

Starting New Ventures 64-361.202

Chap 7. Preparing the Proper Ethical and Legal Foundation

Dr. Jack M. Wilson

Distinguished Professor of Higher Education, Emerging Technologies, and Innovation

Bernard Madoff

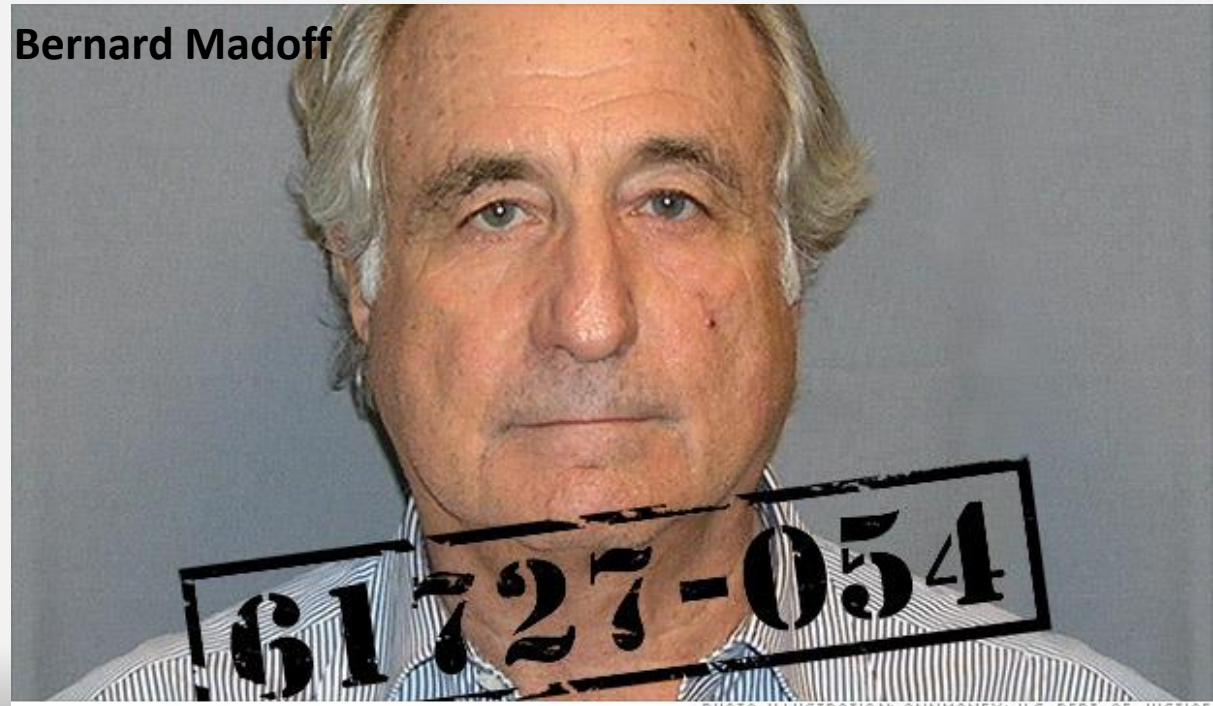


PHOTO-ILLUSTRATION: CNNMONEY; U.S. DEPT. OF JUSTICE

XPLOSafe -opening Profile

- Detection of Explosives for TSA
 - Chemical Test- like pH test
- Shoaib Shaikh,
 - MBA Spears School of Business, Oklahoma State U.
- MBA Students: Shoaib Shaik, Jessie Loeffler, Liviu Pavel
 - two scientists: Allen Apblett and Nick Materer, Chemistry Profs

XPLSafe -opening Profile-legal steps

- Federal Tax ID
- Limited Liability company (LLC)
- Obtained Business License
- Exclusive license from Ok State
- Operating Agreement –from 5 co-founders
 - Structure, operation, equity split, etc.
- Internet domain names
- Defined distribution agreement for potential distributors
- Non-disclosure agreements
- Open bank accounts



Ethics

- Survey of Fortune 500
- Ethics Resource Center
 - 2012

OBSERVATION AND REPORTING OF SPECIFIC TYPES OF MISCONDUCT IN *FORTUNE* 500® COMPANIES

BEHAVIORS	OBSERVED	REPORTED
MISCONDUCT OVERALL*	52%	74%
Conducting personal business on company time	29%	38%
Abusive behavior	22%	72%
Lying to employees	21%	51%
Health/safety violations	18%	70%
Discrimination	18%	57%
Internet abuse	17%	42%
Company resource abuse	17%	55%
Sexual harassment	16%	64%
Stealing	15%	73%
Conflicts of interest	15%	64%
Lying to external stakeholders	14%	59%
Inappropriate social networking	14%	49%
Falsifying time reports	13%	62%
Delivering goods not up to specifications	13%	79%
Improper hiring	12%	50%
Substance abuse	11%	56%
Breaching employee privacy	11%	61%

Ethics Resource Center: <http://www.ethics.org/nbes/files/F500FinalWeb.pdf>



Tone From the Top

- Lead by Example
- Establish a Code of Conduct (Code of Ethics)
 - Google –Don't be evil! And a full code of conduct.
- Implement an Ethics Training Program
 - Ethical Dilemma Good for organization or self \leftrightarrow unethical?

Reasons to create a code of conduct

- Avoid fines or other civil/criminal complaints
- Decrease vulnerability
- Improve Customer loyalty
- Improved Employee Commitment
- Improved Brand Reputation
- Better Access to Capital

Good Legal Advice

- Hire attorney with relevant experience
- Use this expensive resource wisely and sparingly
 - Group legal matters for consultation –not one by one
 - Prepare materials yourself prior to consulting attorney –offer help
 - Bring attorney onto your Board or advisory board
 - Use other professionals
 - management consultants
 - Tax prep services
 - Insurance agents
- While founding ILINC we had one founder who was addicted to attorneys! (“What nice guys!” he said.)
 - They can afford to be nice at \$400/hr



Founders Agreement

- Shareholders agreement
- Specifies legal form (LLC, LLP, Corporation)
- Divides Equity
- Defines how equity acquired; cash, sweat equity, IP
- Defines initial operating capital
- Defines vesting process
- Provides a process for exit of founders
 - Buyback clause
 - -need to ensure that the control of the company does not pass into un-involved hands

Avoid Legal Disputes

- Meet all contractual obligations
- Avoid under-capitalization
- Put everything in writing –avoid misunderstanding
- Non-Disclosure agreements
- Non-compete agreements
 - “A covenant not to compete is enforceable only if it is necessary to protect a legitimate business interest, reasonably limited in time and space, and consonant with the public interest.”
 - Must be reasonable and not overly broad to be enforced
 - California bans almost all non-compete agreements
 - Virginia is very limited in its enforcement
- Set high standards
- Use mediation to settle disputes



Examples

- Patagonia
 - Sells outdoor clothing but outsources the sewing.
 - Selects partners for quality and reliability rather than price
 - Monitors partners closely
 - Tries to develop a win-win partnership
- Build a Bear
 - Children design and build their own stuffed animal in a Santa's workshop like setting.
 - Like Patagonia –very socially conscious
 - Also use partnerships in win-win long term friendly relationships.

Business Licenses and Permits

- Business License
 - Obtained locally for sole proprietorship
 - May require home occupation business license
 - State license if one has employees or is an LLC, LLP, or Corp.
 - Potential sales tax license?
 - Other special licenses
- Federal employer identification Number (EIN)
- Other Business permits
- DBA-Doing Business As –fictitious business name permit.
- Use the SBA website for a guide to licenses and permits



Form of the Business

- Types
 - Sole Proprietorship
 - Partnership
 - Corporation
 - Limited Liability Company

- Considerations
 - Cost of formation
 - Liability protection
 - Tax
 - Types and numbers of investors
 - Liquidity

Sole Proprietorship

- Advantages
 - Easy and inexpensive to create
 - Owner retains complete control and keeps all profits
 - Can deduct any losses against other owner income
 - Is taxed only once to the owner
 - Easy to dissolve the business
- Disadvantages
 - Unlimited liability to owner
 - Very reliant on skills, abilities, and dedication of owner
 - Can be difficult to raise capital
 - Loss of owner to death or disinterest terminate the business
 - Low liquidity of the investment

Partnerships

- General Partnership- with partnership agreement
 - Advantages
 - Easier and less expensive than a corporation or LLC
 - Pools several persons skills and resources
 - Can be easier to raise funds than a sole proprietorship
 - Business losses are deductible to partners against other income
 - Taxed only to the partners and not to the company
 - Disadvantages
 - Unlimited personal liability
 - Relies on small number of people
 - Difficult to raise capital
 - Disagreements among partners are common
 - Unless partnership agreement provide differently- ends at death or withdrawal.
 - Liquidity of investment is low
- Limited partnership (next page)

Partnerships

- Limited Partnerships
 - often have both general and limited partners
 - General partners are liable for debt, but limited partners are limited to the amount of their investment
 - Limited partners do not share in control (or jeopardize the limited liability)
 - This is common in real estate development, oil and gas exploration, motion picture venture.

Corporations

- Either C corporations or S Corporations
- C Corporation - preferred and common stock
 - preferred has special rights over common stockholders for dividends and liquidation.
- File **articles of incorporation** with Secretary of State.
 - Name, purpose, number of shares, classes of stock, other items
 - Corporations must file annual papers with S.O.S. and pay annual fee.
 - Provides protection against personal liability
 - Piercing the corporate veil
 - Profits are taxed to corporation and then again if distributed to stockholders through dividends –double taxation
 - Many owners prefer to profit through stock appreciation rather than through dividends



Sub-Chapter C Corporations

- Public Corporations
 - (Stock listed and traded)- very liquid
- Private corporation
 - (Stock held very closely and not traded) very illiquid
- Closely held corporation
 - (infrequently traded among small group) somewhat illiquid
- Stock options are often issued to reward employees.
 - The right to buy stock at some set price.
 - If stock appreciates, then one can buy -then sell and take the profit.
 - Links success of employee to success of firm. Can also handcuff.



Sub-Chapter C Corporations

- Advantages
 - Protection from liability
 - More ways to raise capital –easier to do so
 - No restrictions on the number of shareholders
 - If traded, then very liquid
 - Private->Public=IPO –initial purchase opportunity
 - Can Offer stock options.
- Disadvantages
 - Requires more work and legal advice to set up.
 - Cannot deduct business loses against your personal income.
 - Double taxation –at corporate and at shareholder level
 - Small shareholders have little influence in management



Sub-Chapter S Corporations

- Does not pay taxes. Files information return and passes profits/losses to the stockholders for their personal tax returns.
- Provides protection from liability like C-Corp
- Only actual salaries are subject to Self Employment tax –not passed through income to shareholders
- Requirements
 - Cannot be subsidiary
 - Shareholders must be US citizens and not partnerships or corporations
 - No more than 100 units (husband-wife is one unit)
 - All shareholders must agree
 - Only one class of stock –either preferred or common



Limited Liability Company

- Originated in Germany. Wyoming first in US
- All partners have limited liability –similar to corporations
- Must be a private business and not a publically traded company
- Income is passed through to owners for taxation
 - No double taxation
 - Can be split any way the wish
- More flexible than S-Corp on number of members and tax-related issues
- New terminology
 - Stockholder → “members”
 - Owning stock → “interests”
- If LLC wants to ‘go public” they must convert to a C-Corp



-
- You be the VC: Prefense
 - Hand sanitizer that lasts 24 hours
 - Case 1: A Start-Up Fable
 - Case 2a: SmartyPants –internet sales of children’s vitamins
 - Case 2b: Donor’s Choose –non-profit directs donations to projects at public schools