

# Harvard Business School Social Entrepreneurship Workshop Series



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## Legal Aspects of Starting a Social Enterprise

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## HBS Teams That Became Foley Hoag Clients

- YouTea!
- KartMe, Inc.
- Good Start Genetics, Inc.
- EyeView
- LeanForward Media
- ThredUp, Inc.
- iShoe, Inc.
- Clear Suppliers Corporation
- Vision Green
- ZEFER
- Elective Medical Lending, Inc.
- Shokay International
- OSComp Systems
- Palliative Care of America
- EGG-energy Inc.
- giiv, Inc.
- Unite for Health
- Mountains for Miracles
- Souktel
- Charitable Donations Group
- C3 BioEnergy
- Living Power Systems
- Uplift
- Extend Fertility
- Physica Solutions
- EcoSquid
- Birchbox, Inc.

# Today's Topics

- **Choosing a form for your enterprise**
- **Basic equity issues**
- **Basic intellectual property issues**
- **Basic employment issues**
- **Key contracts**
- **Questions**

# Choosing a Form for the Enterprise

## ■ Making the Choice: Questions

- Mission and message
- Funding
- Sustainability
- Exit

# Choosing a Form for the Enterprise

	<b>For-Profit</b>	<b>Nonprofit</b>
<b>Mission</b>	<ul style="list-style-type: none"> <li>Financial profit motive</li> </ul>	<ul style="list-style-type: none"> <li>Religious, charitable, scientific, testing for public safety, literary, educational, or other purposes</li> </ul>
<b>Funding</b>	<ul style="list-style-type: none"> <li>Equity investments</li> <li>Loans</li> <li>Earned income</li> </ul>	<ul style="list-style-type: none"> <li>Donations and grants <i>(charitable deduction for donations to 501(c)(3) organizations)</i></li> <li>Loans</li> <li>Earned income</li> </ul>
<b>Ownership</b>	<ul style="list-style-type: none"> <li>Individuals and entities</li> </ul>	<ul style="list-style-type: none"> <li>None</li> <li>Note: AG and IRS</li> </ul>
<b>Taxes</b>	<ul style="list-style-type: none"> <li>Pay income tax and capital gains tax</li> </ul>	<ul style="list-style-type: none"> <li>Exempt from income tax and capital gains tax (but still must file an information return)</li> <li>But: UBIT, employment tax, etc.</li> </ul>

# Choosing a Form for the Enterprise

- **For-profit enterprise**

- Sole proprietorship
- Corporation
- Partnership
- Limited liability company

- **Nonprofit enterprise**

- Non-stock corporation
- Trust
- Separate process: exemption from federal income tax.

- **“Hybrid” enterprise?**

# For-Profit Corporation

- **What is it?**

- Almost always a “C corporation”
- Profit motive: maximize financial return for shareholders
- Limited liability structure
- Two levels of taxation

- **Formation and maintenance**

- Certificate of incorporation and by-laws
- Annual maintenance (meetings, file reports, etc.)

- **Funding sources**

- Investors
- Earned income
- Loans

# For-Profit Corporation (cont.)

## ■ Management

- Board of directors
  - Elected by stockholders
- Officers
  - Named by board
- Both are fiduciaries: duties of care and loyalty; business judgment rule

## ■ Exit

- Distribute assets upon liquidation
- Distribute proceeds upon merger or asset sale
- Achieve liquidity through IPO

## For-Profit Corporation (cont.)

### ■ Equity ownership

- Stockholders are owners
  - “Internal” – founders, directors, officers, and other employees
  - “External” – investors
  - Public market

### ■ Equity ownership; internal (common stock)

- “Founders” shares
  - Issue shares as early as possible
  - Use “reverse vesting” – even for yourself
  - Critical tax consequences (e.g. 83(b) election)
- Shares to employees, new hires
  - Restricted stock vs. stock options
  - Avoid “percentages” – focus on number of shares

## For-Profit Corporation (cont.)

- **Equity ownership; “external” (usually preferred stock)**
  - Choosing investors wisely
    - Best angel and venture investors offer more than just money
    - Keep it simple, especially early on
    - Be mindful of securities laws issues
  - Understand what “preferences” really mean
    - Liquidation preference
    - Anti-dilution protection
    - Board representation
    - “Protective” provisions

## Contrast: Nonprofit Corporation

- **What is it?**
  - Almost always a corporation
- **Formation and maintenance**
  - Similar requirements as a for-profit corporation
- **Management**
  - Similar to a for-profit corporation
  - One difference: statutory members vs. stockholders
- **Equity ownership**
  - None. Major difference from for-profit enterprise
  - Assets held “in trust” for public

## Contrast: Nonprofit Corporation (cont.)

### ■ Funding sources

- Grants and donations
- Earned income
- Loans
- Major difference from for-profit enterprise

### ■ Tax exemption

- Major difference from for-profit enterprise
- Except unrelated business taxable income (“UBTI”), employment taxes, etc.
- No private benefit or private inurement
- Either “publicly supported” or a private foundation
  - Formula for public support test
  - Strict rules for private foundations

## Contrast: Nonprofit Corporation (cont.)

### ■ Use of funds

- Religious, charitable, scientific, testing for public safety, literary, educational purposes, or other purposes
- Oversight by Attorney General and IRS
- Articles of organization: dissolution clause
- No “exit”
- Be careful about arrangements with for-profit entities

# Types of Intellectual Property

- **Patents**

- New and useful invention or process

- **Copyrights**

- Original work of authorship (any medium)

- **Trade secrets**

- Valuable information, maintained in secret

- **Trademarks**

- Distinctive, associated with service or product

# Key Intellectual Property Issues

- Founders, employees, and consultants
  - Assignment of inventions agreements
- Confidentiality agreements
- Agreements with manufacturers, vendors, customers
- Have the right to use the intellectual property of others
- License to others the use of your intellectual property
- Protect intellectual property
  - Use
  - Registration

# Key Employment Issues

- Restrictive agreements with prior employers
- Student status
- Immigration status
- Terms of employment
  - At will
  - Term of employment (inadvertent or explicit)
- Employee or independent contractor
- Exempt or non-exempt status
- Payroll taxes and withholding obligations
  - Potential personal liability for officers and directors

# Initial Contracts to Consider

- Employment agreements/offer letters
- Agreements among founders
- Non-disclosure agreements
- Development and non-competition agreements
- Financial agreements
  - Stock purchase agreements (for-profit enterprises)
  - Loan agreements
  - Private foundation grants and PRIs
  - Private donations (nonprofit enterprises)
- Intellectual property licenses
- Insurance



# Questions?

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