PRACTICING PREVENTIVE LAW: SEVEN COMMON MISTAKES OF CLOSELY HELD COMPANIES

Practicing preventive law is simply the process of addressing legal issues before they become expensive legal problems. The issues summarized below are among those most frequently overlooked by private companies and their owners.

1. **Failure to Maintain Accurate Ownership Records.** There is usually little doubt in the minds of the owners as to who owns the Company. However, this is not something a potential buyer, lender or investor is likely to rely upon, absent legal documentation. As noted in a recent PLDO Client Advisory, a prospective buyer, lender or investor will almost never make a final decision without first conducting a thorough due diligence review of the company. Near the top of most due diligence checklists will be a review of share ownership records and the current "cap table". A cap table is simply a document which provides a snapshot of the current ownership of the company and the relative interests of the owners. It should be broken down by class or series of outstanding securities (voting, non-voting, common or preferred) and include outstanding options, warrants and convertible securities. A prospective buyer, lender or investor will typically compare the cap table with the records of the issuance and transfer of securities. If they do not agree, it sends a very negative message about the company and its management.

2. **Inadequate Succession Planning.** A significant portion of the net worth of many business owners is represented by their interest in the business. In order to realize the value inherent in that business, each owner needs to address what happens upon his or her death, retirement or disability. When there is more than one owner, it is also advisable to take steps to ensure that the owners do not find themselves in business with strangers or even competitors. This can happen if there are no restrictions on transfer of interests in the business. Succession plans vary depending on facts and circumstances, but a well drafted shareholders agreement is at the core of virtually every effective succession plan. If your company does not currently have a shareholders agreement or if the business value, number of owners or other factors have changed significantly, this may be the time to revisit your goals and how best to achieve them.

3. **Failure to Protect Intellectual Property.** You do not need to be a classic "high tech" company to have valuable intellectual property. Most companies have important, non-public information which is valuable to the operation and success of the business. Common examples include customer lists, business processes, manufacturing know-how, methods of estimating jobs, pricing models, strategic plans, compensation arrangements with key employees and terms of strategic relationships. Protecting this intellectual property will help preserve the company's competitive advantage.

   There are several key components to protecting this intellectual property. First, all employees and service providers who have access to this information should be required to sign confidentiality agreements and, where appropriate, assignment of invention agreements. Secondly, even if such agreements are in place, a court may not enforce them unless the company actually treats the information as confidential. This means limiting access of the information to those people with a "need-to-know" in order to perform their jobs. The best confidentiality agreement may not protect a company if it can be shown that allegedly confidential information is routinely left unprotected or is otherwise broadly accessible to anyone who may want to look at or copy it.

If some of your intellectual property is protected as a trademark, service mark or copyright, be sure to include appropriate trademark and copyright notices whenever you use the material. In some cases, the value of these assets may warrant registration, but common trademark law and copyright notices do not require any form of registration or other out of pocket expense and they can go a long way toward protecting your rights in these assets.

4. **Treating Employees as Independent Contractors.** Companies, large and small, have always had a financial incentive to classify a person who provides services to the company as an independent contractor or consultant, rather than an employee. First, if the person truly is not an employee, the company is relieved of the cost and obligation of providing workers compensation insurance, no payroll withholding is required and it permits the company to exclude the service provider from expensive employee benefit plans, including medical insurance, 401(k) plans and other employee benefits. The laws of many states make it difficult to properly classify a service provider as an independent contractor, rather than a W-2 employee. Despite the fact these laws often contain some serious penalties (both civil fines and, in some cases, criminal penalties), an informal poll suggests the law is often being ignored, particularly in certain industries. If your company uses independent contractors to provide services in the ordinary course of its business, you need to examine whether these people should be reclassified as employees.

5. **Raising Money Without Complying with Securities Laws.** Companies can rarely grow and prosper using only cash flow from operations. It is also a fact of life that companies which do not have an established track record find it difficult to obtain bank financing. The gap is usually filled by loans or equity investments from friends and family, angel investors, major suppliers, customers or other strategic partners. Like it or not, those capital raising transactions are governed by a complex set of federal and state securities laws. Although exemptions (so-called "private placement exemptions") from the more onerous registration requirements are usually available, appropriate steps need to be taken in order to qualify for these exemptions. Failing to do so can have serious consequences, including the right of the investors to get their money back, with interest. Perhaps as important, failure to comply with applicable securities laws in early round investments may mean that a more sophisticated venture capital or private equity investor will decide not to invest in your company for fear of becoming involved in an expensive problem arising out of the company's earlier non-compliance.

6. **Deferred Compensation Trap - Internal Revenue Code Section 409A.** The adoption of Section 409A brought about major changes in the way the IRS taxes certain types of deferred compensation paid to employees and other service providers. The rules are complicated and impact companies of all sizes in unexpected ways. Running afoul of these rules can result in the employee or service provider having to recognize income before they actually receive cash payments for services rendered. Furthermore, they may be subject to a 20% penalty, plus interest, in addition to the regular income tax. Even though the law places the tax burden on the person who provided the services, the adverse impact of these rules can be avoided. For that reason, service providers who find that they have fallen into this trap are likely to sue the company for failing to properly structure their compensation arrangements to avoid these adverse tax consequences. If your company has or is planning to put in place any agreements or arrangements with service providers that provide for payment in a year after the services were rendered or grant to the service provider certain options or other forms of equity compensation, you need to know more about these rules.

7. **Inadvertent Loss of S Corporation Status.** Many corporations elect to be treated as S corporations for federal income tax purposes. As a result, no tax is paid at the corporate level. Instead, taxable income or loss is reported on the owners' individual tax returns. The savings can be substantial since the corporation's income is subject to only one level of tax. Unfortunately, the rules have become complicated to the point that some companies run the risk of inadvertently losing their favorable S corporation status. It is widely known that S corporations can only issue voting and non-voting common stock. No preferred stock is permitted. However, the application of this seemingly simple rule can lead to an inadvertent loss of S corporation status.

   First, it is not enough to simply designate stock as common stock in the company's charter documents. If bottom line income is allocated pro-rata according to stock ownership, as required, but the timing of distributions of income to the stockholders varies, the IRS can take the position that, in substance if not in form, the company has impermissibly issued a class of preferred stock. A common example of this potential trap might involve an S corporation with two 50/50 shareholders. At the end of the year, the S corporation has a profit of $100,000. Shareholder A receives his share of profits in January because he needs the money to pay college tuition for his children or for some other purpose. Shareholder B has no current need for the money, so he leaves his share of the profits in the corporation and does not take it out until October. Under applicable IRS Regulations, the timing difference could give rise to an argument that Shareholder A has a preferred class of stock, particularly if this distribution pattern is repeated over a number of years.

   The second area of potential scrutiny involves contractual rights to use company property or other benefits. If one or a select group of shareholders have a preference for the use of corporate owned real estate or other property or they are guaranteed certain levels of income or other distributions and those rights are not demonstrably reasonable compensation for services actually rendered, there is a risk these contractual rights would be viewed as a class of preferred stock in the event of an IRS audit. There are many other situations that can result in loss of S corporation treatment, but the foregoing examples seem to have become increasingly common in recent years.

By practicing preventative law and addressing these common issues before they become problems, closely held businesses can more effectively manage legal risks and costs. If you have questions or would like more information, please contact PLDO Partner William F. Miller at 508-420-7159 or email wmiller@pldolaw.com.

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