



Shareholder Agreements

Why Privately-Owned Companies Need Them

by Peter E. Converse

Virtually every privately-held corporation or LLC with two or more shareholders or members needs a shareholders' agreement. A well-drafted shareholders' agreement can offer entrepreneurs protection from disputes, liquidity for the shares if they leave the enterprise, protection from shares falling into the hands of unwanted individuals, certain tax advantages, and other advantages.

The failure to execute a well thought-out shareholders' agreement is the single most common mistake I see in the legal structure of privately-held companies. A shareholders' agreement is virtually guaranteed to avoid significant problems during the life of a successful privately-held company. Shareholders' agreements restrict how shareholders can sell, transfer, and/or vote their shares.

For limited liability companies, provisions similar to those described below can be embedded in the operating agreement for the LLC.

Shareholders' Agreement Provisions

Shareholders' agreements typically include some or all of the following types of provisions:

1. **Sale Restrictions.** Restrictions on voluntary sales or other transfers of shares prevent shares from falling into the wrong hands. Applicable law in most states prevents an absolute bar on such sales, so these restrictions typically take the form of a "right of first refusal," both for the corporation and the other shareholders. Frequently, the corporation or other shareholders purchasing the shares have the right to pay for them over time.
2. **Required Sale Upon Departure from the Corporation.** Upon termination of employment, disability, or death, shareholders are typically required to sell their shares back to the corporation or the other shareholders at a fixed price, which is established beforehand. These provisions prevent shares from falling into the wrong hands and also allow the departing shareholder to "cash

out." One major negotiating issue is how this fixed price is to be calculated. Methods of establishing this price include appraisal (expensive but likely accurate), mechanical formulas (e.g. book value, two times revenues, four times net income, etc.), or periodic valuation by the parties themselves.

3. **Minority Shareholder Protections.** A wide variety of provisions protect minority shareholders, including rights to Board membership, restrictions on payment of excessive salaries to control shareholders, dispute resolution provisions, reciprocal buyout rights (shareholders make competing bids for the others' shares), and antidilution provisions.
4. **Succession Planning; "Exit" Strategies.** Numerous devices in shareholders' agreements (including those

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What a PEO Can Do For You

by Melissa Donohue

Professional Employer Organizations (PEOs) evolved as a means for small and medium-sized companies to obtain affordable human resource administration through a single source provider. With all the compliance issues and regulations facing business owners today, considering a strategic partnership with a PEO can be a very smart move. The expertise of a PEO falls in the areas of payroll and taxes, benefits administration, risk management, and compliance.

A PEO also assumes specific administrative, regulatory and strategic accountabilities so that the business owner can concentrate on revenue-generating activities.

Saving Money with a PEO

According to the Small Business Administration, the average annual cost (in 1999) of regulation, paperwork, and tax compliance for companies with fewer than 500 employees is about \$5,000 per employee. For companies with more than 500 employees, the cost is about \$3,400 per employee.

According to the Department of Labor, a PEO can handle its administrative responsibilities at one-third to two-thirds of the cost an average business would incur to provide similar services. By grouping employees from many companies, PEOs cost-effectively purchase benefits based on economies of size, therefore employees receive enhanced benefit options.

Better Benefits, Less Risk

Engaging a PEO enables a company to offer a better benefits package and a higher level of HR services. Furthermore, the risk of employment litigation is minimized by getting advice on worksite laws and regulations and assuming liability for many employment-related statutes. Today, more business owners are turning to PEOs to reduce paperwork, contain soaring employee benefit costs, and comply with burdensome government regulations.

In most cases, a PEO contractually assumes responsibility for compliance with the regulations of the Equal Employment Opportunity Commission, the National Labor Relations Act, COBRA, ERISA, ADA, and many more. The IRS considers the PEO to be the employer of record and is liable to pay income and unemployment taxes.

Selecting a PEO

When selecting a PEO, the following criteria should be considered: The ability to offer core services, stable financial history, experienced staff of HR specialists, and a track record with companies of similar size and industry. Be sure to ask for both client and professional references.

For more information on PEOs, visit the National Association of Professional Employer Organizations' Web site at www.napeo.org.

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Dropping the Dot-Bomb

by Margaret K. Cook

A doomed dot-com? How about one of these instead? By the end of 2001, the seven new generic Top-Level Domains (gTLDs) listed below will be available for use.

.BIZ: Intended solely for commercial businesses. Registrants will need to certify that their use of the site is for legitimate commercial use. Expected launch date: October 1, 2001.

.INFO: General information sites for both companies and individuals. Expected launch date: September 19, 2001.

.NAME: Intended for personal use web sites (i.e. john.smith.name). Expected launch date: November 1, 2001.

.PRO: Intended for use exclusively by professionals, such as attorneys, doctors, and accountants. Registrants will need to provide proof of their credentials to reserve a web address. Expected launch date: Late in 2001.

.AERO: Reserved for legitimate members of the air transport industry and civil aviation sector including airlines, airports, and related industry bodies. Expected launch date: Unknown.

.COOP: Intended for Business Cooperatives, such as credit unions and rural electric cooperatives. Initially, registration is only available for members of the National Cooperative Business Association or an affiliate. Expected launch date: Unknown.

.MUSEUM: Intended to provide authenticity and assurance to users that sources of information about cultural and scientific heritage are verifiable. Expected launch date: Unknown.

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Education Tax Breaks are Big Winners

by Kimi Ellen

College savings plans are much more tax favored under the new law. Many states have these programs. They involve IRA-like accounts for kids that are used to pay college tuition and expenses. Depositors select investments from a plan's selection of choices. Money is placed in a blend of mutual funds.

These plans are far more flexible than prepaid tuition programs because funds can be used for ANY college, even out-of-state private universities. And many states let depositors deduct the pay-in amount on their state tax returns. Check with your CPA to see if it is deductible on your state return.

Tax-Free Tuition

Distributions from college savings programs and prepaid tuition plans will be fully tax free in 2002 if used for college. Under the current tax law, students owe tax when plan earnings are withdrawn. The exclusion will not affect availability of tuition tax credits (HOPE and Lifetime Learning). These credits can be claimed as long as the payout from a savings plan isn't used for same expenses for which credit is taken. Additionally, private colleges can set up prepaid tuition plans after 2003.

Another change in the process is that rollovers of accounts for the same beneficiaries will be permitted once every 12 months. If a child with an education IRA doesn't use it by age 30, the account can be switched to siblings under the current tax law. However, the new tax law will include first cousins in 2002.

Changes for the Better

Education IRAs will be broadened substantially after this year. These accounts aren't technically IRAs, but they work much the same way. Amounts withdrawn from ED-IRAs are tax free when used for college tuition, books, lab fees, and

the like. Maximum contribution will rise from \$500 to \$2,000 in 2002.

More couples will also be able to make ED-IRA contributions as the income limit for married filers will be double that for single filers next year. A full \$2,000 can be contributed if adjusted gross income doesn't exceed \$190,000. In addition, deadline for contributions for a tax year will be extended until April 15th of the following year (which is the same as regular IRA contributions).

Who Can Contribute?

Anyone can make ED-IRA contributions for a child, including grandparents, uncles, etc., if they meet income limits. Even corporations can begin making contributions for children after 2001. This is great for small corporation business owners because they can make contributions on behalf of a child and write them off. The contributions normally can not be written off by an individual tax payer. However, aggregate contributions to a child's account can't exceed \$2,000 next year.

Additional Benefits

Contributing to a state plan will not disallow an ED-IRA contribution in 2002. More kinds of expenses can be paid tax free from education IRAs, such as extended-day programs, computers, and Internet access for students.

Another big change is that the accounts can be used for pre-college schooling next year, as they will not be limited to the cost of college and grad school. The funds may be used to pay for kindergarten through 12th grade in private or parochial school.

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Shareholder Agreements

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described previously) can be used as part of a plan to transfer ownership of the corporation to children or long-time employees, or dispose of their shareholdings in a tax-sensitive "exit strategy."

5. **Tax-Related Provisions.** Shareholders' agreements can be very useful in various tax-planning strategies, including "estate tax freezes," disproportionate redemption programs, employee stock ownership plans, other benefit plans, and installment sale/repurchase strategies.

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WBE Certification Helps Small Businesses Grow

by Kristin Johnson

Do you know any women who own and actively manage their own business? Do they include major corporations and government agencies in their target market? If so, read on! Certification as a Women's Business Enterprise (WBE) could be the marketing tool they have been looking for to take their business to the next level.

What is WBE Certification?

WBE certification is a designation made by a neutral third party certifying that a business is majority owned, operated, and controlled by a woman or a group of women. This certification can then be used as a marketing tool to get the attention of buyers at major corporations and government agencies.

Certification can be a powerful marketing tool because many government agencies and corporations have established goals to include women-owned companies in their supplier base — often to the tune of about 5% of their entire purchases.

Who does WBE Certification?

The Women's Business Development Center (WBDC) has been certifying Women's Business Enterprises (WBEs) for over ten years, but it is not alone. In Illinois alone, there are dozens of agencies who conduct WBE certification — the City of Chicago, Cook County Government, the State of Illinois, the CTA, and the Illinois Department of Transportation, to name a few.

Most government entities conduct certification to qualify WBEs primarily to do business with them alone, though some exceptions exist. In contrast to that, the Women's Business Development Center provides a national certification that is accepted by over 400 major corporations including Sears, United Airlines, Motorola, and Com Ed. In addition to the corporate recognition, several government agencies recognize the certification as well, including the State of Illinois and Cook County Government.

What is a WBE?

A Women's Business Enterprise is an ongoing business concern that is majority owned, operated, and controlled by a woman or a group of women. The types of companies certified as WBEs are diverse, with products ranging from office supplies to sheet metal and services ranging from the staffing of temporary personnel to environmental consulting.

To determine eligibility, a business must be willing to reveal a significant amount of proprietary documentation about their business, including tax returns, financial statements, and corporate papers like bylaws and stock certificates. This documentation is evaluated to determine eligibility typically in four main areas (NOTE: This is a summary of the WBDC eligibility criteria. The complete eligibility criteria for the WBDC's certification can be found on our Web site at www.wbdc.org):



- A. Ownership — The business is 51% or more owned by a woman or women.
- B. Contribution of Expertise and Capital — The contribution of capital and/or expertise by women owners to acquire their ownership interest shall be real and substantial and be in proportion to the interest(s) acquired.
- C. Operation and Control — The women must possess the power to direct or cause the direction of the management and policies of the business and to make the day-to-day as well as major decisions on matters of management, policy, and operations.
- D. Independence — The women owner(s) shall have the ability to perform in the company's area of specialty/expertise without substantial reliance upon finances and resources (e.g., equipment automobiles, facilities, etc.) of males or non-women business enterprises.

How Do You Apply for WBE Certification?

You can apply for the Women's Business Development Center's WBE Certification online at www.wbdc.org. For certification with a government entity, you should contact them directly.

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Certificate of Authority: Does Your Client Need One?

by Margaret K. Cook

If a corporation or limited liability company is transacting business in a state different from its state of incorporation, that entity must “qualify” or “apply for authority to transact business.” If an entity is transacting business and does not have a Certificate of Authority, the state will impose penalties. For example, Illinois sanctions two forms of penalties for entities that violate this rule in both the Business Corporation Act of 1983 (805 ILCS 5/13.70) and the Limited Liability Company Act (805 ILCS 180/45-45).

Defining “Transacting Business”

Before the penalties will apply, an entity must be transacting business in Illinois. Like many areas of the law, Illinois law defines “transacting business” by what it is not. The Business Corporation Act of 1983 states that the following does not constitute transacting business (805 ILCS 5/13.75):

1. Maintaining, defending, or settling any proceeding;
2. Holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;
3. Maintaining bank accounts;
4. Maintaining offices or agencies for the transfer, exchange, and registration of the corporation’s own securities or maintaining trustees or depositories with respect to those securities;
5. Selling through independent contractors;
6. Soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if orders require acceptance outside this state before they become contracts;
7. Creating or acquiring indebtedness, mortgages, and security interest in real or personal property;
8. Securing or collecting debts or enforcing mortgages and security interests in property securing the debts;
9. Owning, without more, real or personal property;
10. Conducting an isolated transaction that is completed within 120 days and that is not one in the course of repeated transactions of a like nature; or
11. Having a corporate officer or director who is a resident of this state.

With that being said, the definition of transacting business is still somewhat vague. One may reasonably assume that the activities defined by Illinois law as not constituting the transaction of business is similar to the law of other states. When determining whether your clients are transacting business in another state, ask yourself, “Is the company soliciting business? Is it advertising? Is it conducting regular, continuous business transactions? Does it maintain sales offices and/or a sales force?” Of course, the best road to take is always the safest — obtain a Certificate of Authority to transact business in any state where your client has a presence.

Penalties You Should Know About

Presumably, the penalties imposed by Illinois for failure to obtain authority are similar to the penalties in other states. Illinois law prescribes two forms of penalties in its statutes.

If a foreign corporation or foreign limited liability company is transacting business in Illinois without a Certificate of Authority, it may not maintain a civil action in any state court until it has obtained a Certificate of Authority (805 ILCS 5/13.70; 805 ILCS 180/45-45(a)). This does not seem too exacting until you consider the second penalty — a foreign corporation or foreign limited liability company which is transacting business in Illinois without a Certificate of Authority is financially liable to the state for the years, or parts thereof, during which it transacted business.

The entity is liable for all fees, license fees, franchise taxes, penalties, and other charges that would have been imposed by the state since it started transacting business. The state will consider the entity as having obtained a Certificate of Authority initially (filing fee + franchise tax) but failing to file its annual reports (filing fee + franchise tax + late penalties). It is as if the entity is reinstating its Certificate of Authority. The state, particularly the Limited Liability Department, imposes stiff penalties for failure to file the annual report.

Furthermore, the state imposes an additional penalty. In the case of a foreign corporation, the state assesses a penalty of the greater of 10% of the filing fee, license fee, and franchise taxes due or \$200 plus \$5.00 for each month, or fraction thereof, in which the corporation was transacting business in Illinois (805 ILCS 5/13.70). For a limited liability company, the state assesses a penalty of \$1,000 plus \$50.00 for each month, or fraction thereof, in which the LLC was transacting business in Illinois (805 ILCS 180/45-45 (d)).

All of the above fees, fines, and penalties do not pertain solely to an entity which wants to maintain a civil action. In general, the financial liability results when an entity does not apply for authority within 60 days after it commences transacting business.

You might say, “My client is never going to file a lawsuit or ‘be caught’ by the state for not obtaining a Certificate of Authority, so what is the point?” But what are you going to tell your client when he or she has to pay a sizable fee to the state before being able to file a lawsuit? I guarantee that your client will not be amused by the risk you took.

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**Our thoughts and prayers are with all those affected
by the tragic events of September 11, 2001.**



Chicago Bar Assoc. Calendar of Meetings

Corporation & Business Practice Committee
1st Wednesday of every month at 12:15 P.M.
Upcoming Meetings: Oct. 3, Nov. 7, Dec. 5

Corporate Practice YLS Committee
2nd Thursday of every month at 12:15 P.M.
Upcoming Meetings: Oct. 11, Nov. 8, Dec. 13

Patent, Trademark, & Copyright
Practice Committee
4th Tuesday of every month at 12:00 P.M.
Upcoming Meetings: Oct. 23, Nov. 27

Intellectual Property YLS Committee
1st Wednesday of every month at 12:15 P.M.
Upcoming Meetings: Oct. 3, Nov. 7, Dec. 5

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