

The Recipe for a Successful Business

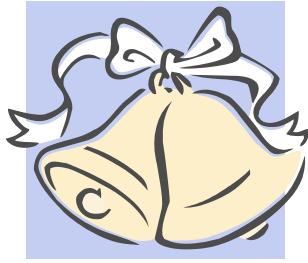
Shared Aspirations, Satisfied Expectations and Cooperation

Robert M. Gottschalk, Esq.

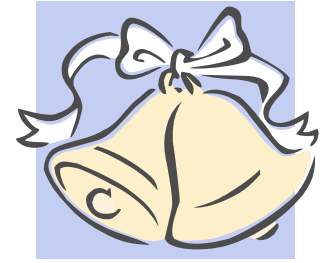
AIN & BANK

A PROFESSIONAL CORPORATION

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Congratulations! ***Mazel tov!***



- The affiliation between owners is very much like a marriage IT'S A RELATIONSHIP.
- The Relationship needs to last in an evolving environment
- Unlike the best marriages, even the best business Relationships come to an end.



A Strong and Certain Agreement ⁽¹⁾

Expectations of the owners need to be known and understood by all other owners.

- Management and Control/Voting rights
- Sharing of profits and losses
- Fiduciary Duties – “no less than that owed by a director”

In Re Boston Celtics Ltd., Partnerships Shareholder Litigation, C.A. 16511 (Del. Ch. Aug. 6, 1999)

The “triad” of fiduciary duties

- Care
- Loyalty
- Good faith/Disclosure

Are these FDs always meaningful and necessary?

If not, then what should owners do?



A Strong and Certain Agreement ⁽²⁾

Most Important Basic Terms for Every Agreement

- Dispute resolution provision including jury trial waiver
- Integration or merger and no oral modifications clauses
- Representation by counsel or informed waiver.

Sole Proprietorship



This is the default status for any business, starting with the simplest lemonade stand and including multi-million dollar businesses, which do not involve a partner and are not organized with the state as a different type of entity.

Only document that might be filed would be a DBA (Doing Business As) certificate.

Might possibly acquire a tax identification number e.g. if it is an employer.

No liability limitations for the owner, no tax advantages, no sharing of profits and losses.

General Partnership



This is the default type of business for two or more persons who carry on a business for profit and share profits and losses.

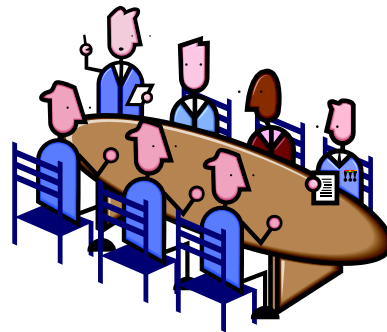
It is formed by an agreement, but that agreement does not need to be written, and often is not written.

Like the Sole Proprietorship, the General Partnership forms without written documents or state filings and there are no liability limitations. In addition, each partner is jointly and severally liable for the obligations of the partnership AND the acts (within the scope of the business of the partnership) of the other partners.

In the absence of an agreement to the contrary, each partner can bind all other partners within the scope of the partnership business.

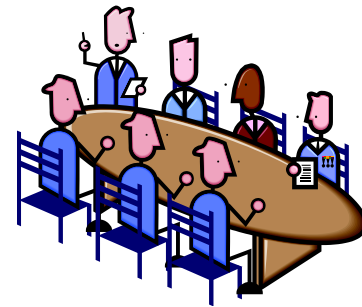
LLC

the Limited Liability Company



Revised Uniform Limited Liability Company Act (adopted in DC)

Limited Liability Company



This type of entity which is effectively a hybrid between a partnership and a corporation. It is relatively new.

The owners, called “members” have essentially the same limited liability as shareholders in a corporation but without requiring a Board of Directors to manage the business.

Formed by filing Articles of Organization with the state and paying a filing fee. Failure to do so will leave a defective LLC – effectively a general partnership regarding liability as set forth above.

Formalities like annual meetings, taking of minutes, and election of officers and directors are not required.

Every LLC has an operating agreement, if not intentionally, then by default.

LP

the Limited Partnership



Revised Uniform Limited Partnership Act (RULPA)

Limited Partnership



A limited partnership is a business entity that has one or more general partners, and one or more limited partners.

The general partners manage the business and affairs of the partnership and are liable for the debts and obligations of the partnership (and each other, just they are in a general partnership).

The limited partners are merely investors who are prohibited from participating in the management and operations of the partnership. Limited members have limited liability.

A certificate of limited partnership must be filed with the state and the applicable filing fee must be paid. Failure to do so will leave a defective limited partnership – effectively a general partnership.

C-Corp

the Corporation



Primacy of Delaware corporate formations is mostly due to its well developed body of case law and experienced courts.

Corporation



A corporation is considered to have an existence and identity separate and apart from its owners, shareholders or stockholders.

Shareholders have limited liability and do not manage the company. They elect a Board of Directors, which in turn appoints/hires Officers (President, Treasurer, Secretary) who operate of the business.

A corporation is formed by filing Articles of Incorporation with the state and paying a filing fee. A defective corporation (i.e. no Articles were filed or fee was never paid) like with the defective limited partnership or LLC, will default to a general partnership and all owners will be liable for the debts and obligations of the entity and the other partners' actions taken within the scope of the business.

Maryland and District of Columbia both recognize “close corporations” intended for small, closely-held corporations wherein the shareholders are permitted to elect not to have a Board of Directors and to manage the corporation directly. This feature allows a single person to hold all officer positions (similar to an LLC manager) and allows the officers of the corporation to elect out of workers’ compensation insurance. Disadvantage: unless the agreement provides otherwise, most actions will require the unanimous consent of all shareholders. The onset of LLCs has made close corporations less popular.

Sub S Corporation



- Also called an “S-Corp”
- A small business corporation for which an election under IRC §1362(a) is in effect.
- Election directly impacts only tax status, but the status change limits other structural flexibility.

Limited Liability Partnerships

Also called Limited Liability Limited Partnerships

- Insulates a general partner from the debts and obligations arising from the wrongful acts or omissions of another partner.
- Each partner remains fully liable for his/her own acts or omissions.
- Registration is accomplished by filing a certificate of limited liability partnership with the state and paying a fee.
- Defective LLP/LLLPs are general partnerships.

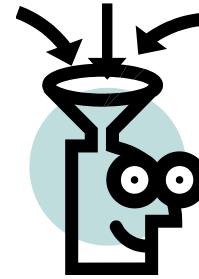
Are Fiduciary Duties in Play for Alternative Entities?



A Fiduciary is a person having a duty to act primarily for another's benefit (good faith, trust, special confidence and candor) in matters connected with a particular undertaking, such as a trustee.

From corporate context, the directors have fiduciary duties to the company and its shareholders.

Duty of Care



In the “Corporate World” this means that the director has a duty to be informed of all Material Information.

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)

Should this be the same standard for all of the Members in a limited liability company?

Duty of Loyalty



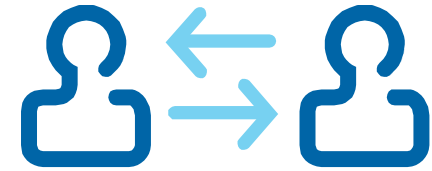
In the “Corporate World” this means that the director actions should be motivated solely by the best interest of the corporation and its shareholders.

Decisions and actions may not be used to advance personal gain.

Guth v. Loft 5 A.2d 503 (Del. 1939)

VGS, Inc. v. Castiel, C.A. NO. 17995 (del. Ch. Aug. 31, 2000) (applying standard to Members and Managers in a Delaware LLC.

Duty of Good Faith and Disclosure



In the “Corporate World” this means that the director must disclose fully all material facts within his or her control to the other directors and shareholders.

Applied to LP

In Re Marriott Hotel Properties II Limited Partnership Unitholders Litigation, 2000 Del. Ch. LEXIS 17; C.A. No. 14961.

Applied to LLC

In Re Bigmar, Inc., 2002 Del. Ch. LEXIS 45; C.A. No. 19289



Business Judgment Rule:

- Business Judgment Rule provides immunity to directors for losses when there is a reasonable basis to indicate that the transaction was made with due care and in good faith.
 - Generally that it makes economic sense
 - Entire fairness test
 - Fair price
 - Fair dealing

Modification of Fiduciary Duties for Entities that are Creatures of Contract



No Specific Fiduciary duties are mentioned or required in the current law (DE) for LPs or LLCs, and the application of corporate/common law fiduciary duties is done only as gap filler (poor drafting) where parties' intent is unclear

- When partners/members need or want to compete with company?
- Permit self-interested transactions?
- Limit duties of disclosure?
- Induce participation by certain necessary and/or synergistic partners/members?

Involuntary Transfers



Problems with the Relationship
or less than all parties want out or want dissolution.

- The governing documents can provide a path to exit for partners/members. (e.g. make ownership units freely exchangeable)
- The governing documents be an impediment to exit for partners/members. (e.g. permit only limited types of transfers under limited circumstances to limited transferees)
- Judicial dissolution – “reasonably impracticable”

Involuntary Transfers

Even if all goes well with the Relationship it eventually comes to an end.



Death



Disability



Divorce



Debt

Planning for Involuntary Transfers

with LLC and LP Agreements

- Predetermine an “Agreed Value”
 Consider using “Book Value”
- Require approval of management for all transfers
- Create a series of triggers for company “Call Rights”
- Transfers are for economic interest only unless admitted as Member
- Require a spousal consent to terms of agreement
- Define Tag-Along rights of Partners/Members
- Define the Drag-Along rights of Partners/Members
- **NOTE: All restrictions come at a price.**



Summary of Law



- At formation, don't ignore the tax implications;
- The Relationship is a Contract -- the terms of the governing documents are primary;
- Know the default terms of the governing statute;
- Rights (e.g. limited liability) require proper registration and maintenance;
- Most business relationships come to an end, so plan for it.

Comparison of Entity Types ⁽¹⁾

Structural features

FEATURE	LLC	LP	C Corp	S Corp
Limited liability	Yes, even for management of the company.	Yes, but only for limited partners as limited partners. The general partners have unlimited personal liability.	Yes, there is generally no liability for shareholders, even for those who participate in management.	Same as C Corp
Documentation	-Articles of Organization/ Formation -Operating Agreement	-Limited partnership agreement -Limited partnership certificate	-Articles of Incorporation -Bylaws -Board Resolutions -Stock certificates -Stock ledger	-Same as C Corp. -Plus need the IRS and State subchapter S elections
Operational formalities	Few	Few	Corporate formalities such as the holding of annual meetings, taking of minutes, and election of officers and directors must be observed; if fail, default status is General Partnership	Corporate formalities must be observed; if fail, default status is General Partnership
Management structure	By all members, unless manager managed; majorities; pluralities; Unanimity	General partner	Board of Directors, which members may be shareholders	Same as C Corp

Comparison of Entity Types ⁽²⁾

Ownership and Funding

FEATURE	LLC	LP	C Corp	S Corp
Types of entities that can be Owners	unrestricted	unrestricted	unrestricted	May not be Corporations, pension plans, nonresident aliens, trusts (except the S-Corp. trust)
Number of Owners	at least one, no maximum	at least two, no maximum	Unrestricted	75 or less
Classes of Ownership	Different Classes are permitted	Different Classes are permitted	Different Classes are permitted	Only one class of economic rights is permitted, different "classes" of voting rights are permitted.
Capital and Funding	Money or services are contributed in exchange for an agreed percentage of profits (losses track profits unless specifically agreed otherwise, which creates tax issues).	General and limited partners both contribute the funds needed for the company in exchange for a commensurate share of profits and losses. Generals unusually a very small percentage. Sometimes contribution commitments over time, as with private equity funds.	Shareholders typically purchase stock in the corporation, often different classes and types, such as common vs. preferred. Most common form of publicly traded securities.	Shareholders typically purchase stock in the corporation, but only one class of ownership is permitted.

Comparison of Entity Types ⁽³⁾

Continuity

FEATURE	LLC	LP	C Corp	S Corp
Transferability of owner interests	-Permitted -Buy/Sell provisions in operating agreement can restrict of free-up this facet.	-Permitted -Buy/Sell provisions in partnership agreement can restrict of free-up this facet.	Permitted Yes, but it may be limited by a buy/sell agreement	Same as C Corp, but the cap on the number of shareholders can also be an impediment
Continuity of entity (perpetual existence)	-Perpetual existence is permitted.	-Perpetual existence is permitted.	Permitted	Same as C Corp
Ownership interest to creditors?	A creditor can acquire a right to receive distributions through a charging order	A creditor can acquire a right to receive distributions through a charging order	Yes.	Same as C Corp.
Dissolution	More than two thirds of ownership interests unless modified by agreement or Judicial dissolution (must prove that it is not, reasonably practicable to carry on the business in conformity with the agreement)	Unanimous consent by all general partners AND consent of more than two thirds of the ownership interests unless modified by agreement of the limited partners Judicial dissolution standard is same as LLC	Action by the Board of Directors according to Bylaws (majority by default) causes meeting of shareholders requiring a majority of the outstanding stock entitled to vote for dissolution.	Same as C Corp.