Entrepreneurship Development

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Preparing the Proper Ethical and Legal Foundation

Chapter Objectives

1. Describe how to create a strong ethical culture in an entrepreneurial venture.
2. Explain the importance of "leading by example" in terms of establishing a strong ethical culture in a firm.
3. Explain the importance of having a code of conduct and an ethics training program.
4. Explain the criteria important to selecting an attorney for a new firm.
5. Discuss the importance of a founder's agreement.

Chapter Objectives

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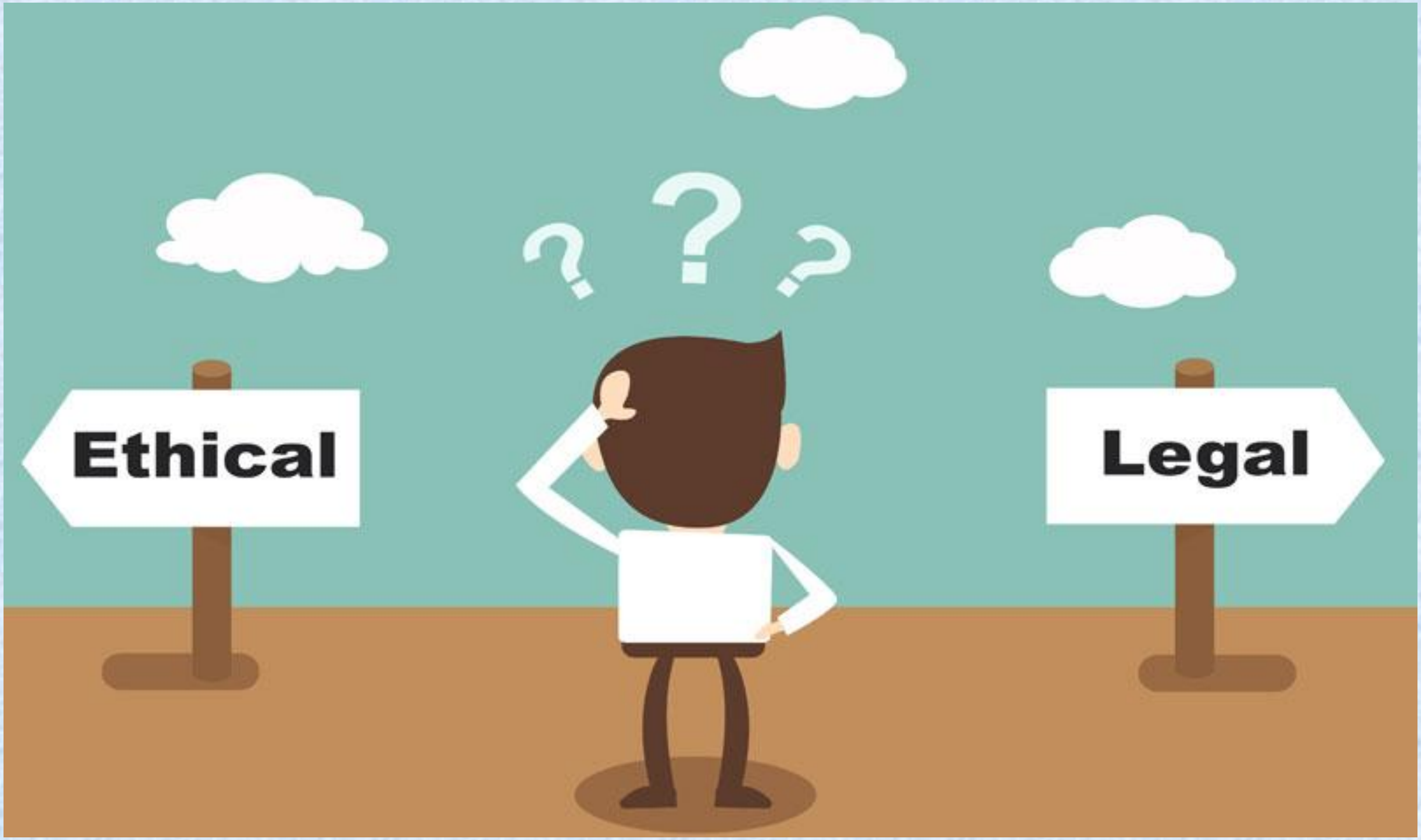
6. Provide several suggestions for how entrepreneurial firms can avoid litigation.
7. Discuss the importance of nondisclosure and noncompete agreements.
8. Provide an overview of the business licenses and business permits that a start-up must obtain before it starts conducting business.
9. Discuss the differences among sole proprietorships, partnerships, corporations, and limited liability companies.
10. Explain why most fast-growth entrepreneurial ventures organize as corporations or limited liability companies rather than sole proprietorships or partnerships.


Ethical
Legal

Introduction

- *That's cheating!* *No it's not!*
- *That's wrong!* *No, it's fine!*
- *It's just part of the game!*

Definitions

- ETHICS – *a sub-discipline of philosophy concerned with issues of right and wrong in human conduct.*
- *It is concerned with good and bad; what is authentic and not authentic; and with the notions of duty, obligation, and moral responsibility.*
- VALUES – *Individual beliefs which motivate and guide behavior.*

Initial Ethical and Legal Issues Facing a New Firm

Establishing a strong ethical culture	Choosing an attorney	Drafting a founder's agreement
Avoiding legal disputes	Obtaining business licenses and permits	Choosing a form of business organization

Establishing a Strong Ethical Culture

- Lead By Example
  - The most important thing that any entrepreneur, or team of entrepreneurs, can do to build **a strong ethical culture** in their organization is to lead by example.
- Establish a Code of Conduct
  - A code of conduct (or code of ethics) is a formal statement of an organization's values on certain ethical and social issues.
  - It is a set of principles designed to guide workers to **conduct** themselves with honesty and integrity in all actions representing the **company**

Establishing a Strong Ethical Culture

- Implement an Ethics Training Program
  - Ethics training programs teach business ethics to help employees deal with **ethical dilemmas** and improve their overall ethical conduct.
  - An ethical dilemma is a situation that involves doing something that <u>is beneficial to oneself or the organization, but may be unethical.</u>

Potential Payoffs for Establishing a Strong Ethical Culture

Choosing an Attorney for a Firm

- Select an Attorney Early
  - It is important for an entrepreneur to select an attorney as early as possible <u>when developing a business venture.</u>
  - It is critically important that the attorney be familiar with startup issues.
- Intellectual Property
  - For issues dealing with intellectual property (patents, trademarks, copyrights, and trade secrets) it is essential to use an attorney who specializes in this field.

How to Select an Attorney

- Contact the local bar association and ask for a list of attorneys who specialize in start-ups in your area.
- Interview several attorneys.
- Select an attorney who is familiar with the start-up process.
- Select an attorney who can assist you in raising money for your new venture.
- Make sure your attorney has a track record of completing his or her work on time.
- Talk about fees.
- Select an attorney that you think understands your business.
- Learn as much about the process of starting a business yourself as possible.

Draft a Founders' Agreement

- Founders' Agreement
  - A founder's agreement (or shareholders' agreement) is a written document that deals with issues such as <u>the relative split of the equity among the founders of the firm, how individual founders will be compensated for the cash they put into the firm, and how long the founders will have to remain with the firm for their shares to fully vest</u>.
  - The items to include in the founders agreement are shown on the following slide.

Items to Include in a Founders' Agreement

- Nature of the prospective business.
- A brief business plan.
- Identity and proposed titles of the founders.
- Legal form of business ownership.
- Apportionment of stock.
- Consideration paid for stock or ownership share of each of the founders.
- Identification of any intellectual property signed over to the business.
- Description of the initial operating capital.
- Buyback clause.

Avoiding Legal Disputes

- Avoiding Legal Disputes
  - Most legal disputes are the result of misunderstandings or a simple lack of knowledge of the law. Getting bogged down in legal disputes is something an entrepreneur should work hard to avoid.
  - There are several steps that an entrepreneur can take to avoid legal disputes:
    - Meet all contractual obligations.
    - Avoid undercapitalization.
    - Get everything in writing.
    - Set standards.

Avoiding Legal Disputes

- Although its tempting to try to show people you trust them by not insisting on written agreements, it’s not a good practice.

- One of the simplest ways to avoid misunderstandings and ultimately legal disputes is to get everything in writing.

Obtaining Business Licenses and Permits

- Business Licenses
  - In most communities, <u>a business needs a license to operat</u>e.
  - If the business will be run out of the founder's home, a separate home occupation business license is often required.
  - If a business has employees, or is a corporation, limited liability company, or limited partnership, it will usually need a state **business license** in addition to its local one.
  - A narrow group of companies are required to have a specific business license, including investment advising, drug, alcohol manufacturing and etc.

Obtaining Business Licenses and Permits

- Business Permits
  - Along with obtaining the appropriate licenses, some businesses may need to obtain one or more permits.
  - The need to obtain a permit depends on the nature and location of the business.
    - If you plan to sell food, you'll need a city or county health permit.
    - If your business is open to the public, you may need a fire permit.
    - Some communities require businesses to obtain a license to put up a sign.
    - All businesses that plan to use a fictitious name need a fictitious business name permit.

Choosing a Form of Business Ownership

When a business is launched, a form of legal entity must be chosen. The most common legal entities are…

- Sole Proprietorship
- Partnership
- Limited Liability Company
- Co-operative Society

Issues to Consider in Choosing a Legal Form of Business Ownership

- The Cost of Setting Up and Maintaining the Legal Form
- The Extent to Which Personal Assets Can Be Shielded from the Liabilities of the Business
- Tax Considerations
- The Number and Types of Investors Involved

Sole Proprietorship

- Sole Proprietorship
  - The simplest form of business entity is the sole proprietorship.
  - A sole proprietorship is a form of business organization involving one person, and the person and the business are essentially the same.
  - A sole proprietorship is not a separate legal entity. The sole proprietor is responsible for all the liabilities of the business, and this is a significant drawback.

Advantages and Disadvantages of a Sole Proprietorship

Advantages of a Sole Proprietorship

- Creating one is easy and inexpensive.
- The owner maintains complete control of the business and retains all of the profits.
- Business losses can be deducted against the sole proprietor’s other sources of income.
- The business is easy to dissolve.

Advantages and Disadvantages of a Sole Proprietorship

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<u>Disadvantages of a Sole Proprietorship</u>

- Liability on the owners’ part is unlimited.
- The business relies on the skills and abilities of a single owner to be successful. Of course, the owner can hire employees who have additional skills and abilities.
- Raising capital can be difficult.
- The business ends at the owner’s death or loss of interest in the business.
- The liquidity of the owner’s investment is low.

Partnerships

- Partnerships
  - If two or more people start a business, they must organize as a partnership, corporation, or limited liability company.
  - Partnerships are organized as either general or limited liability partnerships.

Partnerships

General Partnership

A form of business organization where two or more people pool their skills, abilities, and resources to run a business.

The primary disadvantage is that all partners are liable for all the partnership's debts and obligations.

Partnerships

Limited Partnership

- A modified form of general partnership.
- The major difference between the two is that a limited partnership includes two classes of owners: general partners and limited partners.
- The general partners are liable for the debts and obligations of the partnership, but the limited partners are only liable up to the amount of their investment.

Advantages and Disadvantages of a General Partnership

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Advantages of a General Partnership

- Creating one is relatively easy and inexpensive compared to a corporation or limited liability company.
- The skills and abilities of more than one individual are available to the firm.
- Having more than one owner may make it easier to raise funds.
- Business losses can be deducted against the partners’ other sources of income.

Advantages and Disadvantages of a General Partnership

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<u>Disadvantages of a Partnership</u>

- Liability on the part of each general partner is unlimited.
- The business relies on the skills and abilities of a fixed number of partners. Of course, the owners can hire employees who have additional skills and abilities.
- Raising capital can be difficult.
- Because decision making among the partners is shared, disagreements can occur.
- The business ends with the death or withdrawal of one partner unless otherwise stated in the partnership agreement.
- The liquidity of each partner’s investment is low.

Limited Liability Company

Limited Liability Company

- Is a form of business ownership that is rapidly gaining popularity.
- It is a popular choice for start-up firms.
- The limited liability company combines the limited liability advantage of the corporation with the tax advantages of a partnership.

Advantages and Disadvantages of a Limited Liability Company

Advantages of a Limited Liability Company

- Members are liable for the debts and obligations of the business only up to the amount of their investment.
- The number of shareholders is unlimited.
- An LLC can elect to be taxed as a sole proprietor, partnership, corporation, or corporation, providing much flexibility.

Advantages and Disadvantages of a Limited Liability Company

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Disadvantages of a Limited Liability Company

- Setting up and maintaining one is more difficult and expensive.
- Tax accounting can be complicated.
- Some of the regulations governing LLCs vary by state.
- Because LLCs are a relatively new type of business entity, there is not as much legal precedent available for owners to anticipate how legal disputes might affect their business.

Essential features of the organizations

Type of business organization	Ownership	Capital	Registration	Legal status	Liabilities	Management	Profit / loss	Maintenance and auditing of accounts	Continuity
Sole proprietorship	Rests with the person who committed the capital	owner's savings, help from family members, loans	Not mandatory	No legal status	Un limited	By the owner	Retained by the owner	Not necessary	No
Partnership	Partners 2-20	partners' funds	Not mandatory	No legal status	Un limited	By the participation of all the partners	According to the partnership agreement if any. If not as per the provisions of Partnership Act of 1890	Not necessary	No
Limited company	Share holders	issuing shares and other options	Essential	Has legal entity	Limited	By board of directors	Dividend decided by the board of directors would be issued	Essential	Yes
Co-operative society	**Members** minimum members-10	from the members and other options	Essential	Has legal entity	Limited	By board of directors	Distributed as per the contribution by each	Essential	Yes