

## CHAPTER 1

# *Classifying and Characterizing Businesses*

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### **A. THRESHOLD CHALLENGE**

A lawyer needs to appreciate the breadth of the word "business." The term encompasses a huge range of enterprises that differ in many respects. The differences are important. For any lawyer, a threshold challenge is to have an understanding of core business differences. At the most basic level, such an understanding will help any person communicate and work with others and better comprehend the significance of developments and trends that are reported daily.

The importance of understanding core business differences escalates for the lawyer who wants to assist business owners or executives at any level. It is a prerequisite to developing the capacity to meaningfully assist clients in the processes of identifying and prioritizing specific business objectives. And it is that capacity that is often the difference between good and mediocre (or worse) legal services.

Many business owners and executives, even some of the brightest, are incapable of identifying and articulating specific objectives without the aid of a knowledgeable advisor. They often need help in understanding the significance of an issue and eliciting facts and considerations that will impact the identification of their specific objectives relative to the issue. Then a prioritization challenge often surfaces because of conflicts and inconsistencies triggered by competing business objectives. It's a balancing analysis that requires an understanding of the strategic options and trade-offs. In nearly every situation, this understanding is impossible without the knowledgeable input of a legal advisor who understands the uniqueness of the business. The biggest mistake a legal advisor can make is to assume that businesses are essentially the same and owners and executives share the same basic objectives and require the same essential structural plans. Business is never a "one-size-fits-all" game.

This opening chapter focuses on core business differences by explaining owner and entity differences, illustrating different ways businesses are characterized and contrasted, and describing the tool used by a business to explain how and why it is unique. This is not a comprehensive discussion of all significant business differences; it's hard to imagine what such a discussion would entail. The hope is that this short, introductory discussion will provide a

useful starting point and foundation for what follows in later chapters and help narrow knowledge gaps between business novices and more business-savvy students.

One important, fundamental business difference needs to be identified up front. It's the difference between for-profit businesses and non-profit businesses. The former are organized, funded, and operated with a goal of generating a profit for the owners. As we will see, a for-profit enterprise usually has other important stakeholders, including employees, creditors, vendors, communities, taxing authorities and more, but the ever-present driving force (for good or bad) is the profit motives of the owners.

A non-profit business has no owner profit motive. It is organized, funded, and operated to accomplish specifically-identified community or charitable objectives. Although it lacks profit-seeking owners, it can raise capital, own property, employ people, perpetually exist, and operate on a grand scale. Virtually every state has a statutory scheme that authorizes the creation and governs the operation of non-profit entities. And, of course, important provisions of the Internal Revenue Code exempt qualifying non-profit organizations from the federal income tax<sup>1</sup> and specify requirements for donors to receive an income tax charitable deduction for amounts contributed to a charitable entity.<sup>2</sup>

This book is focused only on for-profit businesses. It's not that non-profits are not important; they play vitally important roles in every community. They are just outside the scope of this effort.

## B. OWNER DIFFERENCES

Businesses differ based on the type, mix, and number of their owners. Following are brief descriptions of nine business owner classifications. These classifications are not perfect; overlaps, exceptions and omissions regularly surface in the real world. But they work for purposes of explaining different owner expectations and illustrating and analyzing the different and competing objectives that often must be addressed in evaluating options for resolving a specific business challenge. The first eight relate to the 27 million privately owned businesses in America that represent more than 99 percent of all employers, historically produce 65 percent of all net new jobs, and produce 16.5 times more patents per employee than their public company counterparts.<sup>3</sup>

### 1. SINGLE-OWNER ENTITIES

A single-owner entity is a true soloist. No partners. No co-shareholders. It may be a corporation, a limited liability company, or a sole proprietorship. Whatever the form, the planning focus is on a single owner. The soloist has no need for buy-sell agreements, control strategies, or the complexity of Subchapter K (the partnership provisions) of the Internal Revenue Code. But he or she must

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1. See, generally, I.R.C. §§ 501 through 505.

2. I.R.C. § 170.

3. See "Small Business Fact Sheet," U.S. House of Representatives Committee on Small Business (May 21, 2013).

still be concerned about entity forms and structures, motivating and retaining key employees, funding and growing the enterprise, developing exit and transition strategies, controlling and managing risks, taxes, and other critical challenges. The business and planning challenges usually are easier only because they are lonelier; there is no need to grapple with the competing objectives and perspectives of co-owners. The focus is always on the hopes, dreams, and risks of a single individual.

## ***2. EMPLOYEE-OWNED ENTITIES***

These businesses are owned by individuals who work fulltime for the business. The owners toil in their businesses every day. To them, the business is much more than an investment; it is their job, their career, and often their sole or primary means of support. They cherish the independence of working for themselves. They long for stability; above all, the business must continue to provide the owners their needed cash flows. The owners know that if the business folds, they likely will end up working for another or standing in an unemployment line.

Among the owners, there often is a “democracy” spin on control issues, with minority rights being protected only on the most sensitive issues. The admission of a new owner is a carefully controlled event because any new owner will become a true day-to-day colleague who will have the capacity to directly impact the success of the business. When one leaves the group, the survival and health of the ongoing entity always trumps the interests of the departing owner.

## ***3. INVESTOR-OWNED ENTITIES***

These organizations are owned by investors who do not work for the business. The owners often are heavily involved in the highest-level management decisions while others sweat out the day-to-day challenges of the business. For most investors, the business is not their primary or sole means of support; it’s an investment. They are looking for a return on that investment – the sooner the better. Compared to employee owners, investors usually are less risk averse and less concerned with the identity of their co-owners or ownership changes.

## ***4. HYBRID ENTITIES***

The hybrid organization has both employee-owners and investor-owners. Often it is the most difficult organization for planning purposes. The employee-owners usually put their careers, but not their checkbooks, on the line. They want to do all in their power to protect their paychecks for the long run and control the operations of the business. The investors are concerned about the money they have at risk and the potential of having to put up more if things don’t go as planned. They want equity growth and the flexibility to exit and cash out at the most opportune time.

## ***5. DOMINANT-OWNER ENTITIES***

This organization has one majority owner and a few small minority owners. The dominant owner may be an employee-owner or an investor-owner. The

minority owners are usually employees. The dynamics are very different with this type of enterprise. In almost every situation of this type, the dominant owner will want and expect special treatment. It's not about democratic votes or minority rights.

From the dominant owner's perspective, real damage can be done by trying to create a level playing field to treat all the owners the same. The dominant owner usually will want exclusive control rights that can be passed onto chosen successors and special buy-out rights and liquidity protections to ensure that his or her position always can be preserved. Often the minority owners maintain their equity interests at the will of the dominant owner, who possesses broad rights to terminate and buy out their interests at any time.

## **6. FAMILY-DOMINATED BUSINESSES**

Many businesses are owned and controlled by a single family. All planning issues are complicated by estate planning challenges and the dynamics among the family members. Usually the parents have family objectives that take priority over business issues, and often the children have special agendas. In many cases, the objectives of children who work in the business collide with objectives of the "outside children." Liquidity issues often are magnified by estate tax realities. Control issues usually are impacted by family considerations unrelated to the business.

Family-dominated businesses compose more than 80 percent of U.S. enterprises, employ more than 50 percent of the nation's workforce, and account for the bulk (some estimate as much as 64 percent) of America's gross domestic product.<sup>4</sup> Although more than 80 percent of senior family owners claim that they want the business to stay in the family, less than 30 percent acknowledge having a transition plan.<sup>5</sup> The result is that most family businesses remain in the family, but at a dear cost. Best estimates are that less than 30 percent of family dominated businesses survive a second generation, and the survival rate is even uglier for those businesses that make it to generation three.<sup>6</sup>

Although many successful family business owners enjoy a net worth that rivals or exceeds that of other well-heeled clients, the planning dynamics usually are much different when a family business takes center stage. In a recent survey, a startling 93 percent of senior business owners acknowledged that the business is their primary source of income and security.<sup>7</sup> With little or no diversification, everything gets tougher. And more often than not, business and planning challenges are further complicated by strong emotional ties to the business as

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4. See generally R. Duman, "Family Firms Are Different," *Entrepreneurship Theory and Practice*, 1992, pp. 13–21; and M. F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good News and the Bad News," *Organizational Dynamics*, 1993, pp. 59–71; W. G. Dyer, *Cultural Change in Family Firms*, Jossey–Bass, San Francisco, 1986; and P. L. Rosenblatt, M. R. Anderson and P. Johnson, *The Family in Business*, Jossey–Bass, San Francisco, 1985; Arthur Anderson/Mass Mutual, *American Family Business Survey*, 2002.

5. *Family to Family: Laird Norton Tyee Family Business Survey 2007*, page 5. The survey also indicated that (1) only 56 percent of the respondents have a written strategic business plan, (2) nearly 64 percent do not require that family members entering the business have any qualifications or business experience, and (3) 25 percent do not believe that the next generation is competent to move into leadership roles.

6. J. I. Ward, *Keeping the Family Business Healthy*, Jossey–Bass, San Francisco, 1987. This study suggests that the survival rate to generation three is less than 15 percent.

7. *Family to Family: Laird Norton Tyee Family Business Survey 2007*, page 5 (Executive Summary).

well as historical perceptions regarding essential bonds between the family and the business.

## **7. PERSONAL SERVICE ORGANIZATIONS**

These are organizations that generate income by their owners providing services in fields such as healthcare, law, engineering, accounting, actuarial science, performing arts and consulting. It's actually a type of employee-owned organization that warrants its own classification for a few reasons.

First, the owners are the instruments of production of the business; their talents generate the fees that drive everything. The owners are well educated, independent and have the flexibility to make a move at any time. Typically, their large incomes are exceeded only by their larger egos. As a result, these organizations tend to be fragile. Their existence is tied to professional talent that can die, become disabled, or just decide to walk if an ego is bruised. Transitions in and out always are a challenge. Often new blood must be recruited to replenish or expand the talent base.

Second, professional service corporations have been a popular target of Congress. They have their own tax provisions, most of which are not friendly.<sup>8</sup> These include a unique tax avoidance and evasion provision that empowers the government to allocate income, deductions, credits and exclusions between a personal service corporation and its employee-owners.<sup>9</sup> There are severe limitations on a personal service corporation's ability to defer earnings by using a fiscal year.<sup>10</sup> But perhaps the harshest provision is the tax rate structure. Unlike all other C corporations, even other employee-owned organizations, a personal service corporation cannot benefit from the favorable graduated corporate tax rate structure that starts at 15 percent. All income accumulated in a personal service corporation is taxed at the maximum corporate rate of 35 percent.<sup>11</sup>

## **8. EMERGING PUBLIC COMPANIES**

Only a tiny fraction of businesses will ever consider "going public" – having their stock owned and regularly traded by a large number of public shareholders. All other closely held businesses are just too small or not suited for public ownership and the associated regulatory hassles and horrendous expenses. But for those select few that are destined for the big time, going public is the ballgame; it is their mission, their purpose, and a prerequisite to their success. Their closely held status is merely preparatory to their real life as a public company. Typically, these companies are developing and preparing to exploit

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8. The exception is the right afforded qualified personal service corporations to use the cash receipts and disbursements method of accounting under I.R.C. § 448(b). Any other corporation (unless in the farming business) may not use the cash method of accounting once its annual gross receipts hit \$5 million.

9. I.R.C. § 269A. Allocations may be made when the services of the personal service corporation are performed for another corporation, partnership or entity, as is the situation where a professional uses a corporation to hold his or her interest in a broader organization of professionals.

10. I.R.C. §§ 441(i). Use of an accounting period other than a calendar year is permitted only upon a showing of a business purpose for the different accounting period. The desire to defer income is not such a valid business purpose. A personal service corporation may adopt a fiscal year with a deferral period of no more than three months under I.R.C. § 444(b)(2), but in such event, the corporation is required to comply with the minimum distribution requirements of I.R.C. § 280H, which eliminate most deferral benefits.

11. I.R.C. § 11(b)(2).

intellectual property rights and are financed and controlled by professional investment funds. All planning is focused on the unique objectives of the deep pockets that are writing the checks and calling the shots in preparation for the big day when the public is invited to the party.

## **9. PUBLIC COMPANIES**

Stocks of these companies are traded daily and available to the public. These are the largest companies, those that populate the pages of the Wall Street Journal. Their primary challenges are building shareholder value and income streams that, in the eyes of all, are viewed as solid and growing. A strong public image is supreme. Staying out of trouble with the SEC and other regulators is a must. Competitive intelligence and strategic planning are essential. A focus and place in the globalization of the world's economy are top priorities. A solid, committed executive management team and board of directors are fundamental to the company's success.

At the end of 2013, the stocks of slightly more than 45,000 public companies traded throughout the world. Since 1997, the number of companies whose stock trades on a U.S. exchange has been declining. The total number stood at 5,008 at the end of 2013, a far cry from the 8,884 that traded on U.S. exchanges at the end of 1997. There was a modest bump up in 2013 (92 companies), the first annual increase since 1997.<sup>12</sup>

Public companies have been dramatically impacted by the growth of institutional investors: mutual funds, state pension funds, hedge funds, labor union pension funds, corporate pension funds, and the like. From 1900 to 1945, the percentage of public company stocks owned by institutional investors always hovered in the 5 percent range. After World War II, institutional ownership ballooned. By 1980, institutions held \$473 billion, 34 percent of the total market value of U.S. common stocks. By 2010, institutional ownership had grown to \$11.5 trillion, 67 percent of all U.S. stocks.<sup>13</sup>

A further complicating factor is that an estimated 70 to 80 percent of the outstanding stock of public corporations is held in "street name" through custodians, such as banks and brokerage firms.<sup>14</sup> The custodians, in turn, hold the shares through accounts at Depository Trust Company (DTC), a depository institution and the record owner registered on the books of the company. The result is that it is difficult, often impossible, for a public company to ascertain the identity of the beneficial owners of its outstanding stock at any given time.

Public companies have always been classified by the size of their market capitalization ("market cap"), which is determined by multiplying the number of the company's total shares outstanding by the market share price for the company's stock. The historical three categories of large-cap, mid-cap, and small-cap have generally been expanded as follows:

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12. World Federation of Exchanges Statistics Report for December 2013.

13. Working paper of Wharton Professors Marshall E. Blume and Donald B. Keim entitled "Institutional Investors and Stock Market Liquidity: Trends and Relationships."

14. See, generally, M. Kahan & E. Rock, *The Hanging Chads of Corporate Voting*, 96 *The Georgetown L. J.* 1227 (2008).

- Mega-cap (over 200 billion market cap)
- Large-cap (from 10 billion to 200 billion market cap)
- Mid-cap (two billion to 10 billion market cap)
- Small cap (250 million to two billion market cap)
- Micro-cap (below 250 million market cap)
- Nano-cap (below 50 million market cap)

Public companies also are slotted into sectors based on the nature and scope of their respective products and services. These sectors are further divided into industry groups, industries, and sub industries. The performance standards of the companies included in a particular category become the yardstick for measuring the performance for a specific company in the category and for sizing up the relative strengths of various sectors and industries in the overall economy. Key sectors include:

- Materials (everything from chemicals to steel)
- Consumer discretionary (example industry groups include apparel, auto, leisure, media)
- Consumer staples (example industry groups include food and staples, household and personal products, and beverage and tobacco)
- Healthcare (example industry groups include healthcare equipment and services and pharmaceuticals)
- Energy (all types)
- Utilities
- Technology (example industry groups include computers, software, office equipment, semiconductors)
- Financials (example industry groups include banks, real estate, insurance, diversified financials)
- Industrials (example industry groups include capital goods, transportation, commercial and professional services)
- Information technology (example industry groups include software, hardware, semiconductors);
- Telecommunication service

## C. ENTITY DIFFERENCES

Businesses operate through different entity forms. A lawyer must understand the basics of these various forms. The last two chapters focus on important core details regarding these various entity forms, including tax differences and factors that should be considered in selecting the best entity form

for a particular business. Following are brief descriptive recaps of the most common forms.

### ***1. SOLE PROPRIETORSHIP***

Sole proprietorships are for single owners who operate simple businesses and do not want the hassles of dealing with a separate entity, such as a corporation or a limited liability company. Tax-wise, everything is reflected through the individual owner's tax return. This form's greatest virtue is its simplicity, but it offers few other benefits. For this reason, it generally is confined to small businesses that create no significant liability concerns for their owners.

### ***2. C CORPORATION***

The C corporation is a regular corporation that pays its own taxes. It is a creature of state law and is recognized as a separate legal and taxable entity. Public companies and many closely held businesses are C corporations. The earnings and losses of a C corporation are taxed at the entity level, not passed through to the shareholders. The result is that C status often triggers a double tax burden - one at the entity level and another at the shareholder level when dividends or liquidating distributions are paid. The tax basics of C corporations are reviewed in Chapter 9.

A C Corporation may have different classes of stock and any number of shareholders. It offers its shareholders personal protection from the debts and liabilities of the business and a host of tax benefits. It is a popular choice for many service organizations, emerging public companies, operating companies that need to retain modest earnings each year, and owners who do not want to endure the administrative and tax hassles of a pass-through entity. Any corporation that does not qualify and elect to be taxed as an S corporation will be taxed as a C corporation.

### ***3. S CORPORATION***

The S corporation is the preferred choice for many. It is organized as a corporation under state law and offers the same corporate limited liability protections as a C corporation. But unlike a C corporation, it is taxed as a pass-through entity under the provisions of Subchapter S of the Internal Revenue Code. The taxable income and losses of the entity are passed through and taxed to the shareholders, eliminating the double tax consequences of a C corporation. These S tax provisions are similar, but not identical, to the partnership provisions of Subchapter K. The tax basics of S corporations are reviewed in Chapter 9.

The S corporation is particularly attractive to shareholders of a corporate entity that makes regular earnings distributions or that may be sold for a substantial profit in a taxable exchange. And usually conversion to S status is the only viable option for a C corporation that wants to eliminate future double-tax bites by converting to a structure that offers pass-through tax benefits.

There are certain limitations and restrictions with an S corporation that often pose problems. Not every corporation is eligible to elect S status. If a



corporation has a shareholder that is a corporation, a partnership, a non-resident alien or an ineligible trust, S status is not available.<sup>15</sup> Banks and insurance companies cannot elect S status.<sup>16</sup> Also, the election cannot be made if the corporation has more than 100 shareholders or has more than one class of stock.<sup>17</sup> For purposes of the 100-shareholder limitation, a husband and wife are counted as one shareholder and all the members of a family (six generations deep) may elect to be treated as one shareholder.<sup>18</sup> The one-class-of-stock requirement is not violated if the corporation has both voting and nonvoting common stock and the only difference is voting rights.<sup>19</sup>

In defining S status eligibility, trusts have received serious Congressional attention over the years. There has been a constant expansion of the trust eligibility rules, but many commonly used trusts still cannot qualify as S corporation shareholders.<sup>20</sup>

Electing in and out of S status requires attention to important details. An election to S status requires the consent of all shareholders.<sup>21</sup> A single dissenter can hold up the show. For this reason, often it is advisable to include in an organizational agreement among all the owners (typically a shareholder agreement) a provision that requires all owners to consent to an S election if a designated number of the owners at any time approve the making of the election. The election, once made, is effective for the current tax year if made during the preceding year or within the first two and one-half months of the current year.<sup>22</sup> If made during the first two and one-half months of the year, all shareholders who have owned stock at any time during the year, even those who no longer own stock at election time, must consent in order for the election to be valid for the current year.<sup>23</sup>

Exiting out of S status is easier than electing into it; a revocation is valid if

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15. I.R.C. § 1361(b).

16. I.R.C. § 1361(b)(2).

17. I.R.C. § 1361(b)(1)(A) & (D).

18. I.R.C. § 1361(c)(1).

19. I.R.C. § 1361(c)(4). Also, there is an important straight debt safe harbor provision that easily can be satisfied to protect against the threat of an S election being jeopardized by a debt obligation being characterized as a second class of stock. I.R.C. § 1361(c)(5). To fit within the safe harbor, there must be a written unconditional promise to pay on demand or on a specified date a sum certain and (1) the interest rate and payment dates cannot be contingent on profits, the borrower's discretion, or similar factors; (2) there can be no stock convertibility feature; and (3) the creditor must be an individual, an estate, a trust eligible to be a shareholder, or a person regularly and actively engaged in the business of lending money. For planning purposes, it is an easy fit in most situations.

20. Trusts that are now eligible to qualify as S corporation shareholders include: voting trusts; grantor trusts; testamentary trusts that receive S corporation stock via a will (but only for a two-year period following the transfer); testamentary trusts that receive S corporation stock via a former grantor trust (but only for a two-year period following the transfer); "qualified subchapter S" trusts (QSSTs), which generally are trusts with only one current income beneficiary who is a U.S. resident or citizen to whom all income is distributed annually and that elect to be treated as the owner of the S corporation stock for tax purposes; and "electing small business" trusts (ESBTs), which are trusts that elect to be treated as an S corporation shareholder and whose beneficiaries are qualifying S corporation shareholders who acquired their interests in the trust by gift or inheritance, not purchase, and who are willing to pay the highest individual marginal income tax rates on all S corporation income allocated to them. I.R.C. §§ 1361 (e)(1)(A), 1361(c)(2)(b)(v).

21. I.R.C. § 1362(a). See generally Reg. § 1.1362-6.

22. I.R.C. § 1362(b)(1).

23. I.R.C. § 1362(b)(2). For potential relief on a late election where there is reasonable cause for the tardiness, see I.R.C. § 1362(b)(5) and Rev. Proc. 2004-48, 2004-2 C.B. 172.

approved by shareholders holding more than half of the outstanding voting and nonvoting shares.<sup>24</sup> For the organization that wants to require something more than a simple majority to trigger such a revocation, the answer is a separate agreement among the shareholders that provides that no shareholder will consent to a revocation absent the approval of a designated supermajority. The revocation may designate a future effective date. Absent such a designation, the election is effective on the first day of the following year, unless it is made on or before the fifteenth day of the third month of the current year, in which case it is retroactively effective for the current year.<sup>25</sup>

#### **4. PARTNERSHIP OPTIONS**

A partnership form often is used for a venture that holds appreciating assets, such as real estate or oil and gas interests. Historically, partnerships also have been effective family planning tools to shift income to family members, freeze estate values, and facilitate gifting of minority interests at heavily discounted values. Often partnerships are used in conjunction with one or more other business entities. Their use with operating businesses has diminished in recent decades as the limited liability company has taken center stage.

Generally, there are four types of partnerships: general partnerships, limited liability partnerships, limited partnerships, and limited liability limited partnerships.

In a general partnership, each partner is personally liable for the debts and liabilities of the entity and has a say in the management of the business. No formal documentation is required to form a general partnership. All that is required is for two or more persons to manifest an intention to carry on a business for a profit. Thus, parties can inadvertently form a general partnership without knowing they have done so.

A limited liability partnership (“LLP”) is a partnership that, pursuant to applicable state law, has filed a statement of qualification (sometimes called an “application”) with the state’s secretary of state to eliminate the personal liability exposure of the partners. The name of an LLP must end with the words “Registered Limited Liability Partnership,” “limited liability partnership,” or the abbreviation “R.L.L.P.,” “RLLP,” “L.L.P.,” or LLP.”

A limited partnership is an entity that has one or more general partners (“GPs”) and one or more limited partners (“LPs”) and is formed under a state’s limited partnership act. GPs have the authority to manage and conduct the business of the partnership and are personally liable for the debts and obligations of the partnership. LPs typically are investors who have no or minimal control over business decisions of the partnership and have no personal liability for the obligations of the partnership beyond their capital contributions to the partnership.

The limited liability limited partnership (“LLLP”) is to a limited partnership

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24. I.R.C. § 1362(d)(1).

25. I.R.C. § 1362(d)(1)(C) & (D).

what an LLP is to a general partnership. Its role is to eliminate the personal liability exposure that general partners have for the obligations of a limited partnership. It's a relatively new entity form that has been adopted in roughly half the states. An LLLP must elect LLLP status in the limited partnership's filed certificate and use a name that includes the phrase "limited liability limited partnership," "LLL," or "L.L.L.P." With LLLP status, a general partner is not personally liable for an obligation of the limited partnership incurred while the partnership is an LLLP, whether arising in contract, tort, or otherwise. This limited liability protection exists even if the partnership agreement contained inconsistent provisions before making the election to become an LLLP.

Although partnerships file separate returns, they are not taxpaying entities. The profits and losses of the partnership are passed through and taxed to the partners under the provisions of Subchapter K of the Internal Revenue Code. The tax basics of partnership-taxed entities are reviewed in Chapter 9.

## **5. LIMITED LIABILITY COMPANY**

The limited liability company ("LLC") is a relatively new candidate. All states now have statutes authorizing LLCs, most of which were adopted during the 1980s. Many advisors claim that the LLC is the ultimate entity, arguing that it offers the best advantages of both corporations and partnerships and few of the disadvantages. It's an overstatement, but not by much in some situations.

As discussed in Chapter 10, there is no question that the arrival of the LLC has made the choice-of-entity challenge easier in many cases. Like a corporation, the LLC is an entity organized under state law. It offers liability protection to all owners, making it possible for its owners to fully participate in the management of the business without subjecting themselves to personal exposure for the liabilities of the business. LLCs are classified as either "member-managed" (managed by all members) or "manager-managed" (managed by designated managers).

Although similar to a corporation for state law purposes, a limited liability company is taxed as a partnership for federal income tax purposes unless it elects otherwise. As such, it offers better pass-through benefits than an S corporation and completely avoids all the S corporation eligibility and election hassles. It can have more than 100 owners, and partnerships, corporations, nonresident aliens, and any kind of trust can be included as owners. For these reasons, many wrongfully conclude that the LLC eliminates the need to consider S corporations and partnerships as viable pass-through entity candidates. As we will see in Chapter 10, there are still many situations where an S corporation or a partnership will be the best entity choice.

The professional limited liability company ("PLLC") is a state-chartered entity that allows licensed professionals (e.g., doctors and lawyers) to enjoy the benefits of a limited liability company. A PLLC does nothing to reduce a professional's personal liability for his or her own mistakes or malpractice, but it eliminates a professional's liability for the errors, omissions, negligence, incompetence or malfeasance of other professionals who are not under his or her supervision and control. It also eliminates personal exposure for contract

liabilities that the professional has not personally guaranteed. States often require that a PLLC register with the applicable state licensing board before filing its organizational documents with the state.

## **D. CHARACTERISTIC DIFFERENCES**

Every business has specific characteristics that define the nature and role of the business and reveal its uniqueness, strengths, weaknesses, market position, vulnerabilities, and a host of other important factors. These characteristics are key indicators of the business' growth potential, most significant risk factors, and long-term survival prospects. The following fifteen factors illustrate some of the common ways businesses are characterized and contrasted. In no sense is it an all-inclusive list.

### ***1. PRODUCT VS. SERVICE***

Whether a business is product-based or service-based is a core defining factor. Generally, a product-based operation is more complicated, poses greater downside risks, and offers the potential of higher yields for the owners of the business. The initial challenges of designing the product, developing manufacturing processes and relationships, and assessing and creating demand for the product set the stage for success or failure. Key operational challenges include managing inventory levels, developing supply chains to efficiently get the product to end-users, monitoring competitive conditions and other product life-cycle factors, and making smart pricing decisions that reflect market realities and preserve profit margins. It usually takes substantial capital and a talented management team. And, of course, the challenges are magnified many times when there is a group of products, as is so often the case.

Getting the product to end-users is a threshold, strategic consideration. Often the only viable option is traditional brick-and-mortar retail that requires a supply chain of regional and national distributors, local wholesalers, and a wide variety of retail outlets. Smart management is required to ensure product availability without ballooning inventories to risky levels, to protect and police the incentives and profit margins of all players in the chain, and to maintain the image of the product and the manufacturer. For example, wholesalers typically are prohibited from cutting out retailers by selling directly to end-users, and often there are manufacturer-imposed prohibitions on selling to businesses outside the approved chain of players or unreasonably discounting the product.

Every manufacturer must assess the role of the Internet in getting product to consumers. For many, it is a powerful tool to enhance product demand, educate potential consumers, and drive end-users into approved retail outlets. For others, the Internet is the sole and ultimate answer to their product delivery challenge, enabling direct communication and shipping to end-users while ignoring or eliminating the hassles and costs of traditional middleman players. The technological advances of e-commerce and ballooning popularity of online shopping have opened opportunities for many manufactures that could not otherwise effectively compete for retail shelf space or reach distant markets.

The profit potential for a product-based business often trumps by many times those of a service business. The driving factors are demand for the product, volume, and profit margins. The traditional service-constraints of time spent and hourly yields do not apply.

A service-based business is a very different and often a simpler enterprise. The focus is on defining the service, identifying and reaching a market, and generating a profit. In some situations, owner-investors can generate a yield by imposing price points that exceed the costs of running the business, including amounts paid to those who actually provide the services. In many others, the business is used to generate an income for employee-owners. Take, for example, the typical law firm that collects fees (usually based on hourly rates) for professional services rendered by members of the firm. Key challenges include professional training and recruiting, developing and exploiting a smart marketing plan and firm reputation, and implementing efficient office (or multiple office) procedures. Such challenges are very different from those required for a successful product-based company.

## ***2. ASSET-BASED VS. OPERATIONAL-BASED***

Some businesses are asset-based. The business exists because of an asset or group of assets. It may be a tract of real estate, a group of oil wells, a movie script, a valuable intellectual property right, a proprietary manufacturing process, or some other valuable, unique asset. Without the asset, there is no business or, at the minimum, a much different business. The useful life of the asset often defines the life cycle of the business.

The defining asset for some businesses is their brand. Often a brand has been developed over decades and has a perceived unshakeable stability, although there are brands that develop and fade quickly. The strength of a brand often is the supreme factor that enables the business to secure a strong market share and generate substantial profit margins by avoiding the competitive pressures of less profitable players. Such a brand can work for a multinational product-based company, a local service business, and everything in between. That's why the development of a strong brand is an overriding goal of many businesses, although very few succeed in enjoying the profitable benefits of a strong brand over the long-term. In 2013, the top five on Forbes' list of the world's most valuable brands (brand value only) were Apple (104.3 billion), Microsoft (56.7 billion), Coca-Cola (54.9 billion), IBM (50.7 billion), and Google (47.3 billion).<sup>26</sup>

However, a unique, valuable asset or strong brand often is not a prerequisite for success. Many successful businesses have neither. They succeed long-term by delivering services or moving products through operations that profitably exploit a defined niche in a market. Their value is measured by the strength, growth potential, and stability of their earnings. Their asset base often is not substantial and has little or nothing to do with their goodwill and going concern values. They often have a reputation for quality, but not the kind of brand

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<sup>26</sup> Kurt Badenhausen, "Apple Dominates List Of The World's Most Valuable Brands," Forbes (November 6, 2013).

identity that drives demand or transcends competitive pressures.

### 3. STAND-ALONE VS. AFFILIATED

Most businesses are stand-alone enterprises that are able to operate free from any direct controls by another system or company. They usually have important strategic relationships, but the business itself is not controlled by another entity or dependant on an affiliated system that the business does not control.

Other businesses are part of a broader affiliated group or system. Their success is tied directly to key decisions of the broader group and factors that impact the broader group. The most common examples are holding companies that have layers of subsidiaries, the control and ownership of which can be traced to a common parent holding company. The business of some of the subsidiaries often serves a niche function or market of a product line or service operation that reaches across the whole or a major segment of the affiliated group. Other subsidiaries may operate self-contained businesses that simply diversify the operations of the holding company and add to its consolidated earnings. One of the biggest examples of such a holding company is General Electric, whose multinational affiliated group includes hundreds of companies throughout the world, purchases dozens of companies each year, and maintains huge integrated operations in power and water, oil and gas, aviation, healthcare, transportation, home and business solutions, and capital formation. It is believed that GE files the largest tax return in the U.S.; its return for 2010, for example, totaled more than 57,000 pages.<sup>27</sup>

Franchising is an affiliated business expansion strategy that has spawned thousands of new companies since the 1950s. Although independently owned, each of these companies is tied to and dependant on a franchisor. Fast food outlets are the best example, but there are many other large franchise operations. The franchisor develops a specific business strategy, usually supported by a distinctive trade name and trademark, a broad-based consumer marketing and advertising campaign, detailed operating procedures, approved vendor sources, site approval procedures, and various other support systems. Expansion is funded by franchisees putting up money to establish their own franchise outlet businesses that are governed by a detailed franchise agreement. The agreement mandates operating requirements and imposes royalty obligations, usually a percent of gross revenues. The strength of the franchisor's control varies among different franchise operations, but it is always a crucial factor that limits flexibility and creates conflict potentials. For these reasons and the fact that franchisees usually must spec investment capital against the promises of a business plan developed and sold by the franchisor, the Federal Trade Commission has rules and many states have statutes that specify disclosure requirements, sometimes require advance registration, and often mandate the inclusion of specific franchisee-protection provisions in the franchise agreement.

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27. John McCormack, "GE Filed 57,000-Page Tax Return, Paid No Taxes on \$14 Billion in Profits," *The Weekly Standard* (November 14, 2011).

Multilevel marketing is another form of affiliated business expansion that has resulted in the creation of thousands of small businesses over the past five decades. Sometimes it is referred to as network marketing or referral marketing, and legally defective programs are often referred to as pyramid schemes. The typical multilevel marketing program recruits salespeople, each of whom receives commissions through the direct sale of products and direct sales generated by others in the “downline” that he or she recruits. Each salesperson operates as an independently owned business. Such marketing programs have often been criticized for their high entry costs, tendency to promote unrealistic profit expectations, price fixing risks, aggressive sales practices, and more. But the fact remains that highly successful multilevel marketing programs operate in all 50 states and have done so for decades. Examples of large, successful programs include Amway and Shaklee. Products that meet a consumer demand independent of any business opportunity factors are the key to long-term success and legality. If product sales predominately occur only as an incidental part of the salesperson recruitment process, the FTC and state regulators will likely deem the program an illegal pyramid scheme that is doomed to fail. Plus, many states have adopted business opportunity statutes that impose disclosure requirements on those who seek to sell business opportunities to others.

#### **4. MARKET POWER OR NOT?**

Some businesses have real market power, which is the power to control or influence the price or availability of a product or service in a given market. The best example is a monopolist, defined as the exclusive seller of a product or service for which there is no close substitute. Being a monopolist is not illegal per se, and even a very small business can enjoy the benefits of a monopolist if that business is the only provider of a product or service that has a demand in the relevant market. The sole plumber or newspaper in a small town may each have strong market power.

Market power is not limited to monopolists. Some markets have a few key sellers, each of whom may easily cue off the actions of the others so that the collective group, without any agreement or understanding, maintains prices and output levels that maximize profits. It’s called an “oligopoly,” and the expected behavior is called “oligopolistic interdependence.”

At the opposite end of the spectrum are atomism markets that have many sellers, none of whom are large enough to influence the market price. The withdrawal of a given seller’s entire supply from the market will not affect the market price. Often this is referred to as pure competition. Each seller accepts that it will sell its share of the market at the price established by the market, and that any attempt to exceed the market price will quickly halt sales.

#### **5. GEOGRAPHIC EXPANSION POTENTIAL OR NOT?**

The geographic reach of a business is always an important factor. A multinational business is defined as a business that maintains offices or assets in at least one country other than its own. Although some multinationals have budgets that exceed those of many small countries, a relatively small business that maintains inventories and sales personnel in a foreign land may meet the

definition of a multinational business. Technological advances and world market conditions are pushing many businesses of all sizes to seriously explore the benefits of international expansion.

A PwC family business survey in 2013 found that nearly half (47 percent) of U.S. family businesses were selling goods and services outside the country and even more (54 percent) anticipate they will be selling internationally by 2017. This represented a major increase from two years earlier when only 30 percent of surveyed family businesses were intending to develop markets abroad and a huge jump from 2007 when only 21 percent planned on exploring international markets. As for the most likely targeted markets, 30 percent of the surveyed companies are eyeing the Americas (primarily Brazil, Canada, and Mexico), 25 percent have their sights on the Asia Pacific region (China alone garnered 14 percent), and 14 percent are focused on Europe.<sup>28</sup>

Any geographic expansion increases complexities and costs. In addition to new employee and management challenges, there are a host of planning issues, including increased risk-management assessments, enhanced regulatory burdens, cultural differences, and the need for an expanded multi-entity business structure. Often a separate subsidiary company needs to be formed to conduct operations in a different state and certainly a different country. It usually makes no sense to expose the main business entity to the regulatory, tax, and liability risks of a new jurisdiction.

## **6. HIGH VS. LOW LEVERAGE**

Leverage refers to the use of debt in financing a business. The yield realized on the capital invested by the owners of a business can be increased by leveraging the borrowed dollar to finance a portion of the business. For example, if the business can grow its earnings by borrowing funds at a 6 percent interest cost and generating a return of 12 percent on the borrowed funds, the spread between the cost and the yield directly boosts the return to the owners. It's Business 101. In nearly all businesses, smart leveraging makes sense. It's not a question of whether. It's a question of how much.

The risks of too much leverage are real. When leverage is overused, a significant drop in asset values or earnings may wipe out the equity capital in the business, leaving the company with liabilities that exceed its asset base and the inability to service its ever-ballooning debt load. The company will be headed for bankruptcy absent one or more of three remedies. The first is a quick reversal of values and earnings, which often becomes progressively less likely as others in and out of the company react to the company's deteriorating condition. The second is an infusion of new equity capital, which usually becomes much tougher when debt takes over. The third is a government bailout, the "too large to fail" answer for the grossly over-leveraged financial institutions that found themselves upside down with debt when their asset values crumbled in the fiscal crisis of 2008.

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28. PwC Family Business Survey 2012/2013 (US Findings). PwC is a network of firms in 158 countries with more than 180,000 employees that provide assurance, tax, and advisory services.



The risks of no or too little leverage are just as real, but not as severe. Owners of successful businesses eventually face a basic decision regarding the profits generated by the business. Are the profits going to accumulate in the company or be distributed to the owners of the company? The easy answer for many is to stockpile. Keep the profits in the company. Let them ride as the business expands and matures.

During the building period of most businesses, stockpiling usually is the only viable alternative. The earnings are needed to finance inventories, receivables, facilities, better technology, and new personnel. More debt isn't possible or prudent. As the business begins to mature, the retained profits are used to retire debt and the pressure to accumulate begins to fade and often disappears completely. But in many cases, this accumulation pattern has been set. The owners enjoy watching the net worth of the business expand every year with a corresponding increase in the value of their equity. Their success is measured and quantified by the accumulations. As time goes on, the balance sheet of the business becomes rock solid – lots of equity, little or no debt – while the balance sheets of the owners become lopsided – a large net worth and a big taxable estate, the bulk of which is represented by a single business equity interest. Concentrating wealth in the business can be risky, imprudent, and damaging in the long run. Beyond diluting the owner's yield, it can hike risk management pressures (too much of the owners' wealth is exposed to business risks), make it harder to transition the business, and reduce the benefits of income and estate tax planning.

There is no stock answer to the "How much leverage?" question. As explained in Chapter 3, a debt-to-equity ratio is often used as a measure of a business' leverage. Generally speaking (and I do mean "generally"), a ratio of under 5-to-1 is considered reasonable for a profitable, mature business while a ratio in excess of 10-to-1 is usually suspect. The gap between five and 10 often is a grey area. This ratio may be a measure, but often is not a sole determining factor. For example, two businesses may each reasonably use a bank line equal to 90 percent of their current collectible accounts receivable and 50 percent of the cost of their current salable inventories. Because of differences in the asset mixes of the two businesses, the bank line produces a 6-to-1 ratio in one business and a 4-to-1 ratio in the other. For many businesses, various factors must be considered in setting a smart leverage level, including industry standards, the asset base of the business, the stability of earnings, current banking practices, and more.

## **7. SCALABLE OR NOT?**

Scalability is an important factor in assessing the growth potential of a business. A scalable business is one that can maintain or increase its profit margins as the volume of the business expands to higher levels. The operations, asset requirements, and market conditions easily accommodate a growth in volume without a hit to profit margins. Many non-manufacturing businesses are scalable. A service business often can continually increase its profitability by adding more personnel to service a growing demand. So too, a product-based company that continually distributes a higher volume of finished goods that it

sources from others may preserve or enhance its margins and thereby increase its profitability as it continues to grow.

A non-scalable business is one that cannot handle a higher volume without making investments or other changes that currently reduce margins. Higher volumes may require significant infrastructure improvements, expensive expansion into new markets, and more. Assume, for example, that a company has the capacity to produce 100,000 units. A production level of 50,000 units results in a cost per unit of \$7.00. As volumes increase and production moves upwards towards 100,000 units, positive economies of scale kick in, high equipment fixed costs are spread over more units, and the cost per unit eventually drops to \$5.00. Production beyond 100,000 units requires a significant new investment in equipment and systems that drives up the cost per unit to \$8.00, resulting in a corresponding decrease in profit margins.

### **8. SMALL VS. LARGE EMPLOYEE BASE**

Few businesses can survive without the loyal support of dedicated employees. But nearly all business owners appreciate (or certainly should appreciate) that the challenge goes beyond motivation and management. Laws have continually evolved to give employees more rights; and these rights pose risks for the uninformed business owner who is determined to run the show just as he or she did 20 years ago.

The role of a company's employment base often is a defining factor for a business. In many businesses, it's everything. The existence, profitability, and growth potential of the business is dependent on an ever-evolving base of rank-and-file and management employees. Every expansion requires, at a minimum, a proportional increase in the employee base.

Other businesses are able to grow with disproportionately small increases in their employment ranks. Technology and management innovations and personal incentives are designed to enhance the productivity of each employee. The focus is higher productivity, not just more employees. Often this is coupled with strategic outsourcing relationships that enable the company to shift specific operations and functions to outside independent contractors.

There are reasons why a company may want to explore options for reducing its dependence on an ever-growing employee base. Recruiting, retaining and motivating a work force usually get progressively more difficult as the base grows. Required cutbacks are painful and expensive. The uncertainties and ballooning costs of employee benefits often put pressure on the bottom line and create ongoing expectation challenges and cost sharing conflicts.

Employee terminations are always a challenge. While most employers believe they operate under the "at will" doctrine as regards their employees, the company takes a risk every time it terminates an employee. Wrongful discharge suits have popped up with increasing frequency throughout the country. Many employee victories have been publicized. New laws have been made in the courts and the legislatures, chipping away at the old "at will" standard. Each victory and law change has provided incentives to aggrieved, discharged

employees and lawyers who are willing to fight their cases. Many companies have had to endure the pain of paying big legal fees to defend the termination, only to pay more when the employee prevails. The operative word is "caution" when terminating an employee.

Employees pose potential liability risks that should be mitigated with smart planning. In general, a company is responsible and liable for those acts of its employees that are carried out within the scope of their employment. This is a true vicarious liability. It is one of the broadest forms of vicarious, third-party liability in the law. The company may be fully liable, even though it had no direct involvement with, or knowledge of, the event creating the problem. In most instances, the liability pops up because an employee has committed one of four wrongs: (1) the employee exceeds his or her authority in making a deal on behalf of the company; (2) the employee, in the process of carrying out his or her duties, negligently or recklessly injures another party; (3) the employee ignores or violates a black letter law that has been established for the good of all; or (4) the employee engages in intentional misconduct that, in some cases, may rise to the level of criminal conduct. Businesses usually need to take specific steps to reduce or mitigate the scope of the liability that may be created by employees

## ***9. UNION VS. NON-UNION***

A relatively small percentage of employees in the private (as opposed to government) sector are represented and protected by union relationships. The percentage of private sector union employment has consistently fallen for decades. In 2013, for example, the private sector percentage was 6.7 percent, about one-fifth of the percentage for public sector employees. In the private sector, industries with high unionization rates included utilities (25.6 percent), transportation and warehousing (19.6 percent), telecommunications (14.4 percent), and construction (14.1 percent).<sup>29</sup>

Union employees usually are subject to contracts that offer various protections. Examples: employee discipline and discharge often are subject to grievance procedures and binding arbitration; wages, benefits and working conditions are subject to negotiation; hiring and promotion decisions may be governed by contractual provisions that impose seniority and other requirements; labor and management are contractually obligated to listen and negotiate and pursue reasonable compromises; contractual changes require the consent of both labor and management.

## ***10. HEAVY REGULATION OR NOT?***

Increasing government regulation is a fact of life for business. According to the Congressional Research Service, over 13,000 final rules were published in the Federal Register from 2009 to 2012. Small businesses are hit the hardest by increased regulation. Small businesses now bear a regulatory cost of \$10,585 per employee, estimated to be 36 percent higher than the regulatory per-employee compliance cost for large businesses. Small business environmental compliance

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29. News Release, Department of Labor Statistics, U.S. Department of Labor (January 24, 2014).

costs exceed by more than four times the corresponding costs for large firms.<sup>30</sup>

The highest three regulated sectors are financial, healthcare, and energy. Any business in these industries must continually be tuned in to government regulators. But since nearly all businesses need energy, want healthcare benefits for their employees, and require financing, the positive benefits and associated increased costs and burdens of ever-growing regulation in these and other industries are ultimately felt across the economy.

### ***11. INTERNET-DEPENDENT OR NOT?***

The Internet is the most powerful communication tool that has ever been available to business enterprises. For business purposes, it has shrunk the world and created countless entrepreneurial opportunities that couldn't possibly exist without it.

Many businesses are not inherently dependent on the Internet. They use the Internet to promote their businesses and educate their customers, but their core operations are not directly tied to their use of the Internet. Generally, they need not fear that a new or expanding company from anywhere in the world may threaten their market share with an Internet-based strategy.

Other businesses exist because of the Internet. These include those that provide Internet support services, such as website design, optimization, and app development services. It also includes businesses that must use the Internet to conduct their businesses. Take Dena, for example, a stay-at-home mom of three young children who imports her custom designed infant parasols from a China manufacturer, takes orders principally from European and African buyers who want quality parasols that bear the names of their children or grandchildren, and customizes and ships the parasols from a garage in a small Northwest town. A tiny business of this type that reaches from China to Africa would be impossible without the Internet, the tool that attracts customers in a foreign land at an insignificant cost. Dena is able to compete heads-up with her competition, but understands that anyone from anywhere could use the same tool she uses to challenge her market share.

### ***12. LOW-TECH VS. HIGH-TECH***

A low-tech business is one that does not rely heavily on new technology to sustain its market position. It does not have to keep coming up with new technology concepts to support the viability of its product mix. It offers a group of products that are readily recognized as non-technical. In contrast, a high-tech business is dependent on its ability to create new ideas and new products. Often the success of the high-tech business is tied directly to the talent of individuals who work in the business. The overriding, ongoing challenge is to secure and recruit new talent.

From a profit perspective, seldom will a low-tech business be able to match the upside potential of a successful high-tech operation. High-tech usually poses

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30. Small Business Fact Sheet, U.S. House of Representatives Committee on Small Business (May 21, 2013).

greater risks, and offers the potential of larger and faster rewards. A successful high-tech start-up can quickly secure the financial future of its founders. As we have seen many times, the age and business acumen of the innovators often are not limiting factors.

Regarding risk and stability, often a low-tech business will be in a much stronger position than a struggling high-tech business. Today's high-tech business can quickly end up being tomorrow's defunct no-tech business if it cannot keep pace by producing new products that play well in the marketplace. The competition in high-tech businesses progressively grows at a rapid pace as players from around the world continue to surface and expand. The past 30 years suggests that no one can comfortably predict who will be the dominant high-tech players in the following decades.

### ***13. STRATEGICALLY-BASED VS. RELATIONSHIP-BASED***

The strength of some businesses is primarily attributable to key personal relationships that have been developed over many years. The relationships may be with suppliers, customers, key employees or all three. These relationships give the business its advantage and make it possible for the business to succeed. In contrast, there are other businesses that are strategically-based. They have identified and filled a market niche that is not dependent or tied to personal relationships. The business succeeds because it is strategically situated to competitively deliver goods or services in its identified market niche.

Obviously, a strategically-based business has a better chance of surviving long-term than a relationship-based business. Relationships are often difficult, if not impossible, to transfer. A child, for example, may develop a friendly interface with a crucial vendor, but that interface may never match the strength of the personal relationship that the child's father had with the vendor. The challenge becomes even more difficult when the vendor's successor takes charge. The reality is that, over time, the strength of personal relationships often breaks down and fizzles out as attempts are made to transition relationships. As this occurs, there is a substantial risk that the business activity between the parties will diminish unless both parties identify a strategic business advantage for maintaining the relationship.

Often it is assumed that a business is strategically-based, when, in fact, the basis of its success is personal relationships that have been developed over many years. Similarly, there are some businesses that appear to be propped up by relationships, but that could be strategically strengthened with some careful analysis, restructuring and public relations. The ongoing challenge is to identify key personal relationships, assess the importance of those relationships to the overall success of the business, and evaluate the capacity of the business to enhance its strategic base.

### ***14. INSTITUTIONALIZATION OR NOT?***

A central challenge for many businesses is to begin the process of institutionalization. In this context, an institutionalized business is one that is bigger than any one individual. Its operations and growth do not primarily

depend on the person who started it all. It has developed systems, personnel, management structures, and expertise to allow it to function like an institution. Usually, this condition is easily recognized by the employees of the company and outsiders who deal with the company on a regular basis. The contrast is the business that is operationally dependent on one individual. That individual is the key to all that happens. Without the daily presence of that individual, the business lacks direction and suffers. The systems, support personnel, and expertise are absent.

Often founders of a business do not want to invest the time or capital required to build systems and personnel that will allow the business to effectively function on its own. In some cases, it takes a financial commitment that the owners are unwilling to make. In others, it's an issue of control or ego. The owner enjoys the importance of his or her invaluable presence. The challenge is to fairly assess whether appropriate steps are being taken to institutionalize the business. Usually these steps are critical if the business is going to survive long term.

### ***15. HIGH VS. LOW MARGIN TOLERANCE***

Does the business have the capacity to survive and prosper if it is faced with some tough price competition? A helpful question: What would be the impact if the business was forced to cut its gross margin by 3 or 4 percent to remain competitive? If the response is a roll of the eyes and a "No way" exclamation, this may suggest that the long-term survival prospects for the business are weak.

In most businesses, price competition is intensifying. Others have found better ways of producing the same products or delivering comparable services at lower prices. New manufacturing techniques and operating systems are being developed to allow businesses to operate more efficiently. Businesses are "right sizing" to cut out the fat and to have the capacity to operate on lean, tough margins. New players are not tied to old systems and old investments.

Often a business finds itself at an extreme competitive disadvantage as bigger and stronger players, sometimes from foreign lands, enter the market. It does not have the capital or the sales volume to justify the development of the economies of scale and operating systems that would allow it to remain tough on price. This condition prompts may to consider selling while the company's market share is still intact. If the opportunity is missed, the owners may be forced to sacrifice or eliminate profitability by cutting margins to preserve the business. This has been the fate of many businesses that have been unable to survive a second generation.

## **E. BUSINESS PLANS**

A business plan is a written document created and used by entrepreneurs and others who desire to develop or expand a business. It's much more than just a marketing plan. It explains in detail all the key aspects (sometimes called the "DNA") of the business. A well-conceived and written business plan takes time, research, analysis, and an intellectual honesty that continually questions base

assumptions and core underpinnings of the proposed business. Plus, the writing must reflect quality – a style that is clear, concise, and convincing and avoids overstated adjectives, convoluted sentences, and sloppy grammar. The role of legal advisors usually never goes beyond select technical aspects of the plan, such as entity choice, tax, and securities law considerations. Although lawyers do not write business plans for their clients, it often helps to have a basic understanding of the purposes and elements of a plan and what separates the good from the bad.

### ***1. PURPOSE AND ROLE***

Is a business plan always necessary? There are countless blogs and articles that try hard to make the case that detailed written business plans often are a waste of time and effort and that business schools should scrap their business plan courses and competitions. Although there are examples of successful company launches without a business plan and virtually no guarantees that a business plan itself will turn an idea into a successful business, the value of a business plan to two vital groups is hard to deny in the real world.

The first group is the organizers of the enterprise, those who must create the plan. The process of creating a plan and reducing it to writing often pushes everything and everybody to a higher level: better critical thinking, deeper market knowledge, smarter risk factor strategies, better understanding of funding needs and expectations, and more. The result is that the key players are more capable and confident to tackle the new enterprise. If done right, the plan becomes a living, evolving document that is continually used as a tool to define and measure performance and success.

The second group that benefits from and needs the document is the potential investors who often are essential to funding and jumpstarting the enterprise. While a few ideas may be sufficiently attractive on their face to attract investor interest without a written business plan, the great bulk of ideas will go nowhere unless the details are fleshed out and the case for success is made in a smartly crafted business plan.

### ***2. PLAN ELEMENTS***

A business plan typically includes the following elements:

- **Executive Summary** – Brief review of plan that sparks interest by recapping mission statement, product or service, relevant markets, key customers, financial requirements, management’s background and expertise, and potential yield to investors.
- **Product or Service** – Detailed description, potential of different versions, why needed and valued by customers, status of development and readiness for market, intellectual property elements, any licensing and royalty requirements, future enhancement potentials, and challenges to volume growth.
- **Market and Competition** – Definition of relevant market(s), size of market, market growth potential, market profitability potential, technology and regulatory impacts on market, customer descriptions and customer segmentation

criteria, competitor strengths and weaknesses, positioning opportunities against existing competitors, future competitor risks, anticipated competitor and market reactions.

- **Sales and Marketing** – Pricing considerations and challenges, volume expectations, consumer education needs and risks, selling process, strategies for reaching customers and getting product or service to customers, advertising strategies and risks, reliance on third parties in supply chain, Internet role and options, launch and ongoing budget needs.

- **Business Organization** – Form of entity, organizational chart, lines of authority, key outside company relationships, needed technical expertise and sources, quality assurance challenges, risk management measures, location of business.

- **Management Team** – Description of key players and their backgrounds, common vision of group, complementary attributes and strengths, staying power and individual commitments to enterprise, prior history working together.

- **Plan Implementation** – Implementation schedule, investment timing and variables, human resources planning, key milestones, bottleneck risks.

- **Financial Elements** – Detailed financial projections (three to five years) under three alternative scenarios, key assumptions and their reasonableness, breakeven timing and key factors, cash flow analysis and risks, setback impacts and alternatives, investor return potentials.

- **Risks** – Description of key market and delivery risks, technology challenges, interest rate risks, key human resources risks, strategies and options for mitigating risks.

- **Appendix** – Management resumes, organization chart, supplemental market and competitor information, key articles, other relevant outside sources.

### 3. APPEALING TO INVESTORS

Many business plans contain all the requisite elements, read like a novel, and completely fail to capture the interest of investors. Often they resemble a canned “paint-by-numbers” project that was approached and executed as a chore. They look complete on their face, but lack genuineness, a demonstrated expertise, and smart, thoughtful analysis. A superficial review by an experienced investor will quickly trigger concerns about management’s vision, passion, and understanding of what lies ahead.

In order to appeal to experienced investors, a plan usually must persuasively explain why and how the proposed company will profitably meet a definable need and be relevant. It must demonstrate that the proponents, through tough analysis and research and their development of market expertise, know their customers, the competition, industry trends, and how specific competitors will be impacted or eliminated. The plan must convincingly describe how a quality team has come together to develop a vision, priorities, and processes that will convert a smart idea into an efficient, well-managed, profitable business.



## STUDENT PROBLEM 1-1

Jennifer, a lawyer who works with many businesses, is having lunch with Jeff, a client who owns and operates a successful trucking company. Jeff explains that his brother-in-law Sam has given him the opportunity to invest in a company (“Twilight”) that operates retirement homes in two states. Sam, Twilight’s chief financial officer, has explained to Jeff that Twilight is owned by five individuals (including Sam), has become very profitable, plans on expanding into six more states, and is seeking expansion capital from a small group (no more than 10) of new investor-owners. Sam characterized the investment opportunity as “a no-brainer windfall.” Jeff has set up a meeting with Sam and other key Twilight officers.

After explaining this background, Jeff states to Jennifer, “I know trucking, but retirement homes and this type of an investment are completely foreign to me. I would like to be able to ask some smart questions at this upcoming meeting in order to assess the opportunity and, perhaps most importantly, to dispel any notion held by my brother-in-law that I am a soft-touch fool who happens to have some money. If you were in my shoes, what are the key questions you would ask?”

Assume that you are Jennifer. Based on what you have read in the prior 24 pages and your general instincts, list the top 10 questions that you would recommend to Jeff.