Entity Creation and Equity Considerations

- Entity Formation
- Founder Arrangements
  - Founder Employment Arrangements
  - Splitting the Pie
  - Founder Agreements
- Employee Equity
Legal Disclaimer

- Not legal advice
- K&L Gates and IPI are not your lawyers
- There is no attorney-client privilege/don’t tell us confidential information
- Roadmaps are intended to assist in thinking through issues in advance of obtaining legal assistance
- Objective: Making you more effective consumers of initial legal services
Choice of Entity Choices

- C Corporation*
- S Corporation*
- Limited Liability Company*
- Sole Proprietorship
- Partnership
- Limited Partnership

* Denotes most likely entity choice
Corporate Structure v. LLC Structure

- Shareholders
- Corporation
  - Managed by Directors/Officers

- Members
- Limited Liability Company
  - Managed by Managers or Members
Choice of Entity

There is no one answer for all companies “It depends…”
Limited Liability – Only Expose the Wager

- Form of entity
- Importance of formalities-“piercing the corporate veil”
- Contractual limitations
- Insurance
- Hidden liabilities
  - Unpaid wages and wage taxes
  - Pass-through entities with no cash to pay tax
  - Guarantees
Tax Considerations in Entity Choice

- Double Taxation (C Corporation)
  - Corporate
  - Individual

- Significance:
  - Material cash distributions/dividends
  - Sale of the Company
Illustration of Double Tax

C Corp

Shareholder

Entity

Dividend

Tax

S Corp/LLC

Shareholder/Member

Entity

“Income”

Tax

No Tax
### Example of Double Tax

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>S Corp/LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Corporate Tax</td>
<td>$ 40</td>
<td>$ 0</td>
</tr>
<tr>
<td>After-Tax Entity Income</td>
<td>$ 60</td>
<td>$100</td>
</tr>
<tr>
<td>Individual Tax</td>
<td>$ 9</td>
<td>$ 40</td>
</tr>
<tr>
<td>Individual After-Tax Cash</td>
<td>$ 51</td>
<td>$ 60</td>
</tr>
</tbody>
</table>

**Assumed Tax Rates**
- 40% corporate and individual tax
- 15% dividend rates
Other Tax Considerations in Entity Choice

- Tax-Free Mergers (benefit for corporations)
- Section 1202 – Qualified Small Business (benefit for C Corporations)
  - 50% exclusion for qualified business stock
  - 5 year minimum holding period
  - Excluded businesses: professional service businesses; real estate companies; financial services businesses
- “Partner” implications (issue for limited liability companies – benefit for corporations)
  - Self-employment taxes (2.9% of wages)
  - 1099’s and estimated payments
Limitations of S Corporations

- Single class of stock (other than voting)
- Limitation on number of shareholders – 100
- Only individual and certain non-profit corporation shareholders
- Only citizens or residents of the United States may be shareholders
Other Considerations

- Investor Favorable (C-Corporations)
- IPO Favorable (C-Corporations)
- Ease of use (e.g., option pools) (corporations)
- Ease of switching from LLC to C-Corporations
## Choice of Entity

<table>
<thead>
<tr>
<th></th>
<th>C Corporation</th>
<th>Limited Liability Company</th>
<th>S Corporation</th>
<th>Sole Proprietorship/Partnership</th>
<th>Limited Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limited Liability</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Flexibility in Ownership</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Eliminates Double Taxation/Flow-Through (losses, sale)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>- Tax-Free mergers on sale</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>- Section 1202 tax favorable treatment</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Flexibility In Structure</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>IPO Favorable</strong></td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>VC Favorable</strong></td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Employer Eligible</strong></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Ease of Use</strong></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Ease of Switching</strong></td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Bottom Line of Entity Choice

- No simple answer
- “Life-style company” or significant dividends/distributions—consider S Corporation or LLC
- Venture-capital oriented
  - Lean toward a C Corporation
- Easier to go from LLC to C Corp than Reverse
Name of Entity

- Check availability
- Quick trademark search
- Quick “Google” search
State of Formation Considerations

- Flexibility
- Taxation
- Predictability
- Cost
- Attractive to capital
- In general
  (a) “Fancy capital structure” or “Venture capital” - Delaware
  (b) Otherwise - PA
Founders Clearance

- Non-competition non-solicitation
- Confidentiality Agreements
- Fiduciary Duties
- Intellectual property assignments
  - Agreements
  - Policies
Founder Employment/Consulting Arrangements

- Role of Founder going forward
- Compensation
- Intellectual Property Assignments—critical
- Restrictive Covenants
  - Confidentiality – no limitation
  - Non-compete
  - Non-solicit (employees and customers)
- Term and geographic limitations
- Severance
Founder Equity Arrangements—Splitting the Pie

- Lessons Learned
  - Keep in mind the inevitable dilution
  - Keep it simple
  - Align incentives
  - It is unusual for the right answer to be split evenly
  - Beware of the dreaded “50/50”
Consider relative contributions (current and anticipated)
  - Idea
  - Business Plan
  - Domain Expertise
  - Commitment and Risk
  - Responsibilities

Use Demmler’s Founders’ Pie Calculator
  - Evaluate related contributions
  - Weight
Demmler Founder Pie Chart – Example

(1) Inventor – leader in domain
(2) “Business guy” – business and industry knowledge
(3) Technology – Inventor’s right-hand man
(4) Research team member – no future
## Demmler Founder Pie Chart (Example)

<table>
<thead>
<tr>
<th></th>
<th>Weight</th>
<th>Founder 1</th>
<th>Founder 2</th>
<th>Founder 3</th>
<th>Founder 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Idea</td>
<td>7</td>
<td>10</td>
<td>3</td>
<td>3</td>
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<tr>
<td>Business Plan</td>
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<td>3</td>
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<tr>
<td>Domain Expertise</td>
<td>5</td>
<td>6</td>
<td>4</td>
<td>6</td>
<td>4</td>
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<tr>
<td>Commitment &amp; Risk</td>
<td>7</td>
<td>0</td>
<td>7</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Responsibilities Going Forward</td>
<td>6</td>
<td>0</td>
<td>6</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
# Demmler Founder Pie Chart (Example)

<table>
<thead>
<tr>
<th></th>
<th>Founder 1</th>
<th>Founder 2</th>
<th>Founder 3</th>
<th>Founder 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Idea</td>
<td>70</td>
<td>21</td>
<td>21</td>
<td>0</td>
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<tr>
<td>Business Plan</td>
<td>6</td>
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<td>0</td>
</tr>
<tr>
<td>Domain Expertise</td>
<td>30</td>
<td>20</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>Commitment &amp; Risk</td>
<td>0</td>
<td>49</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Responsibilities</td>
<td>0</td>
<td>36</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total Points</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder 1</td>
<td>106</td>
<td>33.0%</td>
</tr>
<tr>
<td>Founder 2</td>
<td>142</td>
<td>44.2%</td>
</tr>
<tr>
<td>Founder 3</td>
<td>53</td>
<td>16.5%</td>
</tr>
<tr>
<td>Founder 4</td>
<td>20</td>
<td>6.2%</td>
</tr>
<tr>
<td></td>
<td>321</td>
<td>100.0%</td>
</tr>
</tbody>
</table>
Founder Equity Arrangements

- Vesting Arrangements
  - Amount of vested stock
  - Length of time of vesting
  - Buy-back arrangements

- Decision-Making/Management
  - Who decides who decides?
  - Directors/Managers
  - Officers

- Restrictions on Transfer
  - Absolute prohibition or Company consent
  - Rights of first refusal and modified rights of first refusal

- Drag-Along Rights
Employment/Consulting Arrangements – Similar to Founders

- Term/severance
- “At-will”
- Intellectual Property Assignments—critical
- Restrictive Covenants
  - Confidentiality – no limitation
  - Non-compete [Difficult to enforce with consultants]
  - Non-solicit (employees and customers)
- Term and geographic limitations
Employee Equity

- Types of Equity
  - Restricted equity (corporations; LLC’s)
  - Options
  - Qualified Options (corporations only)
    - Non-Qualified Options (corporations; LLC’s)
  - Profits Interests (LLC’s)
    - Phantom Equity (corporations; LLC’s)
• Restricted Stock
  • Taxed on receipt
  • Section 83(b) election
  • Potential capital gain treatment
Stock Options—Non-qualified

- No tax on receipt
- Taxed on exercise at ordinary income rates (fair market value less exercise price)
- Taxed on sale (capital gain) (sale price less fair market value at time of exercise)
- Most likely outcome – exercise on sale; taxed at ordinary rates
Stock Options – Illusive Qualified Options

- No tax upon receipt
- No tax upon exercise (subject to alternative minimum tax on fair market value over exercise price)
- Tax at capital gain upon sale
Restrictions for Qualified Options (among others)

- Option price at fair market value
- Must hold stock for at least 1 year after exercise
- Shareholder approval of plan
- Employees Only
- Non-transferable
- Must be exercised with 90 days after termination of employment
Profits Interests (LLC’s and Partnerships Only)

- Share in value in excess of value upon receipt
- No tax upon issuance of profits interest
- Treated as a member (e.g., share in distributions)
- Potential capital gain treatment
- Caution: Can be confusing
Phantom Equity

- Form of “Bonus Program”
- Employee receives benefit of increase in value
- Ordinary income upon receipt
Bottom Line

- Restricted Stock is best if company has low value
- Profits interests are attractive if entity is a limited liability company
- Non-qualified options are an attractive vehicle
- Phantom equity is attractive if being used for a broader audience
- Don’t forget about 83(b)
Other Terms

- Vesting
  - Time-Based
  - Performance-Based
- Repurchase Right
  - Vested
  - Non-vested
Amount of Employee Equity

- Amount necessary to attract and retain talent
- A huge option pool may work against you
- Don’t go too low in the employment pool
Roadmap

1. Consider choice of entity
2. Roles of Founders and Employment/Consulting Arrangements with Founders
3. Apply Frank Demmler’s Founders’ Pie Calculator
4. Do a capitalization chart
   ▪ Amount of Equity
   ▪ Vesting Terms
5. Shareholder Arrangements