THIS IS VOLUME I OF
THE HANDBOOK SERIES

HANDBOOK SERIES
for
Start-ups and Emerging Companies

"SELECTION OF A BUSINESS ENTITY"

A GUIDE FOR ENTREPRENEURS

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NOTE: This is a brief summary and is not to be relied upon for legal advice. The subjects of securities and corporate law are arcane and decisions on how to proceed are factually based. The author assumes no responsibility for action undertaken pursuant to this Handbook.

Forward: This Handbook is intended to assist entrepreneurs in thinking through what route to follow when embarking on a start-up, expanding or emerging company, and/or financing their business. It is not a complete guide and should not be considered legal advice. Should the reader desire more precise advice, please contact the author at the address indicated on the front cover of each Handbook.

OTHER HANDBOOKS

Depending on one's needs, there are several volumes that should prove useful to non-lawyers. These are designed primarily for start-ups and emerging companies, executives and interested "angel" financiers. They are:

I Selection of a Business Entity

II. "How To" for Early Stage Structuring

III. Legal

IV. How to Offer and Sell Securities

V. Use of the Internet to Sell Securities

VI. California Corporation Code Sections 25102(n) and the MAIE

The Handbooks were originally written for use in California. They have been slightly rewritten in order to assist clients in other states; however, the emphasis is still on California.

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Section Selection of a Business Entity

I. SCOPE

§1.01 In General.

This section focuses on the factors to be considered when selecting a form of organization for a business. The form of organization adopted will depend upon the particular objectives and situation of each business. This section suggests matters for you to review in making the determination of the best form to choose under the circumstances. The specific attributes of alternative forms of business organization are discussed. The section considers the most common forms of business organization -- sole proprietorships, general partnerships, limited partnerships, limited liability companies and corporations, including "S," "C" and Closed. In 2011, California adopted the Corporate Flexibility Act which established two new corporate forms: the Flexible Purpose Corporation ("FPC") and the Benefit Corporation ("BC"). These new forms are met to respond to the desire of some entrepreneurs who wish to combine the making of money with performing social benefit and environmental enhancement without risking liability for not adhering to the traditional duty to exclusively benefit their shareholders. A discussion of these two additional choices is contained herein. Other, specialized forms of business organization such as business trusts, cooperatives, and professional corporations are beyond the scope of this work.

SPECIAL NOTE: The Business Plan and the Real Agenda. When you contemplate a new venture, think through what you really want and how you are going to achieve your goal. Usually a Business Plan is the tool used to force a think-through.

What are the goals? An IPO in five years? A single store with two owners and no expansion? A "Cash Cow" that licenses an invention? A company that hopes to enhance its profit making by also pursuing social and environmental goals? The answers to these questions will have a substantial influence on what form of organization suits your needs.

If an outside investor is involved, it is doubly important that you have a clear understanding, and full disclosure, of the real agenda of the founder/management team in order to avoid later charges of your having mislead the investors.

This first step: the choice of entity is an area where the lawyer can be critically useful. A wrong choice can be fatal. Your lawyer should take the time necessary to thoroughly understand your real agenda, to measure your resources and to understand the structural and tax advantages and disadvantages involved in the various structures you are considering.

II. ALTERNATIVE FORMS OF BUSINESS ORGANIZATION – ADVANTAGES AND DISADVANTAGES

§2.01 Sole Proprietorship.

A sole proprietorship is a business owned by a single person. As sole owner of the assets, the sole proprietor is entitled to all of the profits of the business and must bear all of the losses. There is no "shield" from liability other than insurance coverage (which usually does not cover debts and financial obligations). As a sole proprietor you will be responsible for all of the liabilities and obligations of the business. No legal formalities are required to bring this form of business organization into being, and there are no particular formalities necessary for its operation. You will wish to avoid the liabilities associated with a sole proprietorship.

Advantages

1. Few formalities are required for organization and hence organizational costs are minimal. This minimizes legal fees. Actually, it is rare for lawyers to be involved in the formation of a sole proprietorship – perhaps its most important advantage!

2. Absence of statutory or other formalities required for decision making and action.

3. Freedom to do business anywhere without elaborate formalities to qualify.

4. Minimal reporting requirements to government entities.

5. Control is centered in one person, thus avoiding the inconvenience of collective decision making and the risks arising when broad powers to manage or to obligate the business are granted to several persons.

6. Income is taxed only once at individual federal income tax rates, which can be lower than federal corporate rates for high income. Of course, state taxes are also payable. In a corporation, income is taxed twice, once when earned and once when distributed.

7. Losses are available on the owner's personal income tax return and can offset other income.

Disadvantages

1. The owner is subject to unlimited liability for obligations and liabilities of the business.

2. The business is subject to termination upon the death or disability of the owner.

3. Transfer of the business through sale or otherwise requires transfer of the individual assets of the business.

4. Risk or equity capital is limited to resources of the individual owner and borrowing capacity may be limited as well.

5. Business profits are taxed as income to the owner at individual income tax rates which can be higher than those of a corporation (if the owner has a small income, the reverse can be true).

Recommendation: Do not use. You are "naked" regarding liability. If you do use this form, have a good insurance broker and avoid debt.

§2.02 General Partnership.

A partnership is an association of two or more persons to carry on a business as co-owners for profit. This form of business organization is ordinarily created by formal agreement, but a partnership may be created by oral agreement or may be implied by the conduct and acts of the parties. Matters not covered by a written partnership agreement may be controlled by state laws, in California by the Uniform Partnership Act of 1994 (Corporations Code Sections 16100 – 16962), which provides certain limited rules for the operation of a partnership and its termination. The laws of the various states are detailed in their treatment and must be reviewed by anyone contemplating the formation of a partnership. The Uniform Partnership Act is the usual state law.

As a partner in a general partnership you are liable for all obligations and liabilities of the partnership, even those incurred by another partner. Because of this exposure you will probably wish to avoid this form of entity.

Advantages

1. Minimal formalities are required for organization, and hence organizational costs are limited.

2. Few formalities are required by law for decision making and action.

3. Minimal reporting to governmental entities is required.

4. If the partnership agreement so provides, a partnership may continue in existence after the death or withdrawal of a partner.

5. Business profits are taxed to the partners and losses are available on partners' personal income tax returns and can offset other income.

Disadvantages

1. Each partner has unlimited personal liability for all debts and liabilities of the business.

2. The general power of every partner to act on behalf of the business requires caution in the selection of partners.

3. A partnership is dissolved upon the death of any one partner, if not otherwise provided by agreement.

4. Partnership profits are taxed as income to the individual partners, which is disadvantageous in that individual rates are frequently higher than corporate rates (if the partners have low incomes, the reverse may be true).

5. As more than one person is involved, lawyers' fees can be substantial due to the need to customize and protect the participants as much as possible.

Recommendation: Same as sole proprietorship, only worse as you must contend with the acts of your partners – avoid.

§2.03 Limited Partnership.

A limited partnership is a partnership formed under the acts of the various states. In California it is the California Revised Limited Partnership Act of 2008 (California corporations Code Section 15900-15912.07). A limited partnership must have at least two partners, and must have at least one general partner and one limited partner. The general partner is liable for the partnership obligations beyond the funds invested. Consequently, most general partners are corporations or limited liability companies. A limited partnership may be formed only by filing a Certificate of Limited Partnership, Form LP-1, with the Secretary of State, with a filing fee. A limited partnership may record a certified copy of the Certificate of Limited Partnership in any county recorder's office. Recordation creates certain conclusive presumptions in favor of bona fide purchasers. Foreign limited partnerships in California are also governed by the Uniform Limited Partnership Act.

The feature which distinguishes a limited partnership from a general partnership is that the limited partners' liability is restricted to their contribution of capital. You, as a limited partner are not responsible for the debts and liabilities of the partnership, beyond your investment, unless you take part in the control of the business. Management of a limited partnership is vested exclusively in the general partner or partners. The general partner is liable for the obligations of the partnership. Consequently, most general partners are corporations or limited liability companies. Limited partnerships, which were very popular in the '80s for syndication purposes (real estate and oil and gas), are being eclipsed by the Limited Liability Company form of organization.

Advantages

1. If you are a general partner, or control a corporation that is, one advantage is that financing, or other support, is available from limited partners, without the need for the general partners to surrender control. There can be great flexibility in the share of available cash flow to be paid to the limited partners; e.g., 75% until they get their money back, then 50% until they get double their money, then 25% thereafter.

2. For limited partners, a limited partnership affords an opportunity to invest and participate in the profits of a partnership without risk of liability or loss beyond the amount invested.

3. The business continues in existence without interruption upon the death of a limited partner or upon transfer of a limited partner's interest.

4. Relatively free transferability is available for limited partnership interests.

5. The tax advantages are the same as those for a general partnership (no double taxation), including the ability to take partnership losses on partners' personal income tax returns and to report partnership income on individual partners' returns. Allocation of profits and losses is also possible.

<u>Disadvantages</u>

1. Organization requires greater formality, which increases organizational costs. The preparation of a Limited Partnership Agreement usually demands a great deal of "customizing" and is therefore quite costly. Legal fees can vary from $2,500 up to $15,000.

2. Operating in states other than the state of organization will require qualifying to do business in the other state.

3. There are greater reporting requirements to governmental entities.

4. Limited partners are required to make a financial or property investment without the right to participate in the operation of the partnership.

5. At least one general partner is required to assume responsibility of unlimited exposure for debts and liabilities of the business. This usually involves the formation of a corporation to act as the General Partner. This, of course, has attendant costs and reporting requirements.

6. Sale or transfer of interests may be subject to securities law regulation.

7. The limited partnership is dissolved upon the death or insanity of a general partner - subject to the terms of the Agreement.

8. The same tax advantages or disadvantages, depending on the owners' position, apply as for general partnerships, including income being taxed to the individual partners.

<u>Recommendation</u>: O.K., but the general partner must be a corporation or limited liability company if one is to avoid liability. There is a heavy preference for the LLC form rather than a LP. In fact, because of this preference, Limited Partnership are now rare.

§2.04 Limited Liability Company.

In 1994, California joined 43 other states in enacting a limited liability company Act (California Corporations Code Sections 17000-17656). The result is a flexible new business entity combining the advantage of corporate limited liability with the one-level taxation of a partnership. It does not suffer the limitations placed on an S Corporation or a Closed Corporation. In addition, there is no need for a corporate entity to shield the general partner as in a Limited Partnership. All members of the LLC are shielded from liability beyond their investment. Because of the perceived advantages of (1) pass-through tax treatment; (2) the operational flexibility of a partnership; and (3) limited liability, the limited liability company ("LLC") has taken its place as one of the most used forms for doing business.

It is interesting to note that the historical roots of the LLC lie in Germany (1892), England and the civil law countries of Europe and Latin America. In all these areas it is an established and popular form of business association.

In a 1997 most innovative watershed ruling, the Internal Revenue Service changed the rules regarding taxation of LLC's. The IRS provided that one may simply "check the box" as to whether to be taxed as a partnership or a corporation. This move cleared the air as to the prior rule concerning having the legal attributes of one or the other form. California has accommodated the change by simply allowing one to "check-the-box" as to whether you wished to be taxed as a corporation or a partnership. (Sec. 23038 Rev. & Tax Code). In the event the corporate form is chosen, corporate tax rules apply.

<u>Advantages</u>

1. Allows great flexibility in the relationship amongst the member-owners as to the distribution of profits, voting and management through the terms of the Operating Agreement. The members may be active in the management of the entity without being subjected to liability as in a Limited Partnership. An LLC is particularly handy when the founders wish to end up with a sizeable amount of equity by providing the investors with a large share (say 75%) of the "available" cash flow until they get their investment back, then a lesser percentage (say 50%) until they receive double their funds and then an even smaller amount, (say 25%) on a permanent basis. Thus, you, as a founder, can end up with 75% of the cash flow while the investors are happy because they have received double their investment back and "ride" at 25%. This is a wonderful vehicle for a "Cash Cow" business.

2. Allows for pass-through tax treatment; i.e., the entity is not taxed, other than the annual minimum California franchise tax (plus a graduation fee from a minimum $800 or $900 for a business doing $250,000 to $500,000 up to a maximum of $11,790 per year for a business doing $5 million or more in income), with the members being taxed as a partnership.

3. Provides limited liability, with exposure for debts and obligations limited to the original capital investment of the members. There is no need for a Managing

Member to be a corporation as in the Limited Partnership form where the General Partner is liable.

4. As compared to the "S" corporation, allows any number of individuals, corporations, trusts, and any other form of organization to be members. It appears that even nonresident alien individuals may be members.

5. Cannot have "piercing" of liability protection due to lack of formalities if the Operating Agreement does not require them.

6. An LLC can also own more than 80 percent of the stock of a corporation.

7. Can be changed to a corporate form without tax consequences. The reverse is not true.

8. Can be formed by one or more members.

<u>Disadvantages</u>

1. Limited participation by members in fringe benefits.

2. On the sale of a member's interest, the capital gain is subject to IRC §751 ordinary income categorization.

3. California imposes a minimum annual franchise tax ($800) on LLC's plus a graduated fee based on total income (with a maximum of $11,790 for gross income of $5 million or more).

4. Professional groups governed by the Business and Professional Code are not permitted to use the LLC form in California; however, attorneys and accountants have the use of a limited liability partnership form.

5. Cost of formation is higher than for a corporation as the Operating Agreement can be highly customized. The initial filing fee with the Secretary of State (California) is only $70. However, the minimum tax soon follows. Figure $5,000 to $25,000 for legal fees.

<u>Recommendation</u>: Excellent form for "Cash Cow" type of business without IPO plans. Best suited for small group, licensing company; etc. **Very flexible.** However, if you wish to have an initial public offering and become a listed company, you should start with a "C" corporation and not complicate the business growth by starting with an LLC, despite its apparent appeal. **<u>More importantly, the early use of the LLC when there are losses "robs" the entity of the use of these losses as a shelter for earnings when the entity becomes profitable.</u>** The LLC owners used the losses and may regret having done so as the shelter of the NOL later can be very important to provide working capital for an expanding company. Again, if early losses and later profits and a vision of an expanding business, start with a "C" corporation.

§2.05 Corporation.

1. A corporation is an artificial, intangible being which is created under state or federal law. A corporation may be owned by one or more persons. It is a separate entity that can acquire, hold, and convey property, be sued and generally act in its own name. It derives its rights from statute and its articles of incorporation. A detailed statutory framework is provided for the creation, operation and termination of corporations. In California, matters dealing with the formation, capitalization and operation of corporations are found in the Corporations Code (Sections 1 – 14631) and the Corporate Securities Law of 1968 (Corporations Code §§ 25000-25707). All states have laws governing the creation and operation of corporations.

If adequately capitalized, and if corporate procedures are followed, the corporation alone is responsible for its debts and liabilities. The owners are not personally liable for these obligations. If you want to "go public" some day and have a vision (plus a "Business Plan") of a large, listed company, the best form is the corporate form – a "C" corporation, not a sub S corporation.

<u>Advantages.</u>

1. If corporate procedures are followed and the initial capital is adequate, shareholders are not liable for debts and liabilities of the corporation.

2. Free and ready transferability of ownership by sale and transfer of stock, without affecting the continuing existence of the business or title to its assets.

3. Perpetual existence of the corporation unaffected by the death of shareholders or transfer of shares.

4. The use of a business format which, if used correctly, provides for structured accountability and governance. The corporation provides an institutional "being" separate and apart from the owners. This accountability of management to the Board of Directors can be the single most telling attribute of the corporate form of doing business. Its efficacy is usually grossly underrated.

5. Flexibility of financing through the sale of various types of securities to many investors. Normally the founders get common stock and the investors get preferred stock (the "Series A" sale). This is to minimize the possible tax problems of the founders being held by the IRS to have received stock either for services, or at "bargain rates" with the receipt or difference being taxable at ordinary income rates.

6. The availability of tax-favored fringe benefits unavailable to other forms of business entities.

7. For simple corporations, relatively inexpensive formation costs. Figure filing fees and corporate books, seal, certificates in California at under $250. Legal fees

should be small as the time involved to form the corporation is minimal. There is a minimum annual tax of $800.

8. A long established body of law which serves to provide a degree of predictability as to corporate actions.

Disadvantages

1. If you are going to be a minority shareholder, you will have very little power to control any aspect of the corporation's operation or policy.

2. Burdensome requirements for reporting to governmental entities.

3. Statutory formalities must be adhered to for decision making and action.

4. Control is vested in a board of directors, not the individual owners (however, the majority owners control the Board of Directors).

5. Stock issuance and transfers are subject to securities law regulation.

6. Limited liability of the corporation causes the assets to be the only source for credit, consequently, often you may be called upon to guaranty corporate indebtedness, which somewhat defeats the value of limited liability.

7. Must qualify to do business in states other than the state of incorporation.

8. Double taxation for federal income tax purposes (business income is taxable initially to the corporation and again upon distribution to the shareholders), unless the corporation qualifies and elects to be taxed as a "S" Corporation.

9. Losses of corporations may not be deducted by individual shareholders, unless the corporation qualifies and elects to be taxed as an S corporation.

10. The distribution of property by a corporation to its shareholders is generally a taxable event for income tax purposes as to both the corporation and the shareholders. Thus, withdrawing property from a corporation can be extremely expensive from a tax standpoint. However, note the present rate of 15% on dividends.

11. In determining who gets what share of the equity, there is little flexibility to have the amount of equity afforded to the founders to be greater than their actual cash contribution. This tends to make it difficult to handle the outside cash contributors unless they loan part of the funds rather than take a full equity position. It is of the utmost importance for the founders to purchase their holdings (which should be Common Stock) at the earliest date possible if the price they pay is considerably less than that to be paid by outside investors (who should purchase Preferred Stock). Otherwise the founders will run the risk of being held by the IRS as having received for services the difference between what they paid and what the investors paid. This "income" would be taxed at ordinary

income rates. As stated above, another technique used to lessen the tax risk is to issue Preferred Stock to the investors and Common Stock to the founders.

<u>Recommendation</u>: Only way to go if an IPO is your aim. Best suited for a public vehicle.

SPECIAL NOTE: If your company is located, owned and operated in California, there is little advantage and some disadvantage to incorporating in Nevada, Utah or even Delaware in order to avoid the California taxes. By incorporating out of state, you do not avoid having to qualify in California and you will simply have to report to two states and, usually, pay taxes in two states. From management's point of view, Delaware has certain advantages relative to providing less minority shareholder rights and the use of Chancery Courts; however, unless you see these as critical, the better program is to incorporate in California or the state in which the corporation's headquarters are located and in which the majority of its shareholders reside. Delaware is favored by those in the Midwest and East and by the investment community, including most venture capitalists (even those in Silicon Valley, California). Please note that it is easy to re-incorporate in Delaware at a later date, if desired. In addition, by using Nevada or Utah, you create a certain negative image in the minds of many in the investment community. They think you are not playing by the rules.

§2.06 Subchapter S Corporation.

A Subchapter S Corporation is a "regular" corporation which has elected to be taxed as a partnership and has adhered to certain requirements in order to obtain that treatment.

Generally, an S corporation may not have more than 75 shareholders, all of whom must be individuals, estates or certain defined trusts. A corporation can not be a shareholder.

An S corporation may not have more than one class of stock, although certain differences in voting rights are permitted. Distributions must be in concert with ownership interests.

The election to be an S corporation must be filed, with the unanimous consent of all shareholders, on or before the fifteenth day of the third month of its taxable year in order for the election to be effective beginning with the year when made.

There are rather strict rules that, if violated, cause the S status to be lost. Thus, the principal advantage of the S corporation is avoidance of double taxation. If there are losses, this can be an advantage for the shareholders for the near term, but a disadvantage for the corporation in that the "loss shelter" is not available to the corporation once it becomes profitable.

With the advent of the Limited Liability Company, S Corporations are rarely used.
<u>Recommendation</u>: Forget it. Too inflexible. Use LLC instead.

§2.07 Close Corporation.

California offers the choice of forming a Statutory Close Corporation. Although this form of doing business affords a degree of flexibility not available in a non-close corporation situation, there are many pitfalls and the close corporation format is rarely used. Particularly now that California has the Limited Liability Company law, the close corporation will be used even less frequently.

The following is intended to be a brief outline of the salient features of the close corporation.

In addition to the normal requirements for incorporation, the following are essential to attain close corporation status:

a. An unanimous, written Shareholders Agreement. This covers what matters the shareholders will control and "any phase of the affairs of a close corporation."

b. There may be no more than 35 shareholders of record of all classes of shares outstanding.

c. The Articles of Incorporation must contain: (a) a provision that all of the corporation's issued shares of all classes shall be held of record by not more than a specified number of persons, not exceeding 35; and (b) a statement "This corporation is a close corporation."

d. The share certificates issued by the corporation must contain a conspicuous legend as follows: "This corporation is a close corporation. The number of holders of record of its shares of all classes cannot exceed _____ (not more than 35). Any attempted voluntary inter vivos transfer which would violate this requirement is void. Refer to the articles, bylaws and any agreements on file with the secretary of the corporation for further restrictions."

Recommendation: Forget it: less flexible than Subchapter S. Use LLC instead.

§2.08 Flexible Purpose Corporation

Preface: Nonprofit corporations are not suitable for those who wish to "do good" while still making money. The IRC and regulations make it difficult to maintain one's non-profit status. Also, getting an IRC Sec. 501(c)(3) tax-exempt status can be a costly and long process. On the other hand, it is difficult to run a for-profit corporation or limited liability company while depleting the shareholders stake by pursuing environmental or social benefit ends. Lawsuits by shareholders are a definite threat. So, the organizers of an enterprise now have two new options, the Flexible Purpose Corporation ("FPC") or the Benefit Corporation ("BC"). The FPC is a for-profit corporation that may pursue environmental or other public purpose objectives. FPC's are governed by Calif. Corp Code Sections 2500-3503. In 2011 the California legislature enacted the Corporate Flexibility Act establishing the FPC and, in a somewhat confusing manner, added to the General Corporation Law, Sections 14600-14631which established the BC which is dealt with herein in Section 2.09 below. The BC is required to have the purpose of creating a "general public benefit" that has a "material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard". There are strict reporting requirement and the need to obtain a "third-party standard".

In short, the FPC appears to be more usable for smaller companies than is the BC – see the following Advantages and Disadvantages for both.

Flexible Purpose Corporation

As noted above, the FPC may pursue environmental or other public purpose objectives. It may engage in any business, subject to its activities being consistent with its special purpose. The articles of incorporation must state one of two statements as set-forth in Section 2602(b)(1)(A) and (B)of the Corporations Code. "A" simply requires a general statement to engage in any lawful activity other than banking, trust company business <u>or the practice of a profession permitted to be incorporated by the California Corporations Code.</u>

In "B" one has to state the specific profession that is permitted to be incorporated by the Corporations Code that one is going to pursue, along with "any other lawful activities other than banking, or trust company business".

In both instances, the underlying purpose must be <u>"for the benefit of the long-term and the short-term interests of the flexible purpose corporation and its shareholders"</u>

In addition, the articles must state the what purpose the corporations is formed for in the area of its employees, suppliers, customers and creditors and/or the community and society and/or the environment.

<u>Advantages</u>

1. An advantage of some note is that it is easier to form a FPC than to obtain a Section 501 C (3) status using the complex 1023 IRS form, especially if the founders wish to have the bulk of their activity be for profit and for environmental and/or social good as a secondary objective.

2. A second advantage is that the directors are protected from lawsuits by shareholders claiming they have expended funds in "non-corporate purposes" such as for environmental or social programs, so long as the expenditures conform to the special purposes of the corporation.

3. Four types of reports are mentioned in the Corporations Code for FPC's: An Annual Report, Special Purpose Current Reports, Financial Statements and a Management Discussion and Analyst ("MD&A").If there are over 100 shareholders, these reports can be so burdensome that one must think twice about using the FPC. (See the "Disadvantages" below). So what is the advantage here? It is murky, but, if there are under100 shareholders, Generally Accepted Accounting Principles ("GAAP") can be avoided and, with annual waivers of two-thirds of the shareholders, these reports can be avoided. Thus, if there is a small group with dedicated purposes, this can be a very useful vehicle for using to "do good" while earning a profit without fear of a shareholders' suit.

<u>Disadvantages</u>

1.The business conducted by the founders must be consistent with the "special purpose" as stated in the Articles of Incorporation. This could cause problems if a change of business is required.

2. If there are more than 100 shareholders, four reports are required: an Annual Report, financials using GAAP ,a MD & A , and Special Purpose Current Reports. Also, the Special Purpose MD&A and the Special Purpose Current Report must be posted on the internet. This is a heavy burden.

3. The directors have a duty to provide in good faith for the benefit of the corporation and the shareholders. This places some constraint on the environmental and social benefit aspects of the possible goals of the founders.

Recommendation: The FPC could be a good vehicle for combining profit making with a "do good" undertaking, IF there are under 100 shareholders and they are willing to waive some of the more demanding reports called for by the law. Otherwise, the reporting requirements must be taken into account when deciding whether to use this route.

§2.09 Benefit Corporation

A Benefit Corporation is a for-profit corporation organized under the General Corporation Law of California that elects to become subject to California Corporations Code Sections 14600-14631.A BC must have the purpose of creating a "general public benefit" that has "a material positive impact on society and the environment, taken as a whole, as assessed against a third- party standard".

This vehicle was created for entrepreneurs and investors who want to build businesses with an eye towards the triple bottom line of people, planet, and profit.

Advantages

1.The concept of the directors acting in the primary role of benefiting the shareholders is not the case in a BC; the shareholders fall within considerations along with those of employees, customers, community and societal considerations, the local and global environment and the general ability to accomplish its general and specific public benefit purpose. This gives the directors license to emphasize the public benefit goals of the corporation over their duty to the shareholders without concerns for liability in a shareholder lawsuit accusing them of misspending corporate funds.

2. Somewhat along the same lines, the directors are not liable for monetary damages if the corporation fails to create a special or general public benefit.

Disadvantages

1.Meeting the requirement of "general public benefit with a material positive impact on society and the environment, taken as a whole, as assessed against a third party standard" may be very difficult as the "third party" must be independent and possess the skills to judge if the standards are being met. The "third party' must also be free of any business interests.

There are already companies that offer this service. As there is also a 30 day period for public input regarding the development of the standard, this creates a daunting challenge.

2. The Annual Benefit Report is **very extensive** (Corp Code Section14630), must be posted on the Internet and cannot be waived as in a FPC. In brief, the Report must cover a **Public Purpose Narrative,** a **Performance Assessment, An Assessment of Meeting the Third-party Standard and the Nature of the Entity Promulgating the Standard.**

The Annual Benefit Report is a daunting challenge that militates against using the BC for most parties.

Recommendation: For a small group (under 100) the FPC could be a handy vehicle for those wishing to "do good" while making money. They would have the option of waiving the reporting requirements if they can garner a two/thirds vote.

The BC appears to be usable only by those with adequate resources to meet the reporting requirements. Presumable this would be involve a major charitable effort that wishes to also have a money-making aspect to further its mission.

III. CONSIDERATIONS RELATING TO FORM SELECTION

§3.01 In General.

Various factors bear on the selection of a form of business organization. Some of these considerations, the advantages and disadvantages of the alternative forms of business organization, and the specific attributes of these various forms are reviewed later in this Handbook.

Generally, choosing the form of business organization is a matter of weighing the various considerations and evaluating their relative importance.

In some cases, the form of organization for a business will be heavily influenced, or even dictated, by a single factor. For example, if you are entering into a relatively risky business, you may be willing to consider only a form of business organization such as a corporation, limited partnership or limited liability company which offers limited liability. In many states, banks and insurance companies must be organized as corporations, so this would be the only choice for this type of business. In most cases, however, the selection of the form of entity will depend upon your consideration of a number of factors.

The selection of a form of business entity is not necessarily an all or nothing proposition.

It is possible to utilize more than one form of organization for a business. For example, a corporation might be organized to operate a business, and some of the assets used in the business might be owned by a partnership which leases them to the corporation.

Your desire to "do good" on environmental or social issues is also of material concern.

Of paramount importance is to ascertain what you wish your position to be in, say, five years in the future. How much available cash flow do you expect to have? How will it be distributed? What is your "exit strategy"? How much financing do you need and when? The answer to these financing questions bears heavily on who will control the company. The answers to these and similar questions will determine what form of entity makes sense. And, of course, tax considerations are always of great importance.

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COMPARISON OF BUSINESS FORMS: TABLE

	(A) General Partnerships	**(B) Limited Partnerships**	**(C) Corporations**	**(D) Limited Liability Companies**
1. Ease of Formation	No writing legally required, but agreement should be in writing. No government approval needed. Fictitious business name statement, statement of partnership, and special licenses or permits may be needed by the particular business	Certificate of Limited Partnership signed by all general partners must be filed with the Secretary of State. Partners must enter into limited partnership agreement. See Column (A) "General Partnerships" for other possible requirements.	Articles of Incorporation must be filed with and approved by the Secretary of State. Statement of Domestic Corporation must be filed within 90 days. Licenses or permits may be required.	Articles of Organization must be filed with, and on form prescribed by the Secretary of State. Annual Statement of Information must be filed within 90 days.
2. Cost of Formation	Cost of drafting the agreement subject to much variation. Fictitious business name statement, if needed, must be filed and published; filing costs are approximately $25 to $75.	Drafting the agreement is more time consuming and costly than drafting simple articles and bylaws for a corporation. Secretary of State's filing fees are around $70. Same minimum franchise tax as corporations. ($800).	Filing fee $100; "Special Handling" is $15; minimum annual franchise tax is $800. Corporate kit $50 to $115. Annual Statement fee is $25. Legal drafting fees can be reduced if standardized forms are used.	Filing fee is $70. Filing fee for Biannual Statement is $20. Legal costs of writing the Operating Agreement are comparable to writing a Limited Partnership Agreement.
3. Raising Capital	Partners' capital contributions and loans to partnership from partners and outsiders are main sources. General partnership interests are not usually deemed securities.	Same as general partnerships, except that limited partnership interests are usually deemed securities.	Sale of shares (equity) in various forms (including common, preferred, and convertible debt) can be in various forms, including bonds, debentures, notes and other evidences of indebtedness.	The Corporations Code states that interests are presumptively securities. Great flexibility aids in raising capital. Excellent vehicle for a "cash cow" business.

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	(A) General Partnerships	**(B) Limited Partnerships**	**(C) Corporations**	**(D) Limited Liability Companies**
4. Control and Management	Control can be shared or centralized; great variety of control and management structures available by agreement. Absent an agreement, control is by a numerical majority of all partners.	Management and control are by the general partners. Limited partners must be excluded from control to retain limited liability (but they are less restricted under new Act than under old Act).	Structure can be highly centralized. Many control devices available to separate management from ownership, such as nonvoting stock, voting trusts, shareholder agreements, and super majority voting requirements for certain matters.	Structure can be highly centralized and does not need to be exercised by a member. Can have a Managing Member or Members, a management Committee or be Member Managed. Absent an agreement, control is by all its members. **Very flexible.**
5. Liability of Owners	Partners ordinarily share risks according to partnership agreement. Partners have joint or joint and several liability without limitation for partnership obligations to outsiders.	General partners have unlimited liability to outsiders; limited partners risk only the loss of their agreed capital contribution. General Partner is usually a corporation.	Risks are born by corporation, and shareholders risk only their investment, not their personal estates, unless courts "pierce the corporate veil." But lenders may require personal guaranties of principal shareholders of closely held corporations.	Liability is limited to the original capital investment of the members.

	(A) General Partnerships	**(B) Limited Partnerships**	**(C) Corporations**	**(D) Limited Liability Companies**
6. Continuity of Business	No perpetual existence. Partnerships may be dissolved by specified events or (unless otherwise agreed in advance) by the death or withdrawal of a partner. Inadvertent dissolution should be guarded against in the partnership agreement.	No perpetual existence (see Column (A.) General Partnerships). Dissolution may result from loss of limited partners. Inadvertent dissolution should be guarded against in the limited partnership agreement.	Corporations have perpetual existence. However, the corporation may be dissolved, its powers may be suspended for failure to comply with corporate formalities, or the business may fail or be sold.	No perpetual existence. Link to one event (e.g., death of partner). Can be extended by agreement in advance.
7. Transfer of Interests	Difficult. Partner's right to receive distributions is assignable, but transferee cannot be substituted as a partner except by consent of the remaining partners.	Same as general partnership with respect to general partner's interest. Limited partner's interest is assignable but the assignee cannot be substituted as a limited partner without the other partners' consent, unless the partnership agreement provides otherwise.	Shares are more readily transferable than interests in partnership (if there is a market for them). However, restrictions on sale to outsiders may be imposed by the articles or bylaws or by a shareholders' agreement.	Membership and economic interests are assignable. Membership interests must be approved unanimously by the members unless the Operating Agreement or Articles provide otherwise.

	(A) General Partnerships	**(B) Limited Partnerships**	**(C) Corporations**	**(D) Limited Liability Companies**
8. Fringe Benefits	Some of the fringe benefits that corporations can offer employees (see Column (C)) are available to partnerships.	Same as General Partnerships.	Many tax-favored fringe benefits are available for corporate employees benefits, such as profit-sharing and pension plans, stock option plans, group insurance, and accident, health, and sick-pay plans (some of these benefits, or comparable alternatives, are also available for use by partnerships).	Limited as in partnerships.
9. Taxation, Generally	Partnerships do not pay income tax but merely file information returns. Partners are taxed on their share of the profits or losses, whether distributed or not; "double taxation" of corporation is avoided. Lower taxes generally, even without considering double taxation.	Same as general partnerships, except that limited partnerships doing business in California are subject to a franchise tax.	Double taxation (corporations are taxed on pre-dividend profits and shareholders are taxed on dividends) is a major disadvantage; where applicable, use of S corporation status may reduce the burden. California imposes a minimum annual franchise tax.	Federal "flow through" tax treatment, i.e., entity is not taxed and the members are taxed as a partnership. Under California tax law, the LLC is subject to a minimum franchise tax ($800) plus a graduated fee based on income.

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10. Other Advantages	Simpler structure, fewer statutory requirements. Doing business in other states may be easier for general partnerships than for corporations. For some businesses (e.g., law firms) partnership is the traditional form.	Limited partners' names need not be disclosed to public under California's new limited partnership act.	Shareholders' identity (unless they are directors or officers) is not disclosed on public records.	Cannot pierce liability protection due to lack of formalities if operating agreement does not require them. Very flexible – can have ownership and control distinct;e.g.90% owned, has only 10% control.

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11. Other Disadvantages	Lack of "prefabricated" structure and rules is a drawback.	If interstate business is contemplated, laws of other states regarding limited liability, foreign limited partnerships, etc., should be investigated.	Required to follow corporate formalities (annual shareholder meetings, minutes of board's actions, annual statement, reports to shareholders, etc.). Corporations doing business in another state may have to register as foreign corporation and pay taxes in that state.	Need for great care in creating Operating Agreement in order to spell-out the agreement as to the management, voting control, and profit distribution. Can be very flexible which demands precision in drafting the Operating Agreement.

Please see sections 2.08 and 2.09 above for a discussion of the use of the Flexible Purpose Corporation and the Benefit Corporation, including their respective Advantages and Disadvantages.