are the tax consequences of patents?

A. For tax purposes, marketing an invention involves two stages. The first is the research and development stage, when the invention is refined and reduced to practice. The expenses incurred in this stage are generally deductible. The second stage involves the tax consequences of sale or license of the patent once it is issued. Self-exploitation of a patented invention has no particular tax consequences. The sale or license of rights in an invention, however, can produce either ordinary income or capital gains, taxable at a lower rate than ordinary income under current law. The Internal Revenue Code has very stringent requirements, however, for obtaining capital gains treatment, and it is very important to seek the early assistance of a lawyer who is familiar with the tax consequences of patents. This is particularly true if there is any possibility the patent will be transferred to a business with the expectation that the owners of the business will receive capital gains treatment on the royalties generated by the patent. For this plan to work, the invention must be transferred to the business prior to the time the invention has been tested and successfully operated or has been commercially exploited, whichever is the earlier. It is often difficult to determine when an invention has been reduced to practice.

If a patent is going to be transferred by the inventor to a business in which the inventor has an ownership interest, it is generally easier to achieve favorable tax treatment if the business is a partnership or limited liability company than if it is a corporation.

Q. What are trade secrets?

A. A trade secret, sometimes referred to as "know-how," is generally defined as an aggregation of data or information not generally known in the industry that gives the user an advantage over competitors. Common examples of "know-how" are formulas, manufacturing techniques and processes, designs, patterns, programs, systems, forecasts, customer lists, specifications, and other technical data. A trade secret is not patentable, nor can it be registered as a trademark. Trade secrets are recognized legally as proprietary rights and are protected against unauthorized use by the courts. However, for information to continue its status as "trade secrets," its owner must take appropriate steps to protect it from disclosure and maintain its confidentiality. The Trade Secrets Home Page—www.execpc.com/~mhalign/--has much helpful information.

Q. How are trade secrets taxed?

A. Trade secrets are not specifically covered anywhere in the Internal Revenue Code. Nevertheless, the tax treatment of trade secrets and "know how" is fairly well established by the courts.

The expenses incurred in developing a trade secret can be either amortized or deducted. There are no other tax consequences associated with trade secrets unless they are transferred, for example, as part of the sale of all the assets of a business. In some situations, the amount allocated to the trade secrets may qualify for capital gains treatment.

Q. What are trademarks and trade names and how are they protected?

A. A trademark is generally defined as any work, name, symbol, or device used by a manufacturer or distributor to distinguish its goods from those manufactured or sold by others. A related property right is a service mark that is basically the same as a trademark except that it relates to services rather than goods. Certification marks, such as seals of approval and collective marks used to indicate membership in an organization, are also related concepts. Applications for registering a trademark are filed with the Commissioner of Patents and Trademarks, Crystal Park Building, 2121 Crystal Drive, Arlington, VA 22202, telephone (800) 786-9199, web address www.uspto.gov.

A trade name is generally the name that the business uses for advertising and sales purposes that is different from the name in its articles of incorporation or other officially filed documents. Most states authorize the protection of a trade name by filing in that state. Drawing the line between a trademark and a trade name can sometimes be difficult. Is "McDonalds" or "Holiday Inn" a trade name, a trademark, or both? It is often advisable to seek protection under both sets of statutes in these situations.

Your lawyer will help you search to discover whether there is an existing trademark or copyright that may conflict with yours.

Q. How are trademarks and trade names taxed?

A. The cost of developing and registering a trademark or trade name must be capitalized. The advertising and promotional expenses incurred in marketing goods and services subject to a trademark or trade name, are, however, deductible as selling expenses.

The sale of a trademark or trade name can generally result in capital gains treatments. Instead of an outright sale, a trademark or trade name is frequently licensed to one or more third parties, often as part of a franchise agreement. (Franchises are discussed in the next section of this chapter.) The income received from this licensing arrangement will generally be treated as ordinary income rather than capital gains.

ART THAT IS PROTECTABLE BY A COPYRIGHT

Seven types of artistic endeavors can be copyrighted:

1. literary works;
2. musical works;
3. dramatic works;
4. pantomimes and choreographic works;
5. pictorial, graphic and sculptural works, including fabric designs;

6. motion pictures and other audio visual works; and
7. sound recordings.

Copyright protection is obtained by placing the symbol and the name of the copyright holder on every publication of the material and filing a copyright application for the artistic work with the Federal Copyright Office, Copyright Information Office, Library of Congress, 101 Independence Avenue, SE, Room #LM 401, Washington, D.C. 20559-6000, telephone, (202) 707-9100, web address www.lcweb.gov/copyright. See also the website of the Copyright Society of America, www.csusa.org.

Q. How are artistic efforts protected by copyrights taxed?

A. An individual who creates an artistic work, unlike the inventor of a patentable product, is unable to obtain capital gains treatment upon the sale or transfer of the rights to the work. However, capital gains tax treatment is possible when the creator of the artistic effort is a corporation or business entity taxed as a partnership. Thus, sales of films produced by a corporation, partnership or limited liability company can, under some circumstances, qualify for favorable capital gains tax treatment.

Sidebar: Need More Help?

- For more on intellectual property generally, the Intellectual Property Owners (IPO) might be able to help. The IPO is a membership association that represents intellectual property owners. The IPO can be contacted at 1255 Twenty-third Street, NW, Suite 850, Washington, D.C. 20037. Its web site is <www.ipo.org>
- For more on patents, contact the National Patent Association, 216 Hulls Hill Road, Southbury, CT 06488-9891; 800-672-2280; <www.nationalpatent.com>. A law firm website <www.patents.com> contains much useful information and links about patents and other forms of intellectual property.
- For copyrights, the Copyright Resource Page--<www.aimnet.com/~carroll/copyright/faq-home.html>--has copyright basics, FAQs, and other very useful material.

Franchises

Q. Is operating a business as a franchise something I should consider?

A. Franchising is essentially a method of marketing and distributing products and services that usually involves the licensing of an established trademark or trade name or both. There are well over 500,000 franchised outlets in this country in virtually every type of business. Franchises employ several million employees and generate several hundred billion dollars of receipts each year. In many industries, franchising is the dominant form of distribution. For example, most automobile and truck dealerships and soft drink bottlers are franchisees.

Q. What are the advantages of franchising?

A. From a manufacturer's or distributor's point of view, the logic behind franchising is simple: it requires a great deal less capital to distribute goods and services by use of franchises than by operating company-owned units, and additional income is generated from licensing trademarks and trade names and from other services provided by the franchisor for the franchisee. The major benefits to the franchisee are the use of the good will of the franchisor's trademarks and trade name, and expert guidance in such matters as site selection, training of employees, bookkeeping and other managerial services. These items are particularly valuable to the inexperienced businessperson who desires to own his or her own business but wants to minimize the risk of failure. These services also make franchising an attractive vehicle for encouraging minority-owned businesses.

Q. What kinds of fees and costs must a franchisee pay to the franchisor?

A. Typically, the franchisee will pay a franchise fee, which can often be spread out over a period of years, for the right to use the trademarks, trade names, and trade secrets of the franchisor and for managerial services involved in getting the franchise established. Frequently, a franchisee will also be required to purchase all its initial equipment, including signs and trade fixtures, from the franchisor. The franchisee may also be required to purchase many of its supplies from the franchisor or from franchisor-approved sources. In addition, a franchisee will normally pay the franchisor a royalty, which is usually based on a percentage of the gross receipts from the franchised goods or services. The royalty covers such items as advertising and continuing managerial services as well as a licensing fee for use of the franchisor's trademark and trade names. If the franchisor owns the franchised location, the franchisee will obviously have to pay rent for the building to the franchisor.

Q. What type of business form should a franchisor or franchisee use?

A. The determination by a franchisor or franchisee to operate as a proprietorship, partnership, corporation or limited liability company is essentially the same as for any other business. The size and financial success of the business, tax considerations, and the potential exposure of the investors to liabilities from the operation of the business are the principal factors that influence the choice of business form.

In this connection, a franchisor may, in some circumstances, be held liable for the debts, torts, or taxes of a franchisee. Increasingly, franchisors are being held liable for product liability claims based on defective products manufactured or distributed to franchisees and ultimately sold by the franchisees in retail sales. In many states the doctrine of privity, which at one time would have barred any damage or injury claim directly against the manufacturer and any intermediate distributor, has been abolished or curtailed. In addition, the Magnuson-Moss Warranty Act authorizes a direct suit against a manufacturer in any case involving express written warranties made by the manufacturer in connection with sales of consumer products. Franchisors are also vulnerable to a variety of claims asserted by their franchisees.

Q. What legal protection does a franchisee have?

A. Considerable evidence suggests that historically the franchise marketing system has been abused by both franchisors and franchisees, particularly by the former. This abuse has prompted a considerable amount of litigation and remedial legislation in recent years both on the state and federal level. Many states, for example, have statutes that regulate the sale, termination and

transfer of franchises.

The most significant federal regulation of franchising is the Federal Trade Commission (FTC) rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures."

Q. What does the FTC franchise disclosure rule require?

A. Essentially the FTC rule requires that a franchisor give a potential franchisee a disclosure statement (on twenty different topics) that is similar to a securities registration statement. Detailed information about the business and financial history of the franchisor and its principals, the franchise agreement, and financial obligations of the franchisee are required by this rule. Provisions regulating statements by the franchisor concerning potential profitability are also included in the rule. These projections must be related to the geographic area where the franchisee is to operate, and the franchisor must disclose the factual basis of the projections. The disclosure statement, which must be updated within ninety days after the close of the franchisor's fiscal year, and a copy of the franchise agreement, must be given to a prospective franchisee before any person-to-person meeting between the franchisor and franchisee, or at least ten business days before the franchisee signs any binding agreement to purchase the franchise or makes any payment for the franchise, whichever date is the earlier. Violation of the rule is an unfair trade practice subjecting the franchisor to a cease and desist order, damages, and fines of up to \$10,000 for each violation.

PRECAUTIONS BEFORE SIGNING A FRANCHISE AGREEMENT?

In addition to careful study of the disclosure statement and all proposed contract documents, the FTC recommends that before investing in a franchise you take the following precautions:

1. consult with an attorney and other professional advisors before making a binding commitment;
2. be sure that all promises made by the seller or its salespersons are clearly written into the contracts you sign and be sure the franchisor provides training programs for new franchisees;
3. talk with others who have already invested in the business and find out about their experiences; and
4. if you are relying on any earnings claims or guarantees, study the statement giving the basis for the claims and find out the percentage of past investors who have done equally well.

Q. How can a lawyer help an individual or group considering a particular franchise?

A. There are a number of areas in which an attorney can provide valuable services to a client considering a franchise. For example, though some state laws make it difficult to make major changes in a franchise agreement, the franchisee's lawyer can often help negotiate the critical terms of the franchise agreement with the franchisor. It is sometimes possible to work out an agreement to reduce the initial fee, to spread out payment of the initial fee over a longer term than originally proposed, or to require a rebate of a portion of the initial fee if the franchise is terminated before the expiration of the contract term. Additional protection of the franchisee against excess competition from the franchisor or other franchisees can also frequently be

negotiated. Rights of the client to additional franchises in the area should be explored. Another important area of negotiation concerns the circumstances under which the franchisor can terminate or refuse to renew the franchise and the amount of the franchisor's control over the price and other terms of any sale or other disposition of the franchise. Although franchisors have traditionally resisted any changes in their standard printed agreements, there is evidence that they are becoming more flexible in their willingness to negotiate terms and to remove from their standardized franchise agreements provisions that have resulted in successful claims of overreaching and antitrust violations.

Besides negotiating the terms of the franchise agreement, the franchisee's lawyer can also provide valuable counseling services, for example, by assisting the client in obtaining additional information on the franchisor from financial services companies such as Dun and Bradstreet, Better Business Bureaus, and other franchisees, and in evaluating the economic risks of the particular venture compared to other similar franchised and nonfranchised ventures. The amount of initial fees and royalties and uses of the royalty income vary significantly even among franchisors in the same line of business. Careful investigation may uncover improper hidden charges and kickbacks. Frequently the franchisee will not be experienced in financial matters, including knowledge of necessary start-up costs, working capital needs, and available financing sources. The information provided a prospective franchisee under the FTC Disclosure Rule and from other sources is of no real value if the client is unable to evaluate it properly. A lawyer can also negotiate the business's lease and other related agreements.

Employer-Employee Relations

Q. How are employer-employee relations regulated?

A. There are numerous federal and state statutes that regulate employer-employee relations. Most of these statutes have been enacted in the past thirty years. A list of some of the most important federal legislation in this field includes the following:

- The Norris-LaGuardia Act and the Labor Management Relations Act, which regulate labor unions.
- The Fair Labor Standards Act, which primarily regulates minimum wages, maximum hours and overtime.
- The Equal Pay Act, which prohibits sex-based pay differentials for equivalent work.
- Title VII of the 1964 Civil Rights Act, the principal statute that prohibits employment discrimination based on race, color, sex, religion or national origin. Title VII also established the Equal Employment Opportunity Commission, which is the main administrative body with responsibility to enforce employment anti-discrimination legislation.
- The Age Discrimination in Employment Act, which prohibits discriminatory practices in hiring, firing, compensating and setting terms of employment of individuals forty years of age or over.
- The Occupational Safety and Health Act of 1970, administered by the Occupational Safety and Health Administration (OSHA), which sets safety and health standards for production plants and machinery.
- The Americans With Disabilities Act, which requires removal of barriers to persons with disabilities by all businesses "providing public accommodations," a term which is

much broader than it sounds and includes restaurants, theaters, and even doctors' offices.

- The Employee Retirement Income Security Act of 1974, referred to as ERISA, which establishes substantive and procedural rules for employee pension and welfare benefits, such as medical coverage.
- The Family and Medical Leave Act, enacted in 1993, which requires employers to allow individuals up to twelve weeks of unpaid leave per year to care for a child or other family member without fear of dismissal or other penalty.

In addition to these statutes, there are a number of federal statutes that affect private businesses only if they receive federal financial assistance. Examples are the Comprehensive Employment and Training Act of 1973, which prohibits discrimination in special employment incentive programs that receive federal assistance, and Titles VII and VIII of the Public Health Service Act, which prohibit discrimination in health training programs that receive federal assistance.

There are also many state statutes that regulate employment relations. Some of these state statutes parallel and often overlap federal statutes. Others, however, deal with issues not dealt with in federal statutes. The most prominent of these are the state workers compensation statutes that compensate employees for job-related injuries on a no-fault basis.

Q. Is every one of these acts applicable to small businesses?

A. Almost all businesses are subject to one or more of these statutes. Some small businesses may, however, be exempt from one or more of the acts, because of their size. For example, Title VII of the Civil Rights Act covers only employers having fifteen or more employees, and the Age Discrimination in Employment Act covers only businesses having twenty or more employees. On the other hand, the Fair Labor Standards Act, the Equal Pay Act and the Americans with Disabilities Act cover virtually all non-governmental employers.

PREVENTIVE LAW TO THE RESCUE

Because of the differing exemptions, the overlap between the various applicable statutes and the involvement of various federal and state administrative agencies, there are many problems in complying with all the regulations (many of which are inconsistent) and developing case law. Moreover, the law in this area is developing and changing so rapidly that it is advisable for businesses to invite employment law specialists to visit the business on a regular basis to review recent legal developments and any existing and potential employment law problems the firm has. This "preventive law" approach can help to reduce the incidence of employment law problems and the severity of any problems that do arise.

Q. Can compliance with these regulations be avoided by the use of temporary workers and independent contractors?

A. The answer is generally yes, assuming the contractual relation creating the arrangement is bona fide. The use of temporary workers, including leased-employee arrangements, part-time employees, and independent contractors, has been growing rapidly in recent years. By using

these kinds of workers instead of full-time employees, a business may be able to qualify for an exemption from many of the federal and state statutes that regulate employers. Moreover, having very few employees saves on health insurance premiums and makes it less costly for a business to have generous fringe benefit plans for the principal executives.

These cost savings must, of course, be borne by the company that provides the temporary employees and the independent contractors providing services for a business, which in turn may increase the amount the business must pay for these services. These companies, however, can often provide compliance more efficiently and cost effectively than most small businesses. The downside for companies using temporary and leased employees is the considerable risk of lower morale on the job, reduced quality and productivity, and the need to be seeking and training workers constantly. When figuring in these factors, many companies have concluded that the cost savings are illusory and they're better off with experienced, full-time employees.

TYPES OF BUSINESS ORGANIZATIONS

There is a wide variety of basic legal formats for structuring a business. Each type has its own special characteristics, uses and limitations. The proprietorship, partnership, and corporation are the most popular and well known. A newer but increasingly popular form of business organization is a limited liability company. The principal characteristics of all these types are described in this section.

For More on Proprietorships

You can find information about tax laws and sole proprietorships from

- www.intuit.com/turbotax/support/taxedge/ref/propriet.html
- www.irs.treas.gov/prod/tax_edu/teletax/tc408.html

Q. What is a sole proprietorship?

A. A sole proprietorship is an unincorporated business that is owned by one person. If there is more than one owner or the business is incorporated as a corporation, a process that is described later in this chapter, it cannot be a proprietorship.

A proprietorship can have employees, however, and, except for a few restrictions that vary from state to state, can operate any type of business. If you conduct a business without co-owners and take no legal steps to become another form of business, then you are a sole proprietor with respect to that business even if you are not aware of this fact. A person who, for example, on a part-time basis paints pictures in her home which she exhibits and sells is a sole proprietor with respect to her paintings and therefore must comply with all applicable tax, licensing and other regulations.

Sole proprietorships are the most prevalent form of business in this country. Recent published statistics indicate that there are over 14 million proprietorships compared to 3.5 million corporations and 1.6 million partnerships.

Q. What are the advantages and disadvantages of a proprietorship?

A. The sole proprietorship is an inexpensive and informal way of conducting a small business. Its drawbacks are full personal liability for the owner (explained below) and the danger of liquidation at the death of the proprietor.

The principal advantage of the sole proprietorship is that it is the simplest form of business organization. No statutes similar to those applicable to corporations and partnerships govern its organization or operation, though, as explained in the section of this chapter on getting organized, if the person uses a name other than his or her own, he or she may need to file a "Doing Business as Certificate" or "Assumed Name Certificate." The sole proprietorship provides an entrepreneur with an opportunity to own his or her own business without the formalities and expense of incorporation or the necessity of sharing control of the business with others, as is the case in a partnership or in a corporation having more than one shareholder.

The fact that the assets and obligations of a sole proprietor are not separate from those of the proprietor results in the proprietor's being fully liable for the debts and other liabilities of the proprietorship, and avoids a separate level of taxation on the business. The taxable income, credits, and deductions of the business must be reported by the proprietor on his or her individual income tax return.

A proprietorship also has the least flexibility of all the business forms with respect to raising capital. No ownership interests can be sold to other persons; and the ability to borrow money for the business is dependent on the net assets of the sole proprietor.

WHEN THE PROPRIETOR DIES

The single-ownership principle combined with the lack of separate entity status creates severe problems at the death of the proprietor. Legally a sole proprietorship ceases to exist at the proprietor's death. Unless the executor is authorized to continue the business during the administration of the estate, a new owner is found, or the business is incorporated, the proprietorship will have to be liquidated with the consequent loss of the going concern value. For the same reasons, providing an optimum estate plan for a sole proprietor is more restricted than with the other forms of business organizations.

Q. What are partnerships?

A. A partnership is an unincorporated association of two or more persons who carry on a business for profit as-owners. A partnership exists if these conditions are met, even though the persons involved do not know or intend that the business be a partnership. If a husband and wife, for example, are jointly operating an unincorporated retail shoe store, unless it is clear from their financial records that one of them is the true owner and the other is merely an employee (in which event the company would be classified as a sole proprietorship), the business will be a partnership and both the husband and wife will be considered as partners and-owners of the business.

Q. What kinds of partnership exist and what are the differences between them?

A. There are two types of partnerships recognized in the United States: general partnerships and limited partnerships. The fundamental distinction between the two types is that in a limited partnership, there must be at least one limited partner and at least one general partner. The advantage of being a limited partner is that if the business is unsuccessful, the limited partner may lose the amount of money invested in the partnership, but has no other financial risk. In this sense a limited partner bears the same risk of loss as a shareholder in a corporation or a member of a limited liability company. General partners, including general partners in a limited partnership, on

the other hand, can lose not only whatever money or other property they have put into the partnership, but in addition their personal assets can be used to satisfy the unpaid claims of the partnership's creditors. This is why general partners are said to have unlimited liability whereas limited partners are said to have limited liability.

The following are the primary differences between general and limited partnerships: first, only limited partners have limited liability; second, limited partners can lose their limited liability if they take part in control of the business and third parties believe them to be general partners; third, a change in the number or composition of limited partners is not potentially as disruptive as the retirement, death, or disability of a general partner; and fourth, there are in general more legal formalities connected with limited partnerships, including the necessity of filing limited partnership certificates in one or more places, keeping them up to date, and maintaining certain records. With the exception of compliance with state and local assumed name statutes, there are no mandatory filing requirements for general partnerships in most states.

Q. What are the advantages of partnerships?

A. The principal advantage of partnerships is the ability to make virtually any arrangements defining their relationship to each other that the partners desire. There is no necessity, as there is in a corporation, to have the ownership interest in capital and profits proportionate to the investment made; and losses can be allocated on a different basis from profits. It is also generally much easier to achieve a desirable format for control of the business in a partnership than in a corporation, since the control of a corporation, which is based on ownership of voting stock, is much more difficult to alter.

Because it is possible to sell equity interests in a partnership, the ability to raise capital in a partnership is greater than in a proprietorship. However, as a result of the greater familiarity with the corporate form, and the potential of personal liability or lack of participation in control in a partnership, a corporation may have a greater ability to raise capital than a partnership.

With careful advance planning, a partnership can avoid some of the problems inherent in a proprietorship when an owner dies, retires, or becomes disabled. In fact, many believe that a limited partnership is an ideal vehicle to provide for continuity and succession in a family business.

The mechanics of succession vary with the situation. If you want to pass your share of the business to other family members (usually a spouse or children), it is relatively simple to transfer your interest to them, perhaps by leaving the family members enough cash (possibly through life insurance proceeds) to buy out the others and thus avoid conflicts. (In a small corporation, you could leave voting stock to family members who will operate the business, and leave non-voting stock to others.)

Things get slightly more complicated if you decide to pass ownership on to people who are not beneficiaries of your will. If your business is a partnership, you will usually want your partners to remain in operational control. A "buy-sell agreement" is the most common device for transferring ownership of a business on the death of a partner. Under such an agreement, the remaining partners agree to purchase your interest when you die. This allows the business to continue running smoothly with the same people in charge, minus one.

Buy-sell agreements typically provide that at the owner's death, his or her interest in the business will be acquired by the remaining partners or shareholders, or by the business itself, leaving the deceased owner's relatives with the proceeds of the sale. Life insurance is usually the vehicle used to finance these arrangements, which lets the business avoid a drain on its cash. The partners buy life insurance on each other's lives, and the proceeds go to the surviving spouse, children, or other designated beneficiaries, in return for the deceased owner's share of the

business.

Partnerships are taxed on a conduit or flow-through basis under subchapter K of the Internal Revenue Code. This means that the partnership itself does not pay any taxes. Instead the net income and various deductions and tax credits from the partnership are passed through to the partners based on their respective percentage interest in the profits and losses of the partnership, and the partners include the income and deductions in their individual tax returns.

For More on Partnerships

- www.bizmove.com/starting/m1r.htm is the URL of a useful checklist on points to consider when entering into a partnership. The site also has other useful information for the businessperson.
- www.inc.com/bbs/list/19 is the URL of a “peer-to-peer” bulletin board on topics of interest to business owners, including partnership disputes and other partnership issues.
- Azriela L. Jaffe, *Let's Go into Business Together: 8 Secrets to Successful Business Partnering* (Avon Books, 1998) looks at the personal dimensions of this sometimes difficult business form.
- Robert L. Davidson, III, *Small Business Partnership Kit*, looks at the pros and cons and provides guidance on many of the legal aspects.

Q. What are the disadvantages of partnerships?

A. The major disadvantages of a partnership, as with a proprietorship, stem primarily from the fact that a partnership is not as stable as a corporation. This results from the fact that a general partnership technically dissolves whenever a general partner dies, files bankruptcy, resigns or otherwise ceases to be a partner (dissociates). A general partnership and a limited partnership dissolve on the dissociation of a general partner unless either a remaining general partner continues the business or all the partners (or under some statutes, a majority) agree to continue in business. Upon dissolution, a partnership will normally be required to be liquidated, but in most large professional general partnerships, the partners agree to continue the business. However, a corporation, under most statutes, continues forever until some affirmative action is taken to dissolve it.

It may be more difficult in a partnership than in a corporation to have a hierarchy of management and to raise capital from outside sources. Careful planning and drafting, however, can minimize or eliminate most of these and other supposed disadvantages of a partnership, through agreements providing for a specific governance relationship and desired variations in capital ownership in a partnership. This is particularly true with respect to limited partnerships.

Q. What are corporations and how do they differ from other types of business organizations?

A. A corporation is a legal entity that is formed by filing what is known as articles of incorporation or a certificate of incorporation with the Secretary of State in your state along with the required filing and license fees.

One or more persons can form a corporation. Thus, a sole proprietor can incorporate if he or she wants to. Although there are some exceptions (doctors and lawyers are prohibited by ethical and regulatory constraints from operating in certain types of corporations), corporations

can generally operate any type of business.

The person or persons who file the articles or certificate of incorporation are called incorporators. The equity ownership interest in a corporation is called stock and the owners of shares of stock are called shareholders or stockholders. There are two types of stock, common stock and preferred stock. They differ in that dividends generally must be paid on the preferred stock before the common stock receives dividends. Another difference is that upon liquidation, the owners of the common stock are paid the amount of the corporation's assets left over after paying all the creditors and the amount due the holders of the preferred stock (which usually includes accrued but unpaid dividends and the par value or redemption value allocated to the preferred stock). In short, the common stock is entitled to the residual value of the corporation. That is why the value of the common stock fluctuates with the success of the corporation. If the corporation is successful, the value of the common stock will increase to the extent the net profits are not paid out in the form of dividends. On the other hand, if the corporation loses money, the value of the common stock will decrease in order to reflect those losses. There are instances in which the value of stock will increase even if the corporation is not showing a profit. This is particularly true in start-up companies in which there are no profits available for reinvestment but the business is growing or developing.

THE BASIC CHARACTERISTICS OF A CORPORATION

Acceptance of a corporation as a separate legal entity evolved during the 19th century. It is now well established that a corporation has a legal status that is independent of its shareholders. Partnerships and limited liability companies are also legal entities for some purposes. The separate entity status of partnerships is, however, less complete than in corporations. The entity status of limited liability companies, on the other hand, is virtually the same as corporations.

The corporation's independent existence as an entity undergirds the basic corporate attributes of limited liability, perpetual existence, free transferability of shares, and the ability to own property, bring suit, and be sued in the corporate name. It also accounts for the tripartite system of corporate management, consisting of shareholders, directors, and officers.

Q. What is the advantage of corporate limited liability?

A. Shareholders generally are at risk only for the amount of money or other property they invest in the corporation, though some state laws impose shareholder liability for unpaid wages in small corporations. Creditors of the corporation whose claims are greater than the assets of the corporation cannot satisfy their excess claims against the personal assets of the shareholders, unless the shareholders have previously obligated their personal assets by personal guarantees or co-signing a note or other obligation in their individual capacity. This ability to shield personal assets from the creditors of a corporation has long been the principal reason why investors have been more willing to invest in a corporation than any other type of business organization. As was pointed out earlier, sole proprietors and general partners are personally liable for all the debts and other obligations of a business they own. Given a choice, an investor will always choose limited liability to unlimited liability.

It is now possible to achieve at least some form of limited liability in most other types of business organizations. Limited partners, for example, have limited liability. So do all of the members in a limited liability company. Moreover, the shareholders of a corporation that is a

general partner also have limited liability, though the corporate general partner itself is liable. Nevertheless, the corporate-style limited liability is generally thought to be more complete and to provide more flexibility than in other types of business organizations. Limited partners, for example, lose their limited liability if they take part in the control of the partnership in a manner not permitted by the state's governing statute, provided that creditors are led to believe by that control that the limited partner is a general partner. Corporate shareholders do not, however, lose their limited liability by exercising control rights. In fact, one of the most important attributes of share ownership is that shareholders control the corporation through their voting rights.

When shareholders of a corporation guarantee its debts, co-sign its notes in their individual capacity, or pledge their own assets as security for loans to the corporation, which frequently occurs because of creditors' demands, the shareholders waive their limited liability with respect to those debts, notes or assets. But this is a limited waiver. The shareholders in question still have limited liability with respect to any other debts or obligations of the corporation.

The following example will help to illustrate this distinction. Suppose the sole shareholder in a corporation personally guarantees payment of a \$20,000 bank loan that is used to purchase a new delivery truck for the corporation. Subsequently the corporation ceases doing business and is liquidated. At the time of liquidation the corporation has \$50,000 of assets and the creditors of the corporation other than the bank that made the truck loan have valid claims of \$75,000. Assume further that the unpaid balance on the bank note is \$15,000. The bank can recover the \$15,000 owed it directly from the shareholder because of the personal guarantee. The other creditors, however, can recover only \$50,000 from the corporation. They cannot recover the additional \$25,000 they are owed from either the corporation, because it does not have any more assets, or from the shareholder, because his other assets are protected by the limited liability doctrine.

For More on Corporations

- The *Business Owner's Toolkit* is a very useful site for small business that contains much useful information on starting corporations and other practical legal matters. Access the material on corporations at www.toolkit.cch.com/text/P01_4770.asp
- Another good general site is the "law tools" of www.lawoffice.com/, which includes helpful excerpts from *West's Encyclopedia of American Law*, among other resources.
- The Quicken site on small business contains a number of steps to take in forming a corporation, as well as FAQs. Access it at http://quicken.webcrawler.com/small_business.
- The IRS is a good source of info on the taxing question of S Corporations v. C Corporations. See in particular Publication 542, Corporations; Publication 17, Your Federal Income Tax; Publication 535, Business Expenses; Publication 533, Self-Employment Tax, Self-Employment Income; and Publication 550, Investment Income and Expenses. The IRS website--www.irs.ustreas.gov--has all of these on line, as well as much more.
- Cornell's Legal Information Institute has many on-line resources about corporations. Access www.law.cornell.edu/topics/corporations.html.

Here are some resources that focus on the questions to ask yourself in deciding if you should incorporate and deepen your understanding of the steps involved.

- Carl R.J. Sniffen, *The Essential Corporation Handbook* (Oasis Press, 1995) answers some important questions and will help you work with your accountant and lawyer.
- Robert L. Davidson, III, *The Small Business Incorporation Kit*, (John Wiley & Sons, 1992), offers plenty of explanations and guidance on actually running the corporation.
- Michael R. Diamond and Julie L. Williams, *How to Incorporate: A Handbook for Entrepreneurs and Professionals* (John Wiley & Sons, 1996) offers guidelines and suggestions on how to avoid problems.

THE IMPORTANCE OF PERPETUAL EXISTENCE

When a general partner ceases for any reason to be a partner, the partnership will end up being dissolved and liquidated unless the remaining partners agree to continue the business. Getting necessary consent from the partners to continue the business can be very difficult and may be impossible. Yet liquidation may result in significant losses to all the partners. This risk of dissolution and liquidation is one of the principal drawbacks of operating a business as a partnership. In a corporation, on the other hand, if a shareholder leaves, there is no risk of liquidation (unless that departing shareholder has a contractual or voting right to force a liquidation) because the life of a corporation is indefinite. Thus, perpetual existence gives a corporation permanence, and this in turn is thought to make investments in a corporation somewhat safer and less risky than investments in business organizations that have less inherent permanence.

A reasonable form of perpetual existence can be obtained in both partnerships and limited liability companies through buyout agreements and other contractual arrangements, but these agreements must be carefully crafted to meet various legal and tax requirements.

Q. Is the ability to freely transfer shares of a corporation important?

A. In large corporations with many shareholders, the answer is yes. Being able to freely transfer shares to anyone at any time gives an investor the right to liquidate his or her investment

at any time. This right to transfer makes shares of the stock very marketable, provided, of course, there is someone who wants to buy them. The shares of all the corporations whose stock is registered with a stock exchange like the New York Stock Exchange are, for example, freely transferable.

But in a small corporation with only a few shareholders, free transferability of stock can often be a detriment. Assume, for example, that one of the three founding shareholders of a corporation that operates a camera store wants to sell his or her shares to someone the other two shareholders intensely dislike. Assume further that in order for the camera store to be successful, it is necessary for all three of the shareholders to work in the store on a regular basis without undue friction between them. If the shareholder who wants to sell can freely transfer his or her shares to anyone, and the other two shareholders cannot prevent the sale, disastrous results may ensue. In many states, a complete prohibition against the transferability of stock is not possible, and that is the reason why in most small corporations, the shareholders will enter into what is known as a shareholders' agreement or a share transfer restriction agreement, which, subject to case law and statutory requirements, will impose restrictions on the sale of stock. Legal counsel is needed to draft the terms of such an agreement.

Restricting the free transferability of the shares, however, can produce its own set of problems, one of which is that the shareholder who wants to sell may not be able to find a buyer acceptable to the other shareholders. To counteract this illiquidity problem, the shareholders may want to enter into what is known as a redemption or cross-purchase agreement, under which the corporation or the other shareholders agree under certain specified conditions to buy the stock of a shareholder who wants to liquidate his or her investment in the corporation.

Q. How does the separate entity status of a corporation affect its right to own property, bring suit or be sued in its corporate name?

A. A corporation as a separate legal entity has the right to own and dispose of property in its own name and to sue and to be sued in its own name. This facilitates commerce by not requiring action by all shareholders.

While partnerships for some purposes are not considered as entities, all states have statutes that allow them to own and convey property in their own name. Moreover, most states now have statutes that allow partnerships to sue and be sued in their own name. Suits by and against partnerships used to be a significant problem, however, until these statutes were enacted. A limited liability company, like a corporation or a partnership, may own property and commence and defend lawsuits in its own name. A proprietorship, on the other hand, does not have separate entity status, but this does not cause any practical problems because there is only one person, the sole proprietor, in whose name title to property belonging to the proprietorship is taken. Moreover, suits by and against a proprietorship must be in the name of the sole proprietor, even if the proprietorship operates under a name different from that of the proprietor.

A DISTINCTIVE MANAGEMENT STRUCTURE

There are three levels of management in a corporation. The shareholders, as previously discussed, own the equity stock and vote on fundamental issues affecting the corporation. One issue of vital importance is the right of the shareholders to elect the directors of the corporation. The directors are by statute in charge of managing the corporation. They in turn select the

officers, who run the corporation on a day-to-day basis and as the agents of the corporation implement the policies established by the board of directors.

Q. How are small corporations managed?

A. The tripartite management scheme works well in a large corporation. But it can cause difficulties in a small corporation having only a few shareholders. In a corporation with one shareholder, or example, it is burdensome to go through the mechanics of having that shareholder elect himself or herself as a director and then in a subsequent meeting elect himself or herself to various offices. Yet that is what is required by the corporate statutes in most states.

Voting is based on number of shares, not number of shareholders. Consider a situation where one of three shareholders in a corporation owns 67 per cent of the stock and the other two own the remaining stock. Because directors are elected by a majority of the stock, the 67 per cent shareholder can nominate and elect all the directors, and the directors in turn will elect all of the officers. Because the holders of two-thirds of the shares under corporate statutes can approve any action that shareholders are entitled to vote on, the 67 per cent shareholder can vote to merge with another corporation or to liquidate the corporation, regardless of the wishes of the two minority shareholders.

It is possible to give the minority shareholders in the above example some protection through various special provisions that have been incorporated into state corporate statutes in recent years. One way is to have cumulative voting, where if three directors are to be chosen, shareholders can use their votes for one director, rather than vote for each candidate. Another way to enhance the rights of the minority shareholders would be to create two classes of shares and allow each class to elect an equal number of directors. Since the directors elect the officers, a slate of officers acceptable to the minority shareholders would have to be proposed in order to elect any officers. Each class voting separately would also have to approve any fundamental change in the corporation, such as a merger or liquidation. Thus, the minority shareholders would, in effect, have equal management rights in the corporation even though they own only one-third of the stock.

Q. How does the management structure of a corporation compare with that of a general partnership?

A. The management structure of a general partnership is very different. Unless the partners otherwise agree, each partner has one vote, and action in the ordinary course of business requires approval by a majority of the partners. Extraordinary action, however, requires unanimous consent of all the partners. Thus, in a general partnership with three partners, one of whom has 67 per cent of the capital and profits, the 67 per cent partner can be outvoted on all ordinary course of business decisions by the other two partners. The 67 per cent partner could, however, prevent the partnership from merging with another partnership.

Another difference between general partnerships and corporations is that in most partnerships the partners perform every management function in their capacity as partners. Therefore, you do not need to have the three levels of management that exist in a corporation. In a large partnership, however, for the sake of convenience and efficiency, the partners will often select one or more managing partners to run the business on a day-to-day basis. In this type of arrangement the managing partners are like the board of directors and officers of a corporation, and the other partners function somewhat like the shareholders in a corporation.

Q. Is the management structure of limited partnership different?

A. A limited partnership has a management structure that is a hybrid between a general partnership and a corporation. The general partners are like the managing partners in a general partnership. The limited partners are like passive non-management shareholders in a corporation. However, they lose their limited liability if they take part in the control of the business with respect to people who are misled by such participation in control into believing that a limited partner is a general partner.

In a limited partnership, voting rights of the partners, including the general partners, may be modified by the agreement of the partners. In the absence of such an agreement, decisions are made by the general partners on a per capita basis, as is the case in a general partnership.

Q. What is the management structure of a limited liability company?

A. The management structure of a limited liability company has features of both partnerships and corporations. Unless management is delegated to designated managers, the investors in a limited liability company, called members, exercise all management rights. This is the same basic scheme as exists in a general partnership. The various limited liability statutes differ, however, with respect to whether the members have per capita voting rights, as in a general partnership, or voting rights based on the respective percentage of total capital.

SIMPLE AS CAN BE

The management structure of a proprietorship is quite simple. The sole proprietor is the only person who has management power so there are none of the complexities that exist in the other forms of business organizations.

Q. How are corporations taxed?

A. There are two subchapters in the Internal Revenue Code that govern corporations. One is Subchapter S, which corporations meeting designated criteria can elect. The other is Subchapter C, under which the majority of corporations operate.

Q. How are corporations that elect to be under Subchapter S taxed?

A. S corporations, as they are commonly called, are taxed in a manner similar to partnerships, although there are important differences between S corporations and partnerships. Except in a limited number of circumstances, an S corporation does not itself pay any taxes. Rather, the income and deductions generated by the S corporation are passed through to the shareholders, who report their proportionate share on their individual tax returns. The requirements for qualifying to elect to be taxed as an S corporation are discussed later.

Q. How are corporations taxed under Subchapter C of the Internal Revenue Code?

A. A corporation which has not made an election to be taxed as an S corporation must pay a tax on its net taxable income, and then the shareholders must pay a second tax on any of the

corporation's net earnings that are distributed in the form of taxable dividends. In many cases, the total of these two taxes, plus the tax on any money received by a shareholder as a salary for working in the corporation, will be more than if the same income was subject to only one level of taxation-as is the case with S corporations, proprietorships, partnerships and limited liability companies, which are taxed on the conduit or flow-through theory. Although the corporation's income is taxed when earned, a shareholder is not taxed until property or cash is distributed to the shareholder in an operating distribution, redemption of the shareholder's shares, or liquidation.

The double taxation of C corporation taxable income is definitely disadvantageous when the combined taxes payable by the corporation and its shareholders exceed the total taxes payable if the business were operated as a partnership, proprietorship, limited liability company or S corporation. With respect to fringe benefits, however, C corporations enjoy a distinct tax advantage over the other forms. Shareholders who are employed by a corporation in some capacity-unlike sole proprietors, partners and the members of a limited liability company, who are regarded as self-employed can qualify as employees of the company and, therefore, are eligible for special life and medical insurance programs and other fringe benefits offering advantageous tax results. For the most part, however, these fringe benefits must not discriminate in favor of any highly paid corporate executives and therefore involve significant costs to the business. The overall tax savings derived from these fringe benefits is usually marginal, and in most situations it will not constitute a significant factor in deciding whether to incorporate a new business.

SEVERAL TYPES OF CORPORATIONS

As is evident from the prior discussion of taxes, there is more than one kind of corporation, just as there is more than one kind of partnership. The various types of corporations, however, are not as distinct as are general and limited partnerships. From a non-tax perspective there are three principal forms of corporation: the general business corporation and two specialized derivatives of the general business corporation, the close corporation and the professional corporation. For federal income tax purposes any of these corporations may be subject to double taxation (a C corporation) or, if the corporation otherwise qualifies and elects to be taxed as such, an S corporation.

Q. What is a business corporation?

A. A business corporation is a corporation, generally organized for profit, that is formed under a state's corporation act or business corporation act. If a general business corporation, (including a professional corporation or a close corporation) does not qualify or elect to be an S corporation, it will be treated as a C corporation and subject to double taxation under Subchapter C of the Internal Revenue Code. Shares of stock in a business corporation are securities subject to state and federal registration unless they or the transactions in which they are sold are exempted from such laws.

Q. What is a close corporation?

A. A close corporation is one in which, as a general rule, all or most of the shareholders are

actively involved in managing the business. Many state corporation statutes have special provisions that are designed to meet the needs of close corporations. These special statutes vary from state to state but generally provide that the shareholders may manage the corporation directly rather than through directors or officers and that the shareholders may make other agreements for management which are not available to other corporations.

The term "close corporation" is applied not only to corporations formed under close corporation statutes, but also to those with a small number of shareholders, who are generally actively involved in the management of corporation. Using this criterion, most corporations qualify as close corporations. A study made several years ago concluded that 95 per cent of all corporations in the United States had ten or fewer shareholders.

Q. What is a professional corporation?

A. This kind of corporation is limited to the practice of one or more professions with licensed professionals as its shareholders. Tax advantages are now marginal, but protection from malpractice on the part of other shareholders remains an important motive for incorporation rather than practicing a profession as a sole proprietorship or in a partnership, although under some state laws these corporations do not protect innocent shareholders from personal liability.

Historically, professionals such as doctors, lawyers, and accountants have been prohibited from conducting business in a corporate form. The main rationale advanced for this policy is the necessity of preserving full individual liability for professional malpractice and the fact that only individuals could be licensed. Under traditional corporate law, the separate entity doctrine would theoretically protect a professional doing business as a corporation from personal liability for malpractice committed by his or her associates, even though a judgment in excess of the corporation's assets is recovered by a claimant.

A professional corporation is a business corporation and may be a close corporation with a fancy name. The major differences are that:

1. most of the professional corporation statutes limit the purposes of a professional corporation to the practice of single profession;
2. only licensed professionals employed by the professional corporation can be shareholders or directors—a requirement that necessitates a mandatory buy-out plan if the professional retires, dies, or has his or her license to practice suspended or revoked;
3. although a professional is individually liable for his or her own malpractice, in most states there is no liability for the malpractice of other professionals in the professional corporation; and
4. either the term "professional corporation" or "professional association," or one of their abbreviations, must be used in the corporate name and included on all letterheads, contracts, and advertising material.

Several states in the past few years have enacted statutes, included as part of their general partnership statutes, which protect partners against malpractice liability to the same extent, and in some cases provide more complete protection than, professional corporation statutes. Partnerships electing this status are called limited liability partnerships.

Because of the decrease in the tax advantage once enjoyed by professional corporations and the advent of limited liability partnerships, there are likely to be fewer new professional corporations founded in the future than in past years.

Q. What is an S corporation?

A. An S corporation is a business corporation (including a professional corporation, a close corporation or both) that has elected to be taxed in a manner similar to a partnership under Subchapter S of the Internal Revenue Code rather than according to the provisions of Subchapter C, the normal corporate tax sections. As previously explained, the principal distinction between S and C corporations is that S corporation income for the most part is not subject to double taxation at both the corporate and the shareholder level. Recent federal tax legislation that has liberalized the eligibility requirements for S corporations and changed the maximum rates on taxable income has dramatically increased the number of S corporations. At the present time, approximately one-third of all corporations are S corporations.

The basic eligibility requirements are that the corporation be a domestic corporation and not have:

1. more than one class of stock;
2. more than seventy-five shareholders,
3. or own 80 percent or more of the stock of another corporation.

All of the shareholders must be individuals (some trusts and estates can qualify, however), and must be United States citizens or resident aliens. Any corporation, including a professional corporation and an existing C corporation, can elect to be taxed under Subchapter S if the eligibility requirements can be met. If it appears it may be advantageous at some point to be an S corporation, however, it is generally advisable, because of some very complex potential adverse tax consequences, to start off as an S corporation rather than converting from a C to an S corporation sometime after incorporation.

Q. How does a corporation choose to be taxed as an S corporation?

A. The election to be taxed as an S corporation is made by filing a Form 2553, which must be signed by all the shareholders. The Form 2553 must be filed not later than two months and fifteen days after the beginning of the taxable year in which it is to be effective. For newly formed corporations that wish to have subchapter S apply from their inception, the taxable year begins when the corporation has shareholders, acquires property or begins doing business, whichever occurs first. This technicality can be a trap for the unwary. For example, the period for filing the Form 2553 begins to run from the day the corporation enters into a lease, even though it is not at that time conducting any business operations and even though the incorporation process is incomplete and no shares have been issued to the shareholders. If the Form 2553 is filed after the two-month, fifteen-day period, the subchapter S election will not be effective until the corporation's second taxable year, and it will be taxed as a C corporation for its first taxable year. Therefore, it is important that the Form 2553 be filed as soon as possible after the articles of incorporation have been filed.

HOW STATES TAX S CORPORATIONS

The taxation of S corporations under state tax laws varies from state to state. For the most part, S corporations are taxed the same under state law as they are under the Internal Revenue Code.

Some states, however, exact a special tax on S corporations that is similar to the state's income or franchise tax on C corporations. The differences in state taxation of S corporations can also cause technical difficulties for shareholders who are residents of states other than the state where the S corporation has its principal place of business. These are issues that shareholders should discuss with a lawyer and accountant before deciding whether to elect subchapter S status.

Q. What is a limited liability company?

A. A limited liability company (LLC) is an unincorporated business organization that provides the same flexibility of organization as a general partnership, the same limited liability protection for its owners, called members, as is provided to the shareholders of a corporation and, generally, the same pass through taxation as a partnership. The combination of flexibility, limited liability and the avoidance of the two-tiered tax on C corporations makes an LLC very attractive to investors.

There are two other features of LLCs that make them attractive. First, the members may have full management rights without the prohibition against taking part in the control of the business that applies to limited partners in a limited partnership and the cumbersome three-tiered management structure of shareholders, directors and officers of a corporation. Second, although a member can, unless otherwise agreed, freely transfer his, her, or its financial rights in an LLC, under many of the statutes rights to participate in the governance may not be transferred without the consent of the remaining members. This protects the remaining members against unacceptable transferees becoming involved in the management of the business.

Moreover, there are no restrictions on the number or type of persons who can be members of an LLC or the types of interests. Consequently, LLCs can be used in far more situations than S corporations, which can have no more than seventy-five shareholders, all of whom, with the exception of certain types of trusts and estates, must be United States citizens or resident aliens. An LLC, for example, can have a nonresident alien, corporation, partnership or another limited liability company as a member.

Q. Aren't limited liability companies fairly new?

A. Yes. The first LLC statute in this country was enacted in 1977 by Wyoming. Florida adopted a similar act in 1982. Very few LLCs were formed, however, until after 1988 when the Internal Revenue Service ruled that they would be taxed as partnerships rather than as C corporations as long as they met certain requirements. The two principal requirements are that the membership interests not be freely transferable and that the limited liability company not have the same type of continuity of existence as a corporation. These requirements are relatively easy to meet under the existing LLC statutes.

New IRS regulations in the summer of 1996 further relaxed the requirements for limited liability companies and other unincorporated businesses to be taxed as partnerships. Now any unincorporated business organization is *automatically* taxed as a partnership unless it elects to be taxed as a corporation. This should mean that LLCs will be used much more widely than in the past.

Almost all states now have LLC statutes. The statutes differ greatly, however, and these differences can create uncertainty. State taxation of LLCs also varies. In addition, many technical state tax issues are still being resolved. As these and other uncertainties, caused

primarily by the newness of this type of business organization, are being resolved, an increasing number of businesses are being formed as LLCs, and this trend is expected to continue. Some experts predict that in time LLCs will supersede partnerships and S corporations as a preferred form of business entity, but in all probability, LLCs will provide an alternative to existing business structures, to be used only in appropriate circumstances.

For More on LLCs

The following provide more information to help you decide whether an LLC is for you.

- ! Corporate Agents, et al., *The Essential Limited Liability Company Handbook* (Oasis Press, 1995)
- ! Martin M. Shenkman, with Ivan Taback and Samuel Weiner, *Starting a Limited Liability Company* (John Wiley & Sons, 1996)
- ! A good Web site--<<http://www.llc-usa.com/>>--is entirely devoted to LLCs. It includes information for lawyers, accountants and business people thinking of setting up an LLC, including resources and useful links. Also available from the site is a 3-volume treatise, *The Limited Liability Company*, by William D. Bagley and Philip P. Whynott.

Q. What kinds of businesses operate as limited liability companies?

A. LLCs can be used for virtually any type of business. The types of businesses where they have been used most frequently have been those where taxation as a partnership produces advantageous tax consequences. LLCs are widely used for real estate ventures; extraction of oil, gas and minerals; high-tech ventures, for example, a company formed to exploit a patent; corporate joint ventures; as a vehicle for acquisitions; agriculture; and venture capital companies. Because of their corporate-style limited liability, LLCs are also becoming more widely used as a form of business organization by professionals such as doctors, lawyers and accountants. Some states, however, do not as yet allow certain professionals to practice as an LLC.

Choice of Business Form

CHOOSING THE BEST ORGANIZATIONAL FORM FOR YOUR BUSINESS

There are many tax and non-tax factors that must be taken into account in making this critical decision. As a general rule, more than one form will be available. Choosing the best of the available forms is a complex task and requires expert assistance from your lawyer, accountant and other advisors.

Q. What are the principal non-tax factors that should be considered?

A. For obvious reasons most investors want limited liability. Investors in businesses where all

or most of the owners will be actively involved in the management of the company will usually also want restrictions on the transfer of ownership interests and a simple management structure. In addition, most investors want to be able to continue the business even after one or more of them leave.

All of these features can be achieved to a greater or lesser extent in most types of business organizations, although it is more difficult to obtain the desired results in some forms. For example, it is possible to have limited liability in a general partnership if all the general partners are corporations or limited liability companies. Similarly, corporate-style limited liability can be achieved in a limited partnership where all of the general partners are corporations or limited liability companies. This type of structure may not be desirable, however, for other reasons. Incorporating all the general partners can add unnecessary expense, especially when the alternatives of forming a corporation or limited liability company are available, and may adversely affect the tax consequences desired by the investors.

Restrictions on transfers and a simplified management structure, inherent characteristics of partnerships, can be obtained in corporations by carefully crafted agreements among the shareholders, although, except in close corporations, most formalities of the statutory management structure in state corporation codes will need to be observed.

Finally, in most situations business continuation agreements authorize the purchase of a departed owner's investment and allow the business to continue. These agreements, however, can be very complex and expensive.

Only a lawyer has the necessary training to analyze the deficiencies in a particular form of business and to be able to draft the proper agreements to overcome these deficiencies, to the extent it is possible to do so.

Q. Are there any other non-tax factors that should be taken in account when soliciting a business form?

A. There are always factors that at first appear to be insignificant, but may in the end turn out to be critically important. Therefore, it is important to be sensitive to the possibility that one or more of these factors may be present.

Organizational and administrative costs are an example. Proprietorships and general partnerships involve the least expense because no written documents or public filings (except possibly to comply with an assumed name statute) are legally required. It would be prudent, however, to have a written agreement or general partnership agreement defining the rights and obligations of the partners. Also, there are generally no annual fees to be paid. Written documents and various filing and annual fees are required for all the other business forms, however. The total of these expenses can be significant.

When a business intends to do business in more than one state, the law of the various states where it expects to operate must be investigated to determine if any special problems exist. A limited liability company, for example, should probably not be used if a significant amount of a company's income is expected to come from sales in a state that does not have a limited liability company act.

If the business organization will borrow money in a state that has usury laws, these laws normally set maximum interest rates that can be charged for a loan, but provide exceptions for corporations, meaning that the corporation is permitted to give up the benefits of the usury law to obtain a loan. If a lender will only make a loan to the business at an interest rate in excess of this limitation, it may be necessary to form a corporation to borrow the money. Having to incorporate for this reason is less likely to occur today than in the late 1970s and early 1980s

because general interest rates are relatively low. But interest rates are very cyclical and at some point in time rates will increase substantially above today's rates.

Finally, state law restrictions can limit the possible choices. A sole proprietor who wants both limited liability and basic partnership taxation, for example, can achieve these goals by incorporating as an S corporation, but because most limited liability company statutes require a minimum of two members, cannot operate the business as a limited liability company.

Q. What are the principal tax factors that should be taken into account in selecting a business form?

A. The applicable tax factors are even more complex than the non-tax factors, and changes in the tax statutes and regulations can dramatically alter the way taxes affect the various types of business organizations. Bearing this limitation in mind, four generalizations might provide some useful guidance.

First, under the present income tax structure, there is a presumption that a business should be formed as a proprietorship, partnership, limited liability company or S corporation rather than as a C corporation.

Although the following chart indicates that except for taxable income between \$75,000 and \$155,950 the C Corporation tax rate for 1998 is less than the individual rates applicable to other types of businesses, tax rates per se do not tell the whole story.

Comparison of 1998 Individual Joint Tax Rates With C Corporation Tax Rates

[these are federal tax rates; the states may apply additional taxes]

Dollar Amount	Individual	C Corp	Differential
Up to \$42,350	15%	15%	None
\$42,350 to \$50,000	28%	15%	C Corp. + 13
\$50,000 to \$75,000	28%	25%	C Corp. + 3
\$75,000 to \$102,300	28%	34%	C Corp. - 6
\$102,300 to \$155,950	31%	34%	C Corp. - 3
\$155,950 to \$263,750	36%	34%	C Corp. + 2
\$263,750 to \$10,000,000	39.6%*	34%**	C Corp. + 5.6
\$10,000,000 to \$15,000,000	39.6%	35%	C Corp. + 4.6
Over \$15,000,000	39.6%	35%***	C Corp. + 4.6
* Includes 10% surtax			
** +5% or \$11,750, whichever is less			
*** + 3% or \$100,000, whichever is less			

NOTE 1: Professional Corporations that are C Corporations are taxed at a flat rate of 34%

NOTE 2: The dollar levels for the various rates are adjusted each year based on increases in the consumer price index

As previously explained, C Corporation taxable income is subject to a double tax. First, a C corporation must pay taxes on its taxable income at the rates specified in this chart. In addition, the shareholders must pay taxes at the individual rates applicable to them for any income they receive from the corporation in the form of salaries or dividends. The combination of both these taxes can often be higher than the taxes that would be

payable if the business was operated as an S corporation, partnership or limited liability company. Even if the total taxes paid by the C corporation and its shareholders on taxable income generated by the corporation are less than if the business were operated in another form, the difference in most cases will not justify operating a small business as a C corporation. Moreover, there are other tax disadvantages of operating as a C corporation, including the potential application of the higher corporate alternative minimum tax and the tax liabilities incurred in liquidating a C corporation or converting it to another business form, which more than offset the possibility of lower annual taxes based entirely on a tax rate structure that can be changed at any time. In this connection, it is worth noting that from 1986-1992, the tax rate for C corporations was higher than that of business forms for most levels of taxable income.

Second, as a general rule, if flow-through taxation is important, partnerships and limited liability companies provide more flexibility than S corporations because of the ability in partnerships to authorize special allocations of income and losses and to make distributions of capital without triggering adverse tax consequences.

Third, consider the possibility that at some point in the expected life cycle of the business it might be advisable to change the organizational format. For this reason it is important to remember that it is possible to go from a proprietorship to any other form, to convert a partnership to another form of partnership or to a limited liability company or corporation, and to convert a limited liability company to a partnership, all on a tax-free basis. It is also possible to convert an S corporation to a C corporation without adverse tax consequences. But it is not possible to convert any type of corporation into a proprietorship, partnership, or limited liability company, or to convert a C corporation into an S corporation without serious tax problems.

Finally, as is the case with non-tax factors, be alert to special facts that may end up limiting the available choices. For example, if the business will have a corporate shareholder, then Subchapter S will not be available and a partnership or limited liability company will have to be used if pass-through tax treatment is desired.

GETTING ORGANIZED

This section will describe in general terms the legal steps that must be taken to organize a new business and get it to the operational stage.

Q. In which state should the business be organized?

A. In the state where the business will have its principal place of business. This will generally also be the state where the principal investors live. Every state's laws have some shortcomings, but as a general rule these can be overcome by carefully drafted agreements.

INCORPORATING IN A "FRIENDLY" STATE

Some states have a reputation for having laws favorable to a particular form of business. This is true, for example, with respect to the Delaware Corporation Code. The features of the Delaware Corporation Code that are touted as being important reasons for incorporating there are for the most part applicable only to large corporations with hundreds of shareholders. For example, if a small corporation whose investors and business operations are in Oregon were to incorporate in Delaware, the corporation would have to qualify as a foreign corporation in

Oregon. Moreover, annual fees and license taxes would have to be paid in both states and a lawyer admitted to practice in Delaware would have to be retained whenever a corporate law problem involving the business arises. These extra expenses are rarely justified.

Q. What steps are involved in organizing a proprietorship?

A. Very few, as a general rule. A sole proprietorship is the simplest form of business. The only legal requirements are usually a business permit or license and tax identification numbers. If the business is to operate in a name other than that of the proprietor, it may be necessary to comply with a state or local assumed name statute. No written documents will be necessary unless the proprietorship is buying or leasing property or will operate a franchise.

Q. What steps are involved in organizing a general partnership?

A. From a strictly legal point of view, the same as in a proprietorship. Although there is no requirement that a general partnership have any kind of written agreement, it would be foolish not to have one, if for no other reason than to provide concrete evidence of the partners' agreement.

A written partnership agreement will typically contain provisions relating to capital accounts and drawing accounts, partner salaries, reimbursement of expenses, vacations and fringe benefits, voting rights, the rights of the partners when one of them leaves the partnership, admission of new partners and what happens if the partnership liquidates. A well-drafted partnership agreement that is carefully tailored to the particular needs of the partners is a lengthy and very complex document.

Q. Is organizing a limited partnership any different from a general partnership?

A. Yes. The most significant difference is that limited partnership statutes require a document known as a certificate of limited partnership to be filed, together with a specified filing fee. While the information required to be in the certificate of limited partnership varies, all the statutes require the name of the limited partnership, the address of its principal place of business and the name and address of the agent for service of process, the name and business address of each general partner, and the latest date when the partnership will dissolve. Some of the statutes also require the business purpose to be specified and also the circumstances under which additional capital may be required. All the statutes also authorize the partners to include any other information they wish in the certificate.

Q. What steps are necessary to organize a limited liability company?

A. There are two documents that a limited liability company must have.

The first is a document generally referred to as "articles of organization" which must be filed in the Office of the Secretary of State in your state. The statutory requirements vary, but generally the articles of organization must contain the same type of information as is required in a certificate of limited partnership. One difference is that most of the limited liability company statutes require the articles of organization to specify whether the LLC will be member managed or manager managed (a situation similar to having managing partners in a partnership) and the names and addresses of the members or managers.

The second required document is generally referred to as an operating agreement. It is also sometimes called a member control agreement or referred to as "regulations." This

agreement is similar in format and content to a partnership agreement. It does not have to be filed in any public office.

Every member of an LLC should have a copy of both the articles of organization and the operating agreement.

Q. What steps are required to form a corporation?

A. The legal formalities for a corporation are more complex than in the other forms of business organizations. Corporate codes require the filing of a document generally known as either "articles of incorporation" or a "corporate charter", bylaws, the issuance of share certificates and an organizational meeting. In addition, in most situations other written documents designed to protect the rights of the investors will be advisable.

Q. What are the requirements for the articles of incorporation?

A. The statutes vary, but generally corporate codes require the inclusion of the following information in the articles of incorporation: the name of the corporation, its duration, the corporation's business purposes, the amount of stock that will be authorized, certification that any required minimum capital has been paid into the corporation, the address of the registered office and the name and address of the registered agent, the names and addresses of the initial directors, and the names, addresses and signatures of the incorporators. Corporate statutes also authorize other information to be included in the articles of incorporation. Examples of the kind of optional provisions often included are share transfer restrictions and elimination or curtailment of the usual powers of the board of directors.

There are some differences between the articles of incorporation of regular corporations, close corporations and professional corporations, but these differences are for the most part technical and not that significant.

Q. What are bylaws?

A. The purpose of bylaws is to provide guidelines for regulating the internal affairs of a corporation. Typically corporate bylaws deal with the mechanisms of shareholder, director and committee meetings, the issuance of stock and dividends, and the appointment, duties and removal of the officers.

STOCK CERTIFICATES

Stock certificates are documented proof of share ownership. A share certificate is like the title certificate you receive when you purchase an automobile. State corporation codes contain detailed requirements for stock certificates. Unless a transfer restriction is clearly noted on them, stock certificates are freely transferable.

Q. What takes place at the organizational meeting?

A. Some state corporation codes require two organizational meetings, one by shareholders to elect the directors and a second by the directors to approve everything else. Most state

statutes, however, require only one meeting, which will typically ratify all the actions taken by the promoters and incorporators, adopt the bylaws and the corporate seal, select and set the salary of the officers, authorize the issuance of shares, approve resolutions designating one or more banks as depositories and establishing check signing authority, approve contractual agreements among the shareholders or with third parties, approve resolutions authorizing the corporation to be taxed as an S corporation (assuming the shareholders want the corporation to be an S corporation) and authorize designated officers to take the appropriate action to complete the incorporation process, including, if necessary, qualification as a foreign corporation in another state.

Q. What other documents are commonly advisable at the time a corporation is organized?

A. Because of gaps in most corporate statutes and the need to protect the rights of minority shareholders to a greater extent than is provided by statute, it is often advisable for the shareholders and the corporation to enter into one or more of the following documents: a shareholder voting agreement or voting trust, a long-term employment agreement for the investors who will become executive officers, a shareholder-management agreement which in effect can create the same type of management scheme as exists in a partnership, a share transfer restriction agreement, and a buy-out agreement providing for the purchase (under specified conditions) of the shares of a shareholder who leaves the employment of the corporation or for some other reason wants to liquidate his or her investment. These are very complex, technical documents that must be drafted by a lawyer.

Other contracts that will typically need to be reviewed or drafted include one or more leases, a franchise agreement and loan agreement.

If the corporation is electing S corporation status, then a Form 2553 must be completed and filed with the Internal Revenue Service. The Form 2553 or a similar document must also be filed with the state tax commission of the state where the S corporation was incorporated. Other forms, such as a patent or trademark application or an application for a tax identification number, may also be necessary. (See the section at the end of this chapter for ways to accomplish these applications or filings.)

In addition, applications for any required licenses and for assumed or trade names need to be filed. Most business licenses, however, are state and/or local, as are assumed and trade names filings. Consult a lawyer for what is required in your area.

Operational Problems and Organic Changes

This section will discuss the legal issues that commonly occur during the life cycle of a business. It is divided into three parts. The first deals with the normal kind of legal problems that an operational business encounters. The second part deals with the principal issues involved in buying and selling a business. The last part discusses the basics of a bankruptcy proceeding involving a business organization.

Operational Problems

Q. What legal problems does a business typically encounter after it is organized and operational?

A. There are four general types:

1. major transactions such as a bank loan, or a purchase or lease of equipment or real estate that involves the drafting or review of various legal documents and the preparation of minutes authorizing the transaction;
2. changes in statutes and regulations that necessitate changes in the company's contractual documents and internal manuals;
3. ongoing regulatory compliance—for example, timely filing of corporate annual reports, assumed name filings and the like; and
4. the necessity of periodically reviewing and updating the company's legal structure.

Q. Must a business have a lawyer involved in all these transactions?

A. At the very least a business should regularly consult a lawyer about major transactions and compliance problems. Even if the law firm representing a bank prepares the loan documents and the borrower has to pay for this work, which is customary, the borrower's attorney should review all of the documents before they are signed.

To provide adequate legal protection for a business, its general counsel needs to review all of the company's legal documents on a regular basis, preferably at least once a year. This annual legal audit can uncover omissions, such as the absence of corporate minutes and changes in documents necessitated by changes in statutes and regulations. The review of the annual audit with the client will also provide the lawyer with the opportunity to discuss with the client recent legal changes so that the executives and employees will be alerted to potential problems and better able to comply with the changes. As part of this process, the lawyer may uncover potentially serious legal problems at a time when they can be resolved in an efficient cost-effective fashion.

Timing Your Annual Legal Audit

The best time is a month or so before the end of the company's taxable year. This enables the audit to include year-end tax planning issues. Frequently, significant amounts of taxes can be saved by either completing a transaction this tax year or deferring the transaction until the next taxable year.

Many businesses have the audit done a month or so before the company's annual meeting and use the audit as a planning vehicle for action that needs to be approved at the annual meeting. Most small businesses, however, operate on a very informal basis and do not hold regular annual meetings. This informality is now built into the corporate statutes, which require an annual meeting but allow the requirement to be met by the use of consent minutes signed by all the shareholders and directors. Consent minutes ratify the action taken even though no meeting is held. Even though it is possible to legally avoid having an annual meeting, however, one should be held if for no other reason than to review the annual legal audit.

Q. What kinds of issues should be dealt with in the annual legal audit?

A. The following is a partial list of the issues to be reviewed:

- basic constituent documents, for example, articles of incorporation, bylaws and stock transfer records of a corporation; the articles of organization and operating agreement of a limited liability company; the partnership agreement, and in a limited partnership, the certificate of limited partnership;
- employment agreements;
- all leases, licensing agreements and other contracts with third parties, with particular emphasis on termination dates, renewal options and the like;
- insurance policies;
- all standardized contract forms used by the business, for example, purchase order forms, warranties, brochures and the like;
- internal policy and procedural manuals, for example, employee policy and procedure manual, antitrust compliance handbook;
- transactions that require additional documentation, such as official minutes;
- regulatory compliance, for example, environmental regulations, ERISA problems, Securities and Exchange Commission requirements;
- structural changes in the business organization, for example, conversion to another business form, adoption a retirement plan or a fringe benefit plan;
- tax planning issues, for example, S Corporation status, legal audit, alternative minimum tax review;
- filing of tax returns, licenses and reports;
- pending and potential litigation involving the company; and
- recent legal developments affecting the business.

Business Acquisitions

Q. What are the ways in which one business can acquire another?

A. There are four basic acquisition methods: merger, consolidation, sale of assets and exchange of ownership interests. Each type is briefly described below.

The distinctive feature of a merger is that one or more of the merging business entities disappears into the surviving business entity, which automatically becomes vested with all the assets and liabilities of the disappearing entities. For example, if the merger agreement between A, B, and C corporations calls for C to be the surviving corporation, A and B will be merged into C, and after the merger C will own all of the assets and will have to pay all of the liabilities of A and B, both of which no longer legally exist.

A consolidation is in essence a type of merger but differs from a typical merger in that all of the merging entities disappear into a new entity. Using the prior example, a consolidation would occur if A, B, and C were merged into D, a new entity, which was probably created and owned by A, B, or C or all of them.

A sale of assets differs from a merger or consolidation in several respects, the most important being that the acquiring company buys only the acquired company's assets and therefore is not legally responsible for payment of the acquired company's liabilities. The acquiring company can, however, be liable in some situations for some of the acquired corporation's liabilities, even if the acquired corporation stays in existence. The acquiring company, for example, may be liable for environmental clean-up costs caused by the acquired

company under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). Moreover, a sale-of-assets transaction may, unlike a merger or consolidation, require consents from third parties to transfer leases, mortgages, franchises and the like, which may not be forthcoming.

An exchange of ownership interests, the final basic acquisition method, involves the owners of one business offering to purchase the ownership interest of another business or one business offering to pay cash or issue ownership interests for the outstanding ownership interests of the other business. All kinds of combinations can result from this type of transaction. The most typical is for the acquired company to be operated as a subsidiary of the acquiring company. For example, assume that corporation A agrees to purchase all of the outstanding stock of B corporation for cash. After the transaction A will own all of the stock of B, which will as a consequence be a subsidiary of A.

There is danger in the outright purchase of stock in a corporation. When such a purchase is made, all of the undisclosed liabilities of the corporation are purchased. As a preventive measure, it is common for an acquisition agreement to provide for a period of diligent investigation, and for the buyer's approval of the results of the investigation.

Q. How do you determine which of these acquisition methods to use?

A. You determine which acquisition method to use with the advice of your company's legal counsel, accountants and other experts. Every type of acquisition is complex and fraught with legal problems. As a general rule, more than one acquisition method will be available, and the acquisition can be structured as either a taxable or a non-taxable event, depending on which produces the best overall tax results.

Selecting the best method, however, is only one of the problems that must be resolved. The mechanics of the transaction can be incredibly complex. Corporate codes have detailed statutory provisions setting out the approval process and the rights of shareholders who vote against the acquisition (called dissenters' rights). These statutes are complex but at least provide some basic guidance. Very few partnership statutes, however, currently have any statutory provisions that describe the mechanics of a merger, and none of the partnership statutes deal specifically with sales of assets or exchanges. Moreover, the coverage of mergers and other acquisition techniques by limited liability companies is also incomplete, and the existing statutes are often confusing and inconsistent. An additional problem is that very few existing statutes deal with the possibility of a cross-entity acquisition, for example a merger between a partnership and a corporation or between a partnership and a limited liability company.

Regulatory compliance problems can also present difficult issues in any type of acquisition. Antitrust clearance is not a problem for most acquisitions but it is sometimes required by both the Federal Trade Commission and the Antitrust Division of the Department of Justice under the Hart-Scott-Rodino Act. Federal and state securities law compliance is also imperative, and environment law compliance issues are becoming increasingly important. These are only a few of the compliance issues that must be reviewed.

In short, acquisitions are very complex transactions, and a company should consult a lawyer about a proposed acquisition in the initial planning stage and before any binding commitments about the method or tax consequences have been made.

Bankruptcy

Q. What happens if the business gets into financial difficulty?

A. Frequently, it is possible for the business to work out accommodations with its creditors on a voluntary basis that will enable the business to survive through a rough period. Banks and mortgage companies, for example, are often willing to refinance indebtedness, especially if they can be convinced that the business's financial difficulties are temporary. Trade creditors are also amenable to stretching out payments for the same reason. After all, the last thing a creditor wants is to foreclose on property securing a debt or reduce a debt to judgment. Everyone loses in that situation.

Even in these difficult straits, it is important for the company to continue paying its payroll taxes, since these are not dischargeable in bankruptcy and will become a personal liability of the owners.

Two Kinds of Business Bankruptcy

If a business's difficulties cannot be resolved, bankruptcy may be the only viable option. There are two types of bankruptcy proceedings available to businesses. The first is a liquidation proceeding under Chapter 7 of the Bankruptcy Code. The second is a rehabilitation proceeding under Chapter 11, or in the case of proprietorships, Chapter 13 of the Bankruptcy Code.

Q. What happens in a Chapter 7 liquidation proceeding?

A. Any type of business can file a Chapter 7 proceeding. It is also possible for creditors of the business to file a Chapter 7 proceeding, but this occurs infrequently.

Once the proceeding is filed, a trustee, who is appointed by the court and technically represents the creditors, is in charge of the debtor business and will proceed to sell all the business assets and distribute the net amount realized to the company's creditors in accordance with the priorities in the Bankruptcy Code.

Q. What happens in a Chapter 11 or Chapter 13 rehabilitation proceeding?

A. These proceedings differ from a Chapter 7 proceeding in two fundamental respects. In a rehabilitation proceeding the ultimate objective is not the payment of the company's creditors out of the liquidation proceeds but rather to have the business continue in a reorganized form and to pay the creditors out of its future earnings. The second major difference is that in most cases the executives who were managing the business before the rehabilitation petition is filed can continue to manage the business during the bankruptcy proceedings. This continuity can be helpful in dealing with customers and creditors.

The business has the first option to submit to the court for approval a rehabilitation plan. If it is not approved, the creditors can submit their plan. If a plan is approved, the proceeding is dismissed and the business continues to operate under the provisions of the plan. If no plan is approved, the proceeding will be converted into a Chapter 7 liquidation proceeding.

Q. When should the business seek legal advice about the possibility of bankruptcy?

A. At the first sign of serious problems. A lawyer can be very helpful in advising the

business about its options and in assisting with negotiations with creditors. The timing of the bankruptcy filing can be very important because the filing of the proceeding results in an automatic stay of all legal actions against the debtor business. This means that no further action in the pending law suit can take place without the permission of the bankruptcy court. The ability to get the stay is often the primary reason for filing a petition, even in circumstances where the company is not currently unable to meet its ordinary debts as they become due.

Partnerships and limited partnerships present special problems under current law. Expert legal advice is, therefore, especially important for businesses operating in these formats. The difficulties with partnerships stem primarily from the personal liability of the general partners for the partnership's debts. The bankruptcy of the partnership will often force all of the general partners also to file bankruptcy petitions. Limited liability companies are so new that there is no case law resolving the questions that are bound to arise. It is not yet certain, for example, whether a limited liability company will be treated as a partnership or a corporation under the Bankruptcy Code.

Where to Get More Information

The best source for general information is the Small Business Administration (SBA), which has branch offices through the United States. The SBA, Washington Office Center, 409 3rd Street, SW, Washington, DC 20416, telephone, (1-800-827-5722), website, www.sba.gov

The SBA offers many "free" and "for sale" management assistance publications to aid small businesses. Examples are: [Incorporating a Small Business](#), [Checklist for Going Into Business](#), [The ABC's of Borrowing](#), [Planning and Goal Setting for Small Businesses](#) and [Woman's Handbook](#).

In addition, the SBA offices regularly offer workshops and counseling sessions for small businesses.

The SBA also has a number of financial assistance programs for small businesses. Information about these programs and applications can be obtained from any branch office.

The Internal Revenue Service publishes a pamphlet entitled [Your Business Tax Kit](#), which contains helpful information about the various federal business taxes. You can access it at www.irs.ustreas.gov. Similar kits and pamphlets, many of which contain other useful information such as business license applications, are available in most states through the state's tax commission or other state administrative offices.

The Secretary of State's office, located in your state capital, can provide you with a great deal of useful information about filing requirements for corporation, partnerships, limited liability companies and other business forms.

Most states have a state development board that provides various forms of assistance to businesses, particularly new businesses and existing businesses that are planning to move to the state. Some states also have regional development boards. Illinois, for example, has Small Business Development Centers located throughout the state.

Many states authorize special financial assistance for businesses, such as industrial revenue bonds. There will generally be one or more agencies or commissions that are in charge of administering these programs and can provide information about them.

Local and state Chambers of Commerce can be useful sources of information about businesses.

Trade associations are excellent sources of statistical information about a particular type of business.

The business section of the public library has directories, manuals, association lists and statistical and demographic data on businesses. In addition, the Federal Trade Commission (FTC) has a number of manuals for business owners, informing them of how to comply with various laws. Included are: *How to Write Adverse Action Notices*, *Offering Layaways*, *Writing a Care Label*, *How to Write Readable Credit Forms*, *Writing Readable Warranties*, and *Road to Resolution: Settling Consumer Disputes*. For information about these publications, call or write the Federal Trade Commission, 6th and Pennsylvania Avenue, NW, Washington, DC 20580; telephone, (202) 326-2222. Many of them are available on the Internet at www.ftc.gov.

Small business incubators exist in many parts of the country. Their purpose is to provide consulting services, access to research and rental space at favorable rental rates for new business.

For trade or service mark applications:

Commissioner of Patents and Trademarks
Crystal Park Building
2121 Crystal Drive
Arlington, VA 22202
Telephone: (703) 305-8600
www.uspto.gov

For tax information, contact your local IRS office or check out their web site at
www.irs.ustreas.gov.

For Federal Securities and Exchange Commission:

Federal Securities and Exchange Commission
450 5th St., NW
Washington, DC 20549
Telephone: (202) 942-8642
Website: www.sec.gov

For copyright:

Federal Copyright Office
Library of Congress
101 Independence Ave., SE
Rm. LM 401
Washington, DC 20540
Telephone: (202) 707-9100
Website: address www.lcweb.gov/copyright. See also the website of the Copyright Society of America, www.csusa.org.

Finally, in addition to lawyers who practice business law, accountants, insurance agents, bankers and management consultants can be helpful sources of information and advice.

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