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# Minimizing Disputes and Maximizing Profits: Five Balancing Acts for New Business Owners

*Trippe S. Fried\**

## I. INTRODUCTION

A business begins with an idea, one person's plan, innovation, or concept that may, in the future, become part of a profit-making endeavor. Developing a going concern around that idea or concept usually involves a number of people, each of whom offers a specific, often indispensable asset or skill. One person may bring money, another expertise in design or marketing, and a third contacts with vendors or customers. Successful businesses are most often built upon a combination of several individuals' resources and talents.<sup>1</sup>

Almost two-thirds of all business start-ups fail within six years.<sup>2</sup> The causes are myriad: The market for the product or service offered may collapse, there may be inadequate capital for the business to produce and distribute the product, government approval for the sale of a regulated commodity or for the payment for a regulated service may take too long to obtain, or competition from established, similarly-situated entities may be too fierce. Companies also frequently collapse from disputes between the very people trying to make it profitable.<sup>3</sup> In many start-ups, a few individuals serve as owners, managers, and employees and perform most of the key functions; if a dispute arises or their interests diverge, each owner's focus shifts away from pursuing mutually beneficial profit-making opportunities to the individual's position in the disagreement. An unresolved conflict between partners, joint venturers, shareholders, or limited liability company members may destroy an otherwise promising endeavor.<sup>4</sup>

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1. See Jolyn Pope, *Braving the Waters: A Guide for Tennessee's Aspiring Entrepreneurs*, 3 TENN. J. BUS. L. 1, 5 (2002).

2. Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 774 (2004).

3. See Cynthia S. Granfield, *The Reasonable Expectations of Minority Shareholders in Closely Held Corporations: The Morality of Small Business*, 14 DEPAUL BUS. & COM. L.J. 381, 401-02 (2002).

4. See *id.*

Destructive disputes are particularly prevalent in small businesses because the stakes for the individual investor are so high. Most investors prefer to diversify their holdings to hedge against losses, but small business owners often pour all of their assets plus borrowed funds into their ventures.<sup>5</sup> For the entrepreneur, business failure can mean personal financial ruin. Furthermore, owners of start-ups anticipating losses or marginal profitability over the short term often opt not to incur the legal and accounting fees and similar costs of fully assessing and allocating the burden of potential risks. Since many courts are reluctant to interfere in business relationships except in cases of extreme misconduct (though ironically many entrepreneur litigants are less sophisticated in legal matters and more in need of judicial guidance than larger corporations with in house or retained lawyers) small business owners must be particularly careful in choosing partners and associates.<sup>6</sup>

This article explores how individuals who form, promote, and run start-up businesses can avoid destructive disputes. It identifies five balancing acts which new business owners must perform and advocates avoiding internal conflict by balancing competing interests openly and in writing. The article concludes by suggesting that small business attorneys familiarize their clients with these five balancing acts at the beginning of the representation and help the entrepreneurs to plan accordingly.

## II. PROTECTING A BRIGHT IDEA: THE FIRST TWO BALANCING ACTS

When a group of entrepreneurs pools its talents to start a business, the individuals involved are at least implicitly agreeing to share both the risks and rewards of the venture. How those risks and rewards are to be allocated among the investors (at least for the short term) must be determined at the beginning of the commercial relationship and reduced to writing. This agreement must specifically set out each participant's contribution to the project - monetary investment, labor, or otherwise - as well as her share of future profits and losses. The process of negotiating the terms of the agreement involves the first two balancing acts.

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5. Richard A. Booth, *Limited Liability and the Efficient Allocation on Resources*, 89 *Nw. U. L. Rev.* 140, 154-56 (1994).

6. Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 *U. Pa. L. Rev.* 1609, 1651-52 (2004).

First, the innovator around whose idea the venture is created must determine that consideration for which she will part with sole ownership of her business concept. An idea is the intellectual property of the person who thought of it.<sup>7</sup> However, the idea by itself is probably worth little. The concept's originator must enlist the help of others with skills in business operation, marketing, human resources, and similar areas to develop a profitable endeavor. Those participants often become equity investors in the business. They are reimbursed for their contributions directly from the business' profits. While the innovator is entitled to fair consideration for the concept itself, to secure the indispensable assistance of other members of the business team the innovator must both accept a finite schedule of remuneration and turn over some level of operational control of the business. The innovator's compensation should be commensurate with the level of risk involved in the venture and with the costs incurred to develop the idea. The greater the likelihood of future profitability (and the greater the accrued costs of development) the more money the person who conceived of the idea should receive. The result must be a mutually beneficial, fairly balanced distribution of the risks and rewards among all involved.<sup>8</sup>

Attracting capital and simultaneously protecting the idea from unnecessary disclosure is the second balancing act. The innovator must safeguard the idea's value by preventing disclosure to or appropriation by third parties.<sup>9</sup> Forming a business team naturally entails the disclosure of sensitive information: the potential profitability of the idea (what makes it attractive to qualified prospective investors) must be conveyed to future team members who will demand adequate information in order to make the best investment decision. However, shared information could also be used by others to establish or benefit a directly competing endeavor. This increased potential for competition (and the prospect of a decreased market share) makes the concept less valuable. As a result, the most qualified potential investors

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7. Eran Kahana, *Intellectual Property in an Information Economy: Protecting Intellectual Property in Startups: A Guide for the Entrepreneurial Attorney in the New Economy*, 28 *Wm. Mitchell L. Rev.* 1187, 1188 (2002).

8. An agreement between investors that is mutually beneficial to all involved runs a much lower risk of being breached. Janet W. Steverson, *I Mean What I Say, I Think: The Danger of Small Businesses Entering into Legally Enforceable Agreements that May Not Reflect Their Intentions*, 7 *J. Small & Emerging Bus. L.* 283, 291 (2003).

9. William L. Schaler, *Growing Pains: Intellectual Property Considerations for Illinois Small Businesses Seeking to Expand*, 35 *Loy. U. Chi. L. J.* 845, 866 (2004).

will closely scrutinize the extent to which the project's intellectual property is protected.<sup>10</sup>

A number of legal tools are available to accomplish seemingly incongruous ends.<sup>11</sup> Many innovations are considered trade secrets under state law; a trade secret is information that is economically valuable, protected from disclosure, and not generally known.<sup>12</sup> Reasonable efforts must be made to maintain its secrecy and the adequacy of the measures employed depends on the specific concept, theory, or idea involved.<sup>13</sup> Materials which contain (or are themselves considered) trade secrets should be clearly designated as confidential. The innovator should seek legal advice or other training on disclosure-prevention measures, and disclosure guidelines should be included in prospectuses and other marketing materials.<sup>14</sup> Prospective investors, directors, members, partners, employees, and independent service providers should be required to sign confidentiality, non-disclosure, and/or non-competition agreements before being given access to sensitive information. These documents prohibit the sharing of protected information with third parties or using the information for pecuniary gain outside of the proposed venture and are generally enforced by courts.<sup>15</sup> In addition, only information relevant to the business proposal should be provided.<sup>16</sup>

Some intellectual property is also subject to legal protection. An invention may be patented, a creative work or computer software copyrighted, a slogan or moniker trade or service marked.<sup>17</sup> The innovator should seek legal advice concerning the applicability and potential benefits of federal and state intellectual property statutes.

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10. See Eran Kahana, *Intellectual Property in an Information Economy: Protecting Intellectual Property in Startups: A Guide for the Entrepreneurial Attorney in the New Economy*, 28 WM. MITCHELL L. REV. 1187, 1198-99 (2002).

11. For example, the Economic Espionage Act of 1996 authorizes the federal government to pursue civil remedies on behalf of victims of trade secret theft and to prosecute wrongdoers. 18 U.S.C. § 1831 (2006). However, the Act does not provide for a private right of action. *Id.*

12. UNIF. TRADE SECRETS ACT § 1(4) (1985).

13. The Uniform Trade Secrets Act adopted by state legislatures generally requires the owner of a trade secret to take measures to prevent its disclosure to the public. See, e.g., COL. REV. STAT. § 7-74-102 (2005); FLA. STAT. ch. 688.002 (2005); IND. CODE ANN. § 24-2-3-2 (2005).

14. Schaler, *supra* note 9, at 867-69.

15. *Id.* at 868-69.

16. See *id.* at 869.

17. See 17 U.S.C. § 102 (2006); 35 U.S.C. § 101 (2006); 15 U.S.C. § 1051, 1053 (2006).

### III. RIGHTS AND RESPONSIBILITIES OF THE BUSINESS TEAM: THE THIRD BALANCING ACT

As with all startups, the promoters or organizers must choose the business form that best serves their needs.<sup>18</sup> This selection entails the third balancing act: minimizing the risk of loss to the investors while apportioning operational control of the entity.<sup>19</sup> Individual liability is minimized by assuming a legal identity distinct from the investors. However, creation of a business entity decreases each individual investor's control over his or her investment.

The available business forms - the limited liability company, sub-chapter S Corporation, sub-chapter C Corporation, closely held corporation, limited liability partnership, general partnership, limited partnership, and sole proprietorship - are well known. The limited liability company has become the most popular form of business entity because it offers both the limited liability and pass through taxation benefits of a sub-chapter S Corporation and the flexibility and relative ease of management of a partnership.<sup>20</sup> An LLC is particularly beneficial for start ups because its flexible structure allows the members to cater a governance plan to the particular issues confronting the enterprise and the business team.<sup>21</sup> “[LLC] statutes typically assume that individual owners will develop their own LLC operating agreements that define their respective rights, responsibilities, and remedies.”<sup>22</sup> This includes the right, within parameters set by the Internal Revenue Service, to allocate the tax benefit of losses to those who assume greater risk of loss.<sup>23</sup>

Partnerships offer the most operational control to the individual investor.<sup>24</sup> A partner has the right to fully participate in the management of the business and can force the dissolution of the partnership

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18. The IRS's adoption of the “check-the-box” regulations allows businesses more flexibility in structuring their internal affairs without the risk of losing favorable tax treatment. Gary W. Derrick, *Oklahoma Limited Liability Companies and Limited Liability Partnerships*, 22 OKLA. CITY U. L. REV. 643, 646-47 (1997).

19. Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Closely Held Corporations*, 24 IOWA J. CORP. L. 913, 916 (1999).

20. See generally, THOMAS A. HUMPHREYS, LIMITED LIABILITY COMPANIES & LIMITED LIABILITY PARTNERSHIPS (2004). The LLC is so popular that the S-corporation may be a dying breed. *Id.* § 1.01.

21. See *id.* § 2.02.

22. Miller, *supra* note 6, at 1610-11.

23. Robert G. Lang, *Utah's Limited Liability Company Act: Viable Alternative or Trap for the Unwary?*, 1993 UTAH L. REV. 941, 956-57 (1993).

24. Rock & Wachter, *supra* note 19, at 920.

at will.<sup>25</sup> However, a partner is personally liable for any business debt whether or not he acquiesced in its accrual or even had knowledge of its existence.<sup>26</sup> Limited partnerships and limited liability partnerships (or professional LLPs) offer more protection from individual liability to investors.<sup>27</sup>

Corporations are the most formally structured of the business forms and can still offer the entrepreneur both pass-through taxation and limited liability.<sup>28</sup> The records that a corporation is required to maintain are particularly useful to the owners of very small entities when they are personally sued for corporate debts. These documents can help establish that the corporation and its shareholders are in fact distinct.<sup>29</sup> Larger firms with multiple classes of stock or businesses considering an IPO in the short-term (or which already offer publicly-traded shares) should operate as sub-chapter C Corporations subject to taxation of both profits and dividends.<sup>30</sup>

Choosing an operational form is the first step in contracting rights and responsibilities among members of the business team. It addresses two key, but narrow, issues: tax liability and individual (as opposed to entity-level) responsibility for corporate obligations.<sup>31</sup> The internal operating procedures also depend to a small extent on the type of entity selected.<sup>32</sup> Corporations, LLCs, and partnerships are all subject to certain default management provisions set out by state statute. These statutes set forth more comprehensive governance requirements for corporations than for LLCs. For example, corporations are required to have a tiered-management system.<sup>33</sup> They must be governed by at least one director who may or may not be a shareholder and must also have at least two corporate officers, a president, and a

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25. See, e.g., Tenn. Code Ann. § 61-1-401(f)(2005).

26. See, e.g., Tenn. Code Ann. § 61-1-602(a)(2005).

27. STEVEN C. ALBERTY, *ADVISING SMALL BUSINESSES* § 5:35 (2005).

28. See 26 U.S.C. § 1366 (2005).

29. Failure to observe corporate formalities may nullify the distinction between the corporation and its individual owners. Courts look to a number of factors when determining whether or not to "pierce the corporate veil" and hold individual owners liable for company debts. See, e.g., *Fairfield Dev., Inc. v. Georgetown Woods Senior Apts., L.P.*, 768 N.E.2d 463, 469 (Ind. Ct. App. 2002). Courts will pierce the veil when the corporation is used to perpetrate a fraud or injustice. See, e.g., *Kansas Gas & Elec. Co. v. Ross*, 521 N.W.2d 107, 112 (S.D. 1994); *Giuffria v. Red River Barge Lines, Inc.*, 452 So. 2d 793, 795 (La. Ct. App. 1984).

30. 26 U.S.C. § 1361 (2004).

31. See generally, HUMPHREYS, *supra* note 20, §2.

32. ALBERTY, *supra* note 27, § 2:9.

33. See, e.g., TENN. CODE ANN. § 48-18-101(a) (1986) (requiring each corporation to have a board of directors); *id.* § 48-18-401(a) (requiring each corporation to have a president and a secretary).

secretary.<sup>34</sup> The directors do not have absolute authority and cannot take certain actions absent the approval of the shareholders.<sup>35</sup> An LLC, on the other hand, can be member-managed (i.e. managed by the owners themselves, akin to a partnership) or manager-managed (managed by managers who may or may not be members, akin to a corporation).<sup>36</sup>

Regardless of the form chosen, the business team must specifically allocate the bulk of the rights and responsibilities among themselves. This should always be done in a writing formally approved by each member. State corporation statutes usually mandate the adoption of written by-laws, but LLC and partnership statutes often do not.<sup>37</sup> Nonetheless, a written partnership agreement or LLC operating agreement is essential to preventing potentially destructive disputes among members of the business team and protecting the members' investments.<sup>38</sup> For one, if the owners of a partnership or LLC fail to adopt a set of governance guidelines, the state code will impute those guidelines for them. For example, if the organizers of an LLC fail to designate whether or not the entity is member-managed or manager-managed, most state statutes will automatically designate the LLC as member-managed.<sup>39</sup> Likewise, in a partnership, all of the partners are presumed to be entitled to an equal share of any profits unless the partnership agreement provides otherwise.<sup>40</sup> Second, a well-drafted agreement is a "road map" to which the business team members can refer if questions concerning rights or obligations arise.<sup>41</sup> It also helps

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34. *Id.* § 48-18-401(a).

35. *See, e.g., id.* § 48-22-102(b) (setting out the procedure for corporate approval of transfers outside of the ordinary course of business).

36. HUMPHREYS, *supra* note 20, § 4.02. Despite its recent popularity, an LLC is not always the optimal business form. For example, a limited partnership may be the best means of combining managerial talent and passive investment. An LP allows investors with no management responsibilities to make capital contributions to and receive monetary reimbursement from a partnership without assuming personal liability for the entity's debts.

37. *See, e.g.,* TENN. CODE ANN. § 48-206-101(a) (1994) (stating that Tennessee requires an operating agreement for board-managed LLCs, but not for member-managed LLCs).

38. An enforceable written agreement also protects the remaining owners in the event that one of them seeks to withdraw from the endeavor. An investor may question the profitability of the enterprise because of a market shift or some other anticipated event or simply decide to pursue other opportunities. The agreement can provide for penalties or other disincentives to keep the enterprise from losing vital sources of capital. Steverson, *supra* note 8, at 297-98.

39. STEVEN C. ALBERTY, *ADVISING SMALL BUSINESSES* § 7:26 (2003).

40. *See, e.g.,* TENN. CODE ANN. § 61-1-401(b) (2002). Tennessee has adopted the Revised Uniform Partnership Act. *Id.* §§ 61-1-101 to -1208.

41. "[Private agreements] are necessary to enable [the small business] to plan for and distribute needed money, goods, and/or services as efficiently as possible." Steverson, *supra* note 8, at 288. This is true both for agreements between the owners of a small business and for those between the business and third parties.



lawyers, accountants, and other professional consultants to advise the business if there is a dispute.<sup>42</sup>

This writing must reflect a consensus in three major areas: (1) contribution requirements, (2) management rights, and (3) rights to distribution. Contractual provisions concerning contribution and distribution codify the financial arrangements agreed to by the investors. Management rights, including the rights of individual owners to make key decisions, policies, and procedures for day-to-day operations, a system for resolving disagreements among the owners, and causes and procedures for dissolution should also be part of the written agreement.<sup>43</sup> Important issues particular to the business must be addressed in the operational agreement. For example, the contract should assign ownership of and use rights to intellectual property exclusively to the business and restrict dissemination of proprietary information by individual owners during and after their involvement with the enterprise. The agreement should set out in plain and unambiguous language the circumstances under which the entity can operate outside of the usual course of business. For example, under what circumstances can the businesses be merged with another entity or liquidate its assets?

In sum, adopting a well-written agreement setting out the rights and responsibilities of each member is as important as selecting the right business form. Even though partnership agreements and LLC operating agreements are not always required by statute, a contract is the optimal means of ensuring a balance between the rights and responsibilities of each member.

#### IV. SELF-INTEREST VS. ENTITY-INTEREST: THE FOURTH BALANCING ACT

The profitability of a small business is in large part a function of the owners' and investors' personal contributions of money, time, and effort. The business team works for the benefit of both the entity and individual and the individual's return will be determined by the success of the entity. The owners must be willing to share operational control of the business and must have confidence that their teammates are fulfilling their obligations and not self-dealing at the business'

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42. These documents should be drafted by an attorney even if the investors are relatively sophisticated. *Id.* at 308-09.

43. Sample by-laws, partnership agreements, and operating agreements are available in STEVEN C. ALBERTY, *ADVISING SMALL BUSINESS* (2005). Sample operating agreements for LLCs and partnership agreements for LLPs are available in THOMAS A. HUMPHREYS, *LIMITED LIABILITY COMPANIES & LIMITED LIABILITY PARTNERSHIPS* (2004).

(and each other's) expense. The fourth balancing act entails personally profiting from the business relationship while acting in the entity's best interests.

Some legal mechanisms are in place that establish a basic code of conduct. The owners of a business must deal with each other fairly.<sup>44</sup> Directors and officers of a corporation have a statutory obligation to act in good-faith and in the corporation's best interests.<sup>45</sup> Partners owe a fiduciary duty of loyalty to the partnership and to each other.<sup>46</sup> Managers and members in an LLC likewise have a fiduciary duty to act in good-faith and in the best interests of the business.<sup>47</sup>

A fiduciary duty is defined as a duty of undivided loyalty that is greater than the obligation of fairness implied in an arms-length transaction.<sup>48</sup> It requires the obligated party to promote a collective, long-term interest and not personal, short-term interests.<sup>49</sup> In general, partners, officers, directors, and employees have a fiduciary duty to the businesses with which they are affiliated. They owe a duty of loyalty to the entity itself and cannot compete directly with it, usurp its commercial opportunities, or use commercial assets for personal profit.<sup>50</sup> Each must account to the others and hold in trust for the benefit of the entity any personal profits derived without the entity's consent, any profits connected with a transaction concerning the formation, business, or liquidation of the entity, and any profits from use of entity property.<sup>51</sup>

The existence and extent of any fiduciary duty between the owners of a closely held entity depend on the entity's business form and the applicable law. Courts will scrutinize the questionable conduct of partners.<sup>52</sup> Jurisdictions differ on the extent to which fiduciary duties exist between officers, directors, and shareholders in closely-held corpora-

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44. Miller, *supra* note 6, at 1654.

45. See, e.g., TENN. CODE ANN. § 48-18-301 (2005); *id.* § 48-18-403.

46. See, e.g., *id.* § 61-1-404.

47. See, e.g., *id.* § 48-239-116 (1995) (regarding board managed entities); *id.* § 48-240-102(1995) (regarding member managed entities).

48. See *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

49. See Terry A. O'Neill, *Toward a New Theory of the Closely-Held Firm*, 24 SETON HALL L. REV. 603, 611-12 (1993).

50. UNIF. P'SHIP ACT § 21 (1914); UNIF. LTD. P'SHIP ACT § 403(a) (1985). See UNIF. LTD. LIAB. CO. ACT § 410(b)(2) (1996). See, generally, Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U.L. REV. 465, 486-87.

51. UNIF. P'SHIP ACT § 21 (1914). The Revised Uniform Partnership Act limits the fiduciary duties to account for profits or benefits, to refrain from dealing on behalf of a party with interests adverse to the partnership, and to refrain from competing with the partnership prior to its dissolution. UNIF. P'SHIP ACT § 404 (1997).

52. See Miller, *supra* note 6, at 1641-42.

tions.<sup>53</sup> The “majority view” holds that owners of a closely-held corporation are fiduciaries akin to partners.<sup>54</sup> The “minority view” only recognizes a heightened duty of officers, directors, and controlling shareholders to the corporation itself.<sup>55</sup> Furthermore, in some states, including Delaware and Maryland, entities can specifically opt to be governed by a distinct close corporation statute.<sup>56</sup>

While courts and commentators have recognized the need for some form of legal protection for business owners and investors from unscrupulous team members, as a practical matter, alternatively ambiguous and technical agency principals do little to prevent disputes and less to deter self-dealing.<sup>57</sup> Neither the Uniform Partnership Act of 1914 nor the Revised Uniform Partnership Act adopted by a number of jurisdictions in the 1990s expressly states whether partners can waive fiduciary obligations.<sup>58</sup> The courts are split on whether or not the fiduciary duties incorporated into the statutes should be discretionary.<sup>59</sup> The specific conduct prohibited or demanded of the obligated party in a particular situation is often unclear or subject to multiple interpretations.<sup>60</sup> Enforcing compliance with fiduciary obligations requires protracted, expensive proceedings, and as a practical matter litigation only deters the most egregious conduct.<sup>61</sup> The only certainty attendant to such lawsuits is the demise of the relationship between its parties. The result is a disincentive to demand that team

53. Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 377-78 (2004).

54. The seminal “majority view” case is *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975). The Massachusetts Supreme Court held that because close corporations resemble partnerships the same fiduciary duty is owed by the owners to each other and to the entity. *Id.* at 512. Moreover, this duty is greater than that of a director or stockholder to a closely held corporation. *Id.* The court revised its focus to whether or not acts damaging to minority shareholders have no legitimate business purpose. *Wilkes v. Springdale Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976). Courts applying Massachusetts law have also held minority shareholders liable for breach of fiduciary duties. *See, e.g., A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1, 25 (1st Cir. 1997).

55. Delaware, a popular state of incorporation, adheres to the minority view.

56. MD. CODE ANN. CORPS. & ASS'NS § 4-201 (2006); DEL. CODE ANN. tit. 8, § 141 (2005); *See generally* David M. Deaton, *Check-the-Box: An Opportunity for States to Take Another Look at Business Formation*, 57 S.M.U. L. REV. 1741 (1999).

57. O'Neill, *supra* note 50, at 603-05.

58. *See, e.g., Dennis J. Callahan, Medieval Church Norms and Fiduciary Duties in Partnership*, 26 CARDOZO L. REV. 215, 265 (2004).

59. *Id.*

60. Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine*, 22 CARDOZO L. REV. 51, 53-4 (2000).

61. *Id.* at 59-60.

members comply with fiduciary obligations and an incentive to breach them.<sup>62</sup>

The statutory remedies available to oppressed corporate shareholders are equally ineffective in promoting fair dealing and efficient dispute resolution. Corporate acts remain focused on addressing the needs of larger, publicly traded entities and not on entrepreneurial endeavors or closely-held start up businesses.<sup>63</sup> They have been amended to accommodate the proliferation of closely-held entities primarily by offering the shareholders opportunities to contract out of the minority shareholder trap using the bylaws or separate agreements.<sup>64</sup> The statutes have also broadened the authority of courts to involuntarily dissolve corporations for oppressive conduct by a majority shareholder. However, there is no uniform standard used to define “oppressive:” abusive conduct, repeated violations of fiduciary duties, and inconsistency with the minority shareholders’ reasonable expectations have been used in different jurisdictions to justify an involuntary corporate dissolution.<sup>65</sup>

To improve the likelihood of a startup’s success, the prohibition against self-dealing codified by the common law of fiduciary duties should be incorporated into an entity’s governing documents and into any separate contracts with officers, directors, partners, and employees.<sup>66</sup> For example, to attract sophisticated minority investors, closely-held businesses owners must provide protection from the minority shareholder trap. Under a traditional corporate governance system, minority owners are restricted in their ability to influence corporate decisions (and to protect their investments).<sup>67</sup> In a publicly held entity, a minority shareholder who disagrees with the majority has the option of selling his stock to a third-party purchaser. However, there is no market for the shares of a closely-held corporation.<sup>68</sup> A minority shareholder unable to influence the company’s decision-makers or to recoup his initial investment is at best relegated to the position of a limited partner with no governance rights. At worst, majority share-

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62. *Id.*

63. James M. Van Vliet & Mark D. Snider, *The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap*, 18 N. ILL. U. L. REV. 239, 263-64 (1998).

64. Siegel, *supra* note 54, at 384-85.

65. *See, e.g.*, *McCallum v. Rosen’s Diversified*, 153 F.3d 701, 703 (8th Cir. 1998); *Colt v. Mt. Princeton Trout Club*, 78 P.3d 1115, 1118-19 (Col. Ct. App. 2003); *Royals v. Piedmont Electric Repair Co.*, 529 S.E.2d 515, 518-19 (N.C. Ct. App. 2000); *Bonavita v. Corbo*, 692 A.2d 119, 126-28 (N.J. Super. 1996).

66. Schaler, *supra* note 9, at 938-39.

67. Cumulative voting is another means of assuring minority shareholder participation in corporate decision-making.

68. Van Vliet & Snider, *supra* note 64, at 242.

holders exploit this disadvantage by forcing minority owners to sell their shares for a reduced value or at a loss. The law of fiduciary duties has provided a legal framework for granting relief to minority shareholders caught in this trap, but protections for such investors must be specifically adopted to maximize their effectiveness.

#### V. PROFIT TAKING WITHOUT UNDERCAPITALIZING THE BUSINESS: THE FIFTH BALANCING ACT

Small business owners should profit from their efforts. Entrepreneurs who do not see a reasonable return for the money, time, and work that they invest will have little incentive to continue in business.<sup>69</sup> However, profits must be taken without jeopardizing the enterprise's ability to continue to grow and make money. The fifth balancing act entails paying investors enough to encourage continued participation in the endeavor while retaining sufficient operating capital for the business to prosper and grow.

One of the biggest problems for small businesses is inadequate or inconsistent cash flow. An entity profitable by accounting standards may lack the liquidity to pay for materials, wages, taxes, and other necessary expenses.<sup>70</sup> Even when the business' balance sheet shows excess cash, prudent planning demands that the entity maintain adequate reserves to handle future hardships. The entity must be able to weather unexpected increases in vendor costs, costs of growth including increased labor or fixed capital demands, natural disasters, tax increases, increased regulatory expenses, or economic downturns. Accordingly, small business owners must carefully consider the entity's long-term viability when determining what to distribute to investors and what to reinvest in the company.

Exacerbating the cash flow problems experienced by many small businesses is the reluctance of many banks, venture capitalists, and other investors without direct ties to the entity to loan it money.<sup>71</sup> Assessing the risk of investing in a start-up is difficult; the viability of the business plan is unproven, potential lenders may be unfamiliar

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69. Small businesses meeting certain criteria can issue stock offering tax incentives to attract investment. The Internal Revenue Code precludes taxation on certain investments in qualified small business stock. 26 U.S.C. § 1045 (2006); *id.* § 1202. See generally David O. Kahn, *Tax Tips: A Qualified Small Business Stock Tax Primer*, 23 L.A. LAW. 17 (2000).

70. Cash flow inconsistencies are even taken into account in determining the amount of compensation due to a small business owner who suffers a personal injury. Gene A. Trevino, *A Note on Formulating and Corroborating Discount Rates for Small Firms*, 7 J. LEGAL ECON. 45, 45-46 (1997).

71. The Small Business Administration is a source of public funding for qualified small businesses.

with the entrepreneurs' skills in operating and managing a business, and there may be insufficient collateral to secure repayment.<sup>72</sup> The increased risk of loss means that entrepreneurs who can obtain financing will pay higher interest rates. Furthermore, banks and other lenders will want to closely and continuously monitor the creditworthiness of the enterprise.<sup>73</sup> Additional monitoring costs decrease the return on investment and are a disincentive to small business loans. At the very least, the increased cost to the lender will be passed on to the entrepreneurs. Accordingly, small businesses must establish their own reserves both to lower the perceived risk to financial institutions of lending it money and to insure sufficient liquidity in the event that borrowing money is not an option.

The undercapitalization of the business can have additional consequences for the owners. Inadequate capital is a key indicator of both a lack of creditworthiness and of an increased risk of loss for lenders.<sup>74</sup> Undercapitalization may also result in a court "piercing the corporate veil" and holding individual owners liable for corporate obligation.<sup>75</sup> Inadequate capital is a key consideration of most courts in determining whether or not the corporate form has been adhered to by the shareholders.<sup>76</sup>

## VI. CONCLUSION

The five balancing acts set forth in this article take place as part of the day to day operation of small businesses all over the country. Entrepreneurs who are unfamiliar with legal or accounting principals cannot rely on trial and error to decide the best means of protecting intellectual property, dividing management responsibilities, allocating risks, and sharing rewards. The margin for error is too slim and the risk of failure too great.

Corporate counsel must identify these five balancing acts for their clients and help them to set and reach attainable goals for business performance. Entrepreneurs must be aware of the consequences of imbalance. For example, the attorney must advise the client on how to maintain the confidentiality of information and still be able to use it to attract investment. She must help entrepreneurs craft contracts

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72. See Curtis J. Milhaupt, *The Small Firm Financing Problem: Private Information and Public Policy*, 2 J. SMALL & EMERGING BUS. L. 177, 180-81 (1998).

73. *Id.* at 180.

74. See Booth, *supra* note 5, at 161-62.

75. See *id.* at 162.

76. See *Nat'l Hotel Assocs. v. O. Ahlberg & Sons, Inc.*, 827 A.2d 646 (R.I. 2003); see also *Rotella v. Derner*, 283 A.2d 1026 (N.Y. App. 2001).

that allocate risks and rewards among investors in a way that creates and incentive for continued participation in the enterprise and allows it to retain sufficient liquidity for "rainy days." By working with entrepreneurs to achieve balance on the issues set forth above, corporate counsel decreases the risks of the destructive internal conflicts which so often doom start-ups to failure.