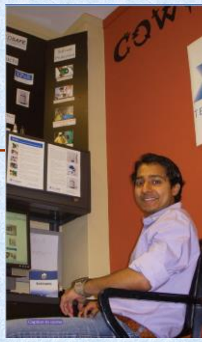

Chapter 7

Preparing a Proper Ethical and Legal Foundation

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Chapter Objectives
1 of 3

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 founders’ agreement.

Chapter Objectives
2 of 3

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.

Chapter Objectives
3 of 3

10. Explain why most fast-growth entrepreneurial ventures organize as corporations or limited liability companies rather than sole proprietorships or partnerships.

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
1 of 2

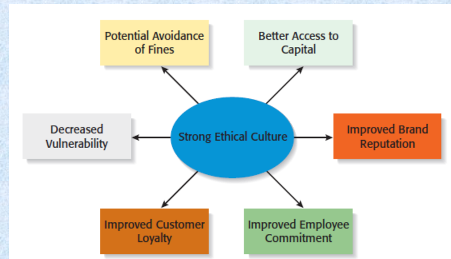
- Lead by Example
  - The most important thing that any entrepreneur, or team of entrepreneurs, can do to build a strong ethical culture in their organization is to lead by example.
- Establish a Code of Conduct
  - A code of conduct (or code of ethics) is a formal statement of an organization’s values on certain ethical and social issues.

Establishing a Strong Ethical Culture

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.

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 when developing a business venture.
  - It is critically important that the attorney be familiar with start-up 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.

Drafting a Founders' Agreement

- 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.

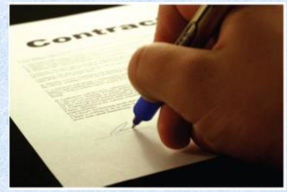
Items to Include in a Founders' Agreement

- Nature of the prospective business.
- Identity and proposed titles of the founders.
- Legal form of business ownership.
- Apportionment of stock (or division of ownership).
- 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
1 of 2

- 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.

Avoiding Legal Disputes
2 of 2



- Although it's 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
1 of 2

- Business Licenses
  - In most communities, a business needs a license to operate.
  - 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 federal business license, including investment advising, drug manufacturing, and interstate trucking.

Obtaining Business Licenses and Permits
2 of 2

- 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
Corporation	Limited Liability Company

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
1 of 2

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.
- It is not subject to double taxation (explained later).
- The business is easy to dissolve.

Advantages and Disadvantages of a Sole Proprietorship
2 of 2

Disadvantages of a Sole Proprietorship
- Liability on the owner's 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
1 of 3

- 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 3

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
3 of 3

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
1 of 2

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.
- It is not subject to double taxation (explained later).

Advantages and Disadvantages of a General Partnership
2 of 2

Disadvantages of a Partnership

- 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.

Corporations

- Corporations
  - 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.

C Corporation
1 of 2

C Corporation

- Is a 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.

C Corporation
2 of 2

C Corporation

- A 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.

Advantages and Disadvantages of a C Corporation
1 of 2

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.

Advantages and Disadvantages of a C Corporation
2 of 2

Disadvantages of a C Corporation
- Setting up and maintaining one is more difficult than for a sole proprietorship or a partnership.
- Business losses cannot be deducted against the shareholder's 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.

Subchapter S Corporation
1 of 2

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.

Subchapter S Corporation
2 of 2

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

- 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.
- 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. Husbands and wives count as one member, even if they own separate shares of stock.
- All shareholders must agree to have the corporation formed as a subchapter S corporation.

Limited Liability Company

Limited Liability Company

- Is a form of business ownership that is rapidly gaining popularity in the U.S.
- Along with the Subchapter S, 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.
- A limited liability company does not pay taxes. Profits and losses are passed through to the tax returns of the owners.

Advantages and Disadvantages of a Limited Liability Company
1 of 2

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.

Advantages and Disadvantages of a Limited Liability Company
2 of 2

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.