

BUSINESS ORGANIZATION

by Shelburne Ferguson, Jr., Attorney at Law

Foreword

Since 1965 I have sought to provide superior legal services to my business clients. I am proud of this tradition and commit to providing you with the quality of service you would expect to receive.

I hope you'll find this booklet helpful as you make the key decisions in launching or expanding your business. Certainly I expect this to be only the start to a long and successful relationship together.

This booklet is not intended to be a substitute for the legal advice of a qualified attorney. The information it contains is general in nature and may not apply fully to your situation. So please do not attempt to use the booklet as a "do-it-yourself-lawyer" because you may be greatly disappointed in your representation and in the outcome.

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Choosing a Form of Business Organization

One of the first decisions a business owner must make when starting a business is to decide what type of "entity" will be used to operate the business. An "entity" simply means the form or structure of the business.

The choices of entity are:

- Sole proprietorship
- Corporation
 - S - corporation
 - C - corporation
- Partnership
 - General partnership
 - Limited partnership
 - Limited liability partnership
- Professional limited liabilities companies
- Limited Liability Company
- Not for profit corporation

The chart on page 3 sets forth in capsule form some of the advantages and disadvantages of each choice of entity. Of course, a more extensive evaluation, explanation, and recommendation will be made as your counsel and perhaps by your CPA before you ultimately select the type of entity you'll use.

The Liability Issues

A key concern of most business owners when choosing a business entity is their personal exposure to liability for claims and lawsuits from those with whom they will be doing business. For example, should a person operating as a sole proprietor be sued and a money judgment rendered, the personal assets of the owner might ultimately be in

jeopardy if there is insufficient insurance or there are inadequate business assets to satisfy the judgment. In other words, a sole proprietor's personal assets such as the home, car and savings account might be “seized” to pay a business debt or judgment.

This issue of personal liability for business obligations applies not only to the business operated as a sole proprietorship but to the general partnership and, to some extent, the limited partnership as well.

The corporation, limited liability company and limited liability partnership are attractive forms of entity to some business owners because each protects the owner's personal assets from business debts and judgments. To a lesser extent the limited partnership shelters some of the business owners from some of the business's liabilities.

The Taxation Issue

The sole proprietorship, the general partnership, the limited partnership, the S-corporation and the limited liability company are all treated under current tax law as “pass-through” entities for tax purposes. This allows the owner of each entity to pay the taxes on business income on their personal tax returns and not have both the entity and the individual owners paying taxes on the same income. Some states do not recognize S-corporations and, therefore, earnings from S-corporations may be subject to state taxation. Pending Tennessee legislation may impact state taxation of limited liability entities.

By passing through the income tax liability to the owners' personal tax returns, this allows the business income to be taxed at the individual tax rate as opposed to the corporate tax rate which is generally a higher tax rate.

You should consult your tax advisor about which entity is most appropriate for your business.

Ownership Issues

Who or what will be an owner in your business is an important issue and can dictate which form of business entity is available to you. For example, the S-corporation can have no more than seventy-five (75) shareholders. None of an S-corporation's shareholders can be a corporation. In addition, the S-corporation shareholders must all be U. S. citizens or taxpayers or residents of the United States. It is possible for certain types of qualified trusts to be S-corporation shareholders.

Also, the S-corporation can have only one “class” of stock. Occasionally, a corporation will want to have various classes of stock such as “preferred stock” or “Class-B non-voting stock.” This may be desirable to allow employees of the business to own stock but not to be able to vote the stock. You aren't allowed to have more than one class of stock in an S-corporation. Those restrictions don't apply to a C-corporation.

A Limited Liability Company allows for foreign ownership, classes of ownership, corporate ownership, two or more owners, active and passive investing and more flexibility. Yet the LLC form is not for every situation, so an analysis of what is best in your unique circumstances will need to be done.

Governing Structures

The “C”, “S” and not-for-profit corporations are required by state law to have certain officers and boards. The law also requires a minimum number of meetings of the boards comprising the corporation. Generally, the shareholders of a for-profit corporation and the members of a membership form of a not-for-profit corporation must meet at least annually. The board of directors is also required to hold an annual meeting.

This is not to suggest that the requirement to hold an annual shareholders and directors’ meeting is necessarily a difficult obligation. It can be and generally is an opportunity to keep the corporation on track toward its objectives. We can help you with the structuring of such meetings and advise you how to keep the minutes of those meetings.

The remaining forms of business entity are governed by their internal rules regarding owners and board meeting.

The following chart summarizes the characteristics of the various business entities.

Form of Entity	Limited Personal Liability	Level of Taxation	Types of Owners/ Investors	Number of Owners	Transfer of Ownership Interest	Formal Management Structure
“C” Corporation	Yes	Corporate	One or more	One or more	Free	Required
“S” Corporation	Yes	Individual	One	75 or less	Free within maximum number and typical owners	Required
Sole Proprietor	No	Individual (but see state tax rules)	One	One	Limited	None
General Partnership	No	Individual	One	One or more	Limited	None
Limited Partnership	Yes for some owners	Individual (but see state tax rules)	One or more	One or more	Limited	None
Limited Liability Company	Yes	Individual (but see state tax rules)	One or more	One or more	Limited	Usually None (depends on whether member-managed or board managed)
Not for Profit Corporation	Yes	Generally no income taxability	No personal ownership	None	None	Required

Operating as the Business Entity You Have Chosen

If you have decided to operate under the corporate form of entity, then you need to remember to “act like a corporation” when conducting the corporation’s business. Failing to “act like a corporation” in conducting your business can cause you to lose the liability protection the corporate structure provides you. In legal language this is called “piercing the corporate veil.”

Let me illustrate what I mean. Assume that your business, a corporation, decides to purchase a new copy machine. You make the deal and sign the papers. Unfortunately, you title the copier in your personal name and not in the corporation’s name.

Later on your corporation suffers an economic set back forcing you to shut down the business. You face bankruptcy of the corporation. However, because you signed the

copier “personally” and not as a corporation, you will be personally liable for the copier payment.

One more illustration may help you see how important it is to act like a corporation involving corporate business. Let’s assume that your corporation is sued for its dealings with another business. The attorneys for the other company will generally ask for copies of all relevant Board and Shareholder’s minutes. Their purpose is to see if the corporation formally authorized the transaction about which they are suing. If you have no minutes or if the officers or employees exceeded their authority, the plaintiff’s attorney may be able to do what in the law is called “pierce the corporate veil” and make the owners personally liable.

You can see from these illustrations how important it is to always carry out corporate business in the right way and to consistently and properly document the corporation’s actions.

We can assist you in drafting notices, minutes and other documents if you request such help. Whether you select the corporate form or one of the other types of entities to operate your business, it is always important to properly document your actions.

Financing Your Business

One critical key to the success of your business start-up or expansion is adequate financing. Raising capital is vital to your success. Yet most business owners find that securing enough money to run or expand their business is quite a challenge. It can be frustrating and even painful at times.

Where will you find the money you need to operate your business? There are a number of sources through which you can secure capital to begin or expand your business, such as:

- Your personal savings
- Credit cards
- Home equity loans
- Loans from friends and relatives
- Credit union loans
- Bank loans
- Venture capital firms
- Small Business Administration loans
- Sale of stock or equity in the business

The use of any one or more of these sources should be carefully weighed before you actually commit to one of them. There are too many considerations to set forth here. Suffice it to say we would be pleased to discuss the strengths and weaknesses of these funding sources as each relates to your particular venture.

The Sale of Stock or Equity Positions

You should talk with us or other competent legal counsel before you set out to sell corporate stock in your corporation or memberships in your limited liability company. There are both state and federal regulations that control what is permissible in selling securities.

These regulations can affect to whom, where, and how you can sell stock in a new or existing company. Violation of these rules can have serious legal consequences.

On the other hand, if you properly follow the rules governing the issuance and sale of stock you will be in a position to legally sell an interest in your business. The point is – discuss these issues with us or other qualified counsel before you attempt to issue and sell securities.

The Government Regulations

There are a number of municipal, state and federal regulations that can affect your right to do business or which can help you in protecting your valuable business rights. The following list, though not exhaustive, can assist you in researching and assessing those regulations:

Business Licenses

Most cities and counties regulate who can do business in their communities by requiring a business license.

Zoning Regulations

Communities generally control what businesses can locate in various parts of the city or county through zoning regulations.

Certificates of Occupancy

You may need to apply for and obtain a Certificate Of Occupancy before being allowed to occupy a new building or open up a new business in an existing building.

Deed & Lease Restrictions

Deeds and leases to the property from which you intend to operate may restrict what activities can be carried on from the property.

Signage Regulations

Most municipalities as well as building leases restrict or dictate the size, number and location of signs, banners and billboards that may be used by a business.

Trademarks and Service Marks

The names, symbols and “signatures” of businesses are subject to state and federal trade mark and service mark regulations.

Patents

A Patent issued by the United States Patent Office protects the use of someone's invention.

Copyrights

Copyrights protect the ideas, thoughts, music and writings of authors, songwriters, composers and artists.

Employee Withholding

Businesses are required to withhold and pay over to the government, federal income taxes, state income taxes and FICA (social security) taxes on behalf of their employees.

Self-employment Taxes and Estimated Taxes

The self-employed business owner is required to pay a self-employment tax as a Social Security contribution. In addition, the self-employed owner will generally be obligated to file and pay quarterly estimated income taxes.

Unemployment Insurance

If your business has at least one employee who works at least 20 weeks in a calendar year, your business will be required to pay an unemployment insurance tax.

Worker's Compensation Insurance

Most states require employers with a small, minimum number of employees to carry worker's compensation insurance to cover on-the-job injuries to workers.

OSHA

The Federal Occupational Safety and Health Administration protects workers from dangerous working conditions. Most states have similar standards.

Minimum Wage/Overtime Regulations

Essentially all businesses are subject to the federal minimum wage, overtime regulations and child labor laws.

Americans with Disabilities Act

Virtually all businesses that are open to the public are subject to provide facilities that are “handicap friendly” allowing ease of access and use. In addition, employers may be subject to regulations relating to employees who have covered conditions requiring an “accommodation.”

Immigration Laws

All employers are required to verify and retain records showing the eligibility of new employees for employment.

Bar Coding

Some businesses require bar coding on all packaged products. These codes are assigned by a non-governmental agency called The Uniform Code Council, Inc.

Fictitious Business Name

If you intend to operate your business using a name other than that of the owner's name you must register the “fictitious name.”

Bankruptcy and Creditors Rights

The Federal Bankruptcy code and regulations affect not only those businesses that “go bankrupt” but their creditors as well.

Discrimination Laws

State and Federal laws prohibiting discrimination against and harassment of employees and applicants for employment based on race, color, religion, national origin, age, sex and creed apply to employers with relatively few employees.

Franchises and “Business Opportunities”

Some people find operating through a franchise arrangement gives them a proven concept, continuing oversight of the operation and periodic assistance with business and marketing issues. However, you should never sign a franchise agreement without first having it reviewed by legal counsel. In addition, it is wise to consult your financial adviser to review and “run the numbers” to determine the level of sales you will need to achieve in order to be successful.

Occasionally, an entrepreneur will start a business that becomes quite successful and lends itself to franchising the concept to others. Please keep in mind that franchise offerings are regulated by Federal Trade Commission rules as well as by regulations in many states. You should, therefore, seek legal advice on the franchise process before you attempt to offer a franchise operation to any prospective purchaser.

In addition, a number of states have passed laws regarding “Business Opportunities”. Simply put, a business opportunity does not fall within the definition of a franchise, generally, because there is no long term, continuing involvement with the business. These arrangements typically involve training, equipment purchases, instruction on marketing, and advice about site selection or on establishing an office.

A number of states now regulate “business opportunity” offerings. Please do consult legal counsel prior to offering or purchasing such an arrangement.

Other Considerations in Setting Up Your Business

We are certain that you are aware that the mortality rate for business start ups is quite high. In fact, more than half of the businesses started each year will not be around in five years.

Your chances of beating those odds increase with good business planning and an honest assessment of whether running your own business is best for you.

Please don't start your own business because you think it will give you more free time for yourself and your family. Most entrepreneurs don't find that to be the norm. On the contrary, you will need to give your new business all the time and effort it needs. Moreover, you'll discover that even when you're not at work you'll still have your business on your mind. We would equate it to, “you don't own the business, it owns you.” Nevertheless, if you have the following abilities your chance of success increases:

- A self-starter.
- Adaptable to different personalities
- Can be tough when necessary.
- Have good judgment.
- Make sound decisions.
- Plan well.
- Organize effectively.
- Have the drive to make it work.
- Have a supportive spouse and/or family.
- Can handle the possibility of a lower standard of living.

For those who can handle the pressures of owning their own businesses there are rewards. For one thing you can be your own boss. The long, tough, difficult, challenging hours you spend will benefit you and not someone else's retirement plan. What you create and grow will be exciting and self-fulfilling. If you like surprises you'll love being a business owner.

How Can I Help You?

I am capable of assisting you in most every step along the way to your owning your own business. I have through the years had experience in forming corporations, partnerships, limited liability companies, and virtually every other business entity. However there may be certain skills that I don't possess, such as accounting or knowledge of State and Federal tax issues. Should you need assistance with an area with which I do not feel that I am the one best suited to handle that issue for you I promise to tell you so. In addition I will recommend that you deal with your own CPA or tax adviser for example.

I will also be able to refer you to local professionals whom I feel will be able to competently deal with any issue that I do not feel comfortable advising you. Frankly, I think that is the best use of your money, that is, to go to someone who can quickly give you the sound advice you need.

In addition, as your business grows and expands, many of the laws that were not initially applicable to you may subsequently affect your business because of the number of employees you then have. Therefore, a periodic review by us is important to prevent you from unknowingly violating a rule or regulation.

Lastly, because of your success, you may someday want to sell your business. I would be pleased to assist you in that process so that you are protected and benefit to the fullest extent from your hard work through the years.

—SHELBURNE FERGUSON, JR., February 2008

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