Essentials of Start-Up Law

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FORMING & ORGANIZING THE STARTUP ENTITY

Choosing the Form of Business Entity

- Common legal organizations
  - Limited liability company (LLC)
  - S corporation
  - C corporation

Limited Liability Company

- Limited liability company (LLC)
  - LLC members can operate as managers; all owners have limited liability (i.e., only the amount of their investment)
  - No entity-level tax – taxes pass through to LLC members
  - Ownership interests of the “members” are defined and established in the LLC operating agreement
  - Can establish of Board of Managers and Officers, similar to a corporation

Limited Liability Company

- LLCs generally work for:
  - Companies will early revenue / profit (i.e. not life science company)
  - Companies that have a licensing model (e.g. platform technology; IP holding company)
  - “Lifestyle” companies or Service companies
  - Buyer of Company
    - Able to structure as an asset sale and “step-up” basis in assets
- LLCs generally do <u>not</u> work for:
  - Venture-backed companies (Unrelated Business Income Tax (UBIT))
  - Companies raising capital from foreign investors
  - Companies with lots of employees
  - Companies that have a pre-revenue sale or IPO exit model

S Corporation

- S corporation has board members/shareholders, etc.; but—
  - Tax benefits and losses passed through to the individual shareholders (*i.e.*, a single level of taxation)
  - Early stage start-ups will sometimes take advantage of "S Corporation" status: losses get passed through to the owners
- Requirements for S corporation status:
  - no more than 100 shareholders
  - all individuals (family trusts are OK in general)
  - no "foreign" shareholders
  - only one class of stock (*i.e.*, no preferred stock)
- Simple conversion to C corporation

C Corporation

- Attributes of a C corporation
  - Corporate governance
    - Stockholders elect board of directors
    - Board appoints officers, oversees strategic direction
    - Officers manage day to day affairs of the company
  - No pass through of tax benefits
    - C corporation is taxed as a separate legal entity (unlike the LLC and the S Corporation).
  - VCs prefer to invest in it; employees can understand stock incentives

Conversion from LLCs to Corporations

- Conversion from LLC to corporation can generally be effected on a tax-free basis (may be taxable if LLC had issued debt and/or LLC has allocated losses to members in excess of their cost basis).
- Generally straightforward corporate process to effect conversion of an LLC to corporation (if LLC issued “profits interests”, it may get more complicated).
- California/Delaware LLC into a Delaware corporation can be effected through a statutory direct conversion (plan of conversion and no new entity is required to be formed).
- If direct conversion not available, LLC can be converted in a Delaware corporation through a merger process where Delaware is the surviving entity.
- Note that conversions from corporations to LLCs are treated for tax purposes as if the corporation liquidated and could be taxable.
- Always confer with your accountant on tax implications before conversion.

Where to Incorporate?

- Delaware or California?
  - Cost – generally immaterial in long-term
  - Beneficial corporate law in Delaware
    - Predictable and well-developed body of law
    - VCs are familiar with law
    - Class voting issues in California
    - Directors afforded high degree of protection
      - Business Judgment Rule – courts generally defer to judgement of directors
      - Indemnification and advancement of expenses
  - IPO objectives & reincorporation
    - Expensive reincorporation process once company grows

Start-up Documents: 4 Buckets

- Incorporation documents
- Founder documents
- Employee documents
- Basic third party agreements

Incorporation Documents

- Certificate of Incorporation
- By-laws
- Organizational minutes and resolutions
  - Establish Board of Directors
  - Appoint Officers
  - Issue stock
  - Adopt stock option plan
  - Approve indemnification agreements
  - Other Administrative matters (e.g. authority to open bank account)

Founder Documents

- Invention Assignment Agreement
  - IP assignment
  - Confidentiality
  - Non-compete? Not in California post-employment.
- Founders’ Stock
  - Agree upon allocation among founders early
  - Restricted Stock Purchase Agreement
  - Vesting Schedule?
    - Looking ahead to financing
    - Keeping the team “honest” vis-à-vis each other
  - Acceleration Terms (Single Trigger v. Double Trigger)
  - 83(b) Elections
    - Only if vesting imposed
    - File within 30 days or miss chance

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Employee Documents

- Offer letter
- Invention Assignment Agreement
- Options
  - What is an Option?
  - ISOs & NSOs

Employee Documents:
Options – What is an option?

- Right to buy common stock at a set strike price
- Typically granted to employees, board members, advisors and consultants
- Issued through an “option plan”
- Boards set strike price in connection with option grants
  - Objective is to price the common stock at <u>fair market value</u>
  - Section 409A of the Internal Revenue Code in many cases requires pricing based on an independent valuation
  - Adverse tax consequences if option priced below fair market value
- Maintaining good records
- Clean-up is costly

Employee Documents:
Options – Incentive Stock Options (ISOs)

- An ISO is eligible for favorable tax treatment
- Key Concepts:
  - No tax at grant
  - No tax at exercise (purchase)
    - Unless alternative minimum tax (AMT) applies
  - Sale or other disposition triggers income
  - Holding periods and other limitations apply to ensure favorable tax treatment
    - Shares held for more than 1 year after exercise and more than 2 years after grant

Employee Documents:
Options – Characteristics of ISOs (cont.)

- Exercise price must be 100% of FMV on date of grant (110% FMV for 10% S/Hs)
- Can only be granted to EMPLOYEES of company (or parent or subsidiary)
- Maximum term of 10 years (5 yrs for 10% S/Hs)
- Must be exercised within 3 months of termination (12 months if disability)

Employee Documents:
Options – Nonstatutory Stock Options (NSOs)

- An NSO is any option that does not qualify as an ISO
- No tax at grant
- At exercise, ordinary income = “spread”
- Subject to tax withholding
  - regardless of liquidity of underlying shares
- Sale – capital gain/loss
  - long-term capital gain/loss if exercised and held for > 1 year

Third Party Documents

- Form NDA
- Consulting Agreement

Thank You!

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