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Editor's Note

This summer issue of *NEDRA News* opens with an article by Charles R. Carr, Senior Principal Gifts Researcher at MIT that dispels any questions we may have regarding the various types of corporations out there. Now when asked to explain the vagaries of an S Corporation or a Limited Liability Company, simply refer to this article for an enlightening overview.

Lisa Howley, our Annual Conference Co-Chair this year, writes a recap of the Annual Conference which was held in the lovely locale of Ogunquit, ME, and which was a huge success. In addition to providing a few photographs from the conference, we profile both the winners of the 2007 Ann Castle Award and the Outstanding Service Award, Elizabeth Crabtree and Dick Luxner, respectively. Finally we could not resist profiling the researcher who traveled all the way from Haifa, Israel to attend our Conference. The presence of Efrat Dekel at our conference is most certainly a sign that our profession as well as our organization is making exciting inroads into the international arena.

We also continue our *Clip and Post It* series for the new researcher with Part II of the article on finding and valuing stockholdings. This time Patricia Kelleher of Suffolk University helps us understand those tricky stock options that so many of us find daunting to understand and present in a clear and understandable way. As the article was being prepared, however, the SEC implemented several changes to proxy reporting requirements that could not be covered in this issue of *NEDRA News.* The information in this article still applies to proxies that were issued in 2006 and earlier. Stay tuned for an update on the latest SEC changes in the next issue!

Sandra Larkin offers the last part of her series on Ethics, this time helping us ask the right questions when confronting an ethical dilemma. She outlines four paradigms that describe most ethical dilemmas, describes five tests that can be applied to an ethical dilemma and lastly presents us with a series of questions that we should address at our organizations. With her handy overview, we should be able to handle most ethical conundrums in the future.

We hope you enjoy the summer issue of *NEDRA News*. Again if any of you have ideas for articles or are interested in contributing in some way, please feel free to contact the co-editors Allison King or Elise Lafosse.

Allison King, co-editor
Elise Lafosse, co-editor.

Beyond "Public" and "Private": Types of Business Organizations

By Charles R. Carr, Senior Principal Gifts Researcher at MIT

What are the different types of business organizations, and what do they mean in terms of our individual prospects ownership concerns?

Every beginning prospect researcher learns the first question to ask when researching a company: Is it public or private? If it's public (basically, if its stock price is reported daily on the Web), that can lead us into a jungle of "too much information", but when we learn to track down and understand the public company's essential filings, we can come out of the jungle with some hard numbers to back up our rating evaluation.

But if the company is private, we find ourselves in an otherworldly landscape—not only as to valuation (for which no objective, hard-data sources may be available), but as to understanding what the business organization is and how its nature affects the prospect's financial picture. Proprietorships, partnerships, corporations—what do those terms mean? And then, at the next level, how about LLC's, S Corporations, limited partnerships, limited *liability* partnerships, professional corporations, business trusts, real estate investment trusts?

While I'm not a business school alumnus or a lawyer, as a researcher of individual prospects I've found it helpful to gain some understanding of these organizational types. If your prospect owns a company, or part of one, it may well be her or his most important asset—not only financially, but emotionally and socially. What are the benefits and risks of each type? And, always in the background of our thinking: what would happen if the prospect decides to sell it?

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The Basic Types

Although there are many variants, which I'll discuss further on, companies generally fall into one of three categories: proprietorship, partnership, or corporation.

A **proprietorship** is an unincorporated business wholly and directly owned by one person (or married couple). The business and all of its assets, earnings, and liabilities are the proprietor's personal property. The business's revenues and expenses will be reported (as self-employment activity) on the proprietor's individual income tax return, which is, of course, private.

A **partnership** is any joint investor/owner situation that is not a corporation or trust. A simple ("general") partnership is two or more people sharing ownership. It can also be thought of as the permanent joining together of two or more proprietorships. A partnership may or may not be governed by a formal agreement, but in any case the documents won't be public.

A **corporation** is an organization, officially chartered by a state, which is legally separate and distinct from the individuals who created, own, or manage it. The ownership of a for-profit corporation "(equity)" is represented by shares of stock, which are given out in exchange for capital investments or as payment for property or services. (A non-profit corporation has no owners, and therefore no stock.) A for-profit corporation can be either public or private, depending on whether its stock is available for sale to the general public.

Let's pause and consider these basic types in a little more depth.

When the founder/owners consider how to structure (or re-structure) their company, they have many factors to take into account, but four of the most basic are: Who will control the company? Will we need more capital than we can raise ourselves? How much protection do we need from the company's potential liabilities (debts, legal vulnerability)? What happens if we (or one of us) wants to "exit" (sell our stake)?

A *sole proprietorship* gives the maximum of control. The proprietor owns the company outright and doesn't have to seek anyone else's approval (within the limits of the law, of course) for how the business is run. And the proprietor can sell the company whenever he or she decides to do so, on any terms they can get a buyer to accept; he or she can also choose not to sell, no matter how generous an offer may be. The flip side is that, because the proprietor owns the company, he or she owns all of its liabilities. If the company's revenues aren't enough to cover its operating expenses, or if it is successfully sued or found guilty of illegal acts, then not only the business property but also the proprietor's personal assets will be fair game to the company's creditors or the plaintiffs.

The proprietorship option also has the greatest disadvantage when it comes to raising capital (invested money which is the basis on which to build and develop the company, as opposed to operating income). Investors (with the possible exception of family members) won't contribute capital unless they get a share of equity (ownership) in return. If the proprietor can't put any more of his or her own money into the business, and doesn't want to take in co-owners by turning the company into a partnership or corporation, the only way he or she can raise capital is by borrowing, which means that a significant part of future revenue will be devoted to paying the debt. The lender may also require the proprietor to comply with certain requirements as far as operating or insuring the company, will require regular reporting, and will have veto power over a sale, all of which will limit the proprietor's "sole-owner" prerogatives.

So the proprietorship offers the maximum of control, but the minimum of liability protection, and the control will have to be sacrificed if capital must be raised.

A *general partnership* can be seen as the second-simplest option, but structuring it casually can lead to major difficulties if things go wrong. Two or more people share ownership of the company, which means that they will need to agree on any major decision, and they will also be vulnerable for the partnership's liabilities (even for problems that were not "my fault"). As in a proprietorship, there is no shielding of the individual partners' income or assets from the company's liability. To raise additional capital, a partnership could let a new partner buy in on whatever terms the existing partners and the new partner agree to — but that means another owner whose wishes must be taken into consideration when decisions are to be made, and with whom profits must be shared. (The addition of more people with whom the "pie" must be divided, leading to smaller "slices" for each, is called "dilution"). Problems can arise when some partners contribute more money and others do more of the work; how is "sweat equity" valued, and what does that mean in terms of profit-sharing and voting? Then there is the question of exiting. If one of the partners wants to sell his or her share, how is the price of that share to be determined, and will one or more of the other partners buy it, or will they consent to its being sold to someone outside the existing group?

The type that really can't be structured any way but formally is the *corporation*. A corporation is formed by one or more people who draw up articles of incorporation and by-laws, and apply for a state charter by filing the appropriate forms and paying what may be substantial fees. The shareholders elect a board of directors who are collectively empowered to hire and direct the management. The directors bear a legal responsibility to supervise management in the shareholders' interest. The great advantage is that the shareholders' personal assets and income are completely shielded from any claims against the corporation. A corporation can raise money by issuing and selling more shares of its stock, without affecting (except by dilution) the existing stockholders. It can even own already-issued shares of its own stock (called "treasury stock"), which it can use to pay employees and buy properties. The ability to use stock rather than cash makes expansion possible even before earnings are substantial, so long as the employees or sellers believe the stock will increase in value. A shareholder may be able to "cash out" by selling some of his or her shares, rather than having to sell his or her entire stake as in a partnership. Thus the corporation provides the greatest financial flexibility, and greatest protection from individual liability, at the cost of greater formality and complexity.

The nature of the corporation makes "control" a less straightforward factor. In a sense, the founders lose some control from the start because the corporation does not really belong to them, even if they own a majority of the stock; the board of directors, and beyond them the state, must act in the interest of all the shareholders, not just the majority holder(s). Even such icons as Kenneth Olsen of Digital and Steve Jobs of Apple have been forced to leave the corporations they founded (and of which they were no longer majority owners) because their boards decided to move on. (Jobs was later invited back).

One way in which the corporation can be structured to protect the insiders' control is by issuing multiple classes of stock. Many corporations issue "preferred" stock for passive

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investors who are willing to contribute capital to the company and receive a share of its earnings without getting voting rights. (Startup companies often issue preferred stock as collateral for bonds or other borrowings; even if the company defaults on the debt, enabling the creditor to take the pledged preferred stock, voting control stays with the equity investors). Some public corporations (typically those strongly associated with a founding family, like the Washington Post Company) have two classes of common stock: one available to the public, with the standard one vote per share, and another, available only to insiders, with multiple votes per share.

The next level

These basic concepts take some patience to understand. But we all know that it gets even more complicated. Financial and legal experts have found many ways to combine the advantages of these basic types of companies.

One way to combine the comparative simplicity of the partnership with financial advantages like those of the corporation is through the **limited partnership**. This consists of two classes of owners—the general partner(s), who manage the business (they often contribute capital as well), and the limited (informally called "silent") partners, who invest money and receive limited-partnership shares. The limited partners are entitled to share in the earnings of the business, but they generally have no vote. (In certain circumstances, such as impending bankruptcy, the limited partners may have the right to "protect their investment" by voting to re-structure the partnership). Limited partners have the same protection from liability as corporate shareholders do, while the general partners have none; limited partners may also be able to sell their shares without disrupting the general partnership. Some businesses of this type offer their limited-partnership shares to the public, treating them very much like preferred stock. (Publicly traded limited partnership shares are sometimes called "shares of beneficial interest"). This is a common structure for investment companies; it used to be the usual model for investment banks, but in recent years most investment banks have become corporations, enabling them to take advantage of more sophisticated financial strategies. (In some cases, the operating business continues in the form of a partnership, but it is owned by a corporation called a "holding company").

Another hybrid is the **Limited Liability Company (LLC)** or **Subchapter S Corporation**. These two designations, which are about thirty years old, mean roughly but not quite the same thing. LLC's were started by state legislation (and thus they vary slightly from state to state); the S Corporation is the analogous designation in federal law. They function as simplified forms of the corporation, preserving the personal liability protection. An S Corp. can have no more than 75 shareholders, and can have only one class of stock, meaning that there can be no differentiation among shareholders as to voting power, dividend rates, or other rights. Because of the limitation on the number of shareholders, an S Corp. can never be public. The participants in an LLC are called "members" and their ownership is expressed in "units"; there is generally no limit on the number of members in an LLC, but LLC units are not sold to the public. One of the main purposes of either structure is to avoid "double taxation", which is the fact that a standard corporation (officially called a "C corporation") pays income tax on its earnings, and the shareholders are also personally taxed on their dividends, which are a distribution of the corporation's after-tax earnings. In an LLC or S Corp., each member/shareholder pays personal income tax on his or her proportional share of the company's net income; that is, the company's tax burden is "passed through" to the owners. If the LLC or S Corp. loses money, a share of the loss may be deductible on the owners' individual tax returns, a benefit that is not available to stockholders in a "C" corporation.

The Limited Liability Company should not be confused with a **Limited Liability Partnership**. This is an even newer form, created by various states in the 1990s, which enables owners to form a general partnership (so that they have equal voting rights) while protecting all partners from certain types of liabilities. (Remember that there is no such shield in the standard general partnership, and that in the standard limited partnership only the "silent" partners, not the voting partners, get this protection). The Limited Liability Partnership is designed for licensed professionals such as lawyers, accountants, or architects, when they form a joint practice in which each partner has his or her own clients or projects; essentially, it protects each of the partners from being vulnerable to a lawsuit for professional negligence or (in some states) malpractice on a project that he or she was not personally involved with. There are some state-to-state differences as to the circumstances in which an LLP can be formed, and what protections it may offer.

Comparable to the Limited Liability Partnership is a more established form, the **Professional Corporation** (PC). Available only to licensed professionals, the PC can be organized as either an S or C corporation. Like the LLP, the PC's purpose is to shield the other members of a professional group practice from one member's professionally-incurred liabilities. A major difference between the two is that the LLP usually protects the non-offending partners only against another's negligence or malpractice, whereas the PC, like any corporation, protects its shareholders from being personally vulnerable to any of the company's liabilities. As you would expect, neither the LLP nor the PC shields a member from personal liability for his or her *own* negligence or malpractice.

There are further variants on the partnership and corporate structures, which are beyond the scope of this article. In addition, there is one form of organization we haven't yet considered: the business trust.

The **business trust** is not a proprietorship, partnership, or corporation. It is often called a "Massachusetts business trust" because it was first developed in my home state in the 19th century, but it is now used nationwide; another term that applies to it is an "unincorporated business organization" (UBO). Like any trust, it is created by the writing of an indenture, or founding document spelling out how the trust is to operate, and the transfer of property to the care of trustees, who serve as the managers. The transfer must be irrevocable. Each beneficiary (owner) receives a trust certificate for their units of beneficial interest. The units are transferable, but cannot be forfeited as collateral on the holder's debts, or be subject to probate, because the underlying assets belong to the trust, not to the beneficiary. For the same reason, the beneficiaries are not liable for taxes, debts, or other obligations of the trust—they are taxed only on any income or capital payouts they personally receive from it. There is no public reporting; even the indenture is a private agreement. Thus, this structure maximizes liability protection and privacy, and has significant tax and estate advantages. However, the beneficiaries (investors) give up control: they have no power to choose the trustees or to influence their decisions (except that they have the right to sue if they have reason to believe the trustees have breached their duty to act in accordance with the indenture and in the beneficiaries' interest). The trustees, in turn, have limited flexibility in managing the business because they must operate according to the rules and policies set out in the indenture, unless they formally amend it. The Massachusetts Business Trust is a suitable structure for a conventional

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mutual fund whose investors want to entrust their money to professional managers, knowing that they will act according to a specified investment strategy that they cannot easily change.

A growing type of business that crosses more of the lines is the **real estate investment trust** (REIT). This type can be organized as a business trust or as a C corporation, and can be public or private. The REIT enables investors to participate in the real estate market without the expertise and capital needed to do so directly, and it enables real estate professionals to pool investors' money to do more and larger deals than they could do on their own. It also sidesteps one of the main drawbacks to direct real estate investment, the risk of being unable to "cash out" of an investment, since the investor can sell shares of the REIT even if the underlying property is hard to sell. Equity REITs buy and manage income-producing real estate; mortgage REITS make or invest in mortgages; and "hybrid REITs" do both. The main features of a REIT are that at least 75% of the company's investments must be in real estate, and 95% of its income must come from dividends, interest, and property income such as rents or sales. The company must have at least 100 shareholders or unit holders, and no more than 50% of the shares or units can be held by the top five holders. It must distribute at least 90% of its net taxable earnings each year to its shareholders (most REITs, in fact, pass through all of their net earnings).

Citations

In this article I have tried to keep entirely to generally known facts; any interpretive comments or discussions of benefits and disadvantages are my own observations, and nothing in the article is intended as investment or legal advice. The Web is rich in descriptions of these business structures; law firms, industry and small-business organizations, and others offer convenient one-page summaries. There are also Wikipedia and All Experts (which may sometimes seem more authoritative than they are, so I avoid relying on them exclusively, but they're a good place to start). Other open, web-posted sources from which I gathered factual details include the Business Owner's Toolkit (www.toolkit.com) of CCH, a Wolters Kluwer business; Form-a-Corp (www.form-a-corp.com) of FAC International; nolo.com, a legal reference publisher; 1065Accountant.com; "Choosing a Professional Business Entity" from *Physician's News Digest* (www.physiciansnews.com), www.svpvril.com of Delta Spectrum Research; the *Daily Journal of Commerce* of Oregon (www.djc-or.com); and the investinreits.com page of the National Association of Real Estate Investment Trusts (www.nareit.com).