Business Update

The Legal Newsletter For Maine's Business Community

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Our One Day Business Incubator

On June 23, 2005, 7:30am, we will have a breakfast seminar at our Portland office on **"Business Startups in Maine."** The seminar will cover choice of business entity, shareholder agreements, financing, tax and other startup issues. For those attending the seminar, we will set up a corporation or LLC without charge (other than filing fees charged by the State).

To RSVP (space is limited), contact Becky Morton (871-7159 or bmorton@perkinsolson.com)

Financing: Seven Questions to Ask and Answer Before You Invest in a Business or Take on an Investor

By Richard Olson

There continue to be a number of legal disputes among equity holders. While relatively few of these involve fraud, they often involve honest misunderstandings or a failure to properly plan for the growth and evolution of a business. Asking and answering a few questions at or near the beginning of your business relationship can save a great deal of expense and suffering later on.

There are two principal ways to finance your business—debt or equity. With debt the business gives the lender a note and perhaps a security agreement and/or mortgage. The debtor-creditor relationship is fairly clear. If the business does not pay, the debt holder has certain rights to accelerate and take collection actions. Notes convertible into equity are a hybrid arrangement that give a creditor a chance to participate in the upside while enjoying the higher status of a creditor.

With equity financing the landscape is far different from the debtor-creditor relationship. There, a person putting in the money is an investor rather than a creditor. An investor

Financing, *continued on page 3*

Why LLCs Should Be the Entity of Choice for Small Start-Ups

By Kevan Rinehart

In the pages of these newsletters, members of this firm have often sung the praises of the statutory creature known as the limited liability company ("LLC"). We have discussed the LLC's suitability for the varied purposes of estate planning, real estate holding companies, professional associations, and operating companies. Because LLCs are clearly so flexible, they are also often the most appropriate choice for start-up businesses. Although a relatively new corporate form—LLC legislation was first enacted by the Wyoming legislature in 1977—they have grown exponentially in popularity since the IRS clarified its treatment of them in the early 1990s. In fact, due to mounting pressure, and the desire to attract business capital, every state had enacted LLC legislation by 1996. Now, each state has LLCs ranging in size from single owners to multimillion companies with officers, directors and hundreds of employees.

Limitation of Liability

Individuals starting a business have many issues to consider, but often the impetus to incorporation is the desire or need to create a separate legal entity. This separation is important for many reasons, the most important being to distinguish the business from the individual(s) owning and operating it in order to protect those same individuals from liability and/or debt stemming from the business. In other words, incorporation protects the assets of the individual owners from the creditors of the business, which would not be the case absent incorporation. LLCs provide one of the quickest ways to create this protection because they are effective simply upon the filing of articles of incorporation with the Secretary of State.

Limited Formalities

Start-up companies are often comprised of only one or two people working hard with little or no staff, therefore little or no need exists for the hierarchal layers found within a large corporation: a board of directors, officers, or even salaried employees. LLCs lend themselves well to this busy time because they require few formalities in order to retain the separate entity accorded by statute. Quite simply, as long as the company (1) files an annual report, which report requires minimal information, every year with the Secretary of State, (2) maintains separate and distinct checking accounts, bills, and financial records from the individual members/owners, and (3) holds itself out at all times to be an LLC by including the name of the business, including "LLC" on the business letterhead, business cards, etc., with the name of the signer's title within the company, then the individual members of the company are protected from liability from company acts creditors. In other words, as long as the members of the company provide notice to the world that they are doing business as a company, and maintain separate company records and accounts, then in turn the statute treats the company's debts and assets as separate and distinct from those of its individual owners.

LLC, *continued on page 4*

Subcontractors or Employees?

By Patrick Mellor

In our representation of small businesses around the State, one recurring theme that we come across is the use of subcontractors in the furtherance of business goals, whether in the construction field, manufacturing, or otherwise.

The benefits of utilizing subcontractors are obvious: the avoidance of unemployment compensation liability, workers compensation liability, and employment taxation are a few that come to mind. In addition, in an arrangement where subcontractors are property utilized, the subcontractors may absorb liabilities from workplace mishaps that would otherwise be shouldered by an employer.

Withholding Tax and Workers Compensation Liability.

For purposes of federal withholding tax liability, the Internal Revenue Code defines an employee to include "any individual, who, under common law rules applicable in determining the employer/employee relationship, has the status of employee." The common law focuses on an employer's control over the details of work and the manner of performance. So to the extent that a business is not exercising control over the details of the subcontractor's work, subcontractors are, indeed, independent contractors, and the business can avoid withholding tax liability issues.

Meanwhile, Maine's Workers Compensation Statute includes a multipart definition of the term employee and provides that an independent contractor is "a person who performs services for another under contract, but who is not under the essential control or superintendence of the other person while performing those services." Additionally, the Statute provides additional factors that are important in determining the status of either an employee or an independent contractor, including the right of the business to control the progress of work, whether the contract is for a fixed price, and a determination of who is providing the supplies and tools/equipment for the job. Again, the common law "control test" is where the analysis hinges and the extent to which a hiring party controls the work in progress of the hired party will determine whether or not the hired party is an employee or an independent contractor for purposes of workers compensation liability.

As a general rule, a business does not have exposure to withholding tax liability or workers compensation liability if it can show that the independent contractors were hired to produce a certain result, and were left to their own discretion to decide the manner of reaching that result.

Unemployment Compensation Tax Liability.

The unemployment compensation liability question is a more difficult issue for an employer/business. Maine Law broadly defines "employment" as "any service performed for wages or under any contract of hire, written or oral, expressed or implied." Maine Law articulates the "ABC Test" for determining when someone is an employee

Subcontractors, *continued on page 5*

Covering against Misconduct: What Customers and Insurers need to Know about the Maine Insurance Code

By Gerry May

Almost everyone has insurance of one kind or another, whether it is the automobile liability insurance required by state law, health insurance through work, or life insurance to provide for your family in your absence. Dealing with insurance companies is a fact of adult life, and so are the problems that arise with insurance coverages.

What are the kinds of insurance problems which customers might face?

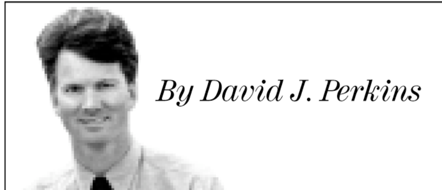
Consider the following examples of the forms that coverage issues can take: You live out of state, and have health insurance through a company in that state. After coverage under that policy has begun, you develop a serious medical condition that requires extensive treatment. In order to live at a more relaxed pace, you move to Maine, and acquire a new health insurance policy from a Maine insurance company. The certificate of coverage for this policy includes language that if you had a medical condition that was not a "pre-existing condition" for the purposes of your previous policy, then coverage for the condition will not be excluded under your new Maine policy. You continue your medical care in Maine, and submit claims to your new insurance company for treatments received. The company sends back notices that it is denying the claims because they relate to a pre-existing condition. This pattern repeats itself for over a year. As a result, you have to pay thousands of dollars to medical providers out of your own pocket.

You apply for life insurance coverage for a certain amount at a certain premium. As a part of the application process the company sends you a questionnaire, which among other things asks you if you have been tested for HIV, and requests any test results. You have been screened for HIV, and tested positive for the presence of HIV antibodies, so you answer yes and send the test results to the company. A week later, a rep calls you to tell you that the company isn't comfortable insuring you under the terms originally offered, and instead offers a considerably lower amount of coverage for a considerably higher premium. Because the terms are much worse than what you had applied for, you withdraw the application.

Your auto insurance policy is set to expire, so you start the renewal process. Since you have had the policy, you have taken out a mortgage on your house, have begun making bigger payments on student loans, and have run up credit card balances to cover your financial needs. Some time later, the company sends you a letter which indicates that it is declining renewal, and cites a drop in your credit score as the reason. You now don't have auto insurance, and scramble to contact another company so you get your car insured and keep driving.

Insuring, *continued on page 4*

Bankruptcy Reform: Issues for Entrepreneurs



By David J. Perkins

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 represents a significant change in the way our country deals with individuals who can not pay their debts. Much of the media reporting on the bankruptcy reform has focused on the new limitations placed on individuals who have consumer debts, like credit card debt. The bankruptcy reform act will also limit the options for debt relief for entrepreneurs who suffer business failures.

In the past, an individual who was insolvent could file chapter 7 bankruptcy to obtain a discharge. The chapter 7 approach to bankruptcy was straightforward and simple. The debtor made his non-exempt assets available to a trustee, who had the job of liquidating the assets for the benefit of the creditors. The debtor was allowed to keep certain assets that are made exempt from creditors, under either federal or state law (Maine exempts $35,000 of the equity in a house and $5,000 of equity in a car, for example). Most importantly, the debtor was given a "fresh start" with the discharge of his debts.

If the debtor wanted to retain non-exempt assets, then the debtor could file a chapter 11 or chapter 13 bankruptcy which involve the debtor retaining his assets and paying his

Bankruptcy, *continued on page 6*

Financing, *continued from page 1*

takes greater risks that a lender and expects a greater reward if the business is successful. This article describes some of the ways that investors can seek to minimize those risks and companies can seek to minimize their exposure to an aggressive investor. These principals apply to both limited liability companies and corporations.

First, pick your partner/investors wisely. Even with the most careful documentation, when a relationship turns sour and one of the parties is willing and able to be unreasonable, the costs are huge. While it might seem like a good idea to give stock or membership interests to supportive friends, family and/or employees, remember the sad fact that people die, get divorced, go bankrupt and just get frustrated. That can leave you dealing with a personal representative, the spouse's divorce lawyer, a bankruptcy trustee or the investor's lawyer. These people can be very difficult to deal with when the company needs to pursue new sources of capital or if the company is facing difficulties.

Second, carefully document the investment. Assuming that there are no securities law issues, where there are multiple shareholders in a corporation or an LLC, the parties enter into either a shareholders agreement or an operating agreement.

These agreements answer the questions that are left unanswered by the statutes and which are difficult and expensive to answer through court proceedings. If you entering into an equity financing arrangement as either an investor or someone seeking capital, some of the key questions/answers are:

What happens if an equity holder dies? The parties need to consider whether the estate should be forced to sell the shares or should be allowed to hold onto them and pass them to the decedent's heirs. Agreements usually provide for a valuation method and a payment structure that seems fair to the parties at the beginning of the relationship. In small companies it can be difficult to buy out a dying equity holder's interest. Some companies obtain insurance for that purpose.

What if an equity holder wants out? Normally equity related agreements provide that the company first and the remaining shareholders have the right to buy out a member who is trying to sell his or her equity interests. These provisions are often set up as rights of first refusal to purchase at either the price offered to the selling equity holder or a price determined under the equity agreement. There is a tension between the departing equity holders who want out soon for the most cash and the company and remaining equity holders who want the price low and the terms stretched. As with the dying equity holder, agreements often provide a valuation method and payment structure.

How does the company deal with employee/equity holders? Sometimes the founder or founders are important employees in the early stages of a company's life, but they may not be appropriate employees later. Decide early on how to deal with the awkward situation of an equity holder that either resigns or get fired. This is a delicate area. Many agreements required departing employee equity holders to sell their shares to the company based upon valuations and terms agreed upon at the beginning of the relationship.

What if you want an equity holder out? There are a number of ways that companies can make life unpleasant for an equity holder, but they do not guarantee that you can make them leave, and some expose the company and the other equity holders to claims. You can include a call option in an equity holder's agreement that entitles the company, with a vote of the majority of holders to force a member to sell their interests at either a predetermined price or using a predetermined value and on terms the parties agree to.

How do you resolve disputes? An agreement among equity holders can provide for mediation and/or binding arbitration. While private dispute resolution is not the panacea that some might have hoped it would be, it tends to be quicker and somewhat more efficient that resolving issues in the state courts. The most common disputes involved valuation, deadlocks and interpretation of contractual language. To deal efficiently with these questions, the agreement can designate an independent accounting firm to determine valuation issues. Similarly the agreement can designate a specific arbitrator or delegate selection to a professional firm.

What, if any, level of control will the equity holder have? Absent an agreement to the contrary, in a corporation one share equals one vote and majority rules in electing directors and virtually all other matters. The result is similar in an LLC, where a majority of interests rules. If you are investing in a business you may want to have a right to elect one or more directors of a corporation or managers of an LLC. As an investor you may want a super-majority vote for certain important corporate actions. As the existing equity holder, you want to minimize the control of the other investors.

What preferences, if any will the equity holder receive? Preferred stock often receives or accrues dividends as well a preference in any sale or liquidation of the business. LLC agreements can provide similar incentives. This is another instance where the existing company and equity holders want to minimize the exposure to the new investor while the new investor wants as much protection and preferential treatment as it can obtain.

LLC, *continued from page 1*

Flexible Management

As noted, LLCs can range in size from one individual to hundreds of employees. They can be owned by individuals, trusts, partnerships, estates, other limited liability companies, corporations or any other legal entity. Further, they can be managed by the individual members making decisions collectively—most feasible in very small LLCs owned by a few individuals, by a manager or managers who are also members, or by an employee-manager without any ownership interest. The rules dictating how a given LLC is managed are determined by the contents of its operating agreement. An operating agreement is signed by all members (owners), and it can be as detailed as the members desire, because necessary issues not addressed by the operating agreement will, by default, be determined by the Maine Limited Liability Company Act.

For example, most operating agreements address the formation and purpose of the company; the capital contributions of each member and how each will be accounted for; taxation of the company; the handling of profits, losses and distributions to members; and the withdrawal, liquidation and/or transfer of membership interests, as well as the rights, duties and restrictions of managers. A manager can be granted sweeping powers to bind the company, borrow money, pledge assets, purchase property, hire and fire employees, open accounts, and/or to delegate any of this authority to others. Conversely, these powers can also be severely restricted so that the manager must receive authority by a vote of the members (owners) before any or certain enumerated of his actions are deemed to bind the company. Additionally, the flexibility of management extends to the ability of an LLC to elect to govern itself as a corporation with a board of directors that makes decisions or appoints officers and employees to make certain decisions and run the daily operations of the company. Finally, operating agreements can be endlessly amended to keep pace with a company as it grows. Just as new members can be added, the members can decide to alter how they want the company to be managed.

Taxation Flexibility

One of the first steps any person or persons needs to take when contemplating the statutory formation of a company is to consult with an accountant. Unless elected otherwise, by default a single member LLC will be taxed as a disregarded entity (flow-through taxation like a sole proprietorship), and an LLC with two or more members will be taxed as a partnership. An LLC, however, can choose to be taxed as a corporation. This taxation flexibility is attractive, but in order to ensure you are receiving the most favorable tax treatment, a CPA should be involved from the outset in order to best advise each member as to election of tax status, as well as treatment of capital accounts, distributions, expenses, income and company loans, among other issues. Like other aspects of an LLC, tax status can be changed if the members desire.

Conclusion

It should be clear from the foregoing that LLCs provide an excellent vehicle for start-up businesses because of the limited formalities, flexibility of management and openness to change and growth. With careful attention at the outset to the few areas discussed herein and armed with a well-executed operating agreement, a small company can be prepared to weather the storms and excitement of the initial months of doing business and emerge poised for growth.

Insuring, *continued from page 2*

What insurers are covered by the Code, and how does the Code regulate these insurers?

What remedy does Maine law provide for the behavior of insurance companies in these situations? Insurance companies and their agents are regulated by 24-A M.R.S.A. § 2151 et seq., which is more commonly known as the Maine Insurance Code ("The Code"). Except for a short list of insurance providers related to fraternal benefit societies and government contracting, and certain limited kinds of agreements (charitable gift annuity, road service contract, home service contract), the Code covers all persons and entities in the business of entering into contracts of insurance.

The health insurance, life insurance, and auto insurance company practices described above all run afoul of the Code. The health insurance company that denied coverage based on a pre-existing condition has engaged in an unfair and deceptive practice by failing to adhere to the policy terms, which include the previously developed medical conditions within the scope of coverage. Additionally, the health insurance company has failed to conduct a reasonable investigation into the facts before refusing coverage. Furthermore, the failure to provide coverage for over a year establishes a pattern of wrongful conduct that probably rises to the level of a general business practice.

The life insurance company has violated the Code's prohibition on asking a person to reveal testing for HIV related diseases undertaken prior to an application for insurance, and has also violated the Code's bar on unfair discrimination against individuals who have antibodies to HIV.

Finally, the auto insurance company has violated the provision of the Code which prevents refusals to renew personal insurance policies solely on the basis of credit information.

These are just some of the protections that the Code offers to customers against misconduct by an insurance agent or insurance company. The full list of unfair claims practices is lengthy, and includes failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims, failing to affirm or deny coverage within a reasonable time after having completed a claims investigation, failing to promptly provide an accurate written explanation of the basis for a claim denial, unreasonably delaying investigation or payment of claims by requiring both a formal proof of loss and subsequent verification that duplicates what is in the proof of loss, and tying the acquisition of additional unwanted coverage to the purchase of coverage that the customer wants and that isn't really available anywhere else. If any of these things have happened to you, you very well might have a cause of action under the Code.

What other theories of recovery are available against insurers that have acted improperly?

While the Code does cover a lot of ground, it is not the only basis for recovery from wayward insurers. Other common theories used in cases against insurance agents and insurance companies include breach of fiduciary duty, misrepresentation,

Insuring, *continued on page 5*

Subcontractors, *continued from page 2*

for purposes of determining liability for unemployment compensation or taxation purposes. The services are deemed to be employment unless and until the business/employer show the following:

a. The individual worker has been and will continue to be free from control or direction over the performance of such services, both under this contract for service and in fact;

b. The individual worker is either outside the usual course of business for which service is performed, or that such service is performed outside of all places of business of the enterprise for which such service is performed; and

c. Such individual is customarily engaged in an independent, established trade, occupation, profession or business.

In a recent article about the application of the ABC Test, an assistant Maine Attorney General provided the following sage advice:

in applying the ABC Test, it is important to note that if the subcontractor brings workers onto your site to do work that is part of your business, you could be held liable for unemployment tax on those workers unless the subcontractor is a registered employer with the Department of Labor and is paying unemployment taxes on these workers. It would be prudent, therefore, to insure that the subcontractor has taken care of this issue and to verify an employment relationship with its workers. Otherwise, the laid-off worker and the subcontractor could file a claim for benefits and name your place of business as the employer.

Examples of Employment/ Independent Contractor Cases to Learn From.

• In the recent past, a client was renovating an apartment building that he owned. He hired a carpenter whom he viewed as a subcontractor. The carpenter brought some tools of his own and also utilized some of the tools present at our client's building. There was a question of whether or not our client controlled the hours that the carpenter worked or whether he only "guided" the carpenter's work hours. When the carpenter severely injured his hand while utilizing our client's chop-saw, he almost immediately sought substantial damages as an "employee" injured while working for an "employer."

Our firm sought protection for our client by trying to establish that the carpenter was an independent contractor. However, in these instances, Maine law holds that an independent contractor is one who carries on an independent business, and, in the line of his business, is employed to do a job of work, and in doing it, does not act under the direction and control of his employer but determines for himself in what manner the work shall be done.

In addition, the term 'independent contractor' presupposes the existence of a binding contract between the parties, for the breach of which a cause of action arises. The most important point in determining [whether a worker is an employee] is the right of either [party] to terminate the relation without liability.

Unfortunately for our client, he had no contract with the carpenter; the carpenter used our client's tools; and our client controlled some of the details of the carpenter's work. There was significant potential for a large judgment and our client settled the case well before trial. The lesson here is apparent: take whatever steps necessary to ensure that the hired help is – in fact – an independent contractor. Have your attorney draft a contract establishing the independent contractor relationship. Do not provide tools unless absolutely necessary and do not assert control over the details of the work relationship.

• Our firm also represents a large group of distributors who deliver baked goods for a national baking/distribution company. The contract between the distributors and the company requires the distributors to be treated as independent contractors. However, the company is exercising control over every facet of the distributors' business: from the number of days worked, to the amount and kind of product delivered, to the manner in which the product is marketed. After numerous requests to be allowed to operate their businesses as independent contractors (as required by the contract), the distributors have retained our firm to file a class-action lawsuit demanding – essentially – to be left alone or to receive the benefits of the "employment" relationship.

In sum, a business can not avoid the liabilities that come with an employer/employee relationship and still expect to control the details of the work of the hired help. Protect yourself and your business by ensuring that—whatever path is chosen—the necessary groundwork is completed to keep the path free from pitfalls.

Insuring, *continued from page 4*

negligence, breach of contract, fraud, and unfair trade practices. Combining these theories with the Code can provide an effective means of recovery from an insurance company.

So the next time you see something that isn't quite right in your dealings with your insurance companies- policy terms that don't match what the rep assured you that you would get, claims investigations that drag on with no resolution, coverage denials without any substantive explanation, or forms that have changes or alterations that you didn't make- remember that the Maine Insurance Code is there to help you out.

What should insurers know about the Code, and what steps should they take to make sure they are not exposed to liability for breaches of the Code?

For insurers, knowing the Code is a prudent business practice and the best defense against liability. Management should review the requirements and prohibitions in the Code with every employee and agent, whether that person was just licensed or has been selling insurance products for the company for decades.

Such a review need not be extremely detailed, but should include an overview of the key components of the Code relating to solicitation, advertising of policies, and proper claims practices, etc. Companies selling life insurance should review relevant administrative regulations pertaining to life insurance with their agents. Educating employees and agents is crucial, since their conduct-or misconduct-can be attributed to the company under the doctrines of respondeat superior and vicarious liability. Management's intimate knowledge of state insurance law does the company no good if an employee violates the Code because he is unaware of its requirements.

Should the company receive a complaint from a customer about actions that may violate the Code, management should promptly investigate these allegations, determine if they have merit, and sanction the employee if they do. Management should also move swiftly to address the customer's complaint. Prompt attention to and correction of these problems is the most effective way to avoid a lawsuit by an angry customer who thinks the company has brushed off his concerns.

In sum, the Maine Insurance Code lays the ground rules for the business of insurance, and the customer-insurer relationship operates much more smoothly when both parties know what those ground rules are.

Legal Services for both Business Growth and Contraction

Our law practice provides services to entrepreneurs for every cycle of the business enterprise. If you are starting up a business, we will advise you on what corporate form to use, how to structure shareholder issues, and help with accessing startup funds. If your business is up and running, we are available to help with employee, contract, sales and acquisitions and collections of accounts. Finally, if your firm is struggling, we will help you reorganize or limit personal exposure on guarantees.

Bankruptcy, *continued from page 3*

creditors a discounted amount pursuant to a plan. Generally, chapter 13 bankruptcies have involved a much more streamlined process for smaller cases, while chapter 11 bankruptcies have involved much more substantial assets, debts, and complexity.

With recent bankruptcy reform, individuals will not be allowed to obtain the chapter 7 discharge if they have the ability to fund a chapter 13 plan over a 5 year period. With chapter 13, the bankruptcy judge can approve a payment plan, provided that the debtor proposes to pay more than the creditors would receive in liquidation, with payments occurring over a 3-5 year period.

While consumer debtors will now need to enter into payment plans under chapter 13, entrepreneurs who become insolvent face a more difficult road to financial relief. Chapter 13 is only available to individuals with regular income who have unsecured debt of less than $250,000 and secured debt of less than $750,000. So, entrepreneurs who have liability on loans that exceed the $250,000 unsecured and/or $750,000 secured threshold requirements will not be able to take advantage of the more debtor friendly chapter 13 bankruptcy process.

That leaves chapter 11 as the only alternative. With chapter 11, the debtor needs to propose a plan of reorganization, the creditors generally need to vote in favor of the plan, the debtor needs to provide "new value" which means some type of cash or property at the outset of the plan, and the plan needs to provide payment to creditors that exceeds what they would receive in liquidation.

The problem with chapter 11 is that the creditors, and not the court, play the dominant role in determining whether the plan is approved. Chapter 11 is also very expensive and time consuming. Many entrepreneurs who suffer a business failure will not have the resources or time to survive the Chapter 11 reorganization process. The loss of the entrepreneur's threat of simply filing chapter 7 may also encourage banks to be more aggressive while bargaining with entrepreneurs in workout negotiations.

So, entrepreneurs need to consider carefully the downside risk to new business ventures. Guarantees and other forms of personal contractual obligations for the repayment of business debt will not be as easily resolved under the new federal bankruptcy laws, in the event the business fails.

David J. Perkins, Esq.—is the president of Perkins Olson, P.A., a law firm focusing on business startup and reorganization matters, as well as litigation in commercial, environmental and construction areas, with offices in Portland and Rockland, Maine.

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