

Minnesota Journal of Business Law and Entrepreneurship

Volume 1

2002

Number 1

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The Minnesota Journal of Business Law and Entrepreneurship is published twice a year at the University of Minnesota Law School. Publication is online only in Internet format at <http://www.kommerstad.org/journal>. Hardcopy reprints are available for authors. Submission requirements are available at the Web site.

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The Business of University Start-Ups: Barriers and Solutions
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The major success of Medtronic, one of the world's leading medical technology companies, shows that commercial successes can result from University research, rewarding both society and investors. The commercialization of the heart pacemaker alone has had tremendous ramifications for the economy of the state, and has spurred the development of a thriving medical device cluster in Minnesota that is the envy of the nation.

The University of Minnesota is the primary research university in the state of Minnesota and among the top research Universities in the United States, with research expenditures approaching \$500 million per year. Over 6,000 doctoral-level scientists and graduate students conduct this research.

A few of the discoveries, inventions, and developments from University of Minnesota research endeavors are:

- Use of the compound Bretylium to treat cardiac fibrillation
- The first heart pacemaker
- Ultrasonic cancer screening
- Flight data recorders (black boxes) for aircraft
- Retractable seatbelts for vehicles
- Anti-HIV compounds – Carbovirs – to treat AIDS
- More than eighty crop varieties that have greatly increased yields worldwide
- The taconite process for making higher grade iron ore pellets from low-grade iron ore
- Vaccines and treatments for poultry and livestock diseases

Commercialization of University research was made possible by the Bayh-Dole Act of 1980¹, which gave Universities the right to

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¹ Bayh-Dole Act, <http://www4.law.cornell.edu/uscode/35/pllch18.html>

commercialize the results of all Federally funded research efforts. Subsequent to the Act, Universities have leapt into the business of commercializing their commercially interesting technology, either by licensing to an established company or by licensing to new startup companies.

About half of this research is in the field of health sciences, funded primarily by units of the Federal government such as the National Institute of Health. Leading-edge research efforts in fields such as stem cell engineering, genomics and bio-informatics appear to have great potential for the formation of future industry clusters and could have a profound effect on future industrial activity and development in the state.

The University of Minnesota today has done a remarkably good job in the field of technology commercialization, with 12 staff licensing professionals responsible for selecting, protecting and licensing those research disclosures that seem to be of interest to commercial entities.

	FY96-98	FY 00-02	
	Average/yr	Average/yr	% Increase
Disclosures	148	226	53%
New US Patent applications	51	78	53%
US patents issued	37	48	30%
Licenses and options			
New	56	81	45%
Startups	6	10	67%
Total active licenses and options	301	509	69%
Gross Revenues*	\$5.6	\$22.3	298%
Patent Expenses (not litigation)*	\$1.8	\$2.6	44%
Patent Cost Reimbursement*	\$0.8	\$1.1	38%

* Dollar amounts (\$) in millions

The table above shows that the number of licenses to start-up companies is increasing quite rapidly, from six per year (FY96-98) to 10 per year (FY 00-02).

Barriers to Commercializing University Research

Despite this progress, the reality is that starting new companies from University research can be a tough business. Failure rates are high

and the road to success can be very long. Breakthrough technologies may be scientifically extraordinary yet have nonexistent commercial markets.

Finding experienced business people to work with scientists during the evaluation stage is a daunting task – scientific and business worlds are often incompatible. The cost of intellectual property protection is high, and early-stage capital is a problem. University startups must overcome the following obstacles:

- The scientists who developed the technology often wish to maintain their positions at the University rather than work full-time at the new companies formed to commercialize their discoveries. This makes investors wary, since adequate time may not be available to fix or improve a technology in order to make it work to commercially acceptable levels.
- The scientist may be confident that the business side of the company is really quite easy and may insist on maintaining a business leadership role, for which many scientists are ill-trained and ill-suited.
- Examining the future business potential of a brand new technology-based opportunity can be difficult, and scientists usually are not experienced or trained in that field.
- Finding a businessperson to run a new company can be very difficult – experienced business-people with proven track records of success often are not eager to take another large risk in their business careers.
- Many University-based technologies are at least a decade away from commercial success. A recent example at the University of Minnesota is Carbovir, the AIDS treatment that took 12 years to generate royalties.
- Many startup entities will not need enough capital at the initial stages of development to attract experienced venture capital investors, who prefer to invest at least several million dollars in a deal. Large investors only will invest later in the cycle, after much of the risk of the deal has been removed.
- A new firm may be forced to find investors in very small seed capital funds for their initial financing needs. An economic problem of small seed capital funds is that most do not generate sufficient current income through management fees to attract partners who are experienced in early-stage companies or skilled in leading new entities to commercial success.

A Solution for Success

For startup companies based on University technologies, these six problems have proven to be formidable barriers to success. Fortunately, a recently formed experiential learning project at the University's Carlson School of Management – the Carlson Venture Enterprise – can address these problems and bridge the gap between University researchers, venture capital investors, and the entrepreneurial community.

In addition to providing a rich learning experience for MBA students, the Carlson Venture Enterprise will have many positive effects for researchers at the University, the entrepreneurial community and the economy of the state of Minnesota.

The Venture Enterprise mission is to use the entrepreneurial talents and networks of the Carlson School to facilitate the creation of excellent high growth firms. The Enterprise primarily focuses on the breakthroughs in science and technology developed within the University.

The Enterprise provides Carlson School full-time MBA students with a unique educational experience for beginning a career in the assessment of new business ideas. Learning occurs through a combination of lectures, assignments, and hands-on, real-world experience where students work directly with scientists in evaluating the commercial feasibility of new technologies.

The goal is to have Venture Enterprise students involved in all aspects of the creation of a high potential venture, including analysis of management, financing needs and potential market acceptance. Students present their findings and recommendations to a Board consisting of venture capitalists, investment bankers, entrepreneurs, industry experts and faculty.

Students work with scientists and the Carlson School faculty to consider whether a technology should be commercialized through a new company start.

- What is the value of the technology?
- Is the technology unique and can it be protected from competition?
- Can the technology work to commercial standards?
- Is the market large enough to justify a venture capital

investment?

- What is the business model for this business?
- Can we recruit a management team for this business?
- Can we raise sufficient capital to execute the business plan?

In those cases where a compelling case can be made, the students present these concepts to a board of experienced venture capital investors, investment bankers, and entrepreneurial managers who provide input as to whether or not the company can be financed. If the discussion is positive, the Venture Enterprise students work with the early-stage firm in the financing effort as well as in the execution of the business plan. For Venture Enterprise students, real-world experience in the analysis of new business development is very valuable.

The Venture Enterprise process offers the following solutions:

- For early-stage seed capital investors as well as early-stage CEOs, much of the due diligence work and company sorting is done by Venture Enterprise, which acts as a "filter," pursuing only those ventures that have potential commercial value. This activity eliminates over 90% of the analysis work, since less than 5 out of 100 deals at this stage can be financed.
- Scientists at the University receive professional experienced assistance in determining whether or not to pursue the commercialization of a given technology.
- For those deals that seem promising, connections have already been made between the scientist and the entrepreneurial community. Although we are in the early stages of the Carlson Venture Enterprise, the future looks promising. Last year's class evaluated about one hundred new opportunities and continues to work with four very interesting new businesses. The promise of this program will continue to provide value to students, scientists and the community well into the future.

Choice of Organizational Form for the Start-Up Business

JOHN H. MATHESON*

Individuals embarking on new business ventures must choose a legal form under which to operate. They can form their business enterprises as sole proprietorships, general or limited partnerships, limited liability partnerships, limited liability companies, or corporations. State laws set forth the attributes of each organizational form. These include criteria for limited liability, centralized or decentralized management, transferability of interests, and duration of existence.

Before 1997, the issue of entity choice for the businessperson and legal counselor was tax-driven, and the determination to obtain pass-through tax treatment depended on the corporate resemblance test of the now-discarded Kintner Regulations.¹ Under the Kintner Regulations, unincorporated businesses were taxed as corporations if they had more corporate than noncorporate characteristics.

On January 1 of 1997, the law of business organizations changed dramatically, when the United States Treasury Department's Simplification of Entity Classification Rules became effective. The current system, sometimes referred to as the "check-the-box regulations," ended decades of manipulation of business organization forms to fit the requirements of the Kintner Regulations and obtain pass-through tax treatment. Only corporations and publicly traded organizations are taxed as separate entities. All other business organization forms have presumptive pass-through federal tax status. Check-the-box regulations reduced the impact of tax issues in the determination of the type of legal organization a business chooses to use.

This article introduces the basic business organization forms and some of the attributes of each that influence the choice of entity decision for the modern start-up business.

Sole Proprietorships

A sole proprietorship is a business owned by one individual and not through a separate entity. Creation of the sole proprietorship

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¹ Prior Treas. Reg. § 301.7701-2 (1993).

requires no organizational formalities and is not subject to any specialized statute. The substantive law of contracts, torts, and agency govern the sole proprietorship, including the personal liability of the owner for the obligations of the business. The proprietor has sole authority to manage the business that ends with the owner's death or decision to end the business. Ownership is transferable as any other personal property.

Most business owners will choose an organizational form that limits personal liability, making the sole proprietorship a less-favored choice.

Sole proprietors can make cash or property contributions to the business and can withdraw money or property from the business without tax consequences.

Sole proprietors report the results of business operations on individual tax returns by reporting all of the net profit from the business, whether or not the proprietor withdraws the amount or reinvests it in the business. In profitable businesses, overall taxable income increases and business income is taxed at the proprietor's marginal tax rate. If the business operates at a loss, the proprietor's overall taxable income decreases. Subject to certain limitations, such losses can offset the proprietor's income from other sources and result in tax savings.

Partnerships

General Partnerships

A partnership is an association of two or more persons who are co-owners of a business for profit. Formation of a partnership does not require a written partnership agreement setting forth the terms of the partnership nor even the explicit intent to form a partnership. Though certain exceptions exist, a person receiving a share of the profits of a business is presumed to be a partner in that business.

If an explicit partnership agreement exists, it will control the rights of the partners. If the agreement fails to address particular areas or there is no explicit partnership agreement, nearly every state has a partnership act that controls.² Partnership acts contain numerous default

² Versions of the Uniform Partnership Act are the basis of most state statutes -- <http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upa97fa.htm>. Summary and history: http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-upa1994.asp

provisions that govern the relationships among the partners, between the partners and the partnership, and between the partnership and third parties. To avoid unanticipated outcomes in the operation of the partnership, parties should approve a written partnership agreement before forming the partnership.

For example, if partners do not explicitly specify profit and loss sharing ratios, partnership acts provide that partners will share profits and losses equally. Partners who want a profit or loss structure different from this default provision should set forth an alternative structure in the partnership agreement.

All partners have an equal right to participate in the management of the partnership, unless they alter its management structure. They may choose to vest management rights in only a few partners and maintain a centralized management structure. Unless the desired management structure is clearly set forth in an agreement, the equal-authority default will apply.

High standards of behavior apply to partners, which include making full disclosure to fellow partners under appropriate circumstances and acting primarily for the benefit of the firm when acting in the partnership's usual course of business. While the enterprise continues, partners owe one another strict loyalty. Many actions permitted by those acting at arm's length are prohibited in a fiduciary relationship.

Fiduciary duties commence at the formation of the partnership and continue until partnership affairs are wound up and the partnership makes final distributions.

A partnership is a small group of business owners who actively participate in the business. Though a partnership is an entity separate and distinct from its partners, all partners in a general partnership are jointly and severally liable for the debts of the partnership - there is no insulation from personal liability. The partners are liable not only for claims involving their own misconduct, but also for the debts, obligations, and liabilities incurred by the partnership, and for actions of other partners in the conduct of the partnership business.

A partner admitted into an existing partnership is jointly and severally liable only for those claims arising subsequent to admission to the partnership.

Partners should consider exit strategies when forming a partnership and drafting a partnership agreement, because partnership interests are not transferable without the consent of all the other

partners. The partnership agreement could make the transfer of an interest contingent on receiving approval from a certain percentage of the partners. Or, the partnership agreement could eliminate all approval requirements, making the partnership interests freely transferable.

A partnership does not have a perpetual existence. In a partnership at will, a partner can dissolve the partnership at any time.

A court may dissolve a partnership. Upon application by a partner, the court may find that the economic purpose of the partnership is likely to be unreasonably frustrated, another partner has engaged in conduct with respect to the partnership that makes it not practicable to carry on the business in partnership with that partner, or it is not practicable to carry on the partnership business as outlined in the current partnership agreement.

Dissolution does not necessarily mean the partnership terminates immediately. The partnership continues after dissolution to wind up its business and terminates when the winding up of the business is completed. During this phase, the partnership completes its business, marshals its assets, pays its liabilities, and distributes its interests. An agreement between partners cannot prevent dissolution but can manage the consequences of dissolution. The partners also may agree to continue the partnership after dissolution rather than entering the winding up phase.

Two fundamental differences exist between the taxation of partnerships (and other non-corporate business entities) and corporations. First, a partnership is a flow-through entity, not a separate taxable entity. Corporations are subject to an entity-level tax, while partnerships are not. Second, partners are liable for tax on the partnership's income, even though there may be no distribution of the income. Shareholders in a corporation are liable for tax only upon the receipt of a distribution from the corporation. A partnership avoids the double tax effect because only the partners, not the partnership, have tax liabilities.

An illustration of the advantageous effect of the single tax:

Smith and Jones form a partnership as equal partners. The partnership earns \$1 million of taxable income for the taxable year. Smith and Jones each report \$500,000 gross income from the partnership. The \$1 million is subject to the maximum individual tax rate of 38.6%, creating a tax liability of \$386,000.

Assume instead that Smith and Jones formed Smith and Jones, Inc., as equal shareholders. The corporation earns \$1 million of taxable income for the taxable year. Since the corporation is a

separately taxed legal person, the corporation pays \$340,000 in tax, at the current corporate tax rate of 34%. Then, if the corporation distributes the \$660,000 after-tax earnings to Smith and Jones as a dividend, in cash, Smith and Jones must pay tax on the dividends. Assuming a 38.6% individual tax rate, Smith and Jones will pay almost \$255,000 in tax.

The combined corporate and shareholder tax on the corporation's \$1 million of taxable income is \$595,000, compared to \$386,000 if the organization operated as a partnership.

Although the partnership does not pay taxes, it files an information tax return, Form 1065.

The partnership nets its ordinary income and expense items resulting from trade or business activities to produce a single income or loss amount. The partnership files a Schedule K, on which it lists all items that must be reported separately to the partners. These items must be listed separately because they may affect individual partners' tax liabilities differently. Examples of separately stated items include charitable contributions, net short-term capital gains and losses, net long-term capital gains and losses, dividends eligible for a dividends-received deduction, and tax-exempt interest. Every partner receives a share of the partnership's income, gains, losses, deductions, and credits on his schedule K-1.

When a partner determines gross income for federal income tax purposes, it must include the partner's distributive share of income from a partnership.

The major disadvantage of a general partnership is that partners are personally liable for the obligations of the partnership. This leaves the personal assets of the partners unprotected and subject to attachment by creditors.

Another drawback is uncertainty under the partnership laws. They are not as detailed as most corporate statutes and they are not clear as to how various disputes or concerns will be resolved. Fewer court decisions interpret partnership statutes than corporate statutes, and this absence of judicial interpretation contributes to the uncertainty.

Limited Liability Partnerships

The limited liability partnership (LLP) is a new type of partnership, nonexistent before 1990, governed by special provisions of a state partnership statute.

Most of the attributes of general partnerships also apply to LLPs,

including the discussion of management structure, period of existence, transferability of interests, fiduciary duties and taxation. As the name suggests, regarding liability of the partners, LLPs have a distinct advantage over a general partnership.

LLP status appeals to members of professional partnerships because they can continue to function as general partnerships while limiting partners' vicarious liability for any malpractice committed by other partners. The LLP does not require the creation and administration of an entirely new type of business entity. Instead, it enables members to continue to hold themselves out as partners. Although LLPs initially were tailored to the needs of professional service practices, they have flourished outside the professional domain.

To create an LLP, partners file a statement of qualification with a designated state agency, usually the secretary of state. Existing partnerships, to achieve LLP status, must vote to amend the partnership agreement and file a statement of qualification.

This statement must include the name of the partnership, the address of the partnership's chief executive office and, if different, of an office in the state where the LLP statement of qualification is filed, a statement that the partnership elects to be an LLP, and a date of commencement. LLP status is effective on the later of the filing of the statement or a date specified in the statement. The name of the LLP must include "Registered Limited Liability Partnership," "Limited Liability Partnership," "R.L.L.P.," "L.L.P.," "RLLP," or "LLP."

LLP status is in effect initially through the end of the calendar year after the year of formation. To maintain LLP status, the LLP must file an annual registration.

Under many LLP statutes, the formation of an LLP protects partners against vicarious liability from both tort and contract claims arising during the partnership's registration as an LLP. The liability shield does not protect a partner from liability for claims based on his or her own wrongful acts, negligence, or misconduct.

Under certain circumstances, the partners in an LLP could lose the limited liability shield and be personally liable for partnership obligations.

Not all states have adopted similar limited liability provisions, and LLPs should not assume that other states automatically would defer to these provisions. So far, it is unclear whether other states will apply their own law or the foreign state's law to claims regarding an LLP formed under the foreign law.

In states with these provisions, the statutes govern all internal affairs of the limited liability partnership, including the liabilities of partners for the debts and obligations of the LLP.

It is a risk to operate as a general partnership, with no chance of protection from personal liability. All partnerships that formerly operated as general partnerships should become limited liability partnerships.

Limited Partnerships

A limited partnership is a creature of statute. It has one or more general partners and one or more limited partners. In a limited partnership, the general partners are in the same position as partners in a general partnership - jointly and severally liable for the debts of the partnership. Limited partners are distinct from the partnership and are usually liable only to the extent of their capital contributions.

Limited partners cannot participate in the management of the limited partnership without risking their limited liability status. If they participate in the control of a business, they can lose their limited liability and become personally liable. This prevents a limited partner from possessing ultimate decision-making responsibility. Individual state statutes may provide a great deal of protection for limited partners with regard to the activities in which they can participate.

Limited partnership interests are freely transferable. Unlike general partnerships, the transfer of an interest in a limited partnership does not require unanimous approval by the other partners. The sale or issuance of a limited partnership interest is treated as a sale or issuance of a security and the entity must comply with the relevant federal and state securities laws.

Limited partnerships do not enjoy perpetual existence. Dissolution occurs at the earliest of (a) the date specified in the limited partnership certificate; (b) the occurrence of events specified in the partnership agreement; (c) the written consent of all partners; (d) the withdrawal of a general partner, unless another general partner continues the business in accordance with the partnership agreement or with the consent of the parties; or (e) judicial dissolution. The limited partnership can agree to avoid a winding up and continue its existence.

General partners owe fiduciary duties to limited partners. A limited partner has the right to bring an action in the name of the limited partnership to recover if: 1) the general partners who have authority to do so refused to bring an action or 2) an effort to force the general partners to bring an action is unlikely to succeed. The plaintiff

must be a partner when he or she brings the action and when the transaction complained of occurred. This action is similar to a derivative suit in the corporate context.

Limited partnerships are rare outside of investment fund and family contexts. Their odd management structure, with both general and limited partners, penalizes limited partners for being active in the business. Limited liability partnerships and limited liability companies offer advantages similar to the limited partnership without this structure and its accompanying restrictions.

Limited Liability Companies

A limited liability company (LLC) is an unincorporated statutory entity that provides presumptive limited liability for all of its owners — its “members.”³ Under the typical LLC statute, because of the check-the-box regulations, an entity can be created with flow-through tax treatment, limited liability for its owners, perpetual existence, free transferability of interests, and a choice of management structures. These developments make the LLC the most appealing non-corporate entity for business organization purposes, making the LLC the entity of choice for closely held businesses in the United States

LLC statutes vary significantly from state to state and may be based on a partnership model, a corporate model, or some hybrid of the two.

Typically, one or more organizers can create an LLC. Most states allow an LLC to have only one member and do not limit the number of members allowed. Members may be corporations, partnerships, trusts, or individuals. Professional organizations, such as accounting and law firms, may organize as LLCs.

To achieve LLC status, “Articles of Organization” must be filed with the secretary of state or other designated office and LLC status commences on the date of filing. Articles of organization must include the LLC’s name, its address, the names and addresses of each organizer, and the period of existence if limited. The LLC’s name must contain the words “limited liability company” or the abbreviation “LLC.”

To maintain LLC status, the LLC must register annually. An LLC

³ National Conference of Commissioners on Uniform State Laws, Uniform Limited Liability Company Act: Limited Liability Companies, a Kind of Business Organization, http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-ullca.asp. Summary and history: http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-llpt97attupa1994.asp.

that fails to file its annual registration may terminate administratively. Loss of LLC status may cause the LLC's members to lose the limited liability shield, leaving members personally liable for any debts incurred after the termination of LLC status.

LLC status provides an organization with flexibility in determining its management structure. Statutes usually allow either a manager-managed governance structure or a member-managed structure. Through contractual agreements, an LLC can limit the management rights of some members. Members may adopt operating agreements specifying the relationship of its members and the manner in which the LLC will operate. The operating agreement is the principal governing document of the organization.

The transferability of the members' LLC interests depends on the type of rights involved. The interests in an LLC usually are divided into financial rights and governance rights. A financial right in an LLC often is freely transferable, while a governance right presumptively is not. Transfer of governance rights to a nonmember typically requires the unanimous consent of all other LLC members.

An LLC is liable for all company obligations, including liability resulting from the wrongful acts of its members or employees. LLC members are liable only to the extent of their capital contributions. This limited liability status remains in full force even in the event of a dissolution, winding up, and termination of the LLC. This protection will be lost only if a complaining party successfully pierces the LLC's limited liability shield.

The presumed duration of an LLC varies among LLC statutes. Some states provide partnership-like dissolution provisions, while others allow a stated of existence or presume a corporate-like perpetual duration.

Corporations

Historically, one advantage of doing business in the corporate form was the ability of the shareholders, as the owners of the business, to limit their personal liability for the business's debts and obligations. This liability shield protects the shareholders' personal assets from any loss incurred by the corporation, because a corporation is a distinct legal entity separate from its owners. Creditors must look to the corporation's assets to satisfy their claims.

Business parties who intend to use the corporate form must follow the proper corporate formalities or risk losing limited liability protection. Corporate law requires that all corporations have a governance group called the board of directors. Responsible for a

corporation's management, shareholders must elect the board of directors through regularly scheduled annual elections or special elections. Shareholders typically do not participate in the management of the corporation.

Centralized management is important in large, publicly traded corporations. With thousands of passive shareholders scattered throughout the globe, a shareholder is not likely to seek or be able to actively participate in the management of the typical multinational corporation. In smaller business entities, centralized management is a disadvantage, because their owners want to manage and their managers want to own.

Directors are fiduciaries to the corporation and have duties of obedience, care, and loyalty. Shareholders do not owe the corporation or each other any fiduciary duties.

An interest in a corporation is readily transferable, unless restricted by the owners. Free transferability of ownership interests is a definite advantage of the corporation, particularly a large one. Typically, only small, closely held corporations restrict the transfer of ownership interests.

Another advantage of the corporation is that it has a presumptive perpetual existence. Unlike a partnership, a corporation does not dissolve upon the occurrence of certain events or the passage of a certain period of time. Corporations need not be concerned that an unwanted dissolution or winding up may occur. The board of directors and the shareholders can determine when a corporation terminates its existence.

Shareholders in a corporation are presumed to be liable only to the extent of their contributions. They may be personally liable, however, under the equitable doctrine of piercing the corporate veil. To pierce the corporate veil, a complaining party must show that the shareholders employed the corporation as an "alter ego" and that use of the corporation was unfair or inequitable.

When third parties seek to pierce the insulation of the corporate form, it usually is in cases involving closely held corporations. Courts may perceive less of a justification for the protection of shareholders of closely held corporations from personal liability. Operating a corporation like a sole proprietorship can justify a court's removal of the limited liability veil.

Corporations are separate taxpaying entities, distinct from their shareholders. They are taxed annually on earnings. When the

corporation distributes its income in the form of dividends, the corporation's shareholders must report this income as well. The effect is double taxation – a major disadvantage of operating as a corporation. Because the corporation is a separate entity, many ongoing transactions between it and its shareholders are taxable events. When the corporation liquidates, any previously unrealized income, such as appreciation of corporate assets, is taxed at the entity level.

S Corporations

Recognizing these problems, Congress and the Internal Revenue Service created tax provisions that allowed small businesses to not be limited or guided solely by tax considerations when choosing an entity form. The result was the creation of S Corporations, governed by Subchapter S of the Internal Revenue Code.⁴

Subchapter S status combines the non-tax legal environment of regular corporations with taxation similar to that of partnerships. S Corporations enjoy many of the corporation's non-tax benefits while avoiding double taxation.

S Corporations are small business corporations that have made an election under section 1362 to become S Corporations. A corporation files Form 2553 – Election by Small Business Corporation to Tax Corporation Income Directly to Shareholders – to make the election.⁵ The Code specifies six requirements that corporations must satisfy in order to be an S Corporation:

1. It must be a domestic corporation.
2. It may have no more than 75 shareholders.
3. Shareholders must be individuals, estates, and certain types of trusts or certain tax-exempt organizations.
4. Shareholders cannot be nonresident aliens.
5. The corporation must not be an ineligible corporation, as are some insurance companies and financial institutions.
6. It may only have one class of stock.

⁴ I.R.C. §§ 1361-1363,
http://www.access.gpo.gov/uscode/title26/subtitlea_chapter1_subchapters_parti_.html

⁵ I.R.S. Form 2553: Election by a Small Business Corporation,
<http://www.irs.gov/pub/irs-pdf/f2553.pdf>

Each of these criteria must be satisfied and all of the S Corporation's shareholders must consent to the election in writing. The election remains in effect unless the corporation voluntarily revokes the election or fails to satisfy any of the six small business corporation tests.

S Corporations are flow-through entities and are like partnerships for tax purposes. S Corporations report an ordinary income or loss amount as well as the corporation's separately stated items. The separately stated items are identical to those of partnerships. Each shareholder receives a pro rata share of the ordinary income or loss amount and of each of the separately stated items. The pro rata allocation method assigns an equal portion of each item to each day of the taxable year and then allocates that portion among the shares outstanding on that day.

Although the S Corporation is not subject to corporate income tax, it must file Form 1120S - U.S. Income Tax Return for an S Corporation - if it existed at any time during the tax year. Also, the S Corporation must give pertinent information to its shareholders and the shareholder's return must be consistent with the corporate return.

Conclusion

The LLP and the LLC are the newest and most popular types of business entities. All fifty states and the District of Columbia have enacted such statutes. The primary drawback of LLP or LLC status is that some uncertainty surrounds the manner in which LLP and LLC laws will be interpreted because of their short periods of legal existence.

Notwithstanding this uncertainty, it is difficult to conceive of any reason why knowledgeable and well-represented entrepreneurs would organize a firm as anything other than an LLP or LLC or a corporation that has made an S corporation election. Only in special circumstances should an entrepreneur use the traditional sole proprietorship, general partnership, or limited partnership.

ENTITY COMPARISON CHART

FACTORS	CORPORATION	PARTNERSHIP	LLP	LIMITED PARTNERSHIP	LLC
1. FILINGS					
A. Documents	Articles of Incorporation	None	Statement of Qualification	Certificate of Limited Partnership	Articles of Organization
B. Signers	Incorporator/s	N/A	Any partner	A general partner	Organizer/s
C. Filing Location	Secretary of State or designated state office	N/A	Secretary of State or designated state office	Secretary of State or designated state office	Secretary of State or designated state office
D. Fees	Yes	None	Yes	Yes	Yes
2. OWNERS, OWNERSHIP INTERESTS, AND LIABILITIES					
A. Owner Type	Shareholders	Partners	Partners	General and limited partners	Members
B. Severability	Yes (variety of series and classes)	Yes	Yes	Yes	Yes, divided into financial and governance rights
C. Transferability	Yes, unless restricted by Articles, Bylaws, or other Agreements	Requires approval of all other partners	Requires approval of all other partners	Yes, for limited partners. Requires approval of all other partners for general partner	Yes, as to financial rights. Assignment of governance rights requires approval of all other partners
D. Designation	Shares of stock	Partnership Interest	Partnership Interest	Partnership Interest	Membership Interest
E. Financial Rights	Equal to number of shares (plus options, warrants, etc.)	Equal share of profits and losses	Equal share of profits and losses	Based on Percentage of Contributions	Based on Percentage of Contributions
F. Voting Rights	Number of voting	Per capita	Per capita	As provided in	Based on Percentage

FACTORS	CORPORATION	PARTNERSHIP	LLP	LIMITED PARTNERSHIP	LLC
	shares			Partnership Agreement	of Contributions
G. Owners Liable for Debts of Entity (absent piercing)	No	Yes	No	No	No
H. Liability Shield Can be Pierced	Yes	N/A	Yes	Yes, if limited partner takes part in control of business	Yes
3. MANAGEMENT OF BUSINESS	Control of business delegated to board of directors	All partners or as delegated	All partners or as delegated	General Partners	Control of business delegated to board of governors
4. DURATION OF ENTITY	Unlimited, unless limited by state law or terms of charter	Specified term; or at will	Specified term; or at will	Specified term; or terminated by withdrawal of last general partner	Unlimited; specified term; or death, retirement, bankruptcy of a member Remaining members can agree to continue existence
5. TAXATION	Corporation, on its taxable income; Shareholders, on their distributions, unless S status elected	Partners, regardless of whether income is distributed to them	Partners, regardless of whether income is distributed to them	Partners, regardless of whether income is distributed to them	Members, regardless of whether income is distributed to them

**Joint Ventures And The Entrepreneurial Small Firm:
A Cautionary Note**
CHARLES A. SCHAFFER*

In joint ventures, definitions are important, since the term "joint venture" usually applies to a very large range of agreements through which firms work collaboratively. As used here the term means an agreement involving two or more firms to use some of the assets or resources of each, by way of contracts or transactions, to perform some action providing a payoff to each firm. This definition includes traditional joint ventures where the participating parties create a new entity, jointly owned by the parties, and the now more frequent "corporate partnering" or "strategic alliance," where the parties collaborate without changing the boundaries of the participating firms or changing the ownership of assets. It does not include mergers where all the assets of the participating parties become part of a single firm, nor does it include acquisitions where one of the participating parties controls the collaborative activity.

Over the past twenty years a substantial body of management literature has emerged, both academic and practical, that stresses the value of joint ventures to a firm's competitiveness. In that literature, small entrepreneurial firms are good candidates for joint venture activity when they are innovative and risk-taking, but resource or asset-constrained. These firms can leverage up their capabilities in cash, equipment, personnel, patents, and processes, through collaboration with one or more firms of the same or different size. Joint ventures allow firms to:

- Work at the point of convergence of disciplines (e.g., "bioinformatics") to develop new products and obtain first mover advantages
- Secure scope economies and cost reduction in industries or product lines where the same or very similar production processes can be used for multiple manufactured products (e.g., chemicals, pharmaceuticals)
- Share the costs of research and development
- Overcome costly barriers to market entry or line up customers, suppliers or distributors in advance of new product development or introduction

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- Secure new financing directly or improve the attractiveness of the participating parties or their joint venture to traditional sources of debt or equity

A joint venture can be of long or short duration, can be structured through formal contracts or more informal relational agreements, and can provide for changes in the use of the participating parties' assets. When added to this very large range of purposes, it is a complicated choice whether to enter a joint venture and limit the application of traditional industrial organization and industrial economics principles. The legal literature, at least as large as the management literature, offers little help, confining itself to post-choice issues of structure (e.g., avoiding unintended partnerships and antitrust liability), capitalization (e.g., investor's rights, recovery of investment or loans), and taxation (e.g., entity choice, taxation of non-liquidating distributions).

Making the Choice to Enter a Joint Venture

As in all costly business efforts, it pays to "look before you leap" into the commitment of resources. Here are some real-life suggestions to guide the decision whether, and with whom, to engage in a joint venture.

A Caveat on "Relational Contracts"

There is no substitute for a formal agreement setting out in detail the parties rights and obligations in the formation and conduct of the joint venture and their intention to have the agreement enforceable in court. In recent years there has been a fair amount of interest in the possibility of joint ventures using less formal "relational contracts," relying less on third party enforcement and more on enforcement through reputation, shared interests in outcomes, the promise of future opportunities.

No one can write a contract complete enough to address every possible contingency. To their proponents, relational contracts are better than formal contracts that will require renegotiation with attendant transaction costs and costs of delay and lost opportunity. Many examples of such relational contracts are drawn from the actions of firms in Silicon Valley engaged in relational activities related to market or industry structure (e.g., standard setting for software or hardware compatibility). Unfortunately, the use of such examples is disingenuous since one cannot in real practice extrapolate from a firm's willingness to use relational mechanisms in market or industry related actions to a willingness to use such relational mechanisms in conduct-of-

business or business competitive actions.

Even in Silicon Valley, individual firms use formal, complete contracts for matters of technology licensing, intellectual property and product development. While renegotiation or amendment of such agreements is costly, those costs are usually less than the costs associated with project “hold up” sustained by the actions of one party to a relational contract who, for example, balks mid-project on the continued use of one of its assets.

Even if parties believe that their goals can be achieved using relational contracts, it is very doubtful that bankers or investors in the joint venture (or in the parties individually) would permit such action that puts at risk their loans or equity in an agreement not enforceable in court.

Clarification of Purpose and Scope

Joint venture parties should articulate early, clearly, and consistently the desired outcome of each party and the relationship of that outcome to the joint scope of work and contribution of assets. Joint ventures offer considerable opportunity for the problem of adverse selection where one party has information not available to the other party in the form of a hidden agenda at odds with the purposes of the venture understood by the other parties.

Consider, for example, a small manufacturer of chemical glues and resins that entered into a joint research and development effort with a paint manufacturer. To the chemical firm the clear purpose of the work was the joint development of a new, long wearing paint for special applications where ordinary paint would not bond well to the surfaces to be painted. As work progressed the chemical firm’s technicians noted reluctance on the part of the paint firm’s technicians to carry the work to conclusion. Their withdrawal of effort and resources held up the project. When confronted, the paint firm admitted that its real reason for entering the joint venture was to develop glue for manufacture in the firm’s current physical plant without adding new technology or equipment. The development of paint was, the firm admitted, a secondary goal to acquisition of the chemical firm’s knowledge of glues and resins.

The articulation of the relationship between desired outcomes and performance of the scope of work is important to prevent a problem of moral hazard. Traditional moral hazard is a hidden action problem — one of the parties to an agreement shirks its duties because its actions

are not immediately observable or verifiable by the other party. In joint ventures a significant variant of this can occur when outcomes and conduct of work are less than clearly articulated and a less than optimal level of effort is sustained, because the wrong people are involved in the effort.

For example, a high level of misdirected and wasteful effort frequently occurs in organizations that seek to implement new computer applications technology into their operations. Although the major issues associated with adoption and successful use of such technology are policy or line operational issues, it is frequently technical staff who control the technology adoption planning. The result is long discussion of "plug A vs. plug B," with little attention to the issues associated with the practical use of the technology in achieving desired outcomes by end users. In addition, when joint venture outcomes are not tied to the actions of the parties in some scope of work, there is an incentive for one party to free ride on the actions of another by contributing the minimum effort.

Considerations of Risk

Before deciding on a joint venture, the parties need to remember that in every joint venture there is a participation constraint. No matter how complimentary the parties' goals or how well directed joint efforts are toward those goals, no party is guaranteed to leave the venture better off, or even as well off, as it entered. Each party has to look at its own and others' degree of risk aversion and risk tolerance and determine if they are immediately congruent or can be made so through structure (limited liability) or conduct (indemnification) of the joint venture.

Risk aversion and risk tolerance are not the same thing. Risk aversion is the degree to which a party demands some premium over a risk-free level of return for taking a given level of risk. Firms demanding such a premium are said to be risk averse; firms not demanding such a premium are said to be risk neutral. Risk tolerance is a measure of a party's willingness to sustain some determined level of risk over time for a given level of return. It is possible, then, to be at the same time very risk averse (by demanding a high premium over risk free return) and very risk tolerant (in the presence of that high return the risk can be sustained at a high level for a long time).

Depending on the decision making structure of the joint venture, it is possible for a party to find itself sustaining uncomfortable levels of risk. For example in cases where there are more than two parties to a joint venture, and where unanimity of the parties is not required for venture decisions the risk aversion and risk tolerance preferences of a

party with regard to three possible courses of action a, b, c, do not necessarily carry over into the preferences of the group. Known as Condorcet's Paradox the problem works like this. Three individuals – I, II, III – are joint venturers rank ordering as 1, 2, 3 their individual preferences for three possible outcomes – a, b, and c – which represent differing degrees of risky action. 1 indicates first preference; 2 indicates second preference; 3 indicates third preference.

	a	b	c
I	1	2	3
II	3	1	2
III	2	3	1

Condorcet's Paradox

In the table, two members prefer a to b. Two members prefer b to c. But two members, a majority, still prefer c to a. If the parties were voting, the group's choice would be inconsistent with the choices expressed as individuals. Absent agreement on the conduct of the joint venture, the parties' actions in the joint venture may not maximize the outcome for every party.

Unanticipated Effects

A careful pre-agreement review can avoid unanticipated costs and unintended consequences of the joint venture. In the matter of costs, for example, two surgical equipment manufacturers engaged in a joint venture that involved in its conduct the loan of an ethylene oxide gas sterilizer by Manufacturer X to Manufacturer Y. New to the technology, Manufacturer Y found itself with substantial additional insurance premiums due to the hazardous nature of the gas used in the sterilization. It also sustained both new and incremental regulatory costs associated with occupational safety and pollution control compliance. An often overlooked and unintended consequence relates to the creation of joint employment situations by joint venture agreements.

Minnesota, for example, has adopted the "loaned servant" doctrine for workers compensation purposes. If certain conditions are satisfied, an employee can be simultaneously in the general employment of one employer and the special employment of another. The employee

may look to either or both employers for compensation under the state workers' compensation law.

For some purposes, in some industries, joint ventures may not yield persistent, sustainable results. Costly research and development joint ventures may not be the most effective or efficient choice in industries where there is very rapid dissemination of new technological innovations, where the speed of product improvement and new product introduction precludes a "winner take all" long term market share for any one firm. There may be benefits, such as the avoidance of sunk development and testing costs, of being a second mover not a first mover in a market. Similarly, using a joint venture to overcome barriers to entry into a given industry or market may not have sustainable effect when new entrants must compete long term with incumbents possessed of substantial market power or economic rents. Entering a market does not make a firm a competitor in that market.

All parties to a joint venture will sustain some transaction and opportunity costs associated with the use and control of their assets and resources in the joint venture. A pre-agreement review of the kinds of issues noted above will help the parties ensure complementarity of purpose and conduct and prevent expense, frustration and disappointment.

Kommerstad Center Speakers Forum

Lessons Learned: Using Your Law Degree in Business

VANCE OPPERMAN*

Introduction of Mr. Opperman

Professor Edward S. Adams, Co-director of the Kommerstad Center for Business Law and Entrepreneurship:

I want to welcome you to hear our speaker on law and entrepreneurship for the Kommerstad Center for Business Law and Entrepreneurship program this afternoon. We're extremely fortunate to have a distinguished alumnus of this law school join us today – Vance Opperman, who graduated in 1969. Let me tell you a little bit about Vance, if you're not familiar with his very distinguished and impressive career. He is the President and Chief Executive Officer of Key Investment, Inc. – a local venture capital firm.

He is the former president of an information provider for computer assisted legal and business research company called West Publishing, a company we all know quite well. He is a member of the Board of Directors of the Thompson Corporation, the entity that purchased West. He is the founder and former Senior Partner of Opperman and Paquin, a position he held before becoming President of West Publishing in August of 1993.

While he was a practicing lawyer, Vance was named the one of the 100 most influential lawyers in America in 1991 by the National Law Journal. He was also named one of the top twenty-five winning litigators in Minnesota in 1991 and one of nation's top litigators by the National Law Journal in 1992. He served on President Clinton's national information infrastructure advisory council from January 1994 through January of 1996. Because he is one of the most generous alumni of this school, you see his name quite often here. It's a pleasure and an honor to welcome him today. I'm sure he will share some insights with you that will be extraordinarily useful in your career, and I'm very honored that he could join us. Thank you very much.

* Vance Opperman is a Minnesota business and political leader and seasoned litigator is the former president of West Publishing and president and CEO of Key Investment, Inc. An alumnus of the University of Minnesota Law School ('69), Mr. Opperman was Spring Semester speaker for the Kommerstad Center for Business Law and Entrepreneurship at the University of Minnesota Law School on March 15, 2002.

Mr. Opperman:

Do they really truly let people in this young? A lot of you will someday find yourself saying the same thing.

Ed called me up this morning actually and asked me if I'd read the Constitution. I said, "Yeah," and he said, "Do you believe in free speech?"

I said, "Yeah."

He said, "Well come on over and give us one."

So here I am. Actually, he interrupted me while I was watching reruns of my favorite television program, *Who Used To Be A Millionaire?* For those of us in venture capital that's not much of a joke.

First, I'd like to give you three things that I discovered in looking back on thirty-three years of law practice that have helped me in business and entrepreneurial activities. Then I want to talk a little bit about one downside of the transition from law to business and finally, two joys of entrepreneurial activity.

The Practice of Law Helps in Business***To Persuade***

We live in an oral society – whether because of our culture or because of our country. Think about it. The Best Evidence Rule against hearsay, the right to face your accusers. Humans live in an oral society. I don't know how that operates with other species, because I don't spend much time with other species – except primates – but then that's my political side, and I won't talk much about that. In my experience the first thing that helps in business is the ability to get up and talk.

I've been honored to serve on a variety of committees to select CEOs of various corporations. In every instance the person selected from a group with moderately equal credentials, male or female, has been the person who was the best at oral presentation. And that makes sense.

It's hard to persuade people, it's hard to motivate people, and it's hard to get people to do something, unless you're pretty good at talking.

The thing that gave me an opportunity to hone my skills was being in the practice of law, a setting where I needed to talk, to persuade,

and to read audiences. In business, if you make a presentation, if you try to sell a company, if you talk to a bond committee, a loan committee, or a group of employees that don't know you from a hole in the ground. One of the things that will help a lot is your ability to persuade orally.

To Learn from Business Client Mistakes

A second good thing about being a lawyer is getting paid to watch other business people make mistakes. You often get hired when someone else has made a mistake, or has been accused of making a mistake, or some regulatory agency thinks things haven't been done the way they ought to be done. I've had a great education watching screw-ups. I've watched small businesses, medium-sized businesses, and large businesses make all kinds of mistakes. It was my business to help them out and solve those problems, and that was a very good practical education.

Let me give you two examples of the kinds of things I learned from clients who made mistakes that I've tried not to replicate in any of my business activities. First, businesses in trouble add and make too much debt. You can fancy that up with leverage – you can call it whatever you want to call it. And although it's been a little tougher in the last two years, I've tried to carry with me what I've learned from seeing that.

The second problem that I saw I call the "magic person syndrome." Whenever you see a law firm that makes a lot of lateral hires, know that they all will fail. Absolute 100% rule. Partners get together around town – big ones, small ones – "You know, by gosh, we have got to be in intellectual property."

"Yeah, that's a great idea. We have to have more intellectual property lawyers, absolutely right! So and so is a great intellectual property lawyer - let's hire her!"

So they work out a deal to get her into the firm. And it will fail. It will fail because expectations will be too high – it's the magic person syndrome. "If we just have that one person, all of our problems will be solved."

It never works. It never works in a law firm, and it never works in business. A vice president in charge of human resources or a vice president in charge of sales will do the same thing. The Vice President of Sales will *always* tell you that. "The northeast region didn't do well this year because we didn't have Jones. If we only had Jones, boy, that

northeast region would take off like a rocket!” And stupidly, you go ahead and hire Jones and what you find out is it doesn’t do any better with Jones there, either. And you’ve ticked off half your sales force, because you paid a lot to get him.

The magic person syndrome. I saw it in law firm after law firm. I think it is the most serious mistake made in personnel management in business, and it’s a mistake I try to avoid.

To Be Disciplined – In Time, Stress, and Decision-Making

Discipline – the third thing I’ve learned. A great thing about being a lawyer is the discipline you learn. You learn it in two ways. First, you work hard, long hours under stress – fabulous training if you’re going to start a company or you’re called in because a well-established company is having trouble and you’re expected to turn it around. Your ability to work very long hours will hold you in good stead. If anyone ever tells you that the practice of law does not take a lot of hours, he or she is not much of a practicing lawyer. I don’t think it’s possible to practice law and not spend a lot of time at it.

I remember interviewing a very talented young lawyer who was clerking at the Eighth Circuit. When I gave that speech, she got up and ran out of my office. She wouldn’t have been a very successful practitioner in my view. Law teaches you the discipline of spending lots of time.

The other thing it teaches you is how to function under stress a lot of the time. It’s a fabulous experience and a great discipline to have. In law, you have a limited amount of time and then you have to get up and argue in within this narrow time frame with very strict rules. Argue in front of an appellate court and as soon as you’re done, someone will stand up and essentially say that you are stupid, you’re poorly reasoned, that your research doesn’t amount to much, that the cases you’ve cited don’t say what you said they do, and, frankly, your whole line of argument is a crock. You’ve managed to save a little time for rebuttal, and what are you going to do? You’re going to get very good at persuading under stress with very little time to do it.

My favorite stress story comes from is a trial I had in Stillwater, Minnesota. I hated state court and this case frankly didn’t endear me to it. We had identified a very serious problem and started a class action. Texaco was concerned that its underground gasoline tanks were leaking gasoline. In the course of discovery, we had uncovered a program at Texaco – the “Three Star Program” for its 1200 proprietary upper

Midwest stations. Stations rated with one star were to be kept and owned by the company and upgraded. Two-star stations were stations that would be sold to the station operator but under no accelerated timetables. Three-star Texaco stations were to be sold at all costs and within 30 days, if possible. What do you think were the conditions of the underground gasoline tanks in three-star stations?

It turned out the first one was in Stillwater and one day when they were digging an excavation down a hill for a major industrial project, they discovered gasoline. My first reaction was "Great! The first gasoline well in the world. Most places only find oil. You found gasoline." But it's kind of a problem when you're building a twelve million dollar industrial park. It's hard to weld stuff with gasoline coming out of the ground. So we sued Texaco with that information on behalf of those property owners. Finding liability wasn't much of a problem. You don't really have to worry much about traumatizing the jury as to the dangers of gasoline seeping out of the ground. They can pretty much visualize that. What you're going to have trouble with is determining the damages. And that of course the most stressful part if you're a plaintiff, because you're taking some contingency or some kind of risk. You're not, believe me, going to risk whatever it is – time or expense or whatever – on a case where liability is bad, at least not after the first year or two of practice.

So the real stress comes in damages – how much has the land been damaged? And one of the ways you do that is to get an appraiser, put them in front of the jury, and ask them two questions: "What was the value before? What was the value after?" And of course it's a great big value before and a tiny little value after. You subtract one from the other and put the number up on a blackboard or some such device so there's a large dollar amount that nobody can possibly miss. And you leave it there if they'll let you, because then when the other lawyer gets up to cross examine at some point, he's going to have to take the eraser and erase it off the board. You use whatever trick you happen to like to dramatize that.

So, I'm confident that my world-famous expert who had done all the appraisals for the highway department in Stillwater will give me the right answer – the one he'd given in his written report. I asked him what the property value was before they discovered gasoline and I wrote a nice big number on the board – the number on the front page of his report. And then I asked him, "Could you tell us what the value is after the gasoline was discovered?" And he looked at me and said, "Oh, that would be impossible." Now that's a moment of stress – and I'm looking for a carpet to crawl under.

The judge made it worse, because she woke up and, being

judicially helpful, said, “What!?!?” At which point, my expert got to repeat, in a nice loud voice, just in case the jury hadn’t caught it, “Oh, that would be impossible.” Now, that’s a moment of stress! But the damage had been done, and we didn’t get any sleep at all that night. But we knew how to operate under stress on three or four hours of sleep night after night – a useful discipline different than you get in almost any other profession.

The second thing the discipline from practicing law gives you is the ability to come to a decision quickly with the facts that are available. This is not the brief-writing, research mentality of library rats who take forever to think things through. They’re not going to make it in the practice of law and they certainly aren’t going to make it in the business world. They accept the myth that there is an ultimate fact, that the answer they are searching for exists someplace. It does not.

If you practice law for any length of time, you will have a moment of epiphany. You’ll have a terribly important but simple issue of law and you’ll be at the helpful computer terminal with all the legal research in the entire world at your fingertips, from Westlaw, of course. And you won’t find the answer. Why? Because none of the questions you have will have the answer. None of them.

In business the problem is the same. You never have enough information or enough time and you have to make a decision that affects either the expenditure of money, the expenditure of time, or a plan to move forward. The discipline I acquired in the practice of law included the ability to come to a decision in less than a day. You’ll have a day to make an important argument, a day to put together a trial brief, a day to tell a client what to do, a day to sign a settlement agreement. And you have to do it in a very tight time frame. And you won’t have complete information, ever, and you’ll wish you could have one more day, one more week, one more month, to see what’s going to happen. But you can’t – you’re forced to make the decision and move on.

If you take anything away from the practice of law – anything – and use it in any business context, that is the discipline I would urge you to take away. The single most important discipline you will ever have in business is the ability to make a decision quickly on the facts you have and move on.

Ten years ago, Shintaro Ishihara wrote a book called *The Japan That Can Say No*. It suggested that requiring the reporting of quarterly profits was hurting American business, that we ought to take the long 20-year view. I didn’t believe it then and I don’t think it’s true today. The fact of the matter is business cycles are about 90 days long. And if you can’t live with that, you also won’t be able to practice law very well

because there isn't a heck of a lot in law with a time period of longer than 90 days. There are some statutes of limitations longer, but I don't think there's a rule of procedure that gives you 90 days for anything. If you depart the confines of a law firm to run a business, this will be the most important form of discipline you have.

I've told you three things you can take away from the practice of law that will help you in business. Notice I didn't give you the usual one? The usual one is "learn to think like a lawyer and that will help you in business." I don't know what that means. I think it's a meaningless cliché. What is meaningful knowing how to marshal the important facts in a very short time, make the decision and move on. If you can't do that, you won't be a very successful lawyer and you sure as heck will be a failure in business.

The Downside

Remember, I said there was a downside? It comes from the organizational structure of law firms. Law firms are not hierarchical organizations – they are very horizontal in their structure, primarily because everyone is a lawyer. Because of that, lawyers are not particularly good at dealing with different kinds of people at different hierarchical levels. They're more accustomed to dealing with peers. And because there's a certain language and type of relationship when you deal with peers, lawyers often are not prepared to function in a corporate setting which is much more structured and more hierarchical. In my view that requires that you deal with people in a much different way.

For example, lawyers aren't particularly good at team building. If they do build teams, for example, for the purpose of putting together a lawsuit, they are relatively small teams – seven or eight or nine people – and they're not put together for the long haul. The reverse is true in business – you need to be able to motivate and interact with large numbers of different types of people in an effective manner at a variety of hierarchical levels – very few of them will be your peers. To me, that's the down side of the practice of law. It does not prepare you for the human part, the personnel part, of running a business.

The Joys in Entrepreneurship

The Equity

At the beginning of my speech, I said there were two joys in business or entrepreneurship. The first joy is building equity. This would have meant nothing to me when I sat in this law school, although not this building, not even on this bank of the Mississippi River. In the practice of law you can make a good living, and that's fine. Great things come from being able to provide for your family and yourself. But you don't build equity.

Law firms generate, partly because of the tax structure that applies, a lot of current income; but they do not develop equity they can sell, pass on, or easily trade. I was a partner in the old established law firm – probably the oldest one in the state – of Dougherty Rumble Butler. By the end of that law firm's existence, after 115 years, it had produced two members of the United States Supreme Court and one of the first members of the Minnesota Supreme Court. And that didn't matter – the firm failed.

No matter how revered any law firm is, it's still a personal services business, and you can't build up equity in a personal services business. Think there's equity at Arthur Anderson? There's not.

So, one of the joys of building a business is that in addition to creating income, you get to build some return. You get to build equity and assets with value that represent what you put into it. And you get to help others do the same thing. It's exciting to be able to build something, know you've built it, and know it's going to be there for a while and that it has value.

The People

The second joy in building a business and being an entrepreneur is experiencing the wide variety of people you get to work with. The most amazing thing – when I left the full time practice of law in 1993 and started working primarily in business circles, I discovered that there were a lot of people out there who actually respected lawyers. It was a revelation. You will learn that when you get involved in civic and charitable activities, maybe even political activities, that there are a lot of people from all kinds of backgrounds.

My favorite entrepreneur, I won't embarrass him by name today – the magazines have embarrassed him on their front covers many times. Anyway, my favorite entrepreneur is a guy who grew up in St. Paul, never graduated from high school, went to a company, got an idea, had the idea adopted, had a fast rise through the ranks, built some equity, was able to sell the equity, and started a number of other companies,

several of whom are now publicly traded. I've known this individual for a long time, and during all that time, the people for whom he held the highest regard were lawyers. They'd obviously gone to school – he had not. They were persuasive and could talk – he's not very good at that. They were able to zero in on the important subject or the important discussion point and suggest an alternative, which he always had trouble doing. He made more money than most lawyers, but nonetheless

So if you are in any kind of business, you'll experience the joy of working with the variety of people you meet from all walks of life.

If you do criminal law, you'll meet other kinds of people, too. I did that for the first two years of my legal career until it dawned on me that it was kind of demeaning to have clients that I was afraid to take home because they'd rape my wife or steal my silverware. So I got out of criminal defense work. But it was good trial experience

You can meet a lot of interesting folks in various kinds of law practice but in entrepreneurship you'll meet a much broader variety of people from a whole bunch of different backgrounds. Drive down Lake Street or drive down University Avenue and see the ethnic changes and the immigrant communities and the tremendous number now of new start-ups and growing businesses – some of them not so new that have been doing quite well for quite a while. Very exciting stuff.

I always tell my kids that of all the degrees you can get – and I'm a big believer in getting more education – a law degree ought to be one of them. It'll prepare you the best for life. It'll prepare you the best for business success. It'll even prepare to practice law. It's a useful thing to have and will bring you great joy. Now you're going to bring me great joy by asking questions. Thank you.

Student Question:

How important are contacts – whether legal contacts or that you made when you were lawyer or contacts you made in business?

Mr. Opperman:

Contacts are one of the great things about any professional or social activity. You know, people don't like to be lonely. That's why some of us get remarried . . . and remarried. But who's counting? Very few humans enjoy being isolated, social islands unto themselves. You

won't meet these individuals in the practice of law.

I won't surprise you by saying that if you read all these self-help business books — how to be a better this, seven effective habits, or whatever — many of them will tell you that if you want to really be successful, you ought to hang out with other successful people and do what they do. That's my view, too. The truth of the matter is you use your contacts all the time.

I assume that many of you chose Minnesota to go to law school because many of you plan to stay, practice, do business, be a judge, be in politics, or try lawsuits in the state of Minnesota. Why did you make that decision? Because you understand that the people you get to know, the people that you work with, the people you go to school with . . .

One of my classmates and closest friends as an undergraduate is a federal judge. I've had the honor of practicing often in front of him. That doesn't get me anything, but it's a more familiar surrounding than other courts I've spent most of my life in. There's a well-known lawyer in town who left a couple of years ago and now advises other venture capital groups. I call him all the time.

The simple answer to your question is the contacts you make in law school and in the first couple years of practice are invaluable. And you will contact those people, and there will be reciprocity, as you go through life.

Student Question:

My friends at the business school tell me that lawyers, as a rule, are too risk averse to be successful as entrepreneurs or in any competitive field of business. How would you respond to a claim like that?

Mr. Opperman:

I think that's wrong. Let me give you an example. There are risk averse individuals. Risk averse lawyers become tax lawyers, or even better, estate lawyers, because all their clients are dead. That's pretty risk averse, if you think about it. There are risk averse people in all professions. In the medical profession, the risk averse people become nutritionists or podiatrists — I don't know. They probably don't become surgeons.

But I think the most risk taking is in the practice of law. We

started the container anti-trust case in 1976. This was a case where we knew that, as counsel for the plaintiffs, you put in all your money and you pay all your experts, all in the hope that there will be a settlement or a verdict that's upheld on appeal. The collective risk undertaken by that group was in excess of fifteen million dollars in out of pocket expense. Calculated time was something in excess of 100 million dollars.

We tried that case for three and a half months – the verdict was 1.2 billion dollars. Then we had another three years to play around in the various appeal courts. It's amazing how defense lawyers with unlimited checkbooks can develop appeal strategies. We ended up in four different appeals courts. You might think, "How's that possible? You try in one district courts, you get one appeal." Oh, no.

Now that kind of practice is not for the risk averse. If the jury comes back and says, "We're sorry, you're out of luck," you're *really* out of luck. You've wasted a lot of your life and a lot of your money. Your partners are going to look at you and wonder what happened. What's even worse, frankly, and any of you who do major plaintiffs' work will have this happen. You finally get to trial, three years or longer after you've started the case. You actually try the case, which is a rarity. You win, which hopefully is not a rarity. And now you've got a verdict.

Listen to this example. The Massey Ferguson case was the last major case I tried before I left the practice. After four and a half years of fighting, we finally got a verdict – the jury gave us forty-six million dollars, forty million of which was punitive damages. We did such a good job in that case that the forewoman of the jury came back to us and said, "You only asked for forty million in punitives, but we wanted to give you more. Did we do the right thing?" Oh, yes!

There you are with a nice piece of paper that says forty-six million bucks – not bad, since you've got about a million bucks in the case plus costs – not a bad return. Now the question is, what happens? Well, on the way to the court of appeals, the Supreme Court affirmed the Delaware Valley HMO case, which essentially says no punitive damages. That'll keep you up a few nights, when most of your award is punitive damages.

Despite that case because, as you know, having read an infinite number of cases, there's always an argument that doesn't apply but somehow gets in. Because of some of those arguments, in the environmental area, punitive damages have actually done well since that very decision.

That's not for the weak of heart; that's for people who enjoy risk. And there are lots of practices where that's true. So I don't think it's at

all true that there's no risk, or that people who are risk averse are lawyers.

You can be an MBA, and not have a whole lot of risk, or be very risk averse. I think it's a personality trait, but if you want risk, get into the plaintiff's side of class action or major commercial litigation. You'll have plenty of risk.

Student Question:

Do you make a distinction between moving into the business world from a transactional practice versus a litigation practice?

Mr. Opperman:

I get an opportunity to speak at large, well-known law firm retreats a couple times a year. I like it because I get to see people I used to try cases against – they're all friendly now. That question always comes up, probably because there's a clear line of demarcation in most law firms between transactional lawyers and litigators. My sense of it is that you will certainly have migration of transactional lawyers where their transactional specialty had a domain that was close to the domain of the company that they went to – you see quite a bit of that. On the other hand, I doubt that Mike Wright, the CEO of Super Value, ever took a grocery class. You see some transference based exclusively on expertise, but I don't think those people do particularly well and I don't think they get very far up in the company.

If you've looked at the people who have done very well, who have moved from law to business, more of them, I think, are litigators. And I don't think that has to do, again, with the specifics of what they litigated. I mean, I don't think Irving Shapiro litigated cases for or against Dupont, where he became the CEO. He's the most famous local example of someone that went on to take over a major company.

I think it has more to do with different kinds of personal skills. And, to be honest, in thinking about a remark such as this, I've come up with that those three and they still apply: the ability to be persuasive, and the ability to move and motivate people, which requires the ability to communicate orally, the ability to be disciplined and come to decisions quickly and be driven in those decisions by the facts available at the time.

Those are the big ones. Another, obviously it helps, is having some knowledge. But I think those are the two that drive business success

more than any other attributes. And I think those are more likely found in a litigator.

That may be a personal bias, but I think that's the experience in England, also. I don't know a lot about the English system. I chair the audit committee for Thompson, and we have a number of our operations overseas also. Most of the people I meet who are in business who have been lawyers seem to all have been barristers as opposed to solicitors.

Student Question:

Can you tell us any more ways that a JD compares favorably, or maybe unfavorably, to an MBA?

Mr. Opperman:

MBA school was not really much of a program when I started law school. It's a 20-year phenomenon. Then I didn't know a lot of smart, bright, verbal, driven, disciplined individuals who got MBAs. I do now.

Where a law degree may come up *unfavorably* is in the networking possibilities. That's really just an impression. I have no idea if there ever have been any studies on that; I don't know how you'd quantify it. But, when I speak over at the Carlson school I recognize a lot of the students by their last names. And that tells me something about the networking that has gone on.

The way a law degree compares *favorably* is in the way students are taught. I look at the materials of my wife, my son, and my younger daughter, and I hear them talk about what they do in MBA school. They use the business case study method. I think that studying business cases studies is kind of a silly exercise because the cases are so narrow and not necessarily replicable. In that regard, I think the case method in MBA school leads people down a false path.

But maybe that's the best way of doing it – just like the old Latin schools used to teach our grandparents or great-grandparents Latin and Greek. It wasn't because they were going to use it; it was just a way to get discipline. I think the method of instruction and the material that is used in law school is superior and more congruent with later life experiences than the methods and materials used in an MBA program.