# REPRESENTING THE GROWING BUSINESS

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## I. INTRODUCTION

A. For most small and medium size accounting and law firms, the privately owned business is the lifeblood of their client base.

B. After the dot com bust, it became apparent that a sensible approach to forming and growing privately owned businesses is essential.

C. Only about one-third of all new businesses make it to the second generation.

D. Only about twenty-five percent make it to the third generation.

E. In order to make a privately owned business successful, it is necessary to address a wide variety of issues:

1. Organizational issues.
2. Tax and non-tax planning issues.
3. Employment issues.
4. Growing the business through distribution, licensing and sales.
5. Protecting intellectual property rights.

## II. STARTING A NEW BUSINESS

A. Preliminary considerations.

1. Is it financially, professionally and personally worthwhile?
2. Most entrepreneurs start their own business to be their own boss.
3. They are not necessarily aware of all of the responsibilities that they will be assuming, and the fact that they will still be accountable in many different ways:

   a. Partners.
   b. Investors.

c. Employees.
d. Customers.
e. Lenders.

4. Alternatives.

a. Employment.
b. Sole proprietor.
c. Entity.

i. Partnership.
ii. Limited liability company.
iii. S corporation.
iv. C corporation.

d. Joint venture.

B. Control and management.

1. Control.

a. Allocation of financial interests.

i. Allocation of financial interests given in exchange for the contribution of cash or assets.
ii. Allocation of financial interests given in exchange for services.
iii. Allocation of financial interests after the initial contributions of assets or services.
iv. Debt vs. equity.

a) Debt.

i) Use of debt avoids the necessity for a valuation of the business.
ii) Debt instruments can be drafted to include automatic or discretionary conversions of debt into equity based on certain events such as subsequent financing of a certain amount or the achievement of certain business milestones.

iii. Debt must be repaid and includes interest that can be expensive for new businesses.

b) Equity.

i) Equity allows newly formed businesses to raise capital by offering ownership interests in the business.
ii) The issuance of equity dilutes the interests of all other owners, which can be of specific concern for the founders who may be unwilling to give up control.

b. Allocation of control.

i. Allocation between the shareholders and the members of the board of directors.
ii. Allocation between shareholders is subject to the legal protections afforded to minority shareholders.
iii. Drafting of the Articles of Incorporation can become quite complex by including control provisions among the different classes or series of shares.
iv. Shareholder agreements, voting agreements, voting trusts and similar arrangements can all be used contractually as control measures.

c. Example of a typical structure.

i. Founders: equity comprising issuance of common stock in exchange for nominal cash or contributed assets.
ii. Employees: equity consisting of stock options or restricted stock issued pursuant to a stock option plan.
iii. Investors: equity consisting of issuance of preferred stock in exchange for cash.
iv. Investors: debt leading up to equity investments consisting of issuance of promissory notes convertible to equity.

2. Management.

a. Many startup businesses have no management structure other than the founder.
b. Without a management team, the product, service or idea will not develop, obtain funding or attract talented employees.
c. Many investors will not consider a business for potential investment if the management team does not possess the capability of leading the business.

C. Pre-formation issues.

1. Expenses.

a. Professional service fees such as for attorneys and accountants.
b. Filing fees for organizing the business and perfecting ownership in intellectual property, such as patents, copyrights, know-how, domain names, and/or trade-marks.
c. Reimbursement of costs and expenses advanced by the entrepreneur prior to formation, versus. the contribution of those initial costs and expenses in exchange for ownership interests.

2. Transaction.

a. The business entity may be liable for goods and services ordered by the promoters of the business on behalf of the entity if the entity ratifies those contracts or commitments, whether expressly or by implication when the entity accepts the benefits of the contracts or commitments by using the property or services obtained with knowledge of the terms of the contract.
b. The promoters may remain personally liable on such contracts, except to the extent the promoters have disclosed that they are negotiating the contract or commitment on behalf of a business entity not yet formed, and the other party agrees to look solely to that business entity after its formation, in which case they may not be liable even if the business entity is never formed.

c. The business entity may indemnify its promoters against liabilities incurred pre-formation.

D. Business names and intellectual property.

1. Business or trade names can be reserved with the State, but it is often easy to check on the availability of names and fairly quick to file the documents necessary to acquire the right to use those names.
2. However, just because a new business can register to use a particular name does not necessarily mean that its right to use the name will not be challenged. Many companies select a name only after checking the following four sources:

   a. Business name (a/k/a trade name).
   b. Fictitious business name (a/k/a “dba”).
   c. Trademark.
   d. Domain name.

3. Intellectual property.

   a. Examples of intellectual property include patents, trademarks, copyrights, domain names, trade names, trade secrets, know-how, confidential information and similar concepts.
   b. Intellectual property is important not only to the business owners, but also to investors.
   c. Intellectual property can be sold, assigned, transferred or even collateralized, and rights in that intellectual property may be licensed to third parties in exchange for royalties or other payments.
   d. The business entity should ensure that intellectual property rights are held by it and not by the individuals that are providing services to the entity. Often, the intellectual property rights of the founders are transferred to the business entity in exchange for an ownership interest in the entity.
   e. All intellectual property rights created by employees of the business should be owned by the business entity.
   f. Contractual relationships with independent contractors and consultants should be clearly defined in writing to

include the assignment of any inventions and intellectual property rights created by them while performing services for the business entity or while using the business entity's materials.

g. Confidentiality agreements should be used routinely to protect confidential information from disclosure by employees, potential investors, strategic partners, vendors and others.

## III. PREPARING A BUSINESS PLAN

### A. Preliminary considerations.

1. Most entrepreneurs begin drafting a business plan by providing general information about the company, its business model, plans, capital needs, strategy, etc. These types of business plans frequently need to be modified substantially to be useful in other situations where there are legal requirements that must be met.
2. A business plan that satisfies the requirements of the Securities Act of 1933 may be more versatile since it can be used both for obtaining investment capital, as well as for managing and developing the business.

### B. Purposes of a business plan.

1. Management tool.

   a. Business plans are frequently used internally and externally for the management of the business enterprise, as well as identifying milestones that management should attempt to achieve.

   b. The pro-forma financial portion of a business plan and its underlying assumptions form the foundation of the business plan as a management tool. Generally, the pro-forma is made for a period of one to three years. The initial pro-forma begins with greater specificity, i.e., monthly detail of significant milestones for a period of 12 to 18 months. Later periods are presented on a quarterly or annual basis. The pro-forma financial

statements consist of a balance sheet, income statement and a statement of cash flows, and should include items such as the following:

i. Sales by unit or total dollar volume and product mix.
ii. Gross margin in total and by product.
iii. Accounts receivable collection period.
iv. Inventory turnover.
v. Useful lives of the company's assets and related depreciation schedules.
vi. Capital expenditures.
vii. Interest income on temporary investments of excess funds.
viii. Effective income tax rate.

2. Capital request.

a. The creation of the business plan assists the entrepreneur in developing his/her request for capital. It gives the entrepreneur a better idea of how much investment capital is needed.
b. Specifically, by taking a cumulative total of the total cash flow in each period in the statement of cash flow, the entrepreneur has an indication of how much capital will be required to get the business to a particular milestone for a time period, or to a break-even position.
c. The cumulative total is only an approximation of the amount of capital that the entrepreneur should seek, because the actual request should allow some flexibility in the event that the details of the company's costs, operating expenditures and projected revenue assumptions vary from the initial projections. By asking for more than the cumulative total, the capital request will cover the capital requirements for the relevant period, plus an additional amount for unforeseen expenditures or shortfalls.

3. Strategic plan.

a. Although many companies are initially successful in developing their products or technology, the development of a particular product or technology does not necessarily lead to a sustainable business.

b. The entrepreneur must also create a business that can bring in follow-on revenues based on several products or a family of products as opposed to a single product or technology, or the entrepreneur must develop plans for the acquisition of the business (i.e., an exit strategy).

c. Thus, the business plan should include a strategy that sets forth an initial blueprint for developing related or similar products that may utilize the original product or technology to create a sustainable and growing business.

4. Private placement memorandum.

a. A business plan should contain sufficiently detailed information to comply with the requirements of both federal and state securities laws to provide the entrepreneur and his/her company with protection against suits for fraud. Such a business plan will also facilitate the development of a package for prospective investors.

b. The most common offering document is a private placement memorandum, which includes the company's business plan, a description of the company's management, and proposed offering terms.

c. Because the securities disclosure requirements for non-accredited investors are quite onerous and extremely costly to provide, during the initial capital raising stage, most entrepreneurs accept investments only from "accredited" investors.

C. Elements of a business plan.

1. The amount of information that should be provided to a prospective investor depends on whether the investor is a sophisticated or an accredited investor, or whether the investor is a non-accredited investor. For non-accredited investors, the information requirements are mandated by law. Generally, non-accredited investors must be provided with disclosure documents that contain the same information in Part II of Form 1-A, or Part I of a registration statement under the Securities Act of 1933.

2. Part II of Form1-A includes information in the following general categories:

   a. Company.
   b. Risk factors.
   c. Business and properties.
   d. Offering price factors.
   e. Use of proceeds.
   f. Capitalization.
   g. Description of securities.
   h. Plan of distribution.
   i. Dividends, distributions and redemptions.
   j. Officers and key personnel of the company.
   k. Directors of the company.
   l. Principal stockholders.
   m. Management relationships, transactions and remuneration.
   n. Litigation.
   o. Federal tax aspects.
   p. Miscellaneous factors.
   q. Financial statements.
   r. Management discussion and analysis of certain relevant factors.

3. Part I of a registration statement includes information in the following general categories:

   a. Summary information.
   b. Risk factors.
   c. Ratio of earnings to fixed charges.
   d. Use of proceeds.
   e. Determination of offering price.
   f. Dilution.
   g. Selling security holders.
   h. Plan of distribution.
   i. Description of securities to be registered.
   j. Interests of named experts and counsel.
   k. Information with respect to the issuer, including:

      i. Description of business.
      ii. Description of property.
      iii. Legal proceedings.
      iv. Market price of and dividends on the registrant's common equity and related stockholder matters.

v. Financial statements, as well as additional financial information.
vi. Management's discussion and analysis of financial condition and results of operations.
vii. Changes in and disagreements with accountants on accounting and financial disclosure.
viii. Quantitative and qualitative disclosures about market risk.
ix. Directors and executive officers.
x. Executive compensation.
xi. Security ownership of certain beneficial owners and management.
xii. Certain relationships and related transactions.

l. Disclosure of indemnification provisions.
m. Expenses of issuance and distribution.
n. Undertakings.

## IV. NON-TAX ASPECTS OF FORMING AND ORGANIZING A NEW BUSINESS

A. Selecting the form of business entity.

1. Limited Liability.

a. Sole proprietors, partners in a general partnership, and general partners in a limited partnership have personal liability.
b. Shareholders of a corporation, whether a C corporation or an S corporation, limited partners and members of a limited liability company are not personally liable for the debts of the entity.
c. Individuals who would otherwise be protected against personal liability are frequently required to provide their personal guaranties with respect to the repayment of any loans made to the entity.
d. All professionals are personally liable for their own negligence. The partners in a limited liability partnership are not liable for the negligence of their fellow partners. MCL 449.46(1).
e. The shareholders of a professional corporation and the members of a professional limited liability company are also not liable for the negligence of their fellow professionals, unless those professionals are under their direct supervision and control. MCL 450.226 and 450.4905(2).

2. Ease and Expense of Organization.

   a. Very minimal expense and few formalities are required to conduct business as a sole proprietorship.
   b. Other than filing an S corporation election, the expense and formalities associated with forming a C corporation or an S corporation are similar.
   c. Forming a partnership or limited liability company is a little easier than forming a corporation, since it is not necessary to issue shares. On the other hand, a partnership will ordinarily necessitate a partnership agreement and a limited liability company will ordinarily necessitate an operating agreement. Operating agreements have become a common practice even with single-member LLCs.
   d. Partnership agreements and operating agreements tend to be somewhat complex, largely due to the incorporation of provisions reflecting the partnership's tax laws. All of these provisions are not necessary in all cases. It depends on the structure and intended operations of the entity. However, on the whole, partnership accounting is more complex than accounting for most corporations, which tends to be reflected in the partnership or operating agreement.
   e. Corporations tend to become more complex when there are different classes of ownership, particularly when the differences are based more than on just voting. When different classes of ownership are desired, a partnership or limited liability company may be more flexible.

3. Management and control.

   a. A sole proprietor has complete flexibility in managing his or her business.
   b. Corporations are managed by their board of directors, general partnerships by their partners, and limited partnerships by their general partners. Limited liability companies may be managed either by their members or by "managers" who operate in a manner similar to general partners, but without the personal liability of a general partner.
   c. In a corporation, the number of votes that a shareholder has depends on the number of shares owned. Absent an agreement to the contrary, in a general partnership all partners have equal rights in the management and

conduct of the partnership business. MCL 449.18(e). Similarly, unless the operating agreement provides otherwise, in a member-managed limited liability company, each member has one vote. MCL 450.4502(1). There is an exception for limited liability companies that provide for their members to vote in proportion to their share of distributions. It applies to limited liability companies that were grandfathered when the statute was changed.

4. Sources of operating capital.

   a. A sole proprietor is generally limited to his or her individual funds and loans from outsiders.
   b. Corporations, partnerships, and limited liability companies can obtain working capital from contributions to capital, loans from the owners, and loans from outsiders.
   c. C corporations, partnerships and limited liability companies can use various types of equity and debt instruments to raise working capital. An S corporation can also use these devices, but must be careful not to violate the requirement that it have only one class of stock.

5. Continuity of existence.

   a. A sole proprietorship will generally terminate upon the death of the sole proprietor, unless the business can be sold or continued by the sole proprietor's heirs. The latter alternative would generally not be available where the business provides professional services.
   b. C corporations and S corporations exist in perpetuity and are not affected by the death, withdrawal or bankruptcy of a shareholder.
   c. A general partnership is dissolved upon the death or bankruptcy of a partner or by the express will of any partner when no definite term is specified in the partnership agreement. MCL 449.31.
   d. A limited partnership will terminate upon the written consent of all of the partners or in the case of an "event of withdrawal" of a general partner, unless at the time there is at least one other general partner and the certificate of limited partnership permits the business of the limited partnership to be carried on by the remaining

general partner who does so or, if within 90 days after the "event of withdrawal," all of the remaining partners agree in writing to continue the business and appoint one or more additional general partners if necessary. MCL 449.1801.

e. A limited liability company is terminated upon the unanimous vote of all of the members entitled to vote. MCL 450.4801.

6. Transferability of interests.

a. A sole proprietor may sell or transfer any portion of his or her business at will.

b. Absent an agreement to the contrary, a shareholder in a C corporation or an S corporation is free to sell or otherwise transfer his or her shares of stock. However, in an S corporation it is necessary to be cognizant of the restrictions on ownership of stock in an S corporation.

c. Absent an agreement to the contrary, the partners in a general or limited partnership and members in a limited liability company are free to transfer their ownership interests except, that absent the consent of all of the other owners, the assignee will only have the assignor's right to share in the profits of the entity and will not be a full substitute owner. MCL 449.27, 449.1702 and 450.4505(2).

B. Ownership agreements.

1. Principal document.

a. In a partnership or limited liability company, the principal governing instrument will be the partnership agreement or operating agreement, respectively.

b. Many corporations have no governing document other than the bylaws. The bylaws will generally not be satisfactory in an arrangement involving professionals. Therefore, a shareholder or operating agreement is often necessary. The purpose of an operating agreement is to address operational issues involving the business. Examples of issues commonly addressed in this type of agreement include who the officers are, the admission and expulsion of shareholders, the management and liquidation of the corporation, and the provision of

various benefits. The two agreements are often combined in a single document.

2. Incentive agreements.

   a. Agreements may be drawn rewarding service. These may be in the form of compensation or deferred compensation. For example, a simple plan might award one year compensation, reduced by a specified percentage for each year of service less than a specified number.
   b. Another kind of arrangement might award the transition of business after an owner retires. For example, such a plan might pay the retiring owner a specified percentage of receipts collected from the retiring owner's clients over a specified number of years.

3. Buy-sell agreements.

   a. Buy-sell arrangements for partnerships and limited liability companies are frequently included in the partnership and operating agreements, respectively.
   b. Buy-sell arrangements for corporations are usually separate agreements, although they may be combined with an operating agreement.

C. Responsibilities of a corporate director.

1. Oversight responsibility.

   a. Operating, financial and other corporate plans, strategies and objectives.
   b. Evaluating the performance of the corporation and its senior management and taking appropriate action, including removal, when warranted.
   c. Fixing and regularly evaluating the compensation of senior executives.
   d. Requiring, approving and implementing senior executive succession plans.
   e. Adopting policies of corporate conduct, including compliance with applicable laws and regulations, and maintenance of accounting, financial and other controls.

f. Reviewing the process of providing appropriate financial and operational information to decision makers (including board members).
g. Evaluating the overall effectiveness of the board.

2. Fiduciary duties.

a. Corporate directors owe a duty of care that requires that they discharge their duties:

i. In good faith;
ii. With a care that an ordinary prudent person in a like position would exercise under similar circumstances; and
iii. In a manner that he or she reasonably believes to be in the best interests of the corporation.

b. The duty of care is qualified by the business judgment rule, which protects a disinterested director from personal liability to the corporation and its shareholders, even though the corporate decision the director approved is unsuccessful or unwise. Upon review of a director's conduct, a court will not substitute its judgment for that of the director, provided that the director:

i. Acted in good faith;
ii. Is reasonably informed; and
iii. Rationally believes the action taken was in the best interest of the corporation.

c. In addition to the duty of care, directors must abide by a duty of loyalty that requires that they act in the interests of the corporation.

3. Sarbanes-Oxley Act.

a. This new law, and the rules promulgated pursuant thereto by the Securities and Exchange Commission ("SEC"), are in response to well-publicized financial frauds involving Enron, Global Crossing, WorldCom and others. The rules apply to the following:

i. Reporting companies, i.e., companies that have registered equity or debt securities with the SEC under the Securities Exchange Act of 1934; and
ii. Companies that have equity securities listed on an exchange or on NASDAQ.

b. Consequently, the Sarbanes-Oxley Act will not be applicable to privately-owned, emerging companies. However, business owners should understand that while these rules may not be legally applicable, they may establish "best practices" that investors and lenders may insist upon.

D. Facilities.

1. Real estate lease agreements.

a. Term.
b. Rent and other assessments.
c. Security deposits.
d. Space and improvements.
e. Other terms and conditions.

i. Responsibility for maintenance and repair, particularly heating and air conditioning systems.
ii. Right to assign the lease and to sublease all or a portion of the leased premises.
iii. Notice and other procedure requirements for early termination of the lease and penalties associated with early termination.
iv. Dispute resolution procedures, including mediation or arbitration.

2. Personal property.

a. Description of the property.
b. Payment and deposit.
c. Representations concerning title, condition, etc.
d. Other issues concerning personal property leases.

i. Term.
ii. Repair.
iii. Loss or damage.

iv. Default, including notice and cure provisions, early termination, and title to the personal property at the end of the lease.

## V. TAX ASPECTS OF FORMING AND ORGANIZING A NEW BUSINESS

### A. Initial formation.

1. There are generally no tax consequences in connection with the organization of a business as a sole proprietorship.
2. The organization of a corporation is tax free only if the requirements of Section 351 of the Internal Revenue Code are satisfied.

   a. Under Section 351, no gain or loss is recognized on the transfer by one or more persons of property to a corporation (other than an investment company) solely in exchange for stock in such corporation if, immediately after the transfer, the corporation is controlled by the transferors of the property. "Control" means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of each other class of stock of the corporation.
   b. If the transferors receive property or money in addition to the stock then they may be required to recognize a gain, but not a loss. I.R.C. §351(b). No gain or loss is recognized by the corporation on the receipt of money or other property in exchange for stock in the corporation. I.R.C. §1032(a). Gain or loss must be recognized if the requirements of §351 are not met.
   c. An S corporation also has to meet the requirements for an S corporation and file an election.
   d. A corporation may amortize its "organizational expenditures" over 60 months. I.R.C. §248(a).

3. No gain or loss is recognized on the contribution of property to a partnership (other than an investment company) in exchange for an interest in the partnership. The transferors do not need to be in "control" of the partnership after the transfer. I.R.C. §721.

a. A partner that contributes appreciated property to a partnership may be required to recognize gain on the distribution of that property to that partner. I.R.C. §704(c)(1)(B).

b. A partner that contributes appreciated property to a partnership may be required to recognize gain on a subsequent partnership distribution of other property to the contributing partner. I.R.C. §737.

c. The transfer of a partnership interest in exchange for services performed by a new partner may be taxable. Treas. Reg. 1.721-1(b)(2).

d. A partnership can also amortize its "organizational expenses" over 60 months. I.R.C. §709(b)(1).

B. Taxation of income.

1. All tax consequences arising out of the business operated by a sole proprietorship are borne by the sole proprietor.

a. Individual income is subject to tax at a maximum rate of 38.6 percent in 2002 and 2003, 35 percent in 2004 through 2010, and then 39.6 percent in 2011 and thereafter. I.R.C. §1.

b. Individual net capital gains are generally taxable at a maximum rate of 15 percent if attributable to property held more than one year. I.R.C. §1(h).

c. Individuals are generally subject to an alternative minimum tax of 26 percent with respect to the first $175,000 of alternative minimum taxable income in excess of the exemption amount and 28 percent with respect to amounts in excess of $175,000. I.R.C. §55(b). For 2003 through 2005, the exemption amounts are $58,000 for married individuals filing a joint return, $29,000 for married individuals filing a separate return, and $40,250 for single individuals who are not a surviving spouse. I.R.C. §55(d)(1). The exemption amounts are subject to a phase-out. I.R.C. §55(d).

2. A C corporation is subject to double taxation. The corporation's earnings are subject to tax at the corporate level. An additional tax applies at the shareholder level on the corporation's after-tax income that is actually distributed to the shareholders as dividends. This is generally less of a problem with service

corporations where most of the corporation's earnings are distributed to the shareholders as deductible compensation.

a. A C corporation is taxed at 15 percent on taxable income that does not exceed $50,000, 25 percent on taxable income that exceeds $50,000 but not $75,000, 34 percent on taxable income that exceeds $75,000 but not $10 million, and 35 percent on taxable income in excess of $10 million. I.R.C. §11(b). There are surtaxes that apply and which are designed to reduce the benefits of the lower brackets.

b. A corporation is taxed on net capital gain at the regular tax rates, including the additional phase-out rates for high-income corporations . I.R.C. §§11 and 1201.

c. Personal service corporations are subject to a tax rate of 35 percent on all of their taxable income (i.e., they are ineligible for the graduated corporate income tax rates). I.R.C. §11(b)(2).

d. A C corporation is potentially subject to the 15 percent accumulated earnings tax on improper accumulations of earnings and to the 15 percent personal holding company tax if five or fewer individuals own more than 50 percent of the corporation's outstanding stock and at least 60 percent of the corporation's adjusted ordinary gross income is personal holding company income. I.R.C. §§531-547.

e. Corporations are subject to an alternative minimum tax of 20 percent of their alternative minimum taxable income in excess of the exemption amount. I.R.C. §55(b)(1)(B). The exemption amount is $40,000, subject to a phase-out. I.R.C. §55(d)(2). The alternative minimum tax does not apply to the first year of a corporation's existence. It also does not apply if the corporation's annual gross receipts are $7.5 million or less for all consecutive three year periods beginning after 1993 and ending before the tax year in question. I.R.C. §55(e)(1)(A). For corporations having three or fewer prior tax years, the $7.5 million average annual gross receipts threshold is reduced to $5 million. I.R.C. §55(e)(1)(B).

3. The profits and losses of an S corporation are generally passed through to its shareholders. Unlike a C corporation, an S corporation is not subject to a corporate income tax, an

accumulated earnings tax, or a personal holding company tax. The S corporation may be taxed under Section 1374 on certain built-in gains and under Section 1375 when passive investment income of an S corporation having Subchapter C earnings and profits exceeds 25 percent of gross receipts.

4. A partnership, including a limited liability company taxable as a partnership, is a pass-through entity like an S corporation. Therefore, the entity itself is not subject to taxation.

C. Losses.

1. A sole proprietor may offset losses from the sole proprietorship against his or her other income, subject to the "at-risk" limitations of Section 465 and the "passive loss" limitations of Section 469 of the Code.
2. The shareholders of a C corporation may not offset losses of the corporation against their other income. The corporation itself, if it is unable to use the losses currently, may carry them back two years or forward 20 years. I.R.C. §172. A shareholder generally realizes a capital loss upon the sale (for consideration less than basis) or worthlessness of his or her stock. I.R.C. §1001(a) and 165(g). However, more favorable ordinary loss treatment may be available under Section 1244. A shareholder may be able to generate a loss deduction for a bad debt arising from a loan by the shareholder to the corporation. I.R.C. §166.
3. The shareholders of an S corporation may deduct their share of the corporation's losses against other sources of income, but only to the extent of the shareholder's basis in his or her corporate stock or debt, and subject to the "at-risk" and "passive loss" limitations. I.R.C. §§465, 469 and 1366(d)(1).

No carry-forward or carry-back of losses may arise at the corporate level for any taxable year during which the corporation is an S corporation. I.R.C. §1371(b)(2). Losses arising in a taxable year during which a corporation was a C corporation may not be carried forward or back to a taxable year during which the corporation is an S corporation. I.R.C. §1371(b)(1). Section 1244 is available with respect to S corporation stock.

4. Partners may offset their partnership losses against other sources of income. I.R.C. §§701 and 702(a)(8). However, a partner may deduct his share of losses only to the extent of his adjusted basis in his partnership interest, taking into account his share of the partnership's debt at the end of the partnership year in which the losses occurred. I.R.C. §704(d). Any excess of those losses over such basis is allowed as a deduction at the end of the partnership year in which the excess is repaid to the partnership. I.R.C. §704(d). Partners are subject to the "at risk" and "passive loss" limitations. I.R.C. §§465 and 469.

D. Special allocations.

1. In a sole proprietorship, all losses and items of deduction are allocated to the sole proprietor.
2. A C corporation may have multiple classes of stock with varying preferences, but otherwise special allocations are not available.
3. Special allocations are not available with respect to an S corporation because of the one class of stock requirement. I.R.C. §1361(b)(1)(D).
4. In a partnership, losses and other deductions may be specially allocated among the partners. Generally, this will be determined according to the partnership agreement. I.R.C. §704(a). However, it will be based upon each partner's

interest in the partnership if there is no provision in the partnership agreement for the allocation of these items or the allocation provided for in the partnership agreement lacks "substantial economic effect." I.R.C. §704(b).

E. Taxable year and accounting method.

1. The taxable year of a sole proprietorship is the same as the taxable year of the sole proprietor. The sole proprietorship's taxable year generally is required to be the same as its annual accounting period. I.R.C. §441(a)-(c). There are no restrictions on the method of accounting that may be used by a sole proprietorship, provided that it clearly reflects income and is consistent with the method used by the sole proprietorship in keeping its books. I.R.C. §446(a)-(c).
2. A C corporation's taxable year is generally required to be the same as its annual accounting period. As a general rule, C corporations may not use the cash method of accounting. I.R.C. §448(a)(1). Instead, they must use the accrual method. However, there are exceptions for qualified personal service corporations, certain corporations with gross receipts of not more than $5 million and certain farming businesses. I.R.C. §448(b).
3. An S corporation must use the calendar year unless it can establish a business purpose for another accounting period. I.R.C. §1378. Unlike C corporations, S corporations may use either the cash method or accrual method of accounting, except that S corporations treated as "tax shelters" must use the accrual method. I.R.C. §448(a).
4. Unless it can establish a valid business purpose for a different taxable year, a partnership must use the taxable year which constitutes the taxable year of one or more partners having an

aggregate interest in partnership profits and capital of more than 50 percent. If there is no such taxable year, the partnership must use the taxable year of all of the partners having an interest of five percent or more in partnership profits or capital. Otherwise, it must use the calendar year. I.R.C. §706(b). A partnership may use either the cash or accrual method of accounting, except that partnerships that have a C corporation as a partner and partnerships that are treated as "tax shelters" must use the accrual method of accounting. I.R.C. §448(a).

F. Sale of an asset or interest in the business.

1. There is only a single level of tax when the assets of a sole proprietorship are sold. For tax purposes, each asset is considered as being sold separately by the sole proprietor.
2. The seller of a C corporation can achieve a single level of tax only by selling the stock of the C corporation. A sale of assets will result in gain at the corporate level, and a second level of tax at the shareholder level when the proceeds of the sale are distributed. In a stock sale, the buyer does not get a basis step-up in the assets, unless the buyer makes a Section 338 election. A non-corporate taxpayer may exclude up to 50 percent of any gain realized on the sale or exchange of qualified small business stock held for more than five years. I.R.C. §1202.
3. The assets of an S corporation can generally be sold and the corporation liquidated with only a single level of tax at the shareholder level. However, Section 1374 imposes a corporate level "sting tax" on the sale or exchange, by an S corporation that has converted from a C corporation, of assets that were held by the corporation when it was still a C corporation.

4. The assets of a partnership can be sold with only a single level of tax at the partner level. The sale of a partnership interest is treated as the sale or exchange of a capital asset, and the purchaser can get a step-up in the basis of his "share" of the assets of the partnership if the partnership makes an election under Section 754 of the Code. There is an exception for partnerships that have unrealized receivables or substantially appreciated inventory items. I.R.C. §§741 and 751. The amount received by a partner in exchange for his or her partnership interest which is attributable to unrealized receivables or substantially appreciated inventory will generally cause the realization of ordinary income. I.R.C. §751.

G. Liquidation or dissolution.

1. The distribution of assets from a sole proprietorship to the sole proprietor is not a taxable event.
2. A shareholder of a C corporation recognizes capital gain or loss on a distribution made in complete liquidation of the corporation in exchange for the shareholder's stock. I.R.C. §331. Gain or loss is also recognized by the liquidating corporation. I.R.C. §336. The result is double taxation on the distribution of appreciated property by the C corporation.
3. A liquidating distribution by an S corporation is taxed only once because gain recognized by the corporation is passed through to the shareholders, whose stock basis is increased by the amount of gain recognized. I.R.C. §§1363(d) and 1367(a)(1).
4. In a partnership liquidation, a partner recognizes gain only to the extent that money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. I.R.C. §731(a)(1). A partner may recognize a loss only to the extent that money, unrealized receivables or

inventory are distributed. I.R.C. §731(a)(2). Gain or loss is generally capital in nature, unless it relates to unrealized receivables or substantially appreciated inventory. I.R.C. §§731, 741 and 751. No gain or loss is recognized by the partnership on a distribution to a partner. I.R.C. §731(b).

## VI. TAX REPORTING AND COMPLIANCE

A. Preliminary considerations.

1. Tax planning.

a. Altering the characteristics of an activity or transaction can achieve a particular tax objective. For example, with a properly structured lease, it may be possible to control the "tax cost" to the company regardless of subsequent changes in property valuations or tax rates. For employment taxes using independent contractors rather than employees may reduce payroll taxes.

b. However, the company may not disregard the joint effect of multiple tax rates across multiple tax bases. Foregoing one tax at a lower rate that results in paying a different tax at a higher tax rate is not good tax planning. For example, if reducing deductible property or payroll taxes results in higher income taxes, the total tax cost to the company could be higher.

c. Also, both the tax and non-tax effects must be considered. For example, treating employees as independent contractors may not be worthwhile if the benefits from being able to directly control the work of the employees outweighs the additional payroll taxes incurred.

2. Tax entity.

a. For an S corporation, the rules on self-employment taxes are well established. S corporation shareholders pay self-employment tax on money received as compensation for services, but not on profits that automatically pass through to the shareholder.

b. By contrast, the rules for members of an LLC are murky.

i. The IRS previously issued regulations, but Congress temporarily placed a moratorium on issuing final regulations. While the moratorium has expired, the IRS has never issued final regulations. Under the proposed regulations, a member's share of LLC profits would be subject to self-employment tax in any of the following situations:

a) The member participates in the business for more than 500 hours during the LLC's tax year;
b) The member works in an LLC that provides professional services in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting (no matter how many hours the member works); or
c) The member is authorized to sign contracts on behalf of the LLC.

3. Tax time period.

a. Individuals report on the calendar year.
b. Sole proprietorships and disregarded entities effectively report according to the same taxable year as their owners.
c. Partnerships report according to the taxable year of their principal partners.
d. Personal service corporations can adopt a fiscal year if they demonstrate the existence of a business purpose.
e. Similar rules apply to S corporations.
f. C corporations can adopt a fiscal year different from the tax year.

4. Tax accounting method.

a. The Internal Revenue Code recognized two primary methods of accounting (cash and accrual) and two secondary methods of accounting (special and hybrid). The special method of accounting is used for certain items of income or expense, primarily related to farming, installment sales and depreciation. The hybrid method of accounting is usually the cash method modified by

some accrual method requirements. For example, individuals may use the accrual method of business income and expenses and the cash method for personal income and expenses. For businesses that sell products where inventory is necessary to account for income, the accrual method must be used for sales and purchases, but the cash method can be used for all other items of income and expense.

b. The accounting method affects a variety of issues:

   i. Applying for appropriate employer identification numbers.
   ii. A variety of income, employment (or self-employment) and excise taxes that will affect business operations, and how to deposit (pay) those taxes.
   iii. Types of information returns that tax authorities may require to be filed.
   iv. Types of penalties that might be applied to late or underpaid tax obligations.
   v. Special tax rules for certain types of business expenses, including startup costs, depreciation of tangible and property and car and truck expenses.
   vi. Recordkeeping requirements, including the kinds of records to keep and how long to keep records.

c. A useful source of information for these kinds of issues can be found in IRS Publication 583: *Starting a Business and Keeping Records*.

B. Withholding and estimated tax payments.

1. Withholding.

   a. Wage withholding.
   b. Social Security taxes (“FICA”).
   c. Federal unemployment tax (“FUTA”).
   d. Federal self-employment taxes.
   e. Return and deposit of taxes.

2. Estimated tax payments.

C. Federal, state and local tax returns.

1. State and local taxes.
2. State and local property taxes.
3. State and local sales taxes.
4. State and local income/SBT taxes.
5. Federal income taxes.

## VII. ACCOUNTING AND FINANCIAL REPORTING ISSUES

A. Accountant's role.

1. Financial management focuses on decisions concerning how financial resources (debt or equity) are acquired and used to meet the production and distribution needs of the company. Finance has traditionally been thought of as the area of financial management that focuses on the acquisition and disposition of cash. More recently, finance has expanded from being concerned only with borrowing funds and investing excess cash resources. The finance function today involves analyzing the financial information produced by the company to improve decisions that will impact on the wealth of the owners.
2. Accounting provides the financial information used in financial management, and is generally divided into financial accounting and managerial accounting.

   a. Financial accounting records the financial history of the company, and is used to report that history to investors and creditors outside the company. Financial accounting often must measure and report the company's business activities in accordance with "generally accepted accounting principles ("GAAP")." For some companies, the reports produced by the financial accounting system must be audited by independent certified public accountants.

b. Managerial accounting provides information useful for making decisions about the future of the company. Where financial accounting looks to the past, managerial accounting looks to the future. Also, while financial accounting must follow GAAP, managerial accounting is free to provide any information in any format to support virtually any decision.

B. Financial reporting.

1. Sales.

a. Allowance for doubtful accounts.
b. Price vs. volume changes.
c. Real vs. nominal growth.

2. Cost of goods sold.

a. Inventory cost-flow assumptions.
b. LIFO layer reduction.
c. Loss on inventory write-downs.

3. Operating expenses.

a. Discretionary expenses.
b. Depreciation/depletion/amortization.
c. Pension accounting.

4. Nonoperating revenue and expense.

a. Sales of assets.
b. Interest income.
c. Equity income.
d. Loss on asset write-downs.
e. Accounting changes.
f. Extraordinary items.

5. Other issues.

a. Number of shares outstanding.
b. Acquisitions and dispositions.
c. Reserves.

C. Financial statement analysis.

1. Liquidity ratios.

a. Current ratio.

i. Current Assets divided by current liabilities;
ii. Measures the ability to pay bills as they become due.

b. Quick (Acid Test) ratio.

i. [Current assets minus inventory] divided by current liabilities;
ii. A more rigorous measure of bill paying ability. Removes inventory, usually the least liquid current asset.

c. Cash ratio.

i. [Cash plus marketable securities] divided by current liabilities;
ii. The most conservative measure of short-term liquidity.

d. Cash flow ratio.

i. Cash flow from operations divided by current liabilities;
ii. A measure of the sufficiency of operating cash flows to support bill paying ability.

e. Working capital.

i. Current assets minus current liabilities;
ii. Not a ratio but an absolute amount. Closely related to the Current Ratio. Another measure of bill paying ability.

2. Cycle ratios.

   a. Accounts receivable turnover.

      i. Net sales divided by average accounts receivable;
      ii. How many times, on average, that accounts receivable is collected during the year. It also measures the amount of sales generated by each dollar of accounts receivable.

   b. Number of days in accounts receivable.

      i. A/R turnover divided by 365;
      ii. The number of days, on average, it takes to collect accounts receivable.

   c. Inventory turnover.

      i. Cost of goods sold divided by average inventory;
      ii. How many times, on average, the entire inventory value is sold during the year. It also measures the amount of cost of goods sold (sales) generated by each dollar of inventory.

   d. Number of days in inventory.

      i. Inventory turnover divided by 365;
      ii. The number of days, on average, it takes to sell the inventory value.

   e. Accounts payable turnover.

      i. Purchases divided by average accounts payable;
      ii. How many times, on average, that accounts payable is paid during the year. It also measures the amount of purchases created by each dollar of accounts payable.

   f. Number of days in accounts payable.

      i. A/P Turnover divided by 365;

ii. The number of days, on average, it takes to pay the accounts payable.

g. Fixed asset turnover.

i. Net sales divided by net property, plant and equipment;
ii. The amount of sales generated by each dollar of fixed assets. It is a measure of the efficient use of fixed assets.

h. Total asset turnover.

i. Net sales divided by total assets;
ii. The amount of sales generated by each dollar of total assets. It is a measure of the efficient use of total assets.

3. Solvency ratios.

a. Debt to assets ratio.

i. Total liabilities divided by total assets;
ii. Measures the proportion of total assets that are financed by debt.

b. Debt to equity ratio.

i. Total liabilities divided by stockholders equity;
ii. Measures the proportion of total debt to total equity.

c. Times interest earned ratio.

i. Operating profit divided by interest expense;
ii. Measures how many times interest expense on debt is covered by operating earnings.

d. Fixed charge coverage ratio.

i. [Operating profit plus lease payments] divided by [interest expense plus lease payments];

ii. A broader measure than Times Interest Earned. Treats lease payments as part of the debt coverage from operating earnings.

e. Cash flow adequacy ratio.

i. Cash flow from operating activities divided by average annual long-term debt maturities;
ii. Measures how many times annual long-term debt maturities are covered by operating cash flows.

f. Financial leverage ratio.

i. Total assets divided by stockholders equity;
ii. The a mount of financial leverage (increase in returns to stockholders) provided by the use of debt in the firm's capital structure.

4. Profitability ratios.

a. Gross profit margin.

i. Gross profit divided by net sales;
ii. Measures profitability after deducting cost of goods sold from sales.

b. Operating profit margin.

i. Operating profit divided by net sales;
ii. Measures profitability after deducting all operating expenses.

c. Return on sales (net profit margin).

i. Net income divided by net sales;
ii. Measures profitability after deducting all other revenues and expenses.

d. Cash flow margin.

i. Cash flow from operating activities divided by net sales;

ii. Measures the ability to generate cash flows from sales.

e. Return on assets.

i. Net income divided by total assets;
ii. Measures the efficiency of generating profits using all available assets.

f. Return on investment.

i. Net income divided by [long-term debt plus stockholders equity];
ii. Measures the efficiency of generating profits using all long-term sources of capital.

g. Return on equity.

i. Net Income divided by stockholders equity;
ii. Measures the efficiency of generating profits using equity.

h. Cash return on assets.

i. Cash flow from operating activities divided by total assets;
ii. Measures the efficiency of generating cash flows from using all available assets.

i. Cash return on equity.

i. Cash flow from operating activities divided by stockholders equity;
ii. Measures the efficiency of generating cash flows from using equity.

5. Equity ratios.

a. Earnings per share.

i. Net income divided by number of shares outstanding;

ii. Measures return to common stockholders for each share owned.

b. Price to earnings (P/E) ratio.

i. Market price per share divided by earnings per share;
ii. Measures the stock market value of the firm as a multiple of earnings.

c. Dividend payout ratio.

i. Dividends per share divided by earnings per share;
ii. Measures the percentage of earnings paid out to stockholders as dividends.

d. Dividend yield ratio.

i. Dividends per share divided by market price per share;
ii. Measures the return to stockholders from dividends.

e. Retained earnings ratio.

i. [Net income less dividends] divided by net income;
ii. Measures internal growth potential as the percentage of earnings not paid in dividends.

f. Retained cash ratio.

i. [Cash flow from operating activities less dividends] divided by cash flow from operating activities;
ii. Measures internal growth potential as the percentage of operating cash flows not paid in dividends.

g. Book value per share.

i. Total assets divided by number of shares outstanding;
ii. The accounting (historical cost based) value of each share of common stock.

## VIII. FINANCING A BUSINESS

A. Preliminary considerations.

1. Different types of potential investors.
2. Key variables affecting each type of investor's decision to provide capital.
3. Business and industry of the company.
4. Company's prospects for growth.
5. Company's projected financial needs.
6. Stage of development of the company.
7. Business goals of the company's founders (for example, acquisition by a larger company).
8. Investment instruments to be used.
9. Impact of state and federal laws regulating the offer and sale of securities.

B. Financing sources.

1. Venture capital ("VC").

a. Advantages.

i. VCs tend to be active, knowledgeable participants in the business.
ii. VCs are relatively long-term investors.
iii. As equity stakeholders, VCs maximize their profits if the business grows significantly.

b. Disadvantages.

i. A great deal of time can be spent raising VC funding.
ii. The founders in the VCs may develop differences of opinion over company direction.
iii. In a negative business cycle, the VCs may require significant concessions in order to provide continuing funding to keep the company growing.
iv. VCs often will want to invest with at least one other VC fund or corporate investor.
v. More companies want venture capital than are truly qualified to obtain it.

2. Alternative financing sources.

a. Founders and family members.
b. Friends.
c. Angel investors (wealthy individual investors who desire to invest in emerging companies).
d. Corporate partner/investor (most common with technology companies).
e. Public shells (offered by promoters who seek to have entrepreneurs looking for capital merge their company into another, inactive company that already has shares that were registered for public trading, typically in the "pink sheets" or a regional U.S. exchange, such as the Denver Stock Exchange, or a Canadian stock exchange, such as the Vancouver Stock Exchange).
f. Grants (through a state or federal technology or business development grant program).
g. Leasing companies.
h. Banks.
i. Licensing technology.
j. Development agreements (use of the new company's technology to create a product or technology for a customer, and then using the cash received to build staff, demonstrate technology or market feasibility, or develop proprietary and intellectual property).
k. Sale of discontinued inventory, equipment or line of business.

C. Financing strategy.

1. Financial needs.

a. Cash flow.
b. Burn rate and dilution.

i. An emerging company business plan will forecast an initial and profitable period while the company is developing its product or establishing a customer base. During that period, the company will be spending more money than it is taking in. This negative cash flow, measured at a monthly, quarterly or annual pace, is the company's "burn rate," i.e., the speed at which it is using up its supply of cash.
ii. As founders sell a percentage of the company to outside investors, the ownership percentage of the founders is reduced. This is referred to as "dilution."

c. Financial protections.

2. Valuation.

a. Valuation is the key determinant of how much ownership interest the new investors take for a given level of investment, and how much ownership interest the founders and early stage investors must give up.
b. One method of valuation routinely used by emerging companies starts by taking a point in the company's projected future when the company does have earnings and a growth rate, and then using those figures to determine a future valuation. Once the future valuation is calculated, the parties discount the projected future market capitalization to come up with a current valuation. For example, if the investors think that the company's chance of achieving a projected growth rate that would yield the value being sought by the investors for their stock is only 50%, then the investors would want to increase their investment percentage to compensate for the risk that the future value might not materialize.

3. Debt versus equity.

a. Equity.

i. Common stock.
ii. Preferred stock.
iii. Options and warrants.
iv. Convertible debt.

b. Debt.

D. Typical venture capital financing terms.

1. Issuance of preferred stock to the venture investor.
2. Dividend preferences.
3. Liquidation preferences.
4. Right to convert the preferred stock to common stock in the future.
5. Anti-dilution protection for the VC.
6. Representation for the VC on the board of directors.
7. Information rights.
8. Registration rights.

E. Securities law considerations.

1. Overview.

a. Under Section 5 of the Securities Act of 1933, it is unlawful to sell or offer for sale any security unless a registration statement has been filed with the SEC or the transaction is exempt from the registration requirements.
b. An exemption from registration in no way exempts the transaction from the anti-fraud provisions of the Securities Act of 1933 and those of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Failure to comply with these provisions can result in civil liability (i.e., money damages). The liability can be personal as to corporate officers, directors, principal shareholders, promoters and others associated with the offering. "Fraud" is defined broadly. It includes, for

example, omissions in disclosure (even unintentional ones) as well as deliberate misrepresentations.

c. There are two broad types of exemptions.

   i. Section 3 of the Securities Act of 1933 lists several types of securities that are exempt from registration, generally due to the nature of the security or the nature of the issuer.
   ii. Section 4 of the Securities Act of 1933 exempts certain types of transactions from registration.

2. Types of exempt securities under Section 3(a) of the Securities Act of 1933.

   a. Section 3(a)(2) exempts securities issued or guaranteed by federal, state or local governments; securities issued by banks or trust funds; industrial development bond securities and specific interests in employee benefit plans.
   b. Section 3(a)(3) exempts any note, draft, bill of exchange or banker's acceptance related to a current transaction and which has a maturity date of within nine months of the date of issuance.
   c. Section 3(a)(4) exempts any security issued by a person organized for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for profit.
   d. Section 3(a)(5) exempts any security issued by a savings and loan and similar institutions and certain cooperatives.
   e. Section 3(a)(6) exempts any interest in a railroad equipment trust.
   f. Section 3(a)(7) exempts certificates issued by a receiver or by a trustee or debtor in possession in a Chapter 11 bankruptcy proceeding.
   g. Section 3(a)(8) exempts insurance policies and annuities contracts issued by regulated corporations.
   h. Section 3(a)(9) exempts, except with respect to a security exchanged in a case under Title 11, any security exchanged by the issuer with its existing security holders exclusively, where no commission or other remuneration is given for solicitation of the exchange.
   i. Section 3(a)(10) exempts, except with respect to a security exchanged in a case under Title 11, any security issued in exchange for one or more outstanding

securities, claims or property interests or partly in such exchange and partly for cash, where the exchange has been approved by a court or federal or state agency.

j. Section 3(a)(11) exempts any security which is part of an issue offered and sold only to persons resident in a single state where the issuer is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such state.

k. Section 3(a)(12) exempts any equity security issued in connection with the formation of a one-bank holding company or savings and loan holding company where there is no significant change in proportional share ownership or assets of the institution.

l. Section 3(a)(13) exempts any security issued by a church plan, company or account that is excluded from the definition of an investment company under the Investment Company Act of 1940.

m. Section 3(b) allows the SEC to exempt any security, up to an aggregate amount of $5 million, for which the SEC has determined that registration is not necessary in the public interest and for the protection of investors.

3. Private placement exemption.

a. Section 4(2) of the Securities Act of 1933 exempts from registration “transactions by an issuer not involving any public offering.” Prior to the adoption by the SEC of Regulation D, case law provided limited and conflicting guidance regarding what constituted a non-public offering. Under SEC v Ralston Purina, 346 US 119 (1953), the focus of the exemption was on whether the offerees could “fend for themselves.” Securities acquired in a private placement are “restricted securities” and cannot be resold for a period of time. The resale must qualify for an exemption or be registered.

b. Regulation D, promulgated by the SEC, provides exemptions from registration for three separate categories of offerings of securities by an issuer.

i. Rule 504 provides an exemption for offerings by an issuer of up to $1 million in securities.

ii. Rule 505 provides an exemption for offerings by an issuer of up to $5 million in securities to any number of “accredited investors” and to 35 additional non-accredited investors.

iii. Rule 506 provides an exemption for offerings of an unlimited dollar amount of securities to accredited investors and 35 additional non-accredited investors. Unlike Rule 505, the non-accredited investors in a Rule 506 offering must be "sophisticated" or have a "sophisticated" purchaser representative, and the issuer must reasonably believe that the investor either alone, or with his or her purchaser representative, has the knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.

iv. Accredited investor.

a) Banks, insurance companies, registered investment and development companies.

b) Employee benefit plans and plans that have total assets in excess of $5 million.

c) Charitable organizations, corporations, trusts not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person, or partnerships with assets exceeding $5 million.

d) Any director, executive officer, or general partner of the issuing company.

e) A business in which all the equity owners are accredited investors.

f) Natural persons with a net worth of at least $1 million or with incomes exceeding $200,000 in each of the two most recent years or who have joint income with a spouse exceeding $300,000 and a reasonable expectation of the same income level in the current year.

4. Intrastate offering exemption.

a. Section 3(a)(11) of the Securities Act of 1933 exempts from the registration requirement any offer or sale of securities to persons residing in a single state by an issuer that is a resident and doing business within, or if a corporation, incorporated by and doing business within such state.

b. Rule 147 provides a safe harbor for use with the Section 3(a)(11) intrastate exemption.

i. The requirement that all of the offerees and purchasers must be a resident in the state is satisfied if the purchaser/offeree is a business and its principal office is in the state or if the purchaser/offeree is an individual, his or her principal residence is located in the state.

ii. The requirement that the issuer must be a resident and doing business within the state at the time of issuance is met if the issuer is organized under the state's laws, 80% of the issuer's gross revenues and assets arise from or are located in the state, 80% of the net proceeds are used in connection with operations in the state, and the issuer's principal office is located in the state.

5. Section 4(6) exemption.

a. Section 4(6) provides an exemption from the registration requirement for offers and sales of securities to one or more accredited investors.

b. Requirements.

i. The aggregate offering price for the transaction may not exceed $5 million.

ii. No advertising or general solicitation is permitted.

iii. All offerees and purchasers must be accredited investors.

iv. All issuers using the exemption must file a notice on Form D.

v. Resales are restricted in the same manner as for Section 4(2) securities.

6. Offerings pursuant to Regulation A.

a. Section 3(b) of the Securities Act of 1933 authorizes the SEC to create exemptions involving offerings where the amount of the offering does not exceed $5 million.

b. The SEC has utilized this authority in creating Regulation A, which provides an exemption from the registration requirements for public offerings of up to $5 million within the prior 12 months.

c. Issuers must file an Offering Statement containing substantially the information required by Form 1-A with the SEC prior to the making of any offers. No sales are permitted prior to qualification of the Offering Statement by the SEC and delivery of a final Offering Circular to prospective purchasers. Issuers must file a report of sales and use of proceeds with the SEC on Form 2-A at the end of each six month period following the date of qualification of the Offering Statement until substantially all of the proceeds of the issue have been applied. Issuers must file a Final Report on Form 2-A within 30 days of either the later of the termination, completion or final sale of the securities in the offering or application of the proceeds from the offering.

7. Rule 701.

a. Rule 701 provides an exemption for certain issuances of securities pursuant to a written compensatory plan or contract.

b. There is no numerical limit on offerees and purchasers, but generally the persons eligible consist of employees, directors, general partners, trustees, officers, or consultants and advisors, and family members of such person who acquire such securities from such persons through gifts or domestic relations orders.

8. Small issuer registered offerings.

a. Regulation S-B was promulgated to provide for simplified registration by "small business issuers."

b. Although technically not an exempt offering, Regulation S-B is nonetheless often of interest to those considering exempt transactions.

c. A small business issuer is a Canadian or domestic issuer with revenues of less than $25 million and a public float of less than $25 million and that is not an investment company.

9. State "blue sky" securities laws.

a. In addition to the requirements of the federal securities laws, issuers must also comply with the requirements of the state securities laws, sometimes called "blue sky"

laws because they were intended to regulate promoters who would sell investors nothing but blue sky.

b. A number of states have passed a variation of the Uniform Limited Offering Exemption ("ULOE"), which relates to the state regulation of private offers and sales of securities that are exempt from SEC registration. The ULOE elements coordinate with the Regulation D elements, particularly on the limitation on participants and the ban on general advertising. However, because each state is free to pass ULOE with its own distinct variations, ULOE is not necessarily uniform from state to state. However, there are some consistent elements:

   i. There must be a limited number of offerees or purchasers.
   ii. Accredited investors are generally excluded from the number calculation.
   iii. The payment of fees to underwriters or promoters is not permitted.
   iv. A prior connection between the investor and the company or a level of financial and business sophistication by the investor is required.
   v. The issuer cannot conduct general advertising of the offering.

F. Debt.

1. Secured vs. unsecured debt.
2. Security interests.
3. Subordination.
4. Warrants as loan condition.

   a. Lenders to emerging companies will often seek the ability to obtain equity at a favorable price as a condition to providing the financing.
   b. The warrant agreement permits the lender to make additional profit without taking additional risk. If the company grows and share value increases, the lender can exercise the warrant to obtain shares at a price below the market. If the company does not succeed, the lender does not exercise the warrant.
   c. Warrant arrangements are common in bridge loan and bank loan arrangements by companies that are venture capital backed. Corporate partners and angel investors may also seek warrants, depending on the issuer's individual circumstances.

## IX. TECHNOLOGY AND INTELLECTUAL PROPERTY RIGHTS

| Distinguishing Feature | Trade Secret | Patent (Utility) | Copyright | Trademark |
|---|---|---|---|---|
| Protected Interest | Business Information | Functional Inventions | Expression Embodied in Fixed Medium | Consumer Recognition & Related Goodwill |
| Requirement for Protection | Not Known; Valuable; Maintained as Secret | New, Useful, Nonobvious, Proper Subject Matter | Originality | Use in Commerce |
| Disclosure Required | No | Yes | Yes | Yes |
| Term of Protection | Potentially Indefinite if Information Remains Secret | 20 Years from Application Date | Author's Life Plus 70 Years * | Potentially Indefinite if Mark is Used Properly |
| Conduct Prohibited by Protection | Misappropriation | Making, Using, Selling, or Offering to Sell Invention | Copyrighting or Substantially Similar Works | Creating a Likelihood of Confusion |
| Independent Development | Not Prohibited | Prohibited | May be Prohibited | Prohibited |
| Reverse Engineering | Not Prohibited | Prohibited | Inapplicable | Inapplicable |
| Damages for Infringement | Compensatory and Treble Damages; Attorney Fees | Compensatory and Treble Damages; Attorney Fees | Compensatory and Statutory Damages; Attorney Fees | Compensatory and Treble Damages; Attorney Fees |

* The term of copyright protection for corporations is 95 years after publication

## X. PRODUCT DEVELOPMENT AND DISTRIBUTION

### A. Development agreements.

1. The founder can contribute technology to the company. This would be covered by the shareholders agreement, operating agreement or partnership agreement.
2. The company can develop technology internally. This requires development agreements with the employees who are doing the work.
3. Development can be outsourced to third parties. These types of research and development arrangements require a separate contractual agreement.

4. An “R&D partnership” involves capital contributed by outside investors to finance research work by a company, usually with previously developed, similar technology. The starter contributes the base technology. The investors contribute capital as limited partners. The starter performs research work for the benefit of a R&D partnership that approximates in value the amount contributed by the investors. The investors receive a return on their investment from royalties on the sale of products using the technology developed by the research program. The company generally has a right to “buy out” the interest of the investors either at a set price or based on a formula.
5. An “R&D subsidiary” involves contributing the base technology to a new wholly owned subsidiary. Capital is raised by a public offering of “units” that consist of callable shares of common stock of the new subsidiary and warrants to purchase shares of common stock of the sponsor.

B. Manufacturing, supply and license agreements.

1. Little documentation is required if manufacturing is performed internally.
2. Contracts are required if manufacturing is performed by an outside third party. Typically, this requires the manufacturer to keep confidential anything that it learns from the emerging company.
3. A third approach is a non-exclusive license granted by the emerging company to a third party in exchange for a royalty. The license authorizes the third party to manufacture and sell the products to end users.
4. An “OEM” or original equipment manufacturer relationship involves a situation where the principal agrees to sell goods to

a distributor who, in turn, adds some “value” to the goods, such as enhancements or additional applications, and then sells the “value added” products to its customers.

C. Sales contracts.

1. Acceptance.
2. Change orders.
3. Cancellation.
4. Pricing.
5. Terms of payment.
6. Shipping terms and risk of loss.
7. Non-conforming or defective shipments.
8. Warranties.
9. Indemnification.
10. Force majeure and excuse.
11. Default.
12. Choice of law.

D. Distribution agreements.

1. Employee/sales person.
2. Sales representative.
3. Agent/broker.
4. Consignment.
5. Distributor.

   a. Products.
   b. Parts and supplies.
   c. Enhancements and improvements.
   d. Rights to new products.
   e. Scope of appointment.
   f. Pricing and payment term.
   g. Ordering and shipping procedures.
   h. Resale pricing.
   i. Product warranty.

j. Technical support and service.
k. Duties of the distributor.
l. Promotional activities.
m. Trademarks and goodwill.
n. Distributor review.
o. Term and termination.

## XI. HUMAN RESOURCES

A. Hiring.

1. Recruiting.
2. Employment applications.
3. Interviewing.
4. Reference checks.
5. Offers of employment.

a. Pre-employment physicals.
b. Immigration Reform and Control Act.

6. Alternative arrangements.

a. Independent contractor.
b. Telecommuting.

B. Employment contracts.

1. Duties.
2. Compensation and expenses.
3. Term.
4. Termination.

C. Personnel policies and strategies.

1. A properly drafted and implemented employee handbook can be extremely useful by reinforcing the employment at-will doctrine, informing employees of their duties, incorporating desirable statements concerning equal employment opportunity

and anti-discrimination, and reducing the probability and severity of lawsuits and administrative actions.

2. It is important to confirm that the employer owns intellectual property developed by employees during the course of their employment.

3. Non-competition agreements are a must in highly competitive industries.

4. Consideration should be given to whether mandatory arbitration should be used for employment disputes.

D. Stock option plans.

1. Incentive stock options ("ISO").

a. Requirements.

i. Option term cannot exceed ten years, unless the optionee owns more than 10% of the voting power of the issuer, in which case the term cannot exceed five years.

ii. Option price must not be less than the fair market value of the stock on the date of option grant, or not less than 110% of the fair market value if the optionee owns more than 10% of the voting power of the issuer.

iii. Optionee must be an employee at time of grant and within three months of the time of exercise, except for disability, when the three-month period is extended to one year. There is no limitation on the exercise period in the event of death (but the issuer normally sets this period at one year).

iv. Shareholders must approve the option plan within 12 months before or after the plan is adopted by the board of directors.

v. If the aggregate option price of the stock that first becomes exercisable by an optionee during any calendar year under all ISOs exceeds $100,000, the excess amount is treated as an NQO. For example, if in year one the optionee may exercise the option for $150,000 of stock (1,500 shares at an option price of $100, meaning 500 shares

would be NQOs; but if the optionee could only exercise 750 shares in the first year and 750 in the second year, all would constitute ISOs even if 1,500 shares were exercised in the second year).

b. Tax attributes.

i. No income is recognized by the optionee at the time an ISO is granted, nor is the issuer entitled to a deduction.

ii. Upon exercise of the option, the optionee does not recognize any income, nor is the issuer entitled to a deduction. This is one of the two major advantages to employees.

iii. The difference between the option price and the fair market value of the stock on the date the option is exercised is treated as income to the optionee for purposes of the alternative minimum tax ("AMT").

iv. Upon sale of the stock by the optionee (unless the sale is a "disqualifying disposition," which essentially means a sale of the stock within two years from the date of grant or within one year of the date of transfer of the stock upon exercise), the optionee recognizes long-term capital gain or loss equal to the amount realized on the sale, less the option price. This is the other great advantage of ISOs to employees – increase in value is treated as a capital gain.

v. Upon the sale of stock (unless the sale is a "disqualifying disposition"), no deduction is allowed to the issuer. This is why ISOs are not beneficial to employers.

vi. If the sale is a disqualifying disposition, the optionee will be taxed as follows:

a) Ordinary income in an amount equal to the difference between the option price and the lesser of (a) the fair market value of the stock on the date the option is exercised or (b) the amount realized from the disqualifying disposition.

b) Capital gain equal to the amount, if any, by which the amount realized upon the disqualifying disposition exceeds the fair

market value of the stock on the date the option is exercised.

c) In addition, if the disqualifying disposition occurs in the year the option is exercised, the AMT is limited to the gain on the disposition of the stock; if the disqualifying disposition occurs in another year, there are no AMT consequences.

vii. Upon a disqualifying disposition, the issuer is entitled to a deduction equal to the amount of ordinary income the optionee recognizes by reason of the disqualifying disposition.

viii. In Notice 2001-14 (2001-61 RB), the Internal Revenue Service announced that it will no longer follow an old Revenue Ruling which exempted ISO exercises from Federal Insurance Contributions Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes, and withholdings on disqualifying dispositions, effective January 1, 2003.

2. Non-qualified stock options.

a. Unless an NQO is determined to have a readily ascertainable fair market value, the optionee recognizes no income upon grant of the option. Essentially, the position of the Internal Revenue Service is that unless options in the issuer's stock similar to the NQO are traded on a recognized exchange, NQOs do not have a readily ascertainable fair market value.

b. Upon exercise, an optionee who is not subject to liability under Section 16(b) (short-swing profits) of the Securities and Exchange Act of 1934 with respect to a sale of the stock will recognize ordinary income in an amount equal to the excess of the fair market value of the stock over the exercise price. This is the main disadvantage of NQOs over ISOs for recipients.

c. If the optionee is subject to liability under Section 16(b), has an unrelated purchase of stock within six months of the exercise of the NQO and does not file a special election, it is likely that income will be recognized six months after the date of the unrelated purchase in an amount equal to the difference between the exercise

price and the fair market value of the stock as of that date.

d. The issuer is entitled to a deduction equal to the amount of the "deemed income" (which is the spread) of the optionee in the taxable year of the employee when the option is exercised which ends in or with the issuer's year. This is the advantage of NQOs over ISOs to issuers.

e. A subsequent sale of the stock results in capital gain or loss treatment, assuming one of the required holding periods is met.

f. The optionee's basis in the option stock is increased by the income recognized upon exercise of the option.

3. A "see-saw" option is a non-qualified stock option where the option price decreases as the value of the stock increases. The purpose of a see-saw option is to provide the same economic results to the issuer as an ISO. Because a see-saw option is a non-qualified stock option, the difference between the option price and the exercise price is deductible by the issuer and is income to the optionee at the time of exercise. The result of a see-saw option is that the issuer will receive, through the option price and the tax deduction, an amount equal to the fair market value of the stock at the date of grant. For example, if the value of the stock at the date of grant is $10, and the value of the stock exercise is $20, the adjusted option price would be $3.33 if the issuer is in the 40% tax bracket. At an option price of $3.33, the issuer would receive a tax deduction of $16.67, which at a 40% rate would save it $6.67 in taxes, which, together with the $3.33 option price, would give it $10, the initial option price.

E. Firing.

1. At-will arrangements permit termination at will, while progressive discipline systems do not.

2. Peer review systems, pre-termination and termination conferences, and the use of release and severance agreements all help to facilitate terminations and minimize risks to the employer.

F. Employment laws.

1. Age Discrimination and Employment Act of 1967.
2. Americans with Disabilities Act.
3. Civil Rights Act of 1964, Title VII.
4. Employee Polygraph Protection Act of 1988.
5. Employee Retirement Income Security Act of 1974.
6. Equal Pay Act of 1963.
7. Fair Labor Standards Act of 1938.
8. Family and Medical Leave Act of 1993.
9. National Labor Relations Act.
10. Occupational Safety and Health Act of 1970.
11. Uniformed Services Employment and Re-Employment Rights Act.
12. Corresponding state statutes and common law.

## XII. GROWING A BUSINESS

A. Joint ventures and other strategic alliances.

1. Joint ventures are collaborative efforts in the form of a legal entity, i.e., a corporation, partnership or limited liability company.

2. The common elements of a joint venture include the following:

a. Common interest in the subject of the undertaking.
b. Sharing in profits and losses.
c. Equal right or right in some measure to direct and control the conduct of each other and the joint venture.

d. Fiduciary relation between or among the parties.

3. For tax purposes, a joint venture will normally be taxed as a partnership.

4. Advantages.

a. Access to new technologies.
b. Cost reduction.
c. Learning opportunity.

5. Disadvantages.

a. Loss of competitive advantage.
b. Lack of control.
c. Potential governmental regulation.

B. Corporate partnering – may include any or all of the following.

1. The established company makes an equity investment in the emerging company.
2. The established company engages the emerging company to conduct a research and development project for a fee and/or royalty arrangement related to the technology developed through the project.
3. The established company agrees to distribute the emerging company's products.
4. The established company funds the emerging company's development of the products incorporating the emerging company's technology and agrees to buy the products.
5. The established company negotiates an option to purchase the emerging company at a future date.

C. University relationships.

1. University technology development activities.

2. Government-sponsored research activities and funding.
3. Licensing university technology to third parties.
4. Research agreements with third parties.
5. Individual consulting agreements with research sponsors.

D. Going global.

1. Entrepreneurs in small countries normally will adopt a strategy for international expansion if not at the time of inception, soon thereafter. The domestic customer markets in small countries are too small to support substantial research and development of products or revenues. In contrast, the U.S. customer market is sufficiently big enough to provide most emerging companies with enough customer demand for a sustained period of time, and the typical U.S. company seeking international expansion is a mature business that has proven its business model domestically.
2. The greatest barrier to a foreign market is not the language barrier, cultural differences, legal issues or government regulations. It is the difficulty to establish and gain access to a business network with the necessary depth in the chosen foreign market.
3. There are several ways in which a U.S. company can structure a business relationship with a foreign entity.

    a. Exports.
    b. Open a representative office of the company overseas.
    c. Acquire a local business.
    d. Enter into a strategic relationship with a local company.

4. The risks of going global can be substantial. It may take time away from other endeavors and may cause a loss in focus in domestic operations.

E. Preparing for an IPO.

1. In the course of the growth of a company, at some point the private equity markets will not be sufficient to fund further growth.
2. A public offering gives access to additional capital that often cannot be raised in private equity transactions.
3. Other benefits include an improved debt-to-equity ratio, which enables the company to borrow money from financial institutions on better terms than prior to the public offering.
4. Another benefit of becoming a public company is that it will be easier to acquire privately held companies, including their technologies.

F. Distressed and troubled companies.

1. For many growing businesses, it is difficult to envision the business in the future at a time when the growing business is concerned with present events such as meeting payroll or getting products to market.
2. This perspective can lead to general sloppiness or cutting corners when it comes to following internal procedures or legal review of substantial transactions.
3. For example, lack of attention in a technology business can require the business at some point in the future to have to unwind the technology to determine how it was developed and who owns the technology. Usually, this review will occur at a critical time, such as before an acquisition or a financing. It can be extremely expensive to revisit issues such as the basis for the company’s technology after the fact, due to fading memories, departing employees and legal expenses.

4. Short-sighted cost cutting measures can also affect future financings of the growing business if agreements and transactions have not been reviewed by legal counsel, who will often be required to render a legal opinion in a financing that the existing agreements do not conflict with the terms of the financing. Legal counsel will not be able to give such an opinion without a substantial review of the growing business' agreements and transactions. At the very least, it is expensive and time consuming for legal counsel to go back after the fact and review the agreements and transactions. In the worst case scenario, legal counsel may uncover problems or conflicts in unreviewed agreements or transactions that must be revisited or unwound, which could derail or kill a financing.

5. In situations involving extreme financial distress, bankruptcy is not the only solution. Bankruptcy is expensive and essentially involves a transfer of the management and control of the company to a bankruptcy court and a trustee appointed by the bankruptcy court. Before taking the drastic step of pursuing bankruptcy, a company in financial distress should consider an out-of-court workout arrangement with its main creditors.

## XIII. <u>PURCHASING AND SELLING A BUSINESS</u>

A. First step – the negotiation and execution of a confidentiality agreement pursuant to which the parties agree not to disclose their negotiations to others.

B. Second step – the negotiation and execution of a term sheet covering the basic deal points.

C. Third step – the conduct of due diligence by the buyer investigating the seller's business and assets.

D. Fourth step – the negotiation and execution of detailed agreements covering the purchase or merger.

E. Fifth step – obtaining approvals from directors.

F. Sixth step – obtaining approvals from shareholders.

G. Seventh step – obtaining third-party approvals from banks, suppliers, customers and government agencies.

H. Eighth step – the closing where the assets are transferred and money received.

## XIV. ESTATE AND BUSINESS SUCCESSION PLANNING

See the outline on this subject from last year's