Structuring Start-Ups and Related Legal Roadmaps

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Overview – Goal – Simulate first meeting with Lawyer

- Choice of Entity
- Founder Arrangements
  - “Clear” the founders
  - Splitting the Pie
  - Founder vesting
  - Restrictive covenants
- Operation of Entity
  - Governance
  - Employee Equity
Legal Roadmaps - 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
- Benefit Corporation/ B Corp

* 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
Corporate Formalities

- Bank accounts
- Signatures
- Shareholder/Member and Board Meetings
- Corporate Records (including stock)
- Filings
  - State
  - Tax
Tax – Why you should care!

- Double Taxation (C Corporation)
  - Corporate
  - Individual
- Significance
  - Material cash distributions/dividends
  - Sale of the Company
Illustration of Double Tax

C Corp

Shareholder

Entity

Tax

Dividend

S Corp/LLC

Shareholder/Member

Entity

Tax

Dividend/Distribution

No Tax
## Example of Double Tax on Sale of Assets

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>S Corp/LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gain</strong></td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Corporate Tax</strong></td>
<td>$21</td>
<td>$0</td>
</tr>
<tr>
<td><strong>After-Tax Entity Income</strong></td>
<td>$79</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Individual Tax - capital gain</strong></td>
<td>$16</td>
<td>$20</td>
</tr>
<tr>
<td><strong>Individual After-Tax Cash</strong></td>
<td>$63</td>
<td>$80</td>
</tr>
</tbody>
</table>

**Assumed Tax Rates**
- 21% corporate
- 20% capital gain

**Point:** Single Layer of tax is better – LLC’s, S Corporations
More reasons to care about tax

- **Section 1202 – Qualified Small Business (benefit for C Corporations)**
  - 100% exclusion from capital gains
    - 5 year minimum holding period
    - Excluded businesses: professional service businesses; real estate companies; financial services businesses
    - Maximum: $10 million exclusion per shareholder

- **Tax-Free Mergers (benefit for corporations)**

- “Partner” implications (issue for limited liability companies – benefit for corporations)
  - Self-employment taxes (2.9% of wages)
  - 1099’s and estimated payments
  - Income on tax returns
S Corporations

- Benefits
  - Simplicity
  - Pass-through treatment
- Down-side
  - 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 in Deciding Entity

- Investor Favorable (C-Corporations)
- IPO Favorable (C-Corporations)
- Ease of use (e.g., option pools) (corporations)
- Relative 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>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limited Liability</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Flexibility in Ownership</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>- Eliminates Double Taxation/Flow-Through (losses, sale)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>- Tax-Free mergers on sale</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>- Section 1202 tax favorable treatment</td>
<td>Yes</td>
<td>No</td>
<td>Yes</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>
</tr>
<tr>
<td><strong>IPO Favorable</strong></td>
<td>Yes</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>
</tr>
<tr>
<td><strong>Employer Eligible</strong></td>
<td>Yes</td>
<td>No</td>
<td>Yes</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>
</tr>
<tr>
<td><strong>Ease of Switching</strong></td>
<td>No</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
- If model is build/sell after 5 years, consider C Corp
- Easier to go from LLC to C Corp than reverse
Benefit Corporations

- For-profit legal entity that has for its purpose a “general public benefit.”

- Benefit corporation statutes impose affirmative duties on directors to consider the interests of several stakeholders. The statutes also restrict standing to sue for breach of these duties.
Benefit Corporations: How It Works (in PA)

• The articles of association must be drafted (or amended) to state that the benefit corporation has for its purpose a “general public benefit” in addition to any specific public benefit.
• Board of Directors must include a Benefit Director.
• The company must submit an annual benefit report.

Advantages: offer legal protection to directors; show a strong commitment to a social purpose
Disadvantages: additional considerations and reporting requirements; no tax incentives
B Corps

- Certification for for-profit enterprises that meet certain social/environmental performance, accountability and transparency standards.
- Established companies take an assessment and must attain a score of 80 points out of 200 to maintain their status.
- Annual certification fees range from $500-$25,000.

**Advantages**: shows strong commitment to social purpose; access to B Corp community; potentially more sustainably profitable.

**Disadvantages**: no tax incentives; burdensome requirements
Name of Entity

- Check availability
- Quick trademark search
- Quick “Google” search

Caution: The name of the entity can be changed – don’t overthink it!!!
State of Formation

- Taxation
- Predictability
- Cost
- Attractive to capital
- In general
  (a) “Fancy capital structure” or “Venture capital” - Delaware
  (b) Otherwise - PA
Legal Roadmap – Part I

- Choice of entity
  - C Corporations
  - Limited liability companies
  - S Corporations
  - Benefit corporations
Founders Roadblocks

- 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 (i.e., Avoid fancy formulas)
  - Err on the side of incenting those who are providing value going forward
  - Even splits are not usually the right answer
  - Beware of the dreaded “50/50”
    - Shot-gun
    - Third party director
    - Arbitration
Use Demmler’s Founders’ Pie Calculator
- Evaluate related contributions
- Weight

Consider relative contributions (current and anticipated)
- Idea
- Business Plan
- Domain Expertise
- Commitment and Risk
- Responsibilities
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>
<td>0</td>
</tr>
<tr>
<td>Business Plan</td>
<td>2</td>
<td>3</td>
<td>8</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Domain Expertise</td>
<td>5</td>
<td>6</td>
<td>4</td>
<td>6</td>
<td>4</td>
</tr>
<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>
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<th></th>
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<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>
</tr>
<tr>
<td>Business Plan</td>
<td>6</td>
<td>16</td>
<td>2</td>
<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>
</tr>
<tr>
<td>Responsibilities</td>
<td>0</td>
<td>36</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Points</strong></td>
<td><strong>106</strong></td>
<td><strong>142</strong></td>
<td><strong>53</strong></td>
<td><strong>20</strong></td>
</tr>
<tr>
<td><strong>% of Total</strong></td>
<td><strong>33.0%</strong></td>
<td><strong>44.2%</strong></td>
<td><strong>16.5%</strong></td>
<td><strong>6.2%</strong></td>
</tr>
</tbody>
</table>
Founder Equity Arrangements

- Vesting Arrangements
  - Amount of vested stock
  - Length of time of vesting
  - Buy-back arrangements
  - Effect of termination and/or sale of company
Legal Roadmap – Part II

- “Clear” the founders
- Allocate equity (perhaps using Demmler’s Pie Chart)
- Founder arrangements
  - Choose vesting
  - Covenants
    - Non-compete (term)
    - Invention assignment
Operational Considerations

- Decision-Making/Management
  - Directors/Managers
    - Right to appoint
  - Officers
- Majority v. super-majority decision-making
  - Board
  - Member/Shareholder
- Restrictions on Transfer
  - Absolute prohibition or Company consent
  - Rights of first refusal
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)
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
Legal Roadmap – Part III

- Governance arrangements
  - Directors/officers
  - Super-majority
- Transferability
  - Restrictions on transfer of ownership
- Employee equity
  - Amount
  - Vesting period