Legal Structure and Equity Distribution

CHOICE OF WRONG LEGAL STRUCTURE ENDANGERS FINANCIAL HEALTH

The distinction between limited and unlimited liability companies is illustrated by the story of the Peroxydent Group. In 1983, Jerome Rudy and Melvin and Jeffrey Denholtz applied for a patent on a peroxide-baking-soda stabilizer toothpaste formulation. The formulation combined peroxide and baking soda in a way that avoids decomposition due to the interaction of peroxide with sodium bicarbonate.

Three years later, the inventors were in need of financing, so they brought in a group of investors—Peter Bohm, Steele Elmi, and Myron Barchas. A partnership was formed called the Peroxydent Group to which the inventors assigned the patent rights. Several years passed, and additional contributions (either in the form of money or effort) were required to take the project to the next stage. Two of the investors, Steele Elmi and Myron Barchas, opted not to risk the additional investment, so control passed to a subgroup of the partnership (two of the inventors, Melvin and Jeffrey Denholtz and one of the investors, Bohm).

For whatever reason, the retiring partners in the Peroxydent Group were not bought out of their ownership interests. Instead, Elmi and Barchas retained their interest in the partnership, and the subgroup of the partnership formed a new entity, Evident Corporation, to which the partnership granted a license under the patents.

In 1997, Evident Corporation brought a patent infringement suit against Church & Dwight (Arm & Hammer) and Colgate-Palmolive. The suit did not go well. The accused infringers counterclaimed, asserting that the patent was unenforceable due to inequitable conduct on the part of the inventors. While the Peroxydent Group partnership was not involved in the initial infringement action, the counterclaim was brought against not only Evident Corporation, but also the Peroxydent Group partnership (as owner of the patent). The court held that "the inventors had been aware of three material references and withheld them from the patent and trademark office with intent to 'deceive,'' rendering the patent unenforceable. This led to the court finding that the case was exceptional, and Church & Dwight were awarded $1.3 million in attorney fees and costs.

To the consternation of the Peroxydent Group partners, the partnership was held to be liable along with Evident Corporation. Equity ownership in the Corporation did not make the shareholders' personal assets available to satisfy the judgment. However, as partners of the Peroxydent group, each of the individual partners, including investors, Steele Elmi and

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Myron Barchas, who had previously opted not to take the risk of proceeding with the Evident Corporation, became personally liable for the entire $1.3 million to the extent not paid by Evident Corporation or the other partners. Elmi and Barchas may not have been personally involved in any of the activities that resulted in the liability, but as general partners of the Peroxydent Group, they were nonetheless each on the hook for the entire liability costs.

Source: *Evident Corporation, and Peroxydent Group, v. Church & Dwight Co., Inc., and Colgate-Palmolive Co., Inc., (Federal Circuit, 399 F.3d 1310, 2005)*

6.1 INTRODUCTION

Building a technology venture is a team sport. At some time during the life of the typical venture, it will need to reach outside of itself for necessary resources. For many ventures, this occurs at inception. The genesis of a venture is often either an idea or a recognition of an opportunity on the part of an individual (commonly referred to as the "founder," "promoter" or, in technology ventures, "inventor"). However, it is a rare individual who alone possesses the skills, expertise, and credibility necessary to develop a viable business around an idea or opportunity. At this stage, he or she must recruit other individuals or entities to supply the prerequisites needed to start a successful venture.

So, how are skills, expertise, and credibility transported into a venture? They can sometimes be brought in by forming a strategic alliance with another entity or by hiring individuals with the needed skills, expertise, or necessary credibility. This, however, presupposes that the founder can actually *afford* to hire those employees. More typically, in start-ups, the individuals who can supply the needed skills, expertise, or credibility are brought into the venture by giving them the opportunity to share in the success of the venture. These individuals are provided an ownership interest, or **equity,** in the venture in lieu of all or part of the compensation that they might otherwise command in the open market and thus become **co-venturers**. The relative ownership interests of the co-venturers, of course, depend upon their relative contributions to the venture.

The foundational choices made by an entrepreneur when setting up a venture can be critical to its ability to attract the interest of co-venturers or sources of capital. In addition, choosing the appropriate type of **investor** and strategically timing capital infusions are critical to obtaining the capital and resources necessary for the success of the venture. Finally, from the perspective of the founders, it is also critical that the cost of obtaining that capital is minimal in terms of interest paid or lost percentage of ownership.

In this chapter, we will explore some of those foundational issues: the various legal structures available for the business entity; tools for attracting the right talent and investors; and equity distribution in the embryonic venture. We begin by exploring some fundamental legal issues that technology venture founders must carefully consider when establishing a new venture.

6.2 OWNERSHIP AND LIABILITY ISSUES

A start-up venture is typically owned by one or more individuals or entities, each making a contribution to or an investment in the business in return for equity interest (percentage of ownership). The individuals or entities that initially form the venture are generally referred to as the **founders**. In general, the individuals or entities that own the venture are referred to as the "principals," "owners," or "equity participants." Individuals or entities that make contributions to the business after it has been formed are referred to as "investors" or "lenders." In the United States, a business entity can take the form of any one of a number of different organic legal structures, including:

- Sole proprietorship
- General partnership
- Limited partnership (LP)
- Limited liability company (LLC)
- Corporation (C-corporation or S-corporation)

Some people would also list various types of organizations that are given special tax treatment, such as a "Cooperative,"[1] or a "Nonprofit"[2] as a business structure. However, these organizations generally are held in the form of one of the structures listed above.

The choice of legal structure can affect the business in many ways, including the potential risk to participants, potential for business growth, availability of benefits, taxation of the business entity along with its individual principals, and the types of **exit strategies** available to principals. One of the primary considerations to make when selecting a particular form of business legal structure is the liability of the principals. Some legal structures limit the liability of the principals and some do not. We turn to that discussion next.

6.2.1 Limited Versus Unlimited Liability

Certain forms of business entities, such as sole proprietorships and general partnerships, are considered to be the "alter ego" of the owners. These are further characterized as **unlimited liability** companies because each owner of the entity (sole proprietor or partner) can be held personally liable for the entire amount of the venture's debts, obligations, and liabilities. Here, liability is not limited to the *pro rata* share of ownership (as Messrs. Elmi and Barchas found to their chagrin with respect to the Peroxydent Group partnership); rather each owner of an unlimited liability company is liable for all of the venture's obligations. All personal assets are at risk to satisfy the debt, obligation, or liability. In legal parlance, each partner is said to be **jointly and severally liable** for all obligations of the business.

Furthermore, the personal assets of each owner of an unlimited liability entity are at risk with respect to not only the debts, obligations, or liabilities that they create through their individual actions, but also those created by an employee or partner, even without any personal involvement or knowledge on the owner's part. In other words, not only is each owner jointly and severally liable for all obligations of the business, but also they are **vicariously liable** for the acts of employees and partners in connection with the business.

This problem with unlimited liability entities has been duly recognized, and most jurisdictions in the developed world (including state governments in all 50 states in the United States) have created other types of entities by statute. These include entities that provide, from a liability perspective and, in some cases, from a tax perspective, a legal existence for ventures that is separate and apart from the individuals participating in the venture, or they limit the liability of the participants to their investment in the venture. These entities, referred to as **limited liability entities**, include corporations, LLCs or Giesellschaft mit beschrankter Haftung (GmbH), and LPs. Limited liability entities are also known as statutory entities. These legal forms limit the principals' liability exposure to the particular assets each contributed to the venture and shield their other assets.

Why would the government want to shield the personal assets of an entity's owners from the debts and obligations of the entity? The reason for the existence of limited liability entities is to promote commerce. Certain types of ventures tend to require substantial infusions of capital well beyond the means of the typical entrepreneur. In order for those types of businesses to be created and sustained, the resources of investors must be brought to bear. The infusion of investor capital can take a number of different forms, including purchase of an equity position in the company. However, unless the venture takes the form of a limited liability entity, merely purchasing or otherwise acquiring even a small equity interest in the venture will make all of the investor's personal assets available to satisfy the debts and obligations of the venture.

Under unlimited liability conditions, it would be difficult to find investors, and if found they would be extremely expensive; the percentage of ownership per dollar invested would have to reflect the amount of risk assumed by virtue of the investment. This is particularly true with respect to wealthier investors because potentially exposing their entire wealth to satisfy the debts of the company would create a disproportionate risk compared to less-wealthy shareholders.

6.2.2 The Extent of Limited Liability

In general, the most important reason for establishing a venture as a limited liability entity is to protect the assets of principals and managers from the consequences of any financial or legal misfortune of the business. As long as these entities are properly formed and are compliant with all necessary formalities, and individuals observe a general fiduciary duty of loyalty and care to the venture in conducting its affairs, they are shielded from personal liability to third parties arising from those business affairs.

Suppose an employee orders goods on behalf of a venture on credit, but the business is unable to make the payments. Under normal circumstances, the employee would have no personal liability for that obligation—the obligation to pay is that of the business not the employee. If the business was an unlimited liability entity, however, the owners of the business *would* be personally liable for that debt. On the other hand, if the business was set up as a limited liability entity, the business entity would be liable, but the owners would not be personally liable for the debt.

It is important to note, however, that individuals do not escape liability for their own improper conduct merely because a business entity was also involved. This personal liability arises not from the individual's equity interest in the business, but rather from the activities of the specific individual. For example, if there had been wrongdoing on the part of the individual placing the order for the goods (such as if the employee knew that payment would not be made), there may well be personal liability based on the individual's culpability. In one case, personal liability was imposed on the president of a limited liability entity when she personally made misrepresentations in order to obtain payment for equipment.[3]

MINI-CASE

Corporate Directors Not Shielded from Consequences of Their Actions

Messrs. Zeh, Gillispie, Krupski, Goodale, Topping, Celic, White, Reeve, Kujawski, Sieminski, and Truskolaski were all non-salaried directors of a duly incorporated Cooperative. The Cooperative entered into a purchase contract for equipment from Aeroglide Corporation provided that Aeroglide would retain title to the equipment until full payment was received, and specified "Buyer agrees to do anything necessary to see that title so remains in the Seller."

A document reflecting Aeroglide's interest should have been filed with appropriate state and/or county agencies—just like recording a mortgage on real property—but for some reason was not filed in this case.

Within a month or so after the purchase contract, an existing loan to the Cooperative from the Springfield Bank came due. The Cooperative had to extend that loan. As a condition to granting the extension, the bank, which did not know that Aeroglide still held the title to the equipment, required that it be given a security interest in the Aeroglide equipment. Without obtaining Aeroglide consent (or advising the bank of Aeroglide's interest) the Cooperative board authorized

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MINI-CASE—Cont'd

a "chattel mortgage" giving the bank its security interest. This effectively was an improper transfer (conversion) of Aeroglide's property to the bank and was in violation of the purchase contract with Aeroglide. Messrs. Zeh, Goodale, Topping, White, Reeve, Kujawski, Sieminski, and Truskolaski, voted to give the bank the security interest, while Messrs. Gillispie, Krupski and Celic, were absent and not involved in the decision. Zeh and Krupski signed the mortgage document.

Ultimately, the Cooperative defaulted on its loan from the bank and the purchase contract with Aeroglide. Because the Aeroglide interest had not been recorded (and the bank was not actually aware of it), the bank's security interest took precedence, the equipment was sold and the proceeds given to the bank.

The Cooperative did not have the money to pay Aeroglide for its equipment and Aeroglide sued the individual directors for the value of the equipment. The trial court held all the directors personally liable. On appeal, the finding of liability was upheld with respect to all of the directors with the exception of Gillespie and Celic.

Ordinarily, equity holders, officers, and directors are not personally liable for the liabilities of a corporation. The individual directors did not become personally liable for the monies owed Aeroglide merely because they approved the purchase of the equipment. And, if the default had occurred through no inappropriate action of the individual directors (even if the default could be traced to unrelated legitimate transactions approved in good faith by the board), they would still be shielded by the corporate structure. That, however, was not the case here. The mortgage to secure the bank loan on the equipment improperly converted rights held by Aeroglide to the bank. Those individual directors and officers who were personally involved in the conversion (voted for the transaction or signed the documents) were personally responsible for the liability. They were liable not because of their positions as officers or directors, but because of their involvement in the "bad acts." Gillispie, and Celic, on the other hand, escaped liability because they neither voted for, nor signed, the mortgage. As it happens, being absent from the meeting when the board voted on the bank mortgage was a lucky break for Gillispie, and Celic.

Source: *Aeroglide Corporation v. Zeh, Gillispie, Krupski, Goodale, Topping, Celic, White, Reeve, Kujawski, Sieminski, and Truskolaski, 301 F.2d 420 (2nd Cir. 1962).*

Limited liability status, often referred to as the **corporate veil** (because the corporate structure establishes a protective "veil" between the business and the personal assets of the principal), is almost always disregarded by courts for criminal acts of the officers, shareholders, or directors of a company. Further, federal and state tax laws generally impose personal liability on those individuals responsible for filing sales and income tax returns for the company. Owners, directors, and/or officers of limited liability entities have been held to be personally responsible for unpaid payroll taxes even if they had no personal involvement in the day-to-day function of the company and had no check-signing authority. And, a single-member LLC structure provides no liability protection to the owner for any taxes that have been unpaid by the company, regardless of the involvement or lack thereof.[4]

There are also circumstances under which limited liability entity status will be ignored and liability will be imposed on the business owners, even in the absence of personal culpability, merely by virtue of their equity interests. The imposition of liability on the owners of a limited liability entity is often referred to as **piercing the corporate veil**. The issue typically comes up in the context of a lawsuit against the business, where it does not have sufficient assets to satisfy the damage claims, or the bankruptcy of a LLC when creditors seek relief from its equity holders. When this occurs, the plaintiff will attempt to convince the court that the business structure should not be respected and that the principals of the company, who may have personal assets sufficient to satisfy a judgment, should be personally liable. Piercing of limited liability entities typically occurs only under specific circumstances, such as:

Defective creation of limited liability entity: If the entity was not properly established, the entity will typically be considered a sole proprietorship or general partnership, and personal liability will attach to the owners. Some jurisdictions, however, will forgive technical deficiencies if there was a good faith attempt to create a limited liability entity. The formalities entailed in creating and maintaining the various forms of limited liability entities vary from state to state.

Failure to observe procedural formalities: As will be discussed, certain legal structures require that specific procedural formalities be observed. If those required formalities were not observed, the structure of the entity may be disregarded. For example, if the owners did not treat the business as an entity separate and apart from themselves and the business is nothing more than an alter ego for the owners, limited liability status is likely to be pierced.

Improper intent or fraud: There are boundaries placed upon the extent of the limited liability entity protection on the basis of the intent and purpose of the business. For example, if a corporation or LLC was set up only to shield its owners from liability arising from a fraudulent technology development start-up deal, and the owners siphon out the entity assets to such an extent that the entity is unable to compensate the victims of the fraud, a court is likely to set aside the limited liability entity and allow the victims to recover from the personal assets of the owners.

Statutory basis: Some statutes, most notably the federal securities laws, specifically impose personal liability on persons in control of a limited liability entity.[5]

Examples of activities that may lead to disregarding limited liability entity status include:

- Knowingly incurring company debt or obligations when the company is already insolvent
- Removing unreasonable amounts of funds from the company, endangering its financial stability

- Personally using company funds or assets by the principal owners
- Commingling company assets with the personal assets of the principal owners
- Hiring nonfunctioning employees who do nothing, yet draw a salary
- The assuming of the principal owner's personal debt by the company
- In the case of corporations, a pattern of consistent nonpayment of dividends, or a payment of excessive dividends
- Engaging in activities with the intent to defraud creditors
- Fraudulently making misrepresentations by owners or management
- Making unreasonable loans to company officials and extending unwarranted benefits to them
- Improperly giving corporate guarantees of loans or contracts benefiting an owner manager
- Little or no separation of corporate business from the activities of the dominant owner

There are also instances where personal liability for corporate debt is imposed by statute, such as in cases involving employers' tax withholding obligations, wage and retirement benefits, environmental liability, and violations of the federal securities laws. Personal liability may also arise because of contractual obligations, such as when a shareholder signs a personal guaranty or fails to adequately identify that he or she is signing on behalf of the company as opposed to signing on a personal level.

With these considerations in mind, the technology entrepreneur is ready to make an informed choice about the legal form for the new venture. We will now review the available choices for legal structure.

6.3 CHOICE OF LEGAL STRUCTURE

Each form of business entity has distinct characteristics that come with advantages and disadvantages, depending upon specific circumstances. Here are some factors to take into consideration in order to determine the optimum form of entity for a particular business venture:

- The potential risks and liabilities entailed in the venture: Limited liability entities limit the participant's exposure to the particular assets contributed to the venture.
- Participants: Certain forms of organization have limits on the number of participants and the nature of those participants.
- Capital growth needs and strategy: Certain forms of organization are more amenable than others to raising high levels of capital from multiple sources.
- Management structure: Certain forms of organization are more flexible than others.

- Tax implications: Tax laws in many jurisdictions vary dramatically between the various types of entity structures.
- Regulatory burden: Securities laws have a greater impact on some forms of entity than others.
- Administrative burden, formalities, and expenses involved in establishing and maintaining the various business structures: Some forms of entity require that documents be prepared and filed with a designated state agency, and/or via written agreements between the participants.
- Survivability: Some entities terminate upon certain events.
- Privacy: Certain business and financial information regarding certain entities are required to be made public.
- Exit strategy and liquidity needs: Certain entity structures provide more flexibility for the participants regarding liquidity and/or withdrawal.

As mentioned earlier, legal form choices for a new venture run from sole proprietorships to publicly held corporations. Let us explore each form in detail and weigh in on the various advantages and disadvantages of each.

6.3.1 Sole Proprietorship

The most basic business legal form is the sole proprietorship. A **sole proprietorship** is created by default anytime an individual owns a business without going through the specific formalities required to create a statutory entity. A sole proprietorship can operate under the individual owner's name or under a fictitious name. Most jurisdictions, however, require that fictitious names be registered. A sole proprietorship does not have separate legal status from the owner.

For liability, as well as tax purposes, a business operated as a sole proprietorship is the alter ego of the proprietor in most jurisdictions. A proprietor is personally responsible for the debts and obligations of the business as well as for the actions of employees. If the sole proprietor sells someone an interest of less than 100% of the business, the business by default becomes a general partnership (unless specific steps are taken to create a statutory entity).

A sole proprietorship is owned and managed by one person (or for U.S. tax purposes, a husband and wife). From the perspective of the U.S. Internal Revenue Service (IRS), a sole proprietor and his or her business are one tax entity. Business profits are reported and taxed on the owner's personal tax return and taxed at the personal income tax rate.

Setting up a sole proprietorship is easy and inexpensive because no legal formation documents need be filed with any governmental agency. Once a fictitious name statement is filed in jurisdictions that require one and once other requisite basic tax permits and business licenses are obtained, the enterprise is ready for business.

When a business is operated as a sole proprietorship in the United States, essentially all income generated through the business is self-employment income and subject to the self-employment tax.[6] The primary and significant downside of a sole proprietorship is that it is an unlimited liability entity—its owner is personally responsible for all the business liabilities. Given that fact, why would anyone operate a business as a sole proprietorship? The unfortunate answer is that most of the time they are simply ignorant of the unlimited liability. However, someone might choose to operate as a sole proprietorship because of the relative ease of, and lack of expenses entailed in, establishing the business. Exhibit 6.1 highlights the advantages and disadvantages of the sole proprietorship legal form.

Exhibit 6.1 Advantages/Disadvantages of a Sole Proprietorship

Sole Proprietorship	
Equity holder liability	Unlimited (Equity holder's personal assets are at risk to satisfy all debts, obligations or liabilities of the business.) Vicariously liable for actions by employees.
Equity interest types and terminology	100% owner/sole owner/sole proprietor
Management	Sole proprietor
Organic documents	None (If a name other than that of the sole proprietor is used for the business, some states require a registration of the "fictitious name" under which the entity does business.)
Formation procedure	None
Maintenance formalities	None
Limits on eligible owners	None (Multiple owners creates a partnership.)
Limits on allocations of profit and loss	None
Fiscal year limitations	Must correspond to the tax year of the sole proprietor.
U.S. Taxation	
Income	There is no tax to the sole proprietorship as a business enterprise for enterprise income. All items of income, gain, or loss, pass through and are taxed to the sole proprietor.
Losses	All items of income, gain, or loss, pass through and are taxed to the sole proprietor.
Appreciated assets	The sole proprietor is taxed upon the sale of appreciated assets. Generally, there is no tax upon the distribution of appreciated assets from business enterprise to sole proprietor.
Entity upon liquidation	There is no tax to the sole proprietorship as a business enterprise *per se* upon the sale or distribution of assets.
Owners upon liquidation	Gain realized upon the liquidating sale of appreciated assets by the sole proprietorship passes to the sole proprietor. No gain is recognized upon distribution except to the extent that the money distributed exceeds the sole proprietor's basis in the business.
Self-employment taxes	Sole proprietor is subject to self-employment taxes.

6.3.2 General Partnership

When the profits and losses of a business are shared between more than one individual (or other entities), unless the formalities for creating a statutory entity have been followed, the business is by default a **general partnership**. For liability purposes, a general partnership is considered the alter ego of each of the partners. Any general partner can bind the business to an agreement, and each partner is liable for the acts of the others. A general partnership is an unlimited liability entity. A general partner's liability is not limited to that partner's percentage of ownership. In more legal terms, each general partner is **jointly and severally** liable for the debts and obligations of the partnership. This means that each partner could be held personally liable for the entire amount of the partnership debt and obligations, irrespective of their proportionate ownership in the venture, and all of their personal assets are at risk to satisfy the obligations of the partnership.

Although a written partnership agreement is not required by law, partners typically enter into one to define the internal rules under which the partnership will operate and how profits and losses will be allocated. In the absence of a partnership agreement, each partner has an equal say in management, and profits and losses are typically divided equally among the partners. Equity interests in a partnership are commonly referred to in terms of percentages of ownership or “units” corresponding to a percentage of ownership. And, there is no certificate or instrument (other than perhaps the partnership agreement) representing ownership interests.

From a U.S. tax perspective, a partner cannot also be an employee of the partnership. This does not mean that the partner cannot receive the equivalent of a salary. However, as in the case of a sole proprietorship, all monies received are considered self-employment income for tax purposes and subject to the self-employment tax. Ever since the creation of the LLC legal form, most new businesses that choose a general partnership form of entity do so primarily out of ignorance of the LLC form, which is discussed later in this chapter. Unless the partnership operates without a formal partnership agreement, in most states there is little cost savings in setting up a partnership over setting up an LLC.[7] Exhibit 6.2 highlights the advantages and disadvantages of the general partnership legal form.

Exhibit 6.2 Advantages/Disadvantages of a General Partnership

General Partnership	
Equity holder liability	Unlimited (equity holders' personal assets are at risk to satisfy all debts, obligations, or liabilities of the business.) Vicariously liable for actions by employees.
Equity interest terminology	Partner Varies according to agreement: Percentage, Partnership Units, etc. Different classes of partnership interests possible.
Management	Per partnership agreement (In the absence of a partnership agreement, each general partner has an equal say in the management of the partnership.)
Organic documents	None required. Written partnership agreement preferred. If a name other than that of the partners is used for the business, some jurisdictions require a registration of the “fictitious name” under which the entity does business.
Formation procedure	Formed by agreement (oral, or, preferably, written) between two or more prospective partners or by representing the business as a partnership to the public or in connection with doing business. The receipt of a share of profits (other than payment on a debt, interest, wages, and rent, etc.) from a business is evidence of being a partner of that business.
Maintenance formalities	None
Limits on eligible owners	Must be at least two partners; otherwise, no limits or requirements on the number or nature (e.g., individual, partnership, LLC, corporation, or trust) of partners. A “partnership” with a single equity owner is a sole proprietorship.
Limits on allocations of profit and loss	None. Allocations of profit and loss are determined by the partnership agreement. In the absence of an agreement, profit and loss are allocated equally among the partners.
Fiscal year limitations	Must use the tax year of partners having a majority interest in the partnership, or the tax year of all principal partners if there is no majority interest.
U.S. Taxation	
Income	There is no tax to the partnership as a business enterprise for enterprise income. All items of income, gain or loss, pass through (per partnership agreement) and are taxed to the partners.
Losses	All items of income, gain or loss, pass through (per partnership agreement) and are taxed to the partners.
Appreciated assets	Generally, there is no tax to the partnership as a business enterprise upon the distribution of appreciated assets. The partners (as individuals or individual entities) are taxed on gains upon the sale of appreciated assets.
Entity upon liquidation	There is no tax to the partnership as a business enterprise *per se* upon the sale or distribution of assets.
Owners upon liquidation	Gain realized upon the liquidating sale of appreciated assets by the partnership passes to the partners (as in the case where there is no liquidation). No gain is recognized upon distribution except to the extent that the money distributed exceeds the partner's basis in his partnership units. Distributed assets will distribute at basis. Liabilities incurred by the partnership increase a partner's basis in his/her partnership interest.
Self-employment taxes	Individuals serving as general partners are typically subject to self-employment taxes.

6.3.3 Limited Partnership

A Limited Partnership (LP) is a legal entity that is created under the laws of a particular jurisdiction, with one or more general partners and one or more limited partners. It is defined by certain documents—specifically, a certificate of LP that is filed with a designated state agency to register the new business and a LP agreement that defines the internal rules under which the LP operates. The LP agreement must make clear which individuals/entities are general partners and which are limited partners.

The general partners are responsible for managing the partnership. The limited partners are, essentially, passive investors. Limited partners can have certain very limited veto and/or approval rights over certain actions, but any substantial involvement with the management or operation of the partnership will convert their status to general partners.

The general partners of the LP are jointly and severally liable with respect to debts of the LP. The limited partners are liable only to the extent of their ownership interest in the LP. In other words, if the LP has a liability, all of the general partners' assets are at risk. In contrast, other than the limited partners' investment in the business, the limited partners' other assets are isolated from liability.

The general partners of an LP often organize as a separate limited liability entity to relieve the burden of unlimited liability. For example, many venture funds are managed by general partners who raise capital from limited partners. The general partners organize as a separate LLC, which manages the LP. By employing a limited liability entity as general partner, only the assets of the LP are at risk.

For tax purposes, an LP is treated as an extension of the partners (general and limited), and profits and losses pass through to the shareholders according to the partnership agreement. These profits or losses are then taxed at the individual income tax rate. It is very important to note that partners are taxed according to their ownership interests *whether or not* profits actually are distributed. The same thing applies to losses. That is, a partner can record those losses on his or her personal income tax that have been allocated by the partnership venture.

Equity interests in a LP are typically referred to in terms of percentages of ownership or units corresponding to a percentage of ownership. However, there typically is not any sort of certificate or instrument representing ownership interests. Exhibit 6.3 highlights the advantages and disadvantages of the LP legal form.

Exhibit 6.3 Advantages/Disadvantages of a Limited Partnership

Limited Partnership	
Equity Holder Liability	General partner—unlimited (see general partnership) Limited partner—potential liability limited to extent of investment
Equity interest terminology	General partner, limited partner Varies according to agreement: General partnership units, limited partnership units There may be different classes of partnership interests.
Management	Per partnership agreement Limited partners are precluded from taking an active role in management; if a partner takes an active role in management, the partner becomes a general partner with unlimited liability.
Organic documents	Certificate of limited partnership filed with designated state agency Limited partnership agreement. If a name other than that of the partners is used for the business, some states require a registration of the "fictitious name" under which the entity does business.
Formation procedure	File a certificate of limited partnership with a designated state agency. Limited partnership agreement defines the internal rules under which the partnership operates.
Maintenance formalities	None. Limited partner may not have any substantial right to be actively involved with the management or operation of the partnership.
Limits on eligible owners	Must be at least one general partner and one limited partner; otherwise, no limits or requirements on the number or nature (e.g., individual, partnership, LLC, corporation, or trust) of partners.
Limits on allocations of profit and loss	None. Allocations of profit and loss are determined by the partnership agreement. In the absence of an agreement, profit and loss are allocated equally among the partners.
Fiscal year limitations	Must use the tax year of partners having a majority interest in the partnership, or, if there is no majority interest, the tax year of all principal partners (defined as owning 5% or more), if no common year-end then that producing the least amount of change in income for partners.
U.S. Taxation	
Income	There is no federal tax to the partnership as a business enterprise for enterprise income. All items of income, gain or loss, pass through and are taxed to the partners. May be special state taxes e.g., margin tax or B&O tax.
Losses	All items of income, gain or loss, pass through and are taxed to the partners.
Appreciated assets	Generally, there is no tax to the partnership as a business enterprise upon the distribution of appreciated assets. The partners (as individuals or individual entities) are taxed on gains upon the sale of appreciated assets.
Entity upon liquidation	There is no tax to the partnership as business enterprise *per se* upon the sale or distribution of assets.
Owners upon liquidation	Gain realized upon the liquidating sale of appreciated assets by the partnership passes to the partners (as in the case where there is no liquidation). No gain is recognized upon distribution except to the extent that the money distributed exceeds the partners basis in his partnership units. Distributed assets will distribute at basis. Liabilities incurred by the partnership increase a partner's basis in his or her partnership interest.
Self-employment taxes	Limited partners are not subject to self-employment taxes except for guaranteed payments for services to the partnership. General partners may be subject to self-employment taxes.

6.3.4 Corporation

A **corporation** is a legal entity, created under the laws of a particular jurisdiction (typically under state law in the United States), separate and apart from its owners. The word "corporation" is derived from the Latin *corparæ*, which means to make corporal, or to physically embody.

The corporate entity is defined by certain documents, including articles of incorporation, and these documents are also referred to as a charter in some jurisdictions. The documents are filed with the designated government agency. In the United States, corporations are formed under the laws of the individual states, usually through the state's secretary of state or corporation commission office. A corporation does not have to incorporate in the jurisdiction in which it is conducting business. In fact, many international businesses elect to incorporate in Delaware or Nevada, two states that have governing laws that are favorable to the corporate legal form. In some jurisdictions, however, **foreign corporations** are required to register to do business before they are recognized as business entities in that jurisdiction.

6.3.4.1 Structure of a Corporation

A corporation is managed by a board of directors and various officers who are selected and serve at the behest of the board. Officers are responsible for the day-to-day operation of the venture, while the board of directors has fiduciary responsibility to the owners (shareholders) of the venture.

Equity interests in a corporation are managed and tracked via the distribution of stock or shares. There are typically written stock certificates representing the interests of the various owners. Not surprisingly, the owners of a corporation are referred to as shareholders, or stockholders. A corporation is a limited liability entity—shareholders are liable only to the extent that they can lose the value of their shares.

A corporation is considered to be a separate entity from its owners, which is why a shareholder can be an employee of the corporation and can receive a reasonable salary for his or her services. In most countries, that salary is subject to payroll taxes. Other monies paid out by the corporation to the shareholder, such as dividends or distributions, are not subject to payroll taxes or self-employment tax.

Payroll Tax: An employer withholds or pays on behalf of their employees payroll taxes based on the employees' wage or salary. In the United States, the payroll tax includes, in addition to an income tax, the Social Security and Medicare Tax (FICA). The employer withholds one half of the FICA tax from the employee's paycheck and pays the other half of the tax. Some jurisdictions also withhold taxes to cover unemployment compensation and workmen's compensation.

Self-Employment Tax: Self-employment taxes are collected on net earnings. A business owner must pay them to the federal government to fund Medicare and Social Security (FICA), generally analogous to the aggregate of the employee and employer portions of the FICA and Medicare payroll taxes. The business owner is responsible for the entirety of the tax.

6.3.4.2 U.S. Tax Laws and Corporation Types

In the United States, the tax laws have created two particular types of corporations: the subchapter C-corporation and the subchapter S-corporation. Both types of corporation are limited liability entities, but are treated differently from a tax perspective. A C-corporation is taxed as an entity separate and apart from its shareholders.[8] A C-corporation's taxable income is subject to a graduated tax rate that increases with the amount of taxable income.[9] On the other hand, an S-corporation is, for tax purposes, treated as an extension of the shareholders, and profits and losses pass through to the shareholders according to their ownership percentages. There are, however, certain limitations on the classes of stock and number and types of shareholders permitted in an S-corporation (no more than 100 shareholders, no nonresident aliens, and only natural persons can be shareholders).

There are a number of noteworthy consequences that flow from the separate tax entity status of a C-corporation, and the choice of this form for a business has certain tax consequences:

Double taxation: Although salaries paid to corporate employees are deductible by the C-corporation, dividends paid to shareholders are not.[10] The dividends are thus taxed twice, first as income to the company (at the corporate tax rate) and then again as dividend income to the shareholder at the individual's tax rate.[11]

Dividends: Monies are paid to corporate shareholders out of the corporation's profits or reserves, to be distinguished from salaries paid to employees.

Retained earnings: Retained earnings are corporate income (on which the corporate income tax has been paid) that is retained by the company and not paid out to the shareholders. However, there must be good business reasons to retain earnings, such as research and development, expanding facilities, or acquiring another business entity. The IRS tends to view retained earnings as a potential attempt to avoid income tax on the shareholders. If the IRS deems the retained earnings excessive, they are subject to an accumulated earnings penalty tax. It is prudent for the board of directors and officers to document the reasons for retained earnings.[12]

In addition, if a C-corporation form is chosen for certain types of ventures, such as holding companies that receive royalties from technology licenses or consulting companies providing engineering services, the companies may be categorized as **personal holding companies,** or "personal service corporations," and subjected to additional taxes and higher tax rates.[13]

On the other hand, U.S. tax laws also provide specific incentives for particular types of C-corporations that qualify as **small business corporations**. A C-corporation is classified as a small business corporation if the aggregate amount of money and other property received by the corporation for stock does not exceed $1 million. Under certain circumstances, individuals are given favorable treatment with respect to losses from investments in a small business corporation. They are permitted to treat losses as ordinary losses that net out ordinary income as opposed to capital losses, which for the most part can be applied only against capital gains.[14]

C-corporations are typically the form of choice when the entity contemplates a large number of generally passive shareholders and/or a public offering of the shares of the business. Characteristics of a C-corporation and an S-corporation are summarized in Exhibits 6.4 and 6.5.

Exhibit 6.4 Characteristics of an S-Corporation

S-Corporation	
Equity holder liability	Potential liability limited to extent of investment
Equity interest terminology	Shareholder, Stockholder
	Stock
Management	Board of Directors and Officers
Organic documents	Articles of Incorporation (also referred to as a "charter" in some jurisdictions.) "By-laws"—define the internal rules under which the corporation operates.
Formation procedure	Articles of incorporation are filed with the designated state agency to "give birth" to the new corporate entity.
Maintenance formalities	Having and observing the bylaws, including meetings
	Minutes of shareholder and board of directors meetings and/or actions
	Separate un-commingled accounts and records
	Board resolutions for significant action/activities
Limits on eligible owners	May not have more than 100 shareholders.
	Subject to certain exemptions, no non-individual shareholders (e.g., corporation, trust). No non-resident aliens
	Some states require more than one shareholder.
Limits on allocations of profit and loss	Special allocations are not permitted. Dividends must be paid on stock ownership.
Fiscal year limitations	Some state require S-corporations to use a calendar year, except under certain circumstances.
U.S. Taxation	
Income	There is no tax to the S-corporation except in two limited circumstances: (1) Recognized built-in gains, and (2) Excess passive net income.
	There may be state taxes.
Losses	Losses may be deducted by shareholders to the extent of their tax basis in their shares (not including any portion of the corporation's debt), subject to certain restrictions, including the basis, at-risk and passive loss limitations.
Appreciated assets	Nontaxable at corporate level until gain is realized, distribution of assets to shareholders is done at current fair market value and can trigger a taxable event for the shareholder to the extent that fair market value exceed basis.

Exhibit 6.4 Characteristics of an S-Corporation—cont'd

Entity upon liquidation	Generally nontaxable at corporate level but taxable at shareholder level through pass-through of corporate tax items.
Owners upon liquidation	Shareholders taxed on gain. Gain is recognized to the extent that fair market value of property distributed exceeds the shareholder's basis in his or her stock.
Self-employment taxes	Self-employment tax does not apply to distributions paid to shareholders. Shareholders pay self employment tax on salary payments provided that compensation for their services is reasonable.

Exhibit 6.5 Characteristics of a C-corporation

C-Corporation	
Equity holder liability	Potential liability limited to extent of investment
Equity interest terminology	Shareholder, stockholder Stock. There may be different classes of stock.
Management	Board of Directors and Officers
Organic documents	Articles of Incorporation (also referred to as a "charter" in some jurisdictions). "By-laws"—define the internal rules under which the corporation operates.
Formation procedure	Articles of incorporation are filed with the designated state agency.
Maintenance formalities	Having and observing the bylaws, including meetings. Minutes of shareholder and board of directors meetings and/or actions Separate un-commingled accounts and records Board resolutions for significant action/activities
Limits on eligible owners	There are no restrictions on eligible owners.
Limits on allocations of profit and loss	Special allocations are not permitted. Dividends must be paid on stock ownership.
Fiscal year lmitations	May use any fiscal year. Personal service corporations are required to use a calendar year, under certain circumstances.
U.S. Taxation	
Income	Taxable income is, in general, subject to a graduated tax rate that increases with the amount of taxable income. Also potentially subject to retained earnings penalty tax (accumulated earnings tax), personal holding company tax, and/or personal service corporation tax.
Losses	Losses may not be passed through to or be deducted by shareholders.
Appreciated assets	There is potential double taxation. There is a tax imposed at the corporate level upon the sale or distribution of appreciated assets. Additionally, there is a potential dividend or capital gains tax upon the distribution of sale proceeds to shareholders.
Entity upon liquidation	Taxed on appreciation in assets upon the sale or distribution of assets. This may result in double taxation as these proceeds are distributed to shareholders in the form of liquidating dividends.
Owners upon liquidation	Shareholders taxed on gain Gain is recognized to the extent that fair market value of property distributed exceeds the shareholder's basis in his or her stock.
Self-employment taxes	Self-employment tax does not apply to dividends or distributions paid to shareholders. Employees of the corporation are not made subject to self-employment tax by virtue of also being shareholders. The corporation pays the employer's portion of the social security and medicare taxes and withholds the employee portion (which equals ½ the self-employment tax) and remits both to the government.

6.3.4.3 Maintaining Corporate Status

In order to maintain corporate status, certain practices and procedures must be observed. Because corporations are creatures of statute, unless the specific formalities required by the applicable statute are met (e.g., filing appropriate organizational papers with the designated state agency), the enterprise will be considered either a sole proprietorship or, if more than one person has an equity interest, a general partnership. Failure to do so would result in the tendency of the courts to ignore the corporate structure and impose liability on the individual owners and officers of the corporation. Filing the organizational papers and obtaining a charter, however, are merely the beginning.

If various corporate formalities are not consistently observed, the corporation can be easily disregarded and the individuals may be held personally liable. Within the court system, for instance, the corporate status is usually determined by whether or not the principals treat the corporation as a separate and distinct entity and hold it out to third parties as such. Similarly, a corporate structure will almost always be ignored and the corporate veil pierced when the management treats the corporation as its alter egos rather than as a separate entity or when the corporation is found to be a "sham" and has been established only to facilitate fraud against third parties. In general, the following tend to ensure that corporate status is respected:

- Issuing of stocks
- Instituting and observing bylaws
- Filing annual reports with the state
- Holding annual shareholder and board of directors meetings
- Maintaining minutes of shareholder and board of directors meetings
- Promulgating formal written resolutions for significant actions
- Keeping up-to-date corporate records
- Separating and maintaining un-commingled funds and assets of the corporation among major shareholders
- Being adequately capitalized (capital sufficient to operate as an actual business)
- Avoiding dependency on the property or assets of a shareholder not technically owned or controlled by the corporation
- Avoiding personal use of corporate funds and assets by major shareholders except with full documentation

It is particularly important to maintain minutes of board and shareholder actions. Minutes can be the written record of meetings or can reflect the unanimous written actions of the directors or shareholders taken without a meeting. the secretary of the corporation typically prepares and signs the minutes of a meeting. To minimize the possibility of inaccuracies, those minutes are then approved by the board or the shareholders at the next meeting or in the next action. It is a good practice for the minutes to reflect that any requirements established by the bylaws with respect to meetings or actions were observed (e.g., proper notice was given or waived, a quorum was present, and so on). The minutes also typically identify who was present and who was absent, and note any abstentions or dissents on a vote. Any formal resolutions adopted by the board should also be included in the minutes. Many corporations have their minutes reviewed by legal counsel before completing them.

6.3.5 Limited Liability Company

A Limited Liability Company (LLC), like a corporation and LP, is a form of business entity created under the laws of a particular jurisdiction that combines corporate and noncorporate features. The LLC is owned by "members" and is run either by the members or by one or more "managers" (who may or may not be a member).

The LLC as a form of entity is a relatively recent innovation in the United States, although a similar entity, the GmbH, has been available in Germany and various other European nations for some time. The first LLC act in the United States was enacted by the state of Wyoming in 1977.[15] However, it was not until the 1990s (after the federal IRS broadcast a revenue ruling to the effect that an LLC formed under the Wyoming LLC Act would be classified as a partnership for federal income tax purposes even though all of its members had limited liability) that most states embraced the concept and enacted LLC statutes.[16] In 1997, the LLC became even more popular when the IRS established the **check-the-box regulations**, permitting the LLC to choose whether it will be treated for tax purposes as a sole proprietorship, a partnership, a C-corporation, or an S-corporation.[17]

6.3.5.1 LLC Characteristics

An LLC is created by filing a document referred to as **articles of organization** with an appropriate state agency and entering into an **operating agreement** between the members. Equity interests in an LLC are typically referred to in terms of percentages of ownership or units corresponding to a percentage of ownership. There generally is no certificate or instrument (such as a share of stock) representing ownership interests.

The LLC is a limited liability entity and provides liability protection to its members in the same way that a corporation provides liability protection to its shareholders; members are liable only to the extent that their ownership interest in the LLC may lose all of its value. LLCs are not subject to many of the formalities associated with corporations. LLCs are not required to hold annual meetings or prepare annual reports, although it may nonetheless be beneficial to hold regular meetings of the members or to provide in the LLC operating agreement that meetings be held before certain actions are taken.

As noted above, an LLC can elect to be treated for tax purposes as a sole proprietorship, a partnership, a C-corporation, or an S-corporation. If no election is made, the default taxation for a single-member LLC is a sole proprietorship and is a partnership for a multimember LLC. If either C-corporation or S-corporation treatment is elected, a member can be an employee of the LLC and can receive a reasonable salary for his or her services. That salary is subject to payroll tax (e.g., income tax withholding, the Social Security [FICA], and Medicare Tax) deductions. Other monies paid out by the LLC to the shareholder, for example, distributions, are not subject to withholding or self-employment tax (FICA). On the other hand, if either a sole proprietorship or partnership treatment is elected, then, from a tax perspective, a member of the LLC cannot also be an employee of the LLC. Essentially, all monies received from the LLC would then be subject to the self-employment tax on the individual's personal tax return.

In most respects, the LLC compares favorably with the other forms of limited liability entity. However, certain states, notably California, have begun charging relatively high fees to do business as an LLC.[18] Exhibit 6.6 highlights the various advantages and disadvantages of the LLC legal form.

Exhibit 6.6 Advantages/Disadvantages of the LLC

Limited Liability Company (LLC)	
Equity holder liability	Potential liability limited to extent of investment
Equity interest terminology	Member
	Membership interests, percentage interest, units. There may be different classes of membership interests.
Management	Managed either by all members, or by specifically designated managers. Members who participate in management are not personally liable.
Organic documents	The entity is created by filing a document referred to as "articles of organization" with an appropriate agency, and entering into an "operating agreement" between the members.
Formation procedure	Filing "articles of organization" with the appropriate agency, and entering into an "operating agreement" between the members.
Maintenance formalities	None; although annual meetings are advisable.
Limits on eligible owners	There are no restrictions on eligible owners.
	Some states require more than one member.
Limits on allocations of profit and loss	None. Allocations of profit and loss are determined by the operating agreement. In the absence of an agreement, profit and loss are allocated equally among the members.
Fiscal year limitations	Some state require LLCs to use a calendar year, except under certain circumstances.

Exhibit 6.6 Advantages/Disadvantages of the LLC—cont'd

U.S. Taxation	
Income	The LLC can choose whether it will be treated for tax purposes as a sole proprietorship, a partnership, a C-corporation, or an S-corporation.
Losses	The LLC can choose whether it will be treated for tax purposes as a sole proprietorship, a partnership, a C-corporation, or an S-corporation.
Appreciated assets	Generally, there is no tax to the LLC as a business enterprise upon the distribution of appreciated assets. The members (as individuals or individual entities) are taxed on gains upon the sale of appreciated assets.
Entity upon liquidation	There is no tax to the LLC as a business enterprise *per se* upon the sale or distribution of assets.
Owners upon liquidation	Gain realized upon the liquidating sale of appreciated assets by the LLC passes to the members. No gain is recognized upon distribution except to the extent that the money distributed exceeds the members basis in his or her membership units. Liabilities incurred by the LLC increase a member's basis in his or her membership interest.
Self-employment taxes	Depends upon choice of tax treatment.
	Managers may be subject to self employment tax on their distributed portion of income whether or not actually distributed. A manager-managed LLC electing partnership taxation may be treated similar to a limited partnership where the manager would be subject to self-employment tax and the members would not.

6.3.6 Limited Liability Entities—A Comparison

Establishing the appropriate legal form for an entity is never a black-and-white decision for the entrepreneur. Instead, many shades of gray intercede into the decision, and there are often good arguments to be made for establishing any one form over another. Fortunately, the entrepreneur is not locked into one particular form. Even though changing from a C-corporation to another form of entity under certain circumstances can be problematical, it is otherwise easy enough to change a venture's legal form when its fortunes change or when the ambitions of the founders change.

Still, making a good decision at the beginning is important to overall venture success. In the sections that follow, we look at some of the factors that may enter into decision making about the appropriate legal form of a technology venture.

6.3.6.1 Expense

Sole proprietorships and general partnerships are potentially easier and less expensive to set up than the alternatives, but they are unlimited liability entities. For that reason, they are rarely an appropriate choice for any technology venture unless it is substantially risk-free. One such example may be a single-person technology consultancy that operates principally out of the home. However, even that simple type of business may be better organized as an

LLC or other limited liability entity to protect against potential lawsuits and other types of claims.

6.3.6.2 Shareholder Options

Of the limited liability types, C-corporations typically are the legal form of choice when the entity contemplates a large number of passive shareholders in the near term or anticipates an eventual public offering of stock. A C-corporation can sell shares of itself through private or public stock offerings. This can make it easier to attract investment capital and to hire and retain key employees by issuing employee stock options (EOSs). An S-corporation can also sell shares of stock in private offerings, but it is limited to common stock only. In public offerings, a C-corporation legal form is the form most often used.

6.3.6.3 Taxation

As noted above, the respective types of entities may receive different tax treatment. One form or another may be advantageous depending upon the particular business plan of the entity and the specific circumstances of the principals. For example, even though C-corporations pay taxes at the corporate tax rate on net income, the owners of the corporation are not subject to personal income taxes on **phantom income** (profits that are not distributed). Depending upon the corporate tax rate when compared to the personal tax rates of the principals, this can sometimes be advantageous; also, depending upon the relative corporate and personal tax rates applicable, it is conceivable that a corporation and its owners may have a lower combined tax bill than the owners of a business with a pass-through structure that earns the same amount of profit.

On the other hand, given the personal tax situation of one or more of the principals, losses incurred by the business entity, if passed through to the principal, could be used to offset income from other sources. In that case, as an example, an LLC or S-corporation may be advantageous. An S-corporation does offer a unique advantage with respect to control of employment taxes (such as Social Security and the like). A shareholder of an S-corporation can be an employee of the business and receive a reasonable salary for his or her services. Self-employment tax is paid only on salary payments, and provided the salary reflects reasonable compensation for services, monies can be paid by the corporation to that shareholder. Self-employment tax does not apply to dividends paid to shareholders. At the same time, the S-corporation is not plagued with the double taxation, retained earnings, personal holding company, and personal service corporation issues like a C-corporation is.

6.3.6.4 Distribution of Profits and Losses

The LLC tends to compare favorably with the other forms of limited liability entities; pass through profits and/or losses can be distributed disproportionately from ownership percentages. S-corporations and LPs also provide pass-through of profits and losses for tax purposes. However, the apportionment of profits and losses in an S-corporation must be in accordance with ownership percentages, and a LP imposes limitations on the extent to which the participants can exert management control without losing the benefit of limited liability. To some extent, particular shareholders in a corporation can be accorded disproportionate control of management through an appropriate **shareholders agreement**, which requires the shareholders to elect and designate individuals to the board of directors.

In comparison, in an LLC with the appropriate provisions in the operating agreement, profits losses are not tied to ownership percentages, and limited liability is available irrespective of management control. For example, to entice an investor, the other LLC members may agree to allocate a disproportionate share of any losses to the investor to allow the investor to offset gains on personal income in other investments he or she may have made. The LLC also has the advantage of not being subject to the limitations on numbers and types of owners that are imposed on S-corporations.

6.3.6.5 Formalities

Formation of LPs, corporations, and LLCs all require comparable effort and cost. Exhibit 6.7 provides a comparison of the documents related to the formation of the various limited liability entities.

Exhibit 6.7 Comparison of Organic Documents for Different Types of Limited Liability Entities

	Limited Partnership	Corporation	LLC
Filing required	Certificate of limited partnership	Articles of incorporation/charter	Articles of organization
Required but not filed	Limited partnership agreement	Bylaws	
Not required but desirable		Shareholders agreement	Operating agreement

LLCs are not subject to the same formalities of meetings, minutes, and so on, that are required to maintain a corporation. LPs are likewise not subject to those formalities. However, because LPs require a general partner and the general partner is very often a separate limited liability entity, the LLC structure provides the same advantage without the complexity.

6.4 EQUITY AND EQUITY TYPES

Equity is simply another term for an ownership interest in a business. The particular terminology used to denominate equity varies depending upon the particular legal structure of the entity. As noted earlier, equity interests in partnerships and LLCs are typically referred to in terms of ownership percentages or units corresponding to a percentage of ownership. Equity in a corporation is referred to as "stock" for shares (Exhibit 6.8).

Exhibit 6.8 Terminology for Ownership Interests

Partnership	Corporation	LLC
Units or percentage	Stock or shares	Units or percentage

6.4.1 Corporate Stocks

The articles of incorporation for a corporation specify a maximum total number of shares of stock that it is authorized to issue. The original number of shares of **authorized stock** is largely arbitrary, but it should be selected carefully on the basis of the venture's financial plan and future fund-raising objectives. The number of authorized shares can be changed, but only through a vote by the venture's shareholders. From the authorized pool of shares, the venture then can issue shares to founders and investors. It is the **issued shares** that constitute the ownership structure of the venture. That is, a shareholder's percentage of ownership of the venture is calculated as the proportion of shares held compared to shares that have been issued. Most ventures will reserve a portion of the authorized shares in the company's treasury for later use. The shares held in reserve are called **unissued shares,** or **treasury stock**.

It is also important to note that not all stock is created equal. A venture's articles of incorporation can be crafted to permit it to issue different classes of shares, each having a specific designation and unique preferences, limitations, and/or rights. These share classes are usually associated with financing rounds and are often designated as Class A, Class B, and so on; or as Series A, Series B, and so on. The articles of incorporation either specify the particulars of each class of shares or delegate the authority to the board of directors. In general, the preferences and relative rights of classes of shares relate to voting, payment of dividends, and distribution of corporate assets on dissolution. Limitations of a class of shares typically relate to restrictions on transferability. Shareholders of private ventures normally do not want to leave it up to shareholders to decide to whom they may transfer their shares. Transferability is usually governed by buy-sell clauses in the shareholders' agreement. Below, we discuss two types of stock, common and preferred, that are commonly used to represent ownership interests and rights in a corporation.

6.4.2 Common Stock

Common stock refers to the baseline of ownership in a corporation and a right to a portion of profits from that company. Many ventures do not specifically define common stock. Instead, they refer to classes of stock having different characteristics without ever specifically categorizing any particular class or classes as common stock. The designation for common stock tends to vary from company to company often depending upon whether or not a special class of stock is issued to the founders. If only one class of stock is issued, it will be common stock. As used in this text, the term *common stock* means a class of stock that does not have any preference over another class of stock. Common stock is normally the last in line when dividends are paid and in the event of liquidation. In the event of liquidation, creditors, bondholders, and preferred stockholders typically are paid first and common stockholders are entitled only to what is left.

Owners of common stock usually have voting rights to elect the members of the board of directors who oversee the management and operations of the company. Different classes of stock may have different voting rights, as will be discussed. Profits of the company may be paid out in the form of dividends to the common stockholders. However, dividends on common stock are not guaranteed and usually only occur when the company is profitable. The amount and timing of dividends are determined by the board of directors.

The owners of common stock get the benefits of increases in value as the company grows. On the other hand, the value of their ownership interest decreases if the company is unsuccessful. So, ownership in common stock may provide the greatest upside potential to investors, but it may also provide the greatest risk of loss if the business does not succeed.

6.4.3 Preferred Stock

Technically, any stock that has any sort of advantageous characteristic over other classes of stock is referred to as **preferred stock**. Preferred stock typically has provisions over and above common stock that:

- Provide a specific dividend on a periodic basis (e.g., monthly, quarterly, semiannually, or annually)
- Classify the stock as senior to other classes of stock in the order of distribution (i.e., payments are made to the preferred stockholder before dividends are paid to the other classes or when there is a distribution upon liquidation)
- Indicate that preferred shareholders have limited or no voting rights

Preferred stock tends to be a more conservative investment than common stock; it is not as volatile. Investors purchase preferred stock for the dividends. Unlike a dividend on common stock that is paid out to shareholders essentially at the discretion of the board of directors, dividends on preferred shares often are a fixed amount regardless of the earnings of the company. In some cases, the right to those dividends can accrue on a periodic basis. Although payment of dividends on preferred classes of stock is not guaranteed *per se*, dividends are guaranteed to be paid before payment is made to any junior classes of stock.

Preferred stock can include a wide range of advantages, also referred to as "sweeteners." A few of these advantages are discussed below.

6.4.3.1 Preferred Stock Distributions

A class of preferred stock can be specified to entitle the holders to distribution—**dividends**—and specify the manner in which the distributions are to be calculated. For example, dividends for a class of stock may be cumulative or noncumulative.

Cumulative preferred stock has a provisional right to a dividend payment that accrues periodically, and all accrued dividends must be paid to the holders of that class of stock before any dividends can be paid to any junior class of stock. For example, assume a company issues a preferred class of stock that has a fixed dividend yield to be paid quarterly. However, because of financial problems the company is forced to suspend its dividend payments in order to pay expenses. If the company gets through the trouble and starts paying out dividends again, it will have to pay all of the dividends that have accrued to the holders of the preferred class of stocks before it can pay any dividends to the junior classes.

On the other hand, if the class of shares is noncumulative, dividends do not accumulate, and the shareholder is not entitled to receive dividend payments for the periods in which no dividend is paid. They are, however, typically still entitled to payment of dividends before payment is made to any junior class of stock when the venture is once again able to pay dividends.

6.4.3.2 Convertibility

A class of preferred stocks can also be redeemable or convertible into cash, debt, common stock, or other property. As specified by provisions of the stock, the conversion can be triggered at the option of the corporation, the shareholder, or another person or on the occurrence of a designated event (e.g., a venture capital round of investment). The conversion can be a designated amount, or can be determined in accordance with a designated formula or by reference to some prespecified extrinsic data or events.

6.4.3.3 Participating Preferred

Preferred stock that pays a fixed dividend regardless of the profitability of the company is referred to as **nonparticipating preferred stock**. However, preferred stock can also be made to participate in the profits of the corporation. For example, a **participating preferred stock** may entitle the holder to the right to participate in any surplus profits in addition to a fixed dividend and after payment of agreed levels of dividends to holders of common stock has been made. In some instances, the participation may relate to dividends. For example, the preferred stockholder may receive the greater of the fixed dividend or the dividends paid to a share of common stock (or, if convertible, to the number of shares of common stock into which the preferred stock can be converted).

The participation can also relate to the distribution upon liquidation of the company. In the event that the company is liquidated, holders of **nonparticipating preferred stock** typically receive predetermined preferential return (e.g., an amount equal to the initial investment) plus any accrued and unpaid dividends prior to any distributions to junior classes of stock. However, if the company is being sold at a sufficiently high valuation, holders of common stock may well receive more per share than holders of the preferred stock. If the preferred stock was convertible, then holders of preferred stock would have the option to convert their shares into common stock, giving up their preference in exchange for the right to share pro rata in the total liquidation proceeds. On the other hand, if the preferred stock was participating, the preferred stockholders could in essence have their cake and eat it too. Participating preferred stock might not only receive the predetermined preferential return, but also participate on an "as converted to common stock" basis with the common stock in the distribution of the remaining assets.

6.4.3.4 Voting Rights

Although at least one of the classes of shares must have voting rights (and, at least in combination with the rights of other classes of shares, voting rights that cover all matters defined in the articles of incorporation that require votes), a preferred stock class may be given special, conditional, or limited voting rights or, for that matter, no right to vote at all.

One vote per share, typically, tends to be the norm for common stock, but a corporation can issue different "classes" of common stock, distinguished by the specific voting rights associated with each share. The voting rights associated with common stock can range from no voting rights at all to multiple votes per share.

6.4.3.5 Founder's Stock

Founder's stock is used to refer to stock issued to the founders of the corporation. There is, however, no universal definition of founder's stock in terms of its characteristics. If the corporation issues a single class of stock, founder's stock is simply common stock issued to the founders. However, founder's stock can sometimes be a separate class of stock with its own specific characteristics. For example, the company founders may issue two classes of stock: Class A stock, which has one vote per share, and Class B stock, which has 10 votes per share. The founders would offer the Class A stock to investors and issue the Class B stock to themselves, with the intent that the super-voting rights would ensure that they retain decision-making control of the company. In addition to the super-voting privilege, there have been a number of characteristics proposed for founder's stock, including:

- Having the right to convert shares into any other class of stock when that class of stock is offered to investors
- Assigning liquidation preferences at a designated amount (such as actual monies invested by the founders, a specified percentage of the founders holdings, or the valuation of the company prior to a successive round of financing)
- Making the founder's stock preferred participating

Often, when part of the founder's contribution to the venture is sweat equity, founder's stock is subject to a **vesting** requirement in accordance with a predetermined, usually time-based, schedule or formula. Actual ownership of stock does not transfer until the vesting condition is met.

Of course, there tends to be a tension between having a special class of founder's stock with protective characteristics and the ability to attract future investors for subsequent financing rounds. In many instances, when a special class of founder's stock is in place, investors will attempt to negotiate away the founder's preferences as a precondition to investment.

It is important that founders understand the tax consequences of receiving stock in return for services. As a general proposition, such stock is considered income to the founder. Under the U.S. tax law, the founder has the option to recognize income (the difference between fair market value of and the price paid for the stock) either when the stock is issued or when the stock vests.[19] However, if the founder/employee elects to recognize the value of the stock as income when the stock is issued, an 83(b) election must be filed with the IRS no later than 30 days after the stock is issued. Because the value of the stock is likely to increase over time, it is generally beneficial for a founder/employee to make an 83(b) election. The 83(b) election starts the one-year capital-gain holding period and freezes ordinary income (or alternative minimum tax) recognition to the issue date.

6.5 RAISING CAPITAL

As previously noted, at some time during the life of the typical venture, it will need to reach outside of itself for necessary resources. One of those necessary resources is often capital.

For a transactional analysis of the process of forming a venture and of subsequently bringing investors into the venture, it is convenient to use a **co-venturing paradigm**: the business venture is considered a separate and distinct entity from each individual participant or investor (co-venturer), and each co-venturer makes a contribution to the venture in return for some form of consideration.

The consideration provided by the respective co-venturers to the venture can take a number of forms, such as, for example, money, intangible assets such as intellectual property, tangible assets, or services. Likewise, the consideration provided by the venture to the co-venturers can take one or more of a number of forms, including equity in the venture, money (e.g., interest on a loan), or a **profit interest** in all or part of the venture. Exhibits 6.9 and 6.10 illustrate such an analysis for the formation of a business venture and the introduction of investors to an existing business, respectively.

The consideration given to an investor in return for the investment is, in effect, the cost of the investment to the preinvestment venture principals. Financing tends to be categorized in terms of the particular consideration given to the investor. For example, debt financing involves taking out a loan or selling **bonds** (debt instruments) to raise capital, in effect paying interest to the lender for the use of the lender's money; the lender contributes money to the venture in consideration of a promise to repay the money to the lender plus a fee (interest). Equity financing involves, in effect, sale of equity (part of the ownership) to the investor; the investor contributes money to the venture in consideration of an equity interest.

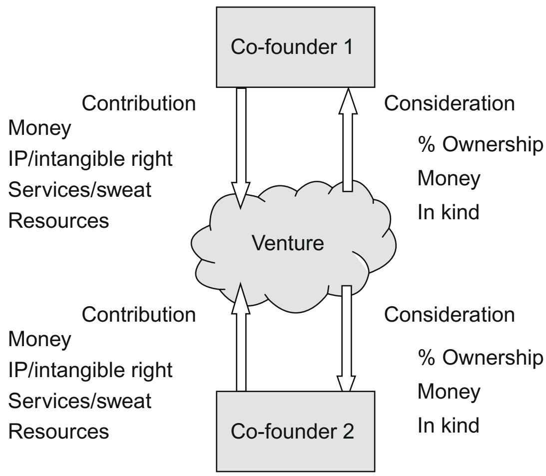

EXHIBIT 6.9

Transactional analysis of business formation. *Source: Lechter, M., 2010. OPM, Other People's Money: The Ultimate Leverage, second ed. TechPress.*

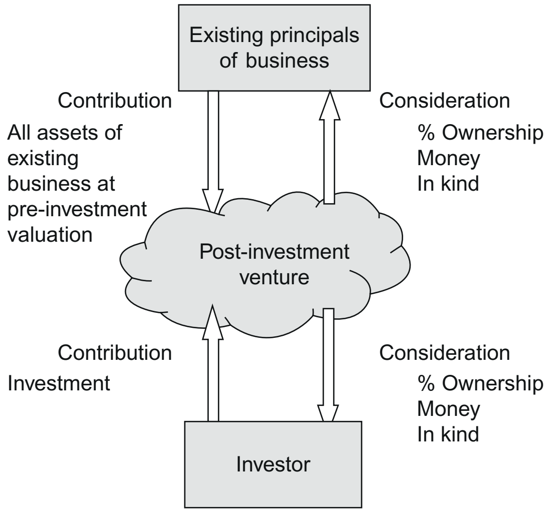

EXHIBIT 6.10

Transactional analysis of investment in existing business. *Source: Lechter, M., 2010. OPM, Other People's Money: The Ultimate Leverage, second ed. TechPress.*

Equity financing should be distinguished from debt financing. The cost of debt financing is typically finite, and the lenders will not share in any appreciation in the value of the business. However, in the short term, repayment of the loan can place constraints on the start-up venture's cash flow; both principal and interest must be repaid, and repayment is required whether the company is successful or not. The requirement to make periodic payments to service debt can make it difficult for the start-up venture to manage its cash flow.

Equity financing entails selling part of the ownership of the company. Equity financing is more flexible than debt financing with respect to cash flow concerns. There are typically no short-term repayment requirements, and equity investors share the risk. However, equity investors also share in any appreciation in the value of the business. And, although profit interests can be separated from governance and control, anytime equity investors are added, there is some loss of independence on the part of the preinvestment ownership team.

6.6 EQUITY DISTRIBUTION IN THE START-UP VENTURE

We have discussed the various legal structures that a business can take and different forms of equity. We now return to the inter-relational dynamics of the creation and growth of the business. When one or more founders form a business, each makes a contribution to the business in return for some consideration. Initial contributions by principals are typically made in return for, at least in part, an equity interest. The particular form of that equity interest depends upon the particular legal structure selected for the venture. The question we now address is: how should the equity be distributed among those individuals or entities?

When the business is founded by more than one person (or entity), the perceived relative values of the contributions that each makes (or will make) to the venture are typically reflected by the relative percentages of ownership. The issue is simplified if each of the founders makes a strictly monetary contribution to the venture in return for his or her equity interest. In that case, the relative percentage of ownership is easily determined. Each principal would hold an ownership interest equal to the ratio of the amount of money contributed by the individual to the total money contributed.

To the extent that founders make nonmonetary contributions to the venture, the venture can provide separate compensation, other than equity, for such contributions. For example, one or more of the founders will often be involved in the management and operation of the business. In that case, each individual will provide those services as an employee or independent contractor and will be separately compensated. Most often, the venture pays a salary or fee for those services. However, compensation can also be in the form of trade, for example, the services are exchanged for an equivalent fair market value of services or product from the business. Likewise, a founder can also provide resources or IP to the entity for compensation other than equity. In that case, the founder provides the IP or resources in the role of an independent entity (e.g., a lessor or licensor) and is compensated with something other than equity, such as a lease or royalty payment.

Despite these alternative compensation options for nonmonetary contributions, such contributions often are compensated with equity. When nonmonetary contributions must be figured into the equity distribution equation, the determination of relative ownership percentages is more complicated. For example, when nonmonetary contributions are made for equity in the business, the relative value of that contribution must be determined. In many instances, this value can be difficult to determine. Nonmonetary contributions can take any number of other forms:

- Intellectual property
- An intangible right or relationship, such as a contractual right (e.g., the right to purchase property or a purchase order from a potential customer)
- Sweat equity (providing time and effort without drawing a "salary" or at a reduced "salary"; services provided at market rates are not a contribution to the venture)

- Resources (facilities, distribution, R & D, and management)
- Credibility (e.g., credit, reputation) or access to sources of capital (network)

When the business is founded by more than one entity, the perceived relative values of the contributions that each makes or will make to the venture are typically determinative of the relative percentages of ownership. There are standard techniques for valuation of an existing business. However, in many instances, those standard valuation techniques are not applicable to nonmonetary contributions. In fact, quite often with start-up ventures, the issue of relative value of contributions is simply a matter of the negotiation skills of the contributors. Factors tending to influence the valuation of a nonmonetary contribution include:

- The relevance of the contribution to the venture. For example, there is often a premium for contributing the idea or premise around which the venture is built.
- The intrinsic or demonstrable merit of the contribution. For example, consider the negotiating position of an inventor with an unproven idea versus that of an inventor who can provide a prototype.
- Favorable assessments by independent third parties.
- Legal exclusivity or protections. For example, consider the negotiating position of an inventor with an unproven idea versus an inventor with a patent.
- Uniqueness of the contribution.
- Demonstrable expertise in the technology or processes that form the basis of the venture.
- Relevant experience and track record.
- Relevant contacts and network.
- Reputation and goodwill.
- Efforts already taken that increase the likelihood of success of the venture.

In practice, pure force of personality and skills in negotiations often tend to play a significant and sometimes definitive role in determining the relative equity positions of the founders.

6.6.1 Employee Stock Options

ESO plans are a flexible tool used by many companies to reward employees for performance and attract and retain a motivated staff.[20] In effect, options preserve cash for the business while giving employees a stake in the success of the company. The popularity of ESO plans has seen remarkably steady growth since the 1980s. ESO plans became particularly popular during the days of the dot.com boom and indeed, for a period of time, were an expected component of a compensation package for employees of high-technology companies. Today, ESO plans continue to be a relatively popular method of compensating employees and garnering loyalty for the employer. One survey estimates that over 11.2 million employees are participants in such plans.[21]

In essence, an ESO plan is a contract between employer and employee that gives the employee the right to buy a specific number of shares in the company at a specified price, referred to as the strike price, over a specified period of time, referred to as the exercise period.[22] When the employee exercises the option, he or she will get the benefit of the difference between the fair market value of the stock at the time of exercise and the strike price. In a typical ESO plan, there are specific provisions regarding the employee's eligibility to earn options under the plan and various restrictions on how the option is exercised and that transferability of the stock after the option is exercised. Several common provisions and restrictions are explored next.

6.6.2 Vesting

In the context of an ESO, vesting is a process or condition that must take place before an option can be exercised by the employee. For example, an ESO plan may require uninterrupted employment for a specified period of time (or some other length of service) before the employee is "vested." The vesting condition is most frequently the passage of time, but it may also be other things, such as the occurrence of an event or a milestone in the growth of the company. ESO plans may incorporate simple or elaborate vesting schedules. A typical vesting schedule for employees of a technology start-up is incremental over four years, with the employee having no exercisable rights until he or she has remained with the company for at least 12 months, at which point the right to exercise the option on the first 25% of the shares vests and approximately 2% vest each month thereafter. No further vesting occurs after an employee leaves the company.

6.6.3 Restrictive Clauses

ESO plans typically include restrictions or limitations on the transferability of the stock after the option is exercised to protect the company's interest. For example, an employee may be precluded from making any transfer of stock for a period of time after exercising the option. Or, an employee who is leaving the company may be required by the plan to sell his or her stock back to the company. Some plans may also require that the option or the shares be offered back to company on a right of first refusal basis whenever a stock sale is contemplated to an outside or unrelated third party.

6.6.4 Tax Issues

In the United States, the Internal Revenue Code creates two basic categories of ESO plans: incentive stock options (ISOs), also referred to as qualified stock options, and nonqualified stock options. In order to qualify as an ISO, the plan must meet relatively stringent requirements of the Internal Revenue Code. For example, the strike price cannot be discounted from fair market value, options cannot be available to nonemployee directors, and the exercise period cannot exceed 10 years.[23] In view of the restrictions of the qualification rules, most ESO plans are nonqualified.

In general, exercise of a nonqualified ESO has tax consequences for the employee. The spread between the market price and option price at the time the option is exercised is considered ordinary income to the employee. Qualified ESO plans however qualify for special tax treatment. Neither the grant nor exercise of an ISO is a taxable event for the employee. Instead, the tax is deferred until the employee sells the underlying stock. At that point, any gain that the employee has made on the stock sale is taxed. If the sale occurs at least two years after the option is granted and at least one year after the option is exercised, the income is taxed at favorable long-term capital gains rates. If these holding-period requirements are not met, the spread at exercise is taxed as ordinary income and only the subsequent appreciation of the underlying shares is taxed as capital gain.

Nonqualifying stock options can create anomalous tax consequences for the employee in the event that the employee does not immediately sell the stock after exercising the option and the value of the stock goes down. Exercise of the option is a taxable event, that is, the employee is taxed on the spread even though the actual gain (or loss) is less than the fair market value at the time the option was exercised. On the other hand, exercise of a qualified option is considered a preference item for purposes of calculating the alternative minimum tax.

6.7 CHAPTER SUMMARY

This chapter examined the various legal forms available for a new technology venture: unlimited liability (e.g., sole proprietorship or general partnership) and limited liability (e.g., LP, corporation, or LLC). Limited liability entities are creatures of statute; to form a limited liability entity it is necessary to file certain documents with the appropriate governmental agency, and certain formalities must be followed to maintain the limited liability entity. The particular documents that must be filed and formalities vary depending upon the particular entity. Unlimited liability entities are the default form of business entity; unless the necessary documents are filed and formalities observed for a limited liability entity, the entity will be either a sole proprietorship, or, if there is more than one owner, a general partnership. Even when not required, it is desirable to draft appropriate governing documents, such as partnership, operating and shareholders agreements, to avoid misunderstandings and establish good operating procedures.

In an unlimited liability entity the owners, merely by virtue of being an owner, are *jointly and severally* responsible for all liabilities of the entity (including those created by its employees in the course of their employment), whether or not they were personally involved in creating the liability. On the other hand, although an unlimited liability entity will not shield an individual from responsibility for their personal actions, principals, officers and directors do not become personally responsible for liabilities of the entity merely by virtue of their position. They are liable only to the extent that they may lose the value of their investment in the entity; their personal assets not invested in the entity are not at risk. It seems unwise for any business owner today to choose a legal form that includes the disadvantage of unlimited liability.

Each particular form of limited liability entities has advantages and disadvantages depending upon the nature, number, and tax circumstances of the principals participating in the venture, the management structure of the venture, and the venture's capital management plan and its tolerance for regulatory and administrative burdens.

Allocating percentage of ownership between founders (or to an investor) is a function of the relative value of the contributions of the individual founders (or investor) to the venture. In practice, however, determining the relative value of contributions is often a difficult process because standard valuation techniques tend to be inapplicable to start-ups. This is especially true when the founders make nonmonetary contributions, such as IP, resources, and services (sweat equity) to the venture. In any event, it is desirable to have written documentation of the nature and extent of each participant's contribution to the venture, and the consideration (e.g., percentage of ownership) to be provided for that contribution.

KEYTERMS

Authorized stock The maximum number of shares of stock that a corporation is legally permitted to issue, as specified in its articles of incorporation.

Bond A document (debt instrument) evidencing the loan of funds (the purchase price of the bond). The bondholder is periodically paid interest at a fixed rate (coupon), and the principal is to be repaid at a specified date (maturity date). Bonds are commonly used by business (and government) entities to finance particular projects and activities.

Common stock A class of stock that does not have any preference over another class of stock.

Corporate veil The protective "veil" established by the corporate structure, separating personal and business assets.

Corporation A legal entity, created under the laws of a particular jurisdiction separate and apart from its owners.

Co-venture A generic term covering not only actual business entities, such as partnerships, corporations, and so on, but also virtual business entities created through contractual relationships such as licenses and profit-sharing arrangements.

Co-venturers The participants in the co-venture. Also used as a generic (entity independent) term for the principals of a venture (e.g., partners, shareholders, and members).

Co-venturing paradigm An analytical model for a business venture where the business venture is considered a separate and distinct entity from each individual participant or investor (co-venturer) and each co-venturer makes a contribution to the venture in return for some form of consideration.

Cumulative preferred stock A type of preferred stock to which dividends are to be paid on a periodic basis, with a right to be paid any of those periodic dividends that have been omitted in the past, before junior classes of stock can receive dividends.

Dividends A distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders, typically described in terms of the dollar amount each share receives (dividends per share).

Employee stock option plan An agreement giving an employee the right, during a specific time period, to buy a specific number of shares of company stock at a specified price.

Equity A generic term for ownership interest in a business entity.

Foreign corporation In a given jurisdiction, a corporation formed and organized in some other jurisdiction. For example, an Arizona Corporation doing business in Florida would be considered a foreign corporation in Florida.

Founder, or promoter The individual or individuals that recognize an opportunity and are the primary forces initiating the creation of a business entity.

Founder's Stock Stock issued to the founders of the corporation. It may be common stock or preferred stock.

General partnership A business created by default anytime two or more individuals own a business without creating a statutory entity.

Inventor In a technology venture, the individual(s) primarily responsible for conceiving the technology.

Investor An individual or entity that makes a contribution to the business after it has been formed. The consideration for the contribution often includes an equity interest in the business entity. Founders that do not actively participate in the management or operations of the venture are also sometimes referred to as investors.

Issued shares or outstanding shares The stock that is actually held by shareholders of the corporation. The number of outstanding shares will increase if the corporation issues additional shares and will decrease if it buys back its shares.

Jointly and severally liable Where each member of a group is responsible for the entirety of a liability and the liability of an individual member is not limited to that member's pro rata share. The liability can be collected entirely from any one of the members of the group, or from any and all of the members in various amounts, until paid in full.

Limited partnership A legal entity with one or more general partners and one or more limited partners.

Nonparticipating preferred stock Preferred stock that pays a periodic fixed dividend regardless of the profitability of the company.

Operating agreement An agreement between the members of an LLC defining the operating rules of the entity. The operating agreement typically governs membership, management, rights, duties, operation, capital contributions, voting rights, transfer of interest, and dissolution and distribution of income and losses of the company.

Participating preferred stock Preferred stock that pays, in addition to any periodic fixed dividend, the profit interest in the corporation.

Personal holding company Under U.S. tax law (26 USC §542), a corporation with more than 50% of its stock owned by five or fewer individuals and more than 60% of its income (after certain adjustments) coming from dividends, rents, royalties, and so on, and/or certain personal service contracts. Personal holding companies are subject to, in addition to regular corporate tax, a significant penalty tax.

Phantom income Revenue that is reported to the Internal Revenue Service as income for tax purposes, but is not actually received by the entity or individual paying the taxes. For example, retained earnings in a partnership or an LLC taxed as a partnership may be considered income to the individual members even though there is no distribution of the income to the members.

Preferred stock Any stock that has advantageous characteristics over other classes of stock, typically a priority (preferred) claim on the assets and earnings of the corporation than on other classes of stock.

Profit interest A right to a percentage of the profit made on a defined interest base. The interest base can be, for example, the entire profits of the business venture, profits made from a particular line of business, profits made from a particular product, profits made from a particular distribution channel, and so on.

Shareholders agreement An agreement between the shareholders of a corporation, generally analogous to the operating agreement of an LLC, typically governing the shareholder's relationship; management and operation of the company, obligations, privileges, and voting rights of the shareholders; and restrictions on the sale of stock. Shareholders agreements are common in closely held corporations.

Small business corporation A C-corporation where the aggregate consideration (money and other property) received by the corporation for stock does not exceed $1 million.

Sole proprietorship A business created by default any time an individual owns a business without creating a statutory entity.

Treasury stock or unissued shares Shares of stock that have been authorized in the articles of incorporation, but not actually issued.

Vesting A process or condition that must take place before an interest is transferred or before the right or option can be exercised.

Vicarious liability and imputed liability This is where, because of a relationship between the respective entities, one entity is strictly liable for harm or damages caused by another. For example, an employer is vicariously liable for harm or damages caused by an employee acting within the scope of employment.

ADDITIONAL READING

Emerson, R., 2009. Business Law, fifth ed. Barron's Educational Series, Inc., Hauppauge, NY.

Glenn, B., 2013. Business Entity Basics. Zinerva Publishing, LLC.

Harris, L., 2012. Mastering Corporations and Other Business Entities. Carolina Academic Press, Durham, NC.

Lechter, M., 2010. OPM: Other People's Money: The Ultimate Leverage, second ed. TechPress. Phoenix, Arizona.

WEB RESOURCES

The websites below are intended to be destinations for your further exploration of the concepts and topics discussed in this chapter:

http://corp.delaware.gov/: The website of the Delaware Division of Corporations.

http://www.sba.gov/category/navigation-structure/starting-managing-business/starting-business/choose-your-business-stru: A discussion of the various types of entities by the Federal Small Business Administration.

http://nvsos.gov/index.aspx?page=425: The Nevada Secretary of State website.

http://www.sec.gov/: The Securities and Exchange Commission (SEC) website.

http://soswy.state.wy.us/Forms/Publications/ChoiceIsYours.pdf: A comparison of various types of Wyoming entities provided by the Wyoming Secretary of State.

ENDNOTES

1 A "Cooperative" is a business or organization owned by and operated for the benefit of (provides services to) its members, also known as user-owners. Profits and earnings generated by the cooperative are distributed among the members. Cooperatives are often organizations of businesses that pool their resources.

2 A "Nonprofit" is an organization that uses any revenues for its own expenses, operations, and programs; any revenues in excess of expenses are used to achieve its goals rather than being distributed to its owners or trustees as profit or dividends.

3 Advantage Leasing Corp. v. NovaTech Solutions, No. 03–216 (Wis. Ct. App. March 24, 2005) (unpublished opinion).

4 Littriello v. United States, 484 F.3d 372 (6th Cir. 2007).

5 Securities Act of 1933 §§§ 11,12,15.

6 A federal "self-employment tax," analogous to the taxes on employee wages related to the Social Security and Medicare system, is imposed on the net "self-employment income" of anyone carrying on a trade or business as a sole proprietor, an independent contractor, a partner in a partnership, a member of a single-member LLC, or is otherwise self-employed. Under the Self-Employment Contributions Act Tax (SE Tax Act). 26 USC Ch 21. This tax is, however, not applicable to dividends and distributions.

7 California is a notable exception because of fees charged with respect to LLCs. See endnote 16.

8 The Internal Revenue Code, Title 26 United States Code (USC).

9 26 USC (IRC) §11. As of 2008, the graduated rate was: (A) percent of so much of the taxable income as does not exceed $50,000 (B) percent of so much of the taxable income as exceeds $50,000 but does not exceed (C) percent of so much of the taxable income as exceeds $75,000 but does not exceed $75,000 $10,000,000 (D) percent of so much of the taxable income as exceeds $10,000,000.

10 Because of the deductibility of salaries, the IRS scrutinizes the compensation paid to owner-executives. If the compensation is found to be excessive, the IRS can reclassify it as a dividend and increase the taxable income of the corporation.

11 As of 2008, the tax on dividend income was 15%.

12 26 USC (IRC) §531 et seq, 26 CFR § 1.531–1 et seq.

13 26 USC §541 et seq, 26 CFR § 1.531–1 et seq, 26 USC §§541 et seq., 26 USC §11.

14 26 USC §1244.

15 Wyoming Statute, Title17, Chapter 15.

16 Rev. Rul. 88–76. 1988-2C. B. 360, September 2, 1988.

17 26C.F.R. §§ 301.7701-1 - 301.7701-3.

18 In California, a Franchise Tax Board has been established to administer Personal Income Tax and the Corporation Tax. For the privilege of doing business in California, an LLC must pay not only an annual franchise tax (as of 2008, a minimum of $800 per year), but also, if it has total annual income above a specified amount (as of $250,000), it must pay a fee to the California Franchise Tax Board (as of 2008, ranging from $500 to $11,790, depending on the amount of the LLC's total income).

19 26 USC § 83.

20 Employee Stock Option Plan should not be confused with a type of retirement plan referred to as an Employee Stock Ownership Plan (ESOP).

21 The National Center for Employee Ownership survey performed by the National Opinion Research Center (NORC) of the University of Chicago relying on survey information and statistics from the Department of Labor, Bureau of Labor Statistics survey. See details at http://www.nceo.org/library/eo_stat.html.

22 An ESO plan can be part of a negotiated comprehensive employment agreement with an individual employee.

23 The requirements include, among other things:

1. The option may be granted only to an employee (grants to non-employee directors or independent contractors are not permitted).
2. The option must be exercised (a) within 10 years of grant and (b) while still employed or no later than three months after termination of employment (unless the optionee is disabled, in which case this three-month period is extended to one year).
3. The option exercise price must be at least the fair market value of the underlying stock at the time of grant.
4. The ISO cannot be transferred by the employee (other than by will or by the laws of descent) and cannot be exercised by anyone other than the option holder.
5. No more than $100,000 in ISOs can become exercisable in any year.