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## Legal Aspects of Organizing and Raising Capital for Innovation in the U.S.

*James H. Bodurtha\**

**F**or the past fourteen months, you have been working in your basement laboratory, developing a ferro-alloy applicable to your abiding extra-curricular interest, golf. Last week you perfected it and poured molded prototypes. You are ecstatic — your prototypes have all the properties you sought: a high tenacity (strength); when polished your clubs are indistinguishable from wood; affixed to a regulation graphite shaft, drives go twenty-five yards further; and the club heads meet the specifications of the U.S. Golf Association.

By profession and training, you are a metallurgical engineer. The only lawyer you know well is the neighbor who did your estate plan five or six years ago. You can raise some money by borrowing against your life insurance, but only about \$20,000. The only significant assets you have are your rainy day savings of \$5,600, your pension plan assets and the equity in your home. The neighbor who did your estate plan introduced you to me, his law school classmate, who “knows all about these things.” What should you do next?

First, you should ask me for a resume of my background and experience in start-up enterprises and for names and telephone numbers of local business references. We should have a written understanding of what it is going to cost you in legal fees to get started, including *when* you pay me and *whether* you pay me if the idea is never born as a business.

You should ask me, and the references I give you, for names of other lawyers who specialize in start-up enterprises and interview two or three before deciding to employ me. In addition, you should ask to meet the people who will actually be doing the work. Don't hire a law firm, hire a lawyer.

Before you talk to any professional (lawyer, accountant, banker, etc.) find out if there will be a charge for the first meeting. There shouldn't be. Be wary of “business brokers”; they can and do claim fees for doing next to nothing. Don't always select the lowest fee arrangement; often what you pay for is what you get. After all, you propose to price your golf clubs at a premium because they are going to be the best available.

After a couple of weeks, you come back to see me, we have reached a fee arrangement and you have prepared an outline of a business plan.

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You have estimated that a \$500,000 investment in machinery and equipment will permit you and three employees to make 10,000 sets of "woods" a year. The costs for labor, materials, advertising, sales and so forth will be about \$180 per set and the retail price should be around \$395 per set. You expect your gross profit to be \$215 per set or \$2.15 million in the first year. You tell me that you and a golfing pal can put in \$20,000 each in equity, so you need to raise \$460,000.

### I. BUSINESS STRUCTURE

Our first focus is business structure. Structure involves three major issues: personal liability; U.S. federal income tax; and control.

We decide you cannot be a sole proprietorship because you need to raise money and hire employees. We consider a partnership in which you are the general partner and your investors are limited partners.<sup>1</sup> The limited partnership maximizes your control of the business because you, as the general partner, make all decisions and your limited partners (i.e. passive investors) have no statutory rights to participate in the control or management of the business.<sup>2</sup> Tax consequences also are generally favorable. The partnership, while it will have to file tax returns, will not itself be required to pay taxes.<sup>3</sup> Instead the tax characteristics of the partnership are shared by the partners according to the terms of the partnership agreement.<sup>4</sup> For example, if the partnership has \$10 of taxable income and you have a 50% interest in items of income under the partnership agreement, then you have \$5 of taxable income. It should be emphasized that income to you or any other partner in a general or limited partnership is taxable regardless of whether it is distributed to the partners,<sup>5</sup> but the tax and control climate are favorable for a start-up. The partnership structure, as it affects you, has one serious drawback: as a general partner you are personally liable for the obligations of the business.<sup>6</sup> When I tell you this, you observe that you would have to personally guarantee any bank loan to the business entity anyway, so why be concerned? You are persuaded that this is a serious problem when I tell you that you could be personally liable for damages if a club head flies off a shaft and hits the President of General Motors in the head. We then

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<sup>1</sup> Limited partnerships are creatures of statute (as opposed to common law). *See, e.g.*, OHIO REV. CODE ANN. §§ 1782 (Baldwin 1982). Typically, filing of a certificate of limited partnership is required, usually in the office of the county recorder where the principal place of business of the partnership is located. *See, e.g.*, OHIO REV. CODE ANN. § 1782.08 (Baldwin 1982). *See also* Revised Uniform Limited Partnership Act (1976) 6 U.L.A. 210 (Supp. 1988) [hereinafter U.L.P.A.].

<sup>2</sup> The rights of the limited partner are governed by the partnership agreement; minimum rights generally include the right to inspect partnership records and to receive financial and tax information from the partnership. *See, e.g.*, OHIO REV. CODE ANN. § 1782.21 (Baldwin 1982). *See also* U.L.P.A. § 305.

<sup>3</sup> I.R.C. § 701 (1986).

<sup>4</sup> I.R.C. § 704(a) (1986).

<sup>5</sup> I.R.C. § 702 (1986).

<sup>6</sup> *See, e.g.*, U.L.P.A. § 403.

digress and discuss product liability insurance and what kind of deductible you should have. While beyond the scope of this discussion, remember that your lender, and perhaps your passive investors, will insist on comprehensive insurance (usually with a deductible that is lower than you think necessary). Lenders also typically seek assignment to the lender of the business' rights under its insurance policy.

We turn to a corporate business format as a means of limiting your personal liability. I tell you that stockholders have greater rights than limited partners,<sup>7</sup> but that you will have greater protection from personal liability; essentially, your liability is limited to the money you put in and personal guarantees.<sup>8</sup> While this may be a lot of money relative to your net worth, it is less than the vast unknown of product liability or personal liability for on the job injury to employees, etc.

I also briefly summarize the rights of stockholders as follows:<sup>9</sup>

- 1) To elect directors;
- 2) To receive notice of and attend stockholders meetings;
- 3) To vote on major corporate transactions (e.g. sale of the business or mergers); and
- 4) To receive annual financial statements of the business (e.g. balance sheets and profit and loss statements), at least under Ohio law.

We decide that you are prepared to deal with stockholders' rights as a trade-off for limited liability. At this time, I note that it is sometimes possible to use a limited partnership in which the general partner is a corporation wholly owned by you, thus achieving maximum control while retaining limited liability, but we reject this structure as too complex.

## II. TAX CONSIDERATIONS

Now we look at the tax situation. You have two choices: a corporation taxable under the general provisions of the Internal Revenue Code, treating the corporation as a separate taxable entity, i.e. a "C-corporation";<sup>10</sup> or an "S-corporation."<sup>11</sup> The C-corporation is fully taxable at the corporate level. The maximum rate is currently about 34%.<sup>12</sup>

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<sup>7</sup> Stockholders' rights include, for example, the right to elect directors, e.g. OHIO REV. CODE ANN. § 1701.39 (Baldwin 1982), and the right to vote on major corporate events such as mergers, e.g. OHIO REV. CODE ANN. § 1707.78(F) (Baldwin 1982).

<sup>8</sup> The specific concept of limited liability *per se* is not articulated in most state corporate statutes; rather this concept is a product of common law.

<sup>9</sup> See *supra* note 7. With respect to the rights of shareholders to receive financial statements, see OHIO REV. CODE ANN. § 1701.38 (Baldwin 1982). Not all states specify that shareholders of corporations must be furnished financial statements.

<sup>10</sup> I.R.C. § 301 (1986), sometimes referred to as Subchapter C, deals with the unique tax characteristics of C-corporations: distributions, dividends, liquidations, etc.

<sup>11</sup> Generally, I.R.C. § 1361 (1986). An election must be filed to be taxable as an "S-corporation." I.R.C. §§ 1362(a)-(b) (1986).

<sup>12</sup> I.R.C. § 11(b) (1986).

Thus, the C-corporation will pay \$.34 in tax for each \$1.00 of pre-tax income. If it pays a dividend, the dividend, which is not deductible by the corporation, will be taxed to the recipient stockholder as ordinary income.<sup>13</sup> Thus, the C-corporation, if it pays a dividend of \$.10 to you from its after tax income of \$.66, creates an additional tax at the stockholder level of approximately \$.03 (using an approximation of today's highest individual rate)<sup>14</sup> for a total of \$.37 in tax on \$1.00 of pre-tax income in a C-corporation.

If, on the other hand, we select an S-corporation, we have a business vehicle that is subject to tax in many respects in the same way as a partnership, i.e. no tax at the corporate level.<sup>15</sup> Instead, income to the corporation is treated as income to its stockholders.

Let's look at the same \$1.00 of pre-tax income in an S-corporation. It is taxed irrespective of whether it is distributed,<sup>16</sup> so it is obviously a good idea to distribute an amount at least equal to the stockholders' tax bill. Assuming, for convenience's sake, a top U.S. individual tax rate of 30%, you should distribute at least \$.30, but because there is no tax at the corporate level, \$.70 is untaxed and left over in the corporation. Remember that the C-corporation paid \$.34 in tax on each dollar of income, so the S-corporation is already ahead \$.04 on the dollar. If the S-corporation distributes an additional \$.10, it will retain \$.60, but the total tax bill remains \$.30 and each stockholder gets to keep the full \$.10.<sup>17</sup> Thus, the combined tax bill to achieve the same economic effect is \$.07 less per dollar of income in an S-corporation.

There's more good news for you, the entrepreneur, if you elect S-corporation status. As in a partnership, your share of corporate losses, up to the total amount of your personal invested risk (i.e. cash put in, plus guarantees of corporate obligations) is deductible from your income for U.S. federal tax purposes.<sup>18</sup> Chances are you will lose money in the first year because of start-up expenses (which include your reasonable salary). So, if you pay yourself \$30,000 in the first year, which normally would be taxable as wages, and your share of the company's losses is \$30,000, the loss offsets the wages and you have no income tax due on your salary, assuming you have at least \$30,000 "at risk" in the business. Incidentally, you should make sure your lending arrangements permit the S-corporation to distribute an amount at least sufficient to cover the tax liabilities of stockholders.

There are limitations on the number and nature of stockholders in an S-corporation. Stockholders must number thirty-five or fewer, all of

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<sup>13</sup> I.R.C. §§ 301(c), 316(a) (1986).

<sup>14</sup> I.R.C. § 1 (1986).

<sup>15</sup> I.R.C. §§ 1366(a)-(c) (1986).

<sup>16</sup> I.R.C. §§ 1366(a)(1), 702(a) (1986).

<sup>17</sup> See Appendix 1.

<sup>18</sup> I.R.C. § 1366(d) (1986).

whom must be individuals, as opposed to corporations.<sup>19</sup> Passive investors (e.g. your friend who works elsewhere, but puts money into your business) may run into limits on “passive loss deductions,”<sup>20</sup> but the S-corporation is today almost always the entity of choice for a start-up business.

### III. SECURITIES LAWS

The final major legal consideration is federal and state securities laws. This is not an item of structure. These securities laws are tough: You should be careful not even to *offer* an investment in your company until you have talked to competent counsel. Every investment for profit is a security.<sup>21</sup> Both its *offer* and *sale* must be registered under applicable law or be exempt from registration. Because registration will cost you \$250,000 to \$400,000, you opt for an exemption. There are two types of exemptions:

1. Exempt securities<sup>22</sup> (i.e. the nature of the security itself is exempt);  
and
2. Exempt transactions<sup>23</sup> (i.e. the nature of the offering is not public and therefore exempt).

You should focus on the transaction exemption because start up businesses rarely, if ever, issue exempt securities to investors. In fact, your bank loan involves the issuance of a security because the bank is buying a note to make a profit, but it is an exempt transaction.<sup>24</sup>

We then discuss the exemption for transactions by an issuer not involving a public offering under section 4(2) of the Securities Act of 1933. This transaction exemption generally is not available in a start-up enterprise. It should be relied upon when sophisticated institutional investors, such as banks, insurance companies, and venture capital funds, are the only passive investors. When individuals are involved, the section 4(2) exemption should be treated with great skepticism.<sup>25</sup> I note that relatives

<sup>19</sup> I.R.C. § 1361(b) (1986).

<sup>20</sup> I.R.C. § 469 (1986).

<sup>21</sup> Security is defined in Section (2)(1) of the Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1982) [hereinafter 1933 Act]. The landmark case defining a security is *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The Supreme Court articulated a four-part test for determining whether a security was present: (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profit and (4) deriving profits from the efforts of others.

<sup>22</sup> Section 3(a) of the 1933 Act, *supra* note 21, defines exempt securities. The question of what is and is not a security was revisited in detail in *International Brotherhood of Teamsters v. Daniels*, 439 U.S. 551 (1979) in which the Supreme Court held that a compulsory noncontributory defined benefit pension plan is not a security.

<sup>23</sup> Section 4 of the 1933 Act, *supra* note 21, defines exempt transactions.

<sup>24</sup> Section 4(2) of the 1933 Act, *supra* note 21, exempts transactions not involving a public offering; bank loans typically qualify.

<sup>25</sup> *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) remains the common law springboard for determining whether a transaction qualifies as a “private placement.”

are individuals entitled to protection under the securities laws; you should be wary of involving relatives in financing your new enterprise.

For the entrepreneur, we usually focus on a "safe harbor" exemption under federal law, Regulation D under the 1933 Act.<sup>26</sup> We decide you need to raise \$150,000 because the bank said they would loan you three times the equity you and your investors put in. We have revised your \$500,000 estimate to \$600,000 because start-ups typically are under-financed and because you made inadequate provision for working capital (e.g. forgot to include a salary for yourself during the start-up period).

I explain that your company, which we have decided to call King Kong Clubs, qualifies for an exemption under the "small offering" provisions of Regulation D because the total amount you seek to raise (\$150,000) is less than the \$1 million maximum that can be issued when claiming this exemption.<sup>27</sup> Using the small offering exemption means that you do not have to prepare an expensive private placement offering document, but you must prepare a disclosure document adequate to inform investors of the risk involved.<sup>28</sup> This document will include a description of the offering, your business plan, all of your essential corporate documents (corporate charter, by-laws, proposed stockholders agreement, biographical data about your board and other executive officers), and a description of your lending arrangements with your bank. In addition, you should have a completed questionnaire from each potential purchaser giving information about the investor's financial wherewithal and sophistication, and providing data for inclusion on Form D, the exemption claim required to be filed with the U.S. Securities and Exchange Commission.<sup>29</sup> A similar claim of exemption is filed in Ohio and a number of other states, but you should know that state requirements are frequently more stringent than the federal requirements.

Note that Regulation D provides for other exemptions from registration, depending on the nature of the offering.<sup>30</sup> The most important factor to remember, however, is that the entire exemption is available only if the offering is not public. "Public" can be achieved easily, so my best advice is to be very quiet about your business venture, talk to counsel early and be wary of describing your business at a seminar and asking those who are interested in investing to pick up a sales brochure. Don't call your friends and ask them if they want to invest; don't advertise in

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<sup>26</sup> 17 C.F.R. §§ 230.501-506 (1986).

<sup>27</sup> 17 C.F.R. § 230.504 (1986).

<sup>28</sup> Because an offering is exempt from registration under the 1933 Act, does not mean it is exempt from the anti-fraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 77b-78kk (1982) [hereinafter 1934 Act], which make unlawful the selling of a security without full disclosure. In particular, see Section 10(b) of the 1934 Act, § 78j and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1986).

<sup>29</sup> 17 C.F.R. § 230.503(a) (1986).

<sup>30</sup> See 17 C.F.R. §§ 230.505, 230.506 (1986).

newspapers or magazines; and don't let anyone else take any of these actions on your behalf.

Proceed with dispatch, but proceed with care. If you do not act with the utmost care, you may restrict your access to the capital markets for an extended period of time, or significantly increase your legal expense.

In conclusion, there are several points to keep in mind when planning your start-up enterprise. Remember that a well-prepared business plan is essential to raising capital (both bank loans and equity). Be realistic. Your business plan should be conservative, it is not a place to advertise. If you have signed an employment agreement with your current employer, check it first and show it to your lawyer early; you may have assigned your invention to your employer. Whenever possible, don't involve family as investors in the first round of financing; business flops have a way of destroying family relationships. If you have money, show it to your lender, but initially try to put in as little of your own money as possible. It's hard to get money out once it is in your business without paying taxes on its return or violating lender imposed financial covenants. Start small — for example, make 1,000 sets of clubs the first year instead of 10,000. If you have a good product, be prepared to have it ripped off. Trademark or patent protection is not always adequate because your application at the very least provides "design-around" information. Limit access to your technology. Develop an exit strategy early, both for failure and for success. Don't become "equal partners" with another stockholder, even a relative. If you each have a 50% vote, unanimity is required for major corporate events such as borrowing money, selling the business, or buying a plant. Choose a Board of Directors which includes an outsider or two who can be objective (i.e. not just you, your wife and fellow investor). If your strength is manufacturing, find a friend (preferably an entrepreneur) who is good at marketing to serve on your board. In other words, be honest with yourself and try to balance your weaknesses with strengths of others.



APPENDIX 1  
 KING KONG CLUBS, INC.  
Tax per \$1.00 of Pre-Tax Income\*

	<u>C-corporation</u>	<u>S-corporation</u>
Pre-Tax Income	\$1.00	\$1.00
Fed. Corp. Tax (at 34%)	(.34)	(-0-)
Stockholder Tax and distribution to make payment	(-0-)	(.30)
Dividend	(.10)	(.10)
Retained in corporation	<u>.56</u>	<u>\$ .60</u>
Tax on Dividend (at 30%)	(.03)	(-0-)
Retained by Stockholder	.07	.10
Total after-tax retention by Corporation and Stockholder	<u><u>\$.63</u></u>	<u><u>\$.70</u></u>

\* This example ignores state tax consequences which vary significantly from state to state. Generally, however, state tax consequences should not control a decision to become an S-corporation.