

## Entity Creation and Equity Considerations

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

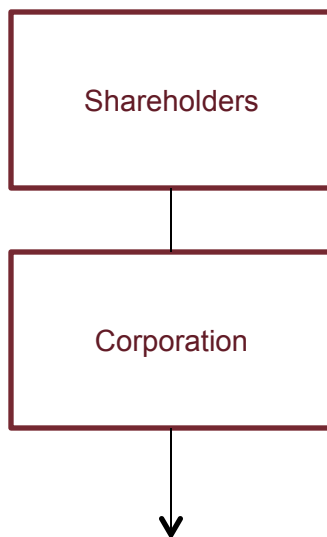
## Legal Disclaimer

- 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

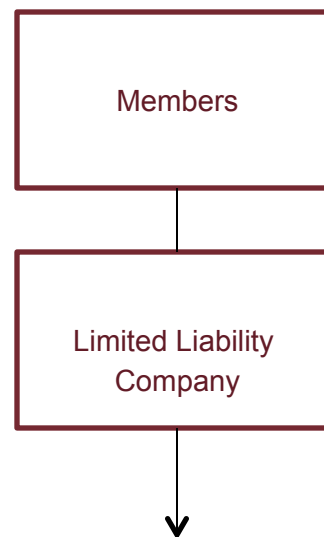
## Choice of Entity Choices

- C Corporation\*
  - S Corporation\*
  - Limited Liability Company\*
  - Sole Proprietorship
  - Partnership
  - Limited Partnership
- \* Denotes most likely entity choice

## Corporate Structure v. LLC Structure



Managed by Directors/Officers



Managed by Managers or Members

## Choice of Entity

There is no one answer for all companies  
“It depends...”

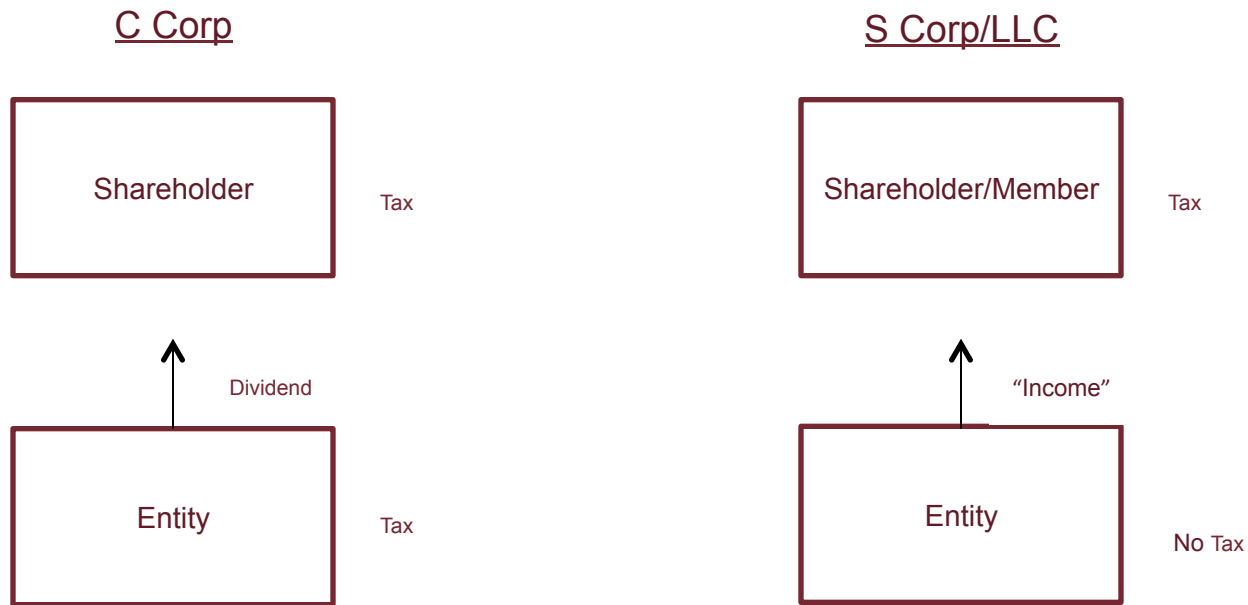
## Limited Liability – Only Expose the Wager

- 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





## Example of Double Tax

	<u>C Corp</u>	<u>S Corp/LLC</u>
Income	\$100	\$100
Corporate Tax	\$ 40	\$ 0
After-Tax Entity Income	\$ 60	\$100
Individual Tax	\$ 9	\$ 40
Individual After-Tax Cash	\$ 51	\$ 60

### 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

	C Corporation	Limited Liability Company	S Corporation	Sole Proprietorship/ Partnership	Limited Partnership
<b>Limited Liability</b>	Yes	Yes	Yes	No	Yes
<b>Flexibility in Ownership</b>	Yes	Yes	No	Yes	Yes
<b>Taxation</b>					
<ul style="list-style-type: none"> <li>• Eliminates Double Taxation/ Flow-Through (losses, sale)</li> </ul>	No	Yes	Yes	Yes	Yes
<ul style="list-style-type: none"> <li>• Tax-Free mergers on sale</li> </ul>	Yes	No	Yes	No	No
<ul style="list-style-type: none"> <li>• Section 1202 tax favorable treatment</li> </ul>	Yes	No	No	No	No
<b>Flexibility In Structure</b>	Yes	Yes	No	Yes	Yes
<b>IPO Favorable</b>	Yes	No	No	No	No
<b>VC Favorable</b>	Yes	No	No	No	No
<b>Employer Eligible</b>	Yes	No	Yes	No	No
<b>Ease of Use</b>	Yes	No	Yes	Yes	No
<b>Ease of Switching</b>	No	Yes	Yes	Yes	Yes

## 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 it 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)

	<i>Weight</i>	<i>Founder 1 Inventor</i>	<i>Founder 2 Business Guy</i>	<i>Founder 3 Technologist</i>	<i>Founder 4 Researcher</i>
Idea	7	10	3	3	0
Business Plan	2	3	8	1	0
Domain Expertise	5	6	4	6	4
Commitment & Risk	7	0	7	0	0
Responsibilities Going Forward	6	0	6	0	0

## Demmler Founder Pie Chart (Example)

	Founder 1 Inventor	Founder 2 Business Guy	Founder 3 Technologist	Founder 4 Researcher
Idea	70	21	21	0
Business Plan	6	16	2	0
Domain Expertise	30	20	30	20
Commitment & Risk	0	49	0	0
Responsibilities	0	36	0	0

Total Points	106	142	53	20	321
% of Total	33.0%	44.2%	16.5%	6.2%	100.0%

## 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 within 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