PINSKY LAW
*Business & Intellectual Property Law*

CONCEPT TRANSFORMING CONCEPTS INTO ASSETS

SUITE 900
45 SHEPPARD AVE. EAST
TORONTO, ONTARIO
CANADA, M2N 5W9
WWW.PINSKYLAW.CA

CORPORATE & BUSINESS SERVICES

# LEGAL ISSUES IN A START-UP. PART II - CHOICE OF BUSINESS ENTITY

The series of several articles intend to highlight critical legal and business issues for start-ups. Part I discussed intellectual property law and the methods available to entrepreneurs to protect their company's primary assets. Considering such factors as personal liability, tax implications, and ownership flexibility, Part II examines choice of entity alternatives for a start-up discusses the factors to consider in deciding where to organize the start-up company. Part III highlights employment law issues and related potential liability of officers and directors. Part IV examines the critically important process of raising capital for a start-up company. Part V addresses the securities regulation and the sale of equity interests in the business. In Part VI, this article reviews typical exit strategies for start-up companies including initial public offerings (IPOs), sales and mergers, and bankruptcies.

## I. CHOICE OF BUSINESS ENTITY

Along with protecting intellectual property, establishing a business entity in order to conduct the business is high priority. Business entities considered by entrepreneurs include: (1) sole proprietorships, (2) partnerships and limited partnerships, (3) corporations, and, additionally in the USA, (4) limited liability companies. Each of these entities has advantages as well as disadvantages.

### A. Factors

Generally, the following factors are significant in determining the type of business entity to utilize: (1) are the owners subject to personal liability; (2) what are the costs involved in establishing and operating the entity; (3) how is the entity taxed; (4) how flexible are control mechanisms; (5) what are the considerations determining transferability of ownership interests; and (6) what is the continuity of existence of the entity? The different business entities vary greatly with respect to these factors.

In selecting a form of business entity, a primary concern should be the personal liability of owners for the obligations of the business. Owners of some business forms have unlimited liability for all of the obligations of the business. In other types of entities, the owners have unlimited liability for some but not all of the entity's obligations. Finally, in certain business entities, owners enjoy limited liability, which means their liability is limited to the extent of their capital contribution (i.e., their investment in the entity and not their personal assets). It should be noted, however, that creditors often require that the owners of small businesses personally guarantee loans made to the businesses, thereby expanding an owner's liability. Moreover, an owner in any type of business does not have limited liability for his own tortious conduct; that owner is liable as an individual tortfeasor.

In evaluating the type of entity to select, transaction costs can be a significant factor to entrepreneurs. Business entities differ considerably in the costs required to create and operate them. Some forms of businesses, such as a sole proprietorship or a simple general partnership have no or low start-up costs and are very inexpensive to establish and run. In contrast, other business entities, such as corporations, entail greater costs.

Taxation plays a major role in selecting the form of business. Some business entities are not considered to be separate taxable entities, and taxation is on a “pass-through” basis. In these cases, the income of the business is presumed to have been distributed to the owners. The owners are taxed on this presumed amount of income, and it is the owners who must pay taxes on income of the business whether or not they actually receive the income. Losses receive comparable treatment and, subject to certain limitations, can be used to offset an owner's other income. In contrast, some business entities, most significantly corporations that have not elected to be taxed as a flow-through entity, are considered separate tax entities and are directly taxed. When such an entity distributes income to its owners, that income is taxed again to the owner. Thus, these funds are taxed twice: once to the entity and once to the owners. In the USA under recent Internal Revenue Service regulations, unincorporated business entities can elect whether or not to be taxed as a separate entity. However, all businesses that have publicly traded ownership interests, other than real estate investment trusts, must be taxed as a corporation.

Flexibility of control refers to the extent to which the owners can control the conduct of the business. In some entities, the owners can fully share in the control of the business. In other types of business associations, the owners are restricted as to their right to take part in control. The level and degree of control is an extremely important factor that entrepreneurs should not overlook when considering the type of business they want to create.

The extent to which ownership interests may be transferred is an important factor affecting the liquidity of the owners' interests. An ownership interest in a business includes the right to share in the profits of the business (the financial interest) and the right to participate in the management of the business (the management interest). In some types of business associations, the owners may freely transfer their financial interest but may not transfer their management interest without the consent of all of the other owners. In other types of business associations, the entire ownership interest is freely transferable. Also, certain types of business associations limit the number of owners a business can have.

Continuity of existence refers to duration of the business entity and whether it can survive changes in ownership. Some business associations have low continuity, which means that they dissolve upon death, bankruptcy, or the withdrawal of an owner. Other types have high continuity and are not affected by the death, bankruptcy, or withdrawal of owners. For example, corporations and limited liability companies can elect to have perpetual existence, subject to the statutory right of the owners to dissolve the business at any time.

In addition, for high-tech start-ups another significant factor applies: potential future financing. As discussed below, future financing effectively limits the choice for entrepreneurs to incorporation or organization as a limited liability company. The major factors driving the choice between these two are taxation, liability, and financing.

### B. Sole Proprietorships

The simplest form of business association is the sole proprietorship. A sole proprietorship is an unincorporated business consisting of one person who owns and completely controls the business and is personally liable for all the obligations of the business. The costs in establishing and running a sole proprietorship are minimal; it is formed without any formality. The profits from the busi-

SUITE 900
45 SHEPPARD AVE. EAST
TORONTO, ONTARIO
CANADA, M2N 5W9
WWW.PINSKYLAW.CA


ness are taxed to the individual owner and filed on the individual's tax returns. The business is freely transferable by sale, gift or will. Finally, the sole proprietorship may have a relatively short life span because the death of the sole proprietor dissolves the sole proprietorship. Typically, the sole proprietorship is used for small family businesses.

C. Partnerships

Broadly speaking, partnerships are either general partnerships or limited partnerships. A general partnership (usually referred to simply as a partnership) is an unincorporated business entity that is formed when two or more persons join together to co-own a business for profit. No formal agreement is necessary to create a general partnership. Thus, if two or more people conduct a business, under normal circumstances a general partnership will result by default. Each partner is personally liable for an unlimited amount of the obligations of the general partnership. The cost to create and run a general partnership depends on the complexity of the ownership arrangement.

A general partnership is not a separate taxable entity. Consequently, the taxation of a general partnership is comparable to a sole proprietorship as the profits and losses “pass-through” to the general partners. Income allocated to the partners is subject to the self-employment tax. The partnership must file an informational return with the Revenue Canada. A general partnership is very flexible in that the management responsibilities can be divided among the partners in virtually any way the partners agree. In the absence of a specific agreement, each partner has an equal right to control of the partnership. Partners may assign their financial interest in the partnership, but the assignee may become a member of the partnership only if all of the members consent. Lastly, under the original partnership agreement, the death, bankruptcy, or withdrawal of a partner dissolves the general partnership. Under the a revised partnership agreement, these dissociations of a partner result in dissolution only in limited circumstances; in many instances, they will result merely in a buyout of the withdrawing partner's interest rather than a termination of the partnership.

In contrast to the informal creation of a general partnership, a limited partnership must be established by filing a certificate of limited partnership with the appropriate provincial or federal office. The limited partnership is a creation of a statute, and the members of the limited partnership must strictly comply with the provincial or federal laws. A limited partnership must have at least one general partner and one limited partner. General partners have unlimited personal liability for the partnership's obligations, whereas limited partners have limited liability. The costs of creating and managing a limited partnership will typically be more expensive than a general partnership. Each general partner has an equal right to control of the partnership; limited partners have no right to participate in control. Partners may assign their financial interest in the partnership, but the assignee may become a limited partner only if all of the members consent. Unless otherwise agreed, a limited partnership must dissolve if a general partner dies, goes bankrupt, or withdraws. The limited partnership will survive the death, bankruptcy, or withdrawal of a limited partner. A limited partnership is not a separate taxable entity, so income of the partnership is deemed to be distributed to the partners, similar to a general partnership. Limited partnerships are frequently used to raise capital and to bring together passive investors with managerial talent.

D. Corporations

A corporation has a separate legal existence apart from its owners. A corporation is created by filing articles of incorporation with the appropriate provincial or federal office. Because each province has adopted its own corporate statutes, the rules governing the creation, internal affairs, and dissolution vary from province to province. A board of directors elected by the shareholders manages the corporation but the board normally delegates to certain officers the oversight of day-to-day activities. Owners are not liable for the actions of the corporation. However, under certain circumstances, state courts will strip away the corporation's protective shield and expose the owners to liability. Provincial courts will “pierce the corporate veil” in extreme cases where shareholders do not follow corporate formalities or intentionally undercapitalize a corporation. The costs of creating and running a corporation may be significant depending upon the complexity of the corporation's organizational documents. A corporation is a more formal entity that requires many administrative tasks such as regular board meetings, shareholder votes, and other corporate governance formalities. The taxation considerations for corporations are also considerable. One tax disadvantage to becoming a corporation is that corporate profits are subject to double taxation: a corporation is taxed as a separate entity, and shareholders are taxed on corporate earnings that are distributed to them. There are substantial advantages, however, to selecting the corporate form of business. Corporate structures permit the creation of sophisticated financial structures in which variable ownership classes are entitled to different rights and preferences. Also, absent shareholder agreements restricting transfers, an ownership interest is freely transferable. Finally, the corporation's existence can be perpetual.

E. Limited Liability Companies

A limited liability company (LLC) is entity available in the USA. A limited liability company is a relatively new form of business that combines the “pass-through” tax advantages of partnerships while providing limited liability to all its owners. As the name suggests, the owners of a limited liability company are not personally liable for the LLC's obligations. Also, all members of a member-managed LLC may participate in the management of the business. LLC statutes permit LLCs to be managed by one or more managers who may, but need not, be a member. In a member managed LLC, the members have actual and apparent authority to bind the LLC. In a manager-managed LLC, the managers have this authority; while the members have no actual or apparent authority to bind the manager-managed LLC. The ownership interests are transferable and assignable with the consent of the other owners. Depending on the state in which the LLC is organized, the LLC will dissolve on the death, bankruptcy or withdrawal of a member, unless the remaining members take action to prevent the dissolution.

F. Choice of Business Entity Analysis

Arguably, because of tax advantages, using an entity with pass-through taxation is a better choice than using a corporation. Given that the start-up costs of a company are tax deductible, a partnership structure would allow the inevitable losses in the early stages of the start-up to pass through to each individual partner. These losses could be used to offset income from other sources and reduce the partner's tax liability. On the other hand, if the new entity is a corporation, only the corporation can deduct

CONCEPT
TRANSFORMING CONCEPTS INTO ASSETS

SUITE 900
45 SHEPPARD AVE. EAST
TORONTO, ONTARIO
CANADA, M2N 5W9
WWW.PINSKYLAW.CA



the losses. Obviously, a newly-formed company, has no material source of present or past income against which to deduct the expense. Yet, most start-ups incorporate and thereby forego many of the tax advantages that partnerships receive. While the theory regarding the value of losses is interesting, as a practical matter, these losses have little if any value to the traditional venture fund supported by institutional investors.

By mid-1996 every state of the USA had enacted an LLC statute. LLCs became popular because they combined the best attribute of partnerships, pass-through taxation, with the best attribute of corporations, limited liability. Therefore, taxation wise, the LLC is the best initial choice for entrepreneurs. On the other hand, one of the advantages of incorporating is separating equity ownership from control, an attribute not always present with an LLC. LLCs are specifically designed to be more flexible than corporations and can be organized as manager-managed entities. However, venture capitalists appear to be cool to this approach - conventional wisdom holds that venture capital firms generally do not invest in limited liability companies.

Not surprisingly, the choice of entity for start-ups often is driven by their subsequent need for additional money from venture funding. Venture capitalists invest in companies that statistically are likely never to go public. As private company investors, the venture capitalist seeks as much certainty as possible in an investment. In this respect corporations have the advantage because they have many years of case law providing much greater predictability relating to shareholder rights and director duties. Furthermore, even those arguing that the LLC should be the entity of choice, acknowledge that if the start-up ever goes public, the market will require it to incur the costs of restructuring as a corporation. Nevertheless, they contend that the transaction costs associated with a restructuring are less than the tax benefits derived from starting out as an LLC.

## 2. CHOICE OF LAW

A. Introduction

When starting a business, entrepreneurs may choose which law will govern the business's internal affairs. For example, an entrepreneur in Ontario may choose to incorporate the business in Delaware because of Delaware's favourable business laws. The choice of law decision is made in conjunction with the choice of entity decision, because the choice of law decision impacts the rights and responsibilities of the business owners.

B. Factors

When deciding which state to choose, entrepreneurs will normally consider for incorporation either their home province, federal jurisdiction, or overseas. In many cases, the administrative costs will be lower if incorporation is in the home province. Also, choosing a federal or overseas jurisdiction will require additional legal expenses, including potential tax burdens and qualification expenses (filings, fees, and taxes).

In addition to transaction costs, entrepreneurs should also examine other considerations. Does the province permit the type of business form the entrepreneur has chosen? Does it have residency requirements for shareholders? Does it have favourable law concerning the rights and duties of directors, officers, and shareholders? Does it have an established and predictable judiciary system? Unless the business is already large or multi-province in nature, the institutional benefits of incorporating in Delaware will typically not justify leaving the home province.

C. Delaware - The Most Popular Jurisdiction of Incorporation

The majority of public companies are organized as Delaware entities. Delaware has an established body of corporate law that is favourable to businesses and has created special courts to specifically handle corporate law issues in order to provide businesses with a predictable judiciary. Furthermore, Delaware courts have interpreted Delaware's corporate statutes to provide considerable deference to the decisions of officers and directors. Delaware courts are reluctant to become involved in managing the affairs of businesses. Although Delaware is generally considered the ultimate “permissive haven,” virtually all provinces have grown friendlier toward business.

***CONCEPT LAW*** ™