

Tuesday, September 19, 2006

**Business Law Network
Business Formation Focus Group
“Overview: Choice of Entity”**

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1st, Why Incorporate

When to Incorporate: Founders of companies often make the mistake of waiting for venture capital before they decide to incorporate. Particularly in this economy, not only is forming a corporate entity early significantly more attractive to venture capitalists, (by providing a track record for assessment of value) it may also avoid a taxable event for the founders of the corporations when the business takes in the capital. Reasons to form a corporation early are as follows:

- Limitation of Liability: One of the primary reasons to form a corporation is to limit the liability of the founders. One should not lose their home because their business fails. Investing funds to incorporate at the onset protects your personal assets – So long as you adhere to the corporate governance requirements of your specific corporation, which will vary by type and jurisdiction;
- Taxable Event; VC Capital: An advisable course of action is to issue founders' stock (or equity interest) as early as possible allowing the company to develop and meet milestones. These factors can be used in assessing the disparity in founder's equity price (usually .01 a share) and that of the investors (hopefully much higher). If there are no factors, which can be attributed to the valuation increase in the company, then the founders may find that the IRS will deem that the founders have issued themselves stock "significantly below" market value and tax them appropriately;
- Bank Accounts & Credit Cards: Establishing a bank account and corporate credit card as early as possible will help build a history of liquidity and a credit rating for the legal entity. This may become key factors down the road for emerging companies as they seek initial funds, particularly for small business loans. Additionally, it will aid in separating the activities of the individual incorporators and that of the entity.
- Contracting: Most any company needs to enter into contracts be it a lease, a nondisclosure agreement, sales contract. It is almost always better to have the entity enter into the contract and not the individual founders, for a variety of reasons. As a general rule, contracts entered into by a founder in their role as a "promoter" of the business prior to incorporation of the entity **NEEDS** to be assignable to the corporation once formed. Thereby, you should specifically have an assignment clause in every agreement allowing assignment, ideally without permission.

2nd Types of Legal Entities

What Kind & Where to Form a Corporation. There are a number of business entity types sole proprietorships ("d/b/a"), general partnerships, limited partnerships, limited liability partnerships, business trusts, non-profit organizations, limited liability corporations, S corporations and C corporations. Additionally, there are a number of places that one can incorporate the Commonwealth of Massachusetts, State of Delaware, Bahamas, and Ireland. For this discussion we will look, **briefly**, these types of entities and then the pros and cons of the specific entities that are Limited Liability Corporations, S Corporations and C corporations.

- Sole Proprietorships ("d/b/a"): The least formal business entity. The sole proprietor can engage employees to carry out the activities of the business but remains personally liable for all losses and retains all profits;
- General Partnerships: Another informal entity choice, two (2) or more persons (of legal competence, *e.g.* of age and mentally sound) who carry on as co-owners of a business. This is a default entity in many instances and can be formed orally or through actions. Taxes are passed through to the

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individual. Each partner has joint and severable liable for the other partner(s)' actions. Also, all partners may remain personally liable;

- Limited Partnerships: A more formal version of the General Partnership, which then affords protection in that the partner's liability is limited to such partner(s)' sum of his/her capital contributions to the partnership plus certain distributions. Must adhere to governance formalities and the limited partnership and must *not* participate control or management of the partnership's business to preserve limited liability.

- Limited Liability Partnership: The same as the Limited Partnership but has registered as a limited liability partnership. Must put customers and other contracting parties on notice of the "limited liabilities status" with LLP or a derivation in the name. If all corporate governances are adhered to then the partners are not personally liable except for their own negligence, gross negligence, acts of willful misconduct and errors and omissions.

- Business Trusts: An unincorporated business association created by a trust investment in which property is held and managed by a trustee. This is a hybrids, sharing some of the characteristics of a corporation, a limited partnership and a trust. Has stock like a corporation and liability similar to a Limited Partnership. Must adhere to the doctrines of trust law. For tax purposes it elect to be taxed as a S Corp.

- Non-Profit Organizations: Corporate entities that may be afford tax-free status so long as they are incorporated for the specific purposes defined under the individual State's legislature as qualifying entities, e.g. Religious, Educational, to Provide Public Services, *etc.* This is an entire area of corporate law unto itself beyond the scope of this document.

- Limited Liability Corporations: There are two types of LLC, member-managed and manager-managed. With exception of how the operating agreement will be drafted and day-to-day control they are pretty much equal. All LLC must have in their corporate name followed by LLC, Ltd, or spell out "Limited Liability Corporation". Unless an LLC affirmatively elects to be treated as a C corporation short after establishment, the LLC shall be treated as a partnership for tax reasons (or sole proprietorship d/b/a if the state allows for a single-member LLC). However, the founder will enjoy "limited liability" so long as they establish the corporation correctly, specify certain clause in the operating agreement and adhere to the corporate governances of an LLC. LLC allow for foreign investors and investment for differently entity types. A negative aspect of an LLC is that there is no stock to issue (it has membership interest) to motivate employees, through a stock option plan. And, prior to taking in investor capital the founders will most likely be required to reorganize as a C corporation. LLC make sense when you want to avoid double taxations, issue multiple classes of membership, act as a partnership, keep the protection and operating structure of a corporation, take advantage of the partnership or disregarded entity tax status and have lighter corporate governance requirmets. If you starting an LLC make sure of the following:

- (i). In the Operating Agreement you want an [Indemnification of Directors Clause](#);
- (ii). In the Operating Agreement you want a [Limitation of Liability Clause](#);
- (iii). Make sure you have an separate operating account that is funded;
- (iv). Make sure you obtain [Director's Liability Insurance](#) and [Professional Liability Insurance](#);
- and
- (v). Strictly adhere to the state/country corporate governance requirements, which includes going through the formalities of operating like a corporation, meeting minutes, foreign certificate filings, etc.

- S Corporation: Once again, has the flow-through taxation aspects which founder want in order to avoid double taxation (see the C Corporation below) and has stock therefore an S Corp can offer stock option plans to founder and employees. However, some of the negative aspects of the S Corporation are that they may only have a single class of stock and must have fewer than one hundred (100) stockholders

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all of whom must be U.S. resident individuals, estates or certain types of trusts, qualified retirement plan trusts, or charitable organizations. Once an S Corporation issues a second type of stock, usually preferred stock, it is automatically treated as a C Corporation for tax reasons. If you are starting a S Corporation make sure you do all the items listed above in the LLC sections and the following:

- (i). In your Articles of Organization consider carefully a “[Blanket Preferred Stock](#)” clause; and
 - (ii). Create and have founders sign a “[Stock Holder Agreement](#)” early on.
- C Corporation: Strongly favored by venture capitalists, since most VC funds are partnerships or business trusts and cannot participate in a S Corporation and they will want to purchase preferred stock. C Corporation may have varieties of classes of stock, common stock, preferred stock, which may also vary by rounds of investment Series A, Series B, *etc.* However, a C Corporation is treated as a stand alone entity and is taxed as such, referred to as “[Double Taxation](#)”. This basically means all funds that the corporate entity takes in are taxed at a corporate tax rate and all funds provided to founders and employees are once again taxed at their individual tax rate. If you are starting a C Corporation, there are a variety of issues that must be addressed with your chosen legal counsel.

Special Note: Why Delaware? Most venture capitalists desire a Delaware C Corporation and about eighty percent (80% +/-) plus or minus of all big business in the US are Delaware C Corporations. The reasons are as follows (i) Delaware has one of the nations most permissive and flexible corporate statutes; (ii) Delaware has a extensive history of common law pertaining to commercial matters; and (iii) Delaware allows for stockholder to act with the requirement of only a [minimum number](#) of shares providing written consent (Unlike Massachusetts and other states which requires [unanimous](#) written consent of all stock holders.)

3rd. Offering Equity Blue Sky Laws

Blue Sky Laws are the state security laws that govern the offering and sale of securities; this includes equity and debt of start-up entities. Most states permit offerings to a limited number of residents, but may impose information and filing requirements on the offeror. They are called “Blue Sky Laws” because it pertains to a speculative scheme, “which has no more basis than so many feet of blue sky”, State v. Cushing (137 Me. 112, 15 A.2d. 740).

4th. Piercing the Corporate Veil

An essential part and one of the primary reasons to incorporate is to protect the founder’s personal assets. The claim of action where a defendant seeks to find the founders personal liable for the actions of its principals is called “*piercing the corporate veil*”. For obvious reasons, this types of actions should be at the for front of the incorporators mind when establishing an entity.

Massachusetts courts are generally reluctant to pierce the corporate veil but they became somewhat more willing after the case of My Bread Baking Co. v. Cumberland Farms, Inc., (353 Mass. 620, 233 N.E.2d at 752). In, My Bread Baking Co. v. Cumberland Farms, Inc. a two prong test is set forth for courts to analyze piercing the corporate veil, if (1) an agent of one corporation use its power in another corporation to commit fraud or injury to another party; or (2) if parties merge two corporation so as to create serious ambiguity about the way each separate entity is acting. *Id.* This analysis was expanded in case Pepsi-Cola Metropolitan Bottling Co. v. Checkers, Inc., (754 F.2d 10, 16 (1st Cir. 1985) (applying MA law). Pepsi-Cola Metropolitan Bottling Co. v. Checkers, Inc. added several factors that will affect a court decision whether to pierce the corporate veil. And then there are federal decision this these same matter and state court may apply a federal test, see United Electrical, Radio and Machine Workers of America v. 163 Pleasant Street Corporation, (960 F.2d 1080 (1st Cir. 1992).

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In combining these cases the following list of concerns arise:

- When one of the two prongs of the “Bread Test” is met: My Bread Baking Co. v. Cumberland Farms, Inc., 353 Mass. at 620, 233 N.E.2d at 752.
 - “(a) when there is active and direct participation by the representatives of one corporation, apparently exercising some form of pervasive control, in the activities of another and there is some fraudulent or injurious consequence of the inter-corporate relationship; or”
 - “(b) when there is a confused intermingling of activity of two or more corporations engaged in a common enterprise with substantial disregard of the separate nature of the corporate entities, or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting.”
- Factors detailed in Pepsi-Cola Metropolitan Bottling Co. v. Checkers, Inc. included (a) the use of corporate funds for personal expenses of the officers, (b) lack of a corporate telephone listing, (c) operation of the corporation out of the home of the officers, and (d) no records of shareholder meetings or major corporate transactions.
- Factor’s detailed at the Federal level from United Electrical, Radio and Machine Workers of America v. 163 Pleasant Street Corporation which includes (a) insufficient capitalization for purposes of the corporate undertaking; (b) nonobservance of corporate formalities; (c) nonpayment of dividends; (d) insolvency of the corporation at the time of the litigated transaction; (e) siphoning of corporate funds by the dominant shareholders; (f) nonfunctioning of officers and directors other than the shareholders; (g) absence of corporate records; (h) use of the corporation for transactions of the dominant shareholders; and (i) use of the corporation in promoting fraud.

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5th, Sources & Disclaimer

Books & Publications

Massachusetts Business Lawyering (MCLE 2003)

Advanced LLC Topics “Advising Clients on Complex LLC Operations & Transactions” (MCLE 2002)

Advising Corporate Directors and Officers in Troubled Times (MCLE 2002)

S Corp vs. LLC: Which Structure is Right for Your Business? by Chrissie Mould

Links & Research Tools

WestLaw (www.westlaw.com)

Massachusetts Secretary of State (www.sec.state.ma.us)

Internal Revenue Services (www.irs.gov)

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6th, Business Entity Comparison Chart

[----- See Attached -----]

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