

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

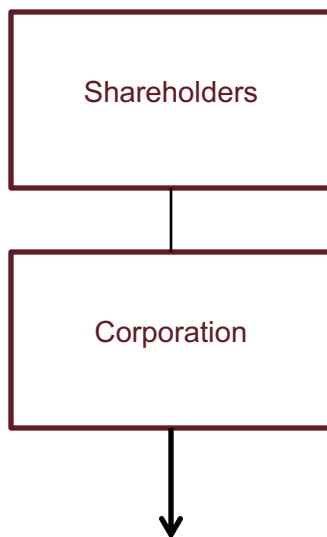
- Not legal advice
- K&L Gates and IPI are not your lawyers
- There is no attorney-client privilege/don't tell us confidential information
- Roadmaps are intended to assist in thinking through issues in advance of obtaining legal assistance
- Objective: Making you more effective consumers of initial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

Choice of Entity Choices

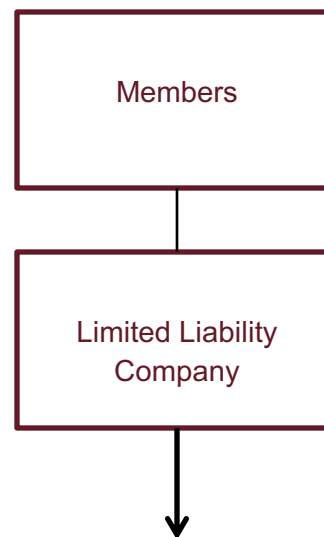
- C Corporation*
 - S Corporation*
 - Limited Liability Company*
 - Sole Proprietorship
 - Partnership
 - Limited Partnership
 - Benefit Corporation/ B Corp
- * Denotes most likely entity choice



Corporate Structure v. LLC Structure



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



Corporate Formalities

- Bank accounts
- Signatures
- Shareholder/Member and Board Meetings
- Corporate Records (including stock)
- Filings
 - State
 - Tax



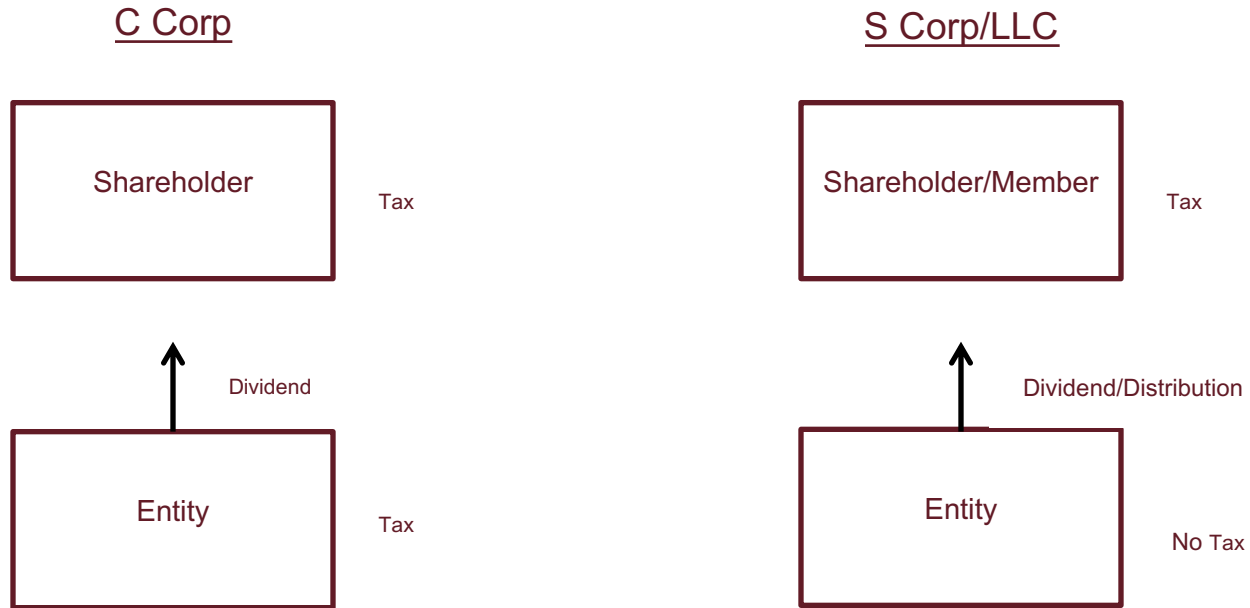
Formalities

Tax – Why you should care!

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



Illustration of Double Tax



Example of Double Tax on Sale of Assets

	<u>C Corp</u>	<u>S Corp/LLC</u>
Gain	\$100	\$100
Corporate Tax	\$ 21	\$ 0
After-Tax Entity Income	\$ 79	\$100
Individual Tax - capital gain	\$ 16	\$ 20
Individual After-Tax Cash	\$ 63	\$ 80

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

	C Corporation	Limited Liability Company	S Corporation	Sole Proprietorship/ Partnership
Limited Liability	Yes	Yes	Yes	No
Flexibility in Ownership	Yes	Yes	No	Yes
Taxation				
• Eliminates Double Taxation/Flow-Through (losses, sale)	No	Yes	Yes	Yes
• Tax-Free mergers on sale	Yes	No	Yes	No
• Section 1202 tax favorable treatment	Yes	No	No	No
Flexibility In Structure	Yes	Yes	No	Yes
IPO Favorable	Yes	No	No	No
VC Favorable	Yes	No	No	No
Employer Eligible	Yes	No	Yes	No
Ease of Use	Yes	No	Yes	Yes
Ease of Switching	No	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
- 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!!!

*What’s in a
Name?*

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)

	<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
 - 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