

Entrepreneurship: Successfully Launching New Ventures

Seventh Edition



Chapter 7

Preparing the Proper
Ethical and Legal
Foundation

Learning Objectives

- 7.1** Discuss actions founders can take to establish a strong ethical culture in their entrepreneurial ventures.
- 7.2** Describe actions new firms can take to deal effectively with legal issues.
- 7.3** Provide an overview of the business licenses and permits that startups must obtain before they begin operating.
- 7.4** Identify and describe the different forms of organizations available to new firms.

Initial Ethical and Legal Issues Facing a New Firm

- Establishing a strong ethical organizational culture
- Choosing a lawyer
- Drafting a founders' agreement
- Avoiding litigation
- Obtaining business licenses and permits
- Choosing a form of business organization

7.1 Establishing a Strong Ethical Culture for a Firm (1 of 2)

- 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.

7.1 Establishing a Strong Ethical Culture for a Firm (2 of 2)

- 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 is beneficial to oneself or the organization but may be unethical.

7.2 Dealing Effectively with Legal Issues (1 of 4)

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

Table 7.3 How to Select an Attorney

- Contact the local bar association and ask for a list of attorneys in your area specializing in business startups.
- Interview several attorneys.
- Select an attorney who is familiar with the startup process.
- Select an attorney who can help you raise money for your venture.
- Make sure your attorney has a track record of completing work on time.
- Talk about fees.
- Trust your intuition.
- Learn as much about the process of starting a business yourself as possible.

7.2 Dealing Effectively with Legal Issues (2 of 4)

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

Table 7.4 Items Included in a Founders' (or Shareholders') Agreement (1 of 2)

- Nature of the prospective business
- Founders' identities and proposed titles
- Legal form of business ownership
- Apportionment of stock (or division of ownership)
- Consideration paid for stock or ownership share of each founder (may be cash or “sweat equity”)
- Identification of intellectual property any founders signed over to the business

Table 7.4 Items Included in a Founders' (or Shareholders') Agreement (2 of 2)

- Basic description of how the firm will operate and each person's responsibilities regarding the firm's operations
- Description of the outside business activities in which founders may not participate (e.g., you would not want a founder to engage in an outside business that competes directly with your business)
- Provisions for resolving disputes (many founders' agreements include a stipulation that founders will use mediation or arbitration, rather than courts, to resolve disputes)
- Buyback clause, which explains the disbursement process of a founder's shares if the person dies, wants to sell, or is selling because of a court order to do so

7.2 Dealing Effectively with Legal Issues (3 of 4)

- Avoiding Legal Disputes
 - Most legal disputes are the result of misunderstandings, sloppiness, 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.

7.2 Dealing Effectively with Legal Issues (4 of 4)

- Legal Agreements That Many Firms Ask Their Employees to Sign
 - A nondisclosure agreement binds an employee or other party (such as a supplier) to not disclose a company's trade secrets.
 - A noncompete agreement prevents an individual from competing against a former employer for a specific period of time.

7.3 Obtaining Business Licenses and Permits

- Depending on the nature of the business, the business may need local, state, and/or federal licenses and permits to operate.
- There are two ways for those leading a business to determine the licenses and permits it needs to acquire.
 - The first is to ask someone who is running a similar business, and they will usually be able to point you in the right direction.
 - The second is to contact the secretary of state's office in the state where you intend to launch the business.
- The number-one rule is that if you are uncertain, ask.

Federal Licenses and Permits

- Most businesses do not require a federal license to operate, but some do.
 - Examples of businesses that require federal licenses and/or permits to operate include businesses that sell (or provide):
 - Alcohol, Firearms, Animal Transport Across State Lines, Commercial Fisheries, Preparation of Meat Products, and Radio and Television Broadcasting.

State Licenses and Permits

- In most states, there is no license required to start or own a business.
- States typically require entrepreneurs to obtain licenses and permits to operate a business in specific industries and to complete certain business activities.
 - Most states have startup guides that walk you through the steps of setting up a business in the state.
- Two of the most common state-level requirements for starting a business are obtaining a sales tax permit and obtaining professional and occupational licenses and permits.

Sales Tax Permit

- Most states and communities require businesses that sell goods, and in some cases services, to collect sales tax and submit the tax to the proper state authorities.
 - If you have an obligation to collect sales tax, you need to obtain a permit from your state.
 - Most states have online portals that make it easy to obtain a sales tax permit.

Professional and Occupational Licenses and Permits

- In all states, there are laws that require people in certain professions to pass a state exam and maintain a professional license to conduct business.
 - Examples include plumbers, daycare centers, trucking companies, and insurance agencies.

Local Licenses and Permits (1 of 2)

- Local Licenses and Permits
 - On the local level, there are two categories of licenses and permits that may be needed.
 - The first is to operate a certain type of business.
 - Examples include child care, barber shops and salons, automotive repair, and hotels and motels.
 - The second category is permits for engaging in certain types of activities.
 - Examples include building permit (required if you are building or remodeling), health permit (normally required if you are involved in preparing food), and signage permit (may be required to erect a sign).

Local Licenses and Permits (2 of 2)

- Additional Requirements
 - If you plan to use a fictitious name for your business, in most cases you'll need to obtain a fictitious business name permit (also called dba or doing business as).
 - A fictitious name permit allows a business to operate under a fictitious name, like Gold Coast Sea Food or Red Rock Bakery.
 - All businesses, other than sole proprietorships that do not have employees, are required to obtain a Federal Employee Identification Number (also called an EIN).
 - The easiest way to obtain an EIN is to go to www.irs.com and click on Apply for an EIN online.

7.4 Choosing a Form of Business Organization

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

- Sole Proprietorship
- Partnership
- Corporation
- Limited Liability Company

Figure 7.2 Factors Critical in Selecting a Form of Business Organization

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 (1 of 3)

- 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.

Sole Proprietorship (2 of 3)

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.
- The owner can deduct business losses against other sources of income.
- It is not subject to double taxation (explained later).
- The business is easy to dissolve.

Sole Proprietorship (3 of 3)

Disadvantages of a Sole Proprietorship

- Unlimited liability on the owner's part.
- 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 (1 of 5)

- 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 (2 of 5)

- General Partnerships
 - A form of business organization where two or more people pool their skills, abilities, and resources to run a business.
 - The primary advantage is that the business isn't dependent on a single person for its survival and success.
 - The primary disadvantage is that all partners are liable for all the partnership's debts and obligations.

Partnerships (3 of 5)

Advantages of a General Partnership

- Creating one is relatively easy and inexpensive compared to a corporation or limited liability company.
- The firm has access to skills and abilities of more than one individual.
- Having more than one owner may make it easier to raise funds.
- Partners can deduct business losses against their other sources of income.
- It is not subject to double taxation (explained later).

Partnerships (4 of 5)

Disadvantages of a General Partnership

- Each general partner has unlimited liability.
- The business relies on the skills and abilities of a fixed number of partners. Of course, the partners can hire employees who have additional skills and abilities.
- Raising capital can be difficult.
- Because partners share decision-making responsibilities, disagreements among them 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.

Partnerships (5 of 5)

- Limited Partnerships
 - 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.

Corporations (1 of 8)

- A corporation is a separate legal entity organized under the authority of a state.
- Corporations are organized as either C corporations or subchapter S corporations.
- C corporations are what most people think of when they hear the word “corporation.” However, business startups are often organized as subchapter S corporations.

Corporations (2 of 8)

- C Corporations
 - A C corporation is separate legal entity that, in the eyes of the law, is separate from its owners.
 - In most cases a corporation shields its owners, who are called shareholders, from personal liability for the debts of the corporation.
 - A corporation is governed by a board of directors, which is elected by the shareholders.
 - A corporation is formed by filing articles of incorporation.

Corporations (3 of 8)

- C Corporations (continued)
 - A C corporation is taxed as a separate legal entity.
 - A disadvantage of a C corporation is that it is subject to double taxation. This means that a corporation is taxed on its net income, and when the same income is distributed to shareholders in the form of dividends, the income is taxed again on the shareholders' personal tax returns.

Corporations (4 of 8)

Advantages of a C Corporation

- Owners are liable only for the debts and obligations of the corporation up to the amount of their investment.
- The mechanics of raising capital is easier.
- No restrictions exist on the number of shareholders, which differs from subchapter S corporations.
- Stock is liquid if traded on a major stock exchange.
- The ability to share stock with employees through stock options or other incentive plans can be a powerful form of employee motivation.

Corporations (5 of 8)

Disadvantages of a C Corporation

- Setting up and maintaining one is more difficult than for a sole proprietorship or a partnership.
- Shareholders cannot deduct business losses against their other sources of income.
- Income is subject to double taxation, meaning that it is taxed at the corporate and the shareholder levels.
- Small shareholders typically have little voice in the management of the firm.

Corporations (6 of 8)

- Subchapter S Corporation
 - Combines the advantages of a partnership and a C corporation.
 - Is similar to a partnership in that the income of the business is not subject to double taxation.
 - Is similar to a corporation in that the owners are not subject to personal liability for the debts or behavior of the business.
 - A subchapter S corporation does not pay taxes. Profits and losses are passed through to the tax returns of the owners.

Corporations (7 of 8)

There are strict standards that a business must meet to qualify for status as a subchapter S corporation. The standards are shown below and on the next slide:

- The business cannot be a subsidiary of another corporation.
- The shareholders must be U.S. citizens. Partnerships and C corporations may not own shares in a subchapter S corporation. Certain types of trusts and estates are eligible to own shares in a subchapter S corporation.

Corporations (8 of 8)

- It can only have one class of stock issued and outstanding (either preferred stock or common stock).
- It can have no more than 100 members. Both spouses count as one member, even if they own separate shares of stock. In some instances, family members count as one member.
- All shareholders must agree to have the corporation formed as a subchapter S corporation.

Limited Liability Company (1 of 3)

- Is a form of business ownership that is rapidly gaining popularity in the United States.
- Along with the subchapter S, it is a popular choice for startup firms.
- The limited liability company combines the limited liability advantage of the corporation with the tax advantages of a partnership.
- A limited liability company does not pay taxes. Profits and losses are passed through to the tax returns of the owners.

Limited Liability Company (2 of 3)

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, S corporation, or corporation, providing much flexibility.
- Because profits are taxed only at the shareholder level, there is no double taxation.

Limited Liability Company (3 of 3)

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.
- Some states levy a franchise tax on LLCs—which is essentially a fee the LLC pays the state for the benefit of limited liability.

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