

# Starting a Business with an Eye Toward an Exit

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## Agenda

- Choosing entities and limiting liability
- Founder arrangements
- Importance of contracts
  - Non-Disclosure Agreements
- Approaches to intellectual property
- Employment/Consulting Matters
- Regulatory matters
  - Formation and raising capital

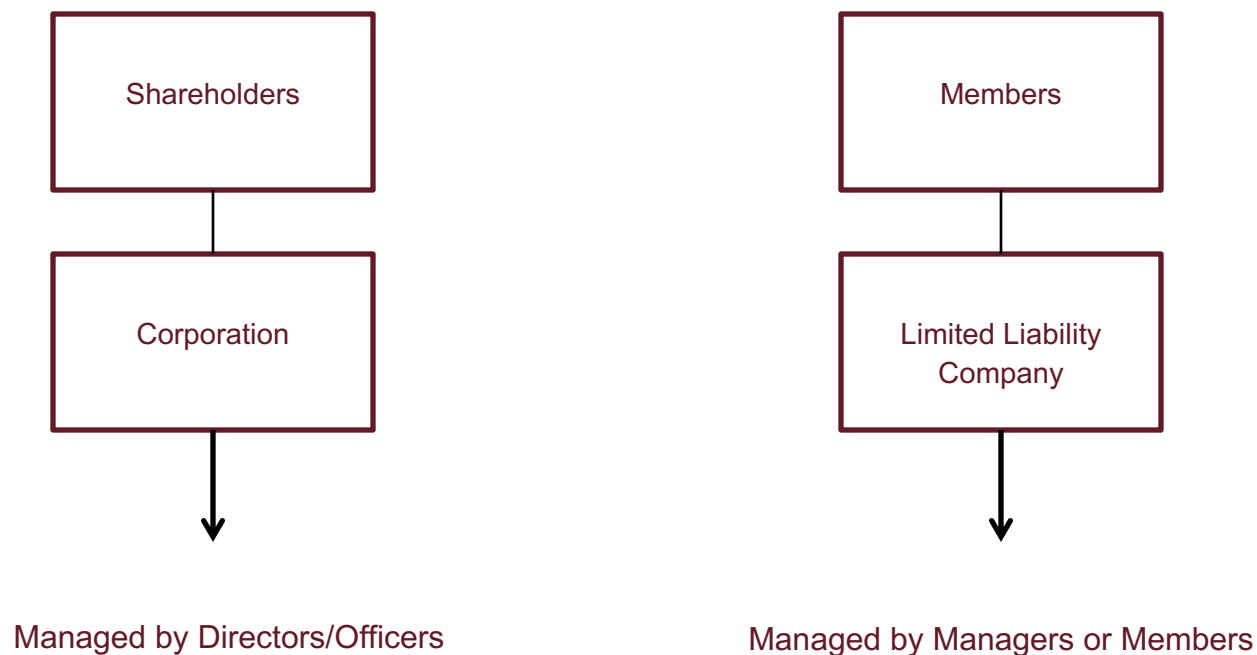
Main Point: Prepare for an Exit from Day 1 !!!!

## 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



## Choice of Entity

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



## Limit personal liability

- Form an entity
- Adhere to formalities-“piercing the corporate veil”
  - Important for acquisition, as well
- Avoid personal guarantees



## Personal liability chart

Entity	Limited Liability
Corporation	Favorable
Limited liability company	Favorable
Partnership	Unfavorable
Limited partnership	Mixed
Sole proprietorship	Unfavorable

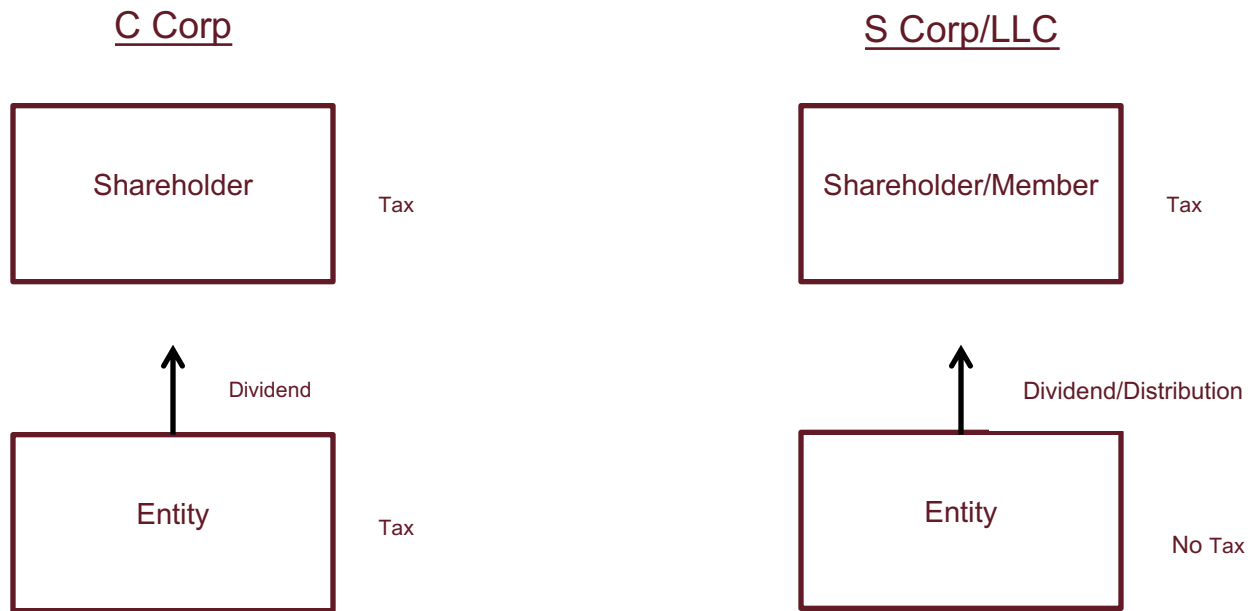
## Tax – Why you should care!

- 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>
Income	\$100	\$100
Corporate Tax	\$ 21	\$ 0
After-Tax Entity Income	\$ 79	\$100
Individual Tax	\$ 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
- Grants as income
- Impact on personal tax returns

## Other Considerations in Deciding Entity

- Investor Favorable (C-Corporations)
- Availability of Losses (LLC/S Corps)
- IPO Favorable (C-Corporations)
- Ease of use (e.g., option pools) (corporations)
- Relative ease of switching from LLC to C-Corporations



## 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
- If not sure, start at LLC and convert to C Corp

## Limit corporate liability

- Contractual limitations
  - Cap liability
  - Limit liability for consequential damages
- Insurance

## 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?*

## **Founders Rules of Engagement – Agreement with the Entity and Among Owners**

- Formation
  - Certificate of Formation/Incorporation
  - Bylaws
  - Shareholder Agreement or Operating Agreement
- Restricted Equity Agreement
- Employment/Consulting Agreement



## Founder Employment/Consulting Arrangements

- Role of Founder going forward
- Compensation
- Intellectual Property Assignments—critical (discussed below)
- Restrictive Covenants (discussed below)
- Severance

## Founder Equity Arrangements— How much?

- 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

## Founder Arrangements

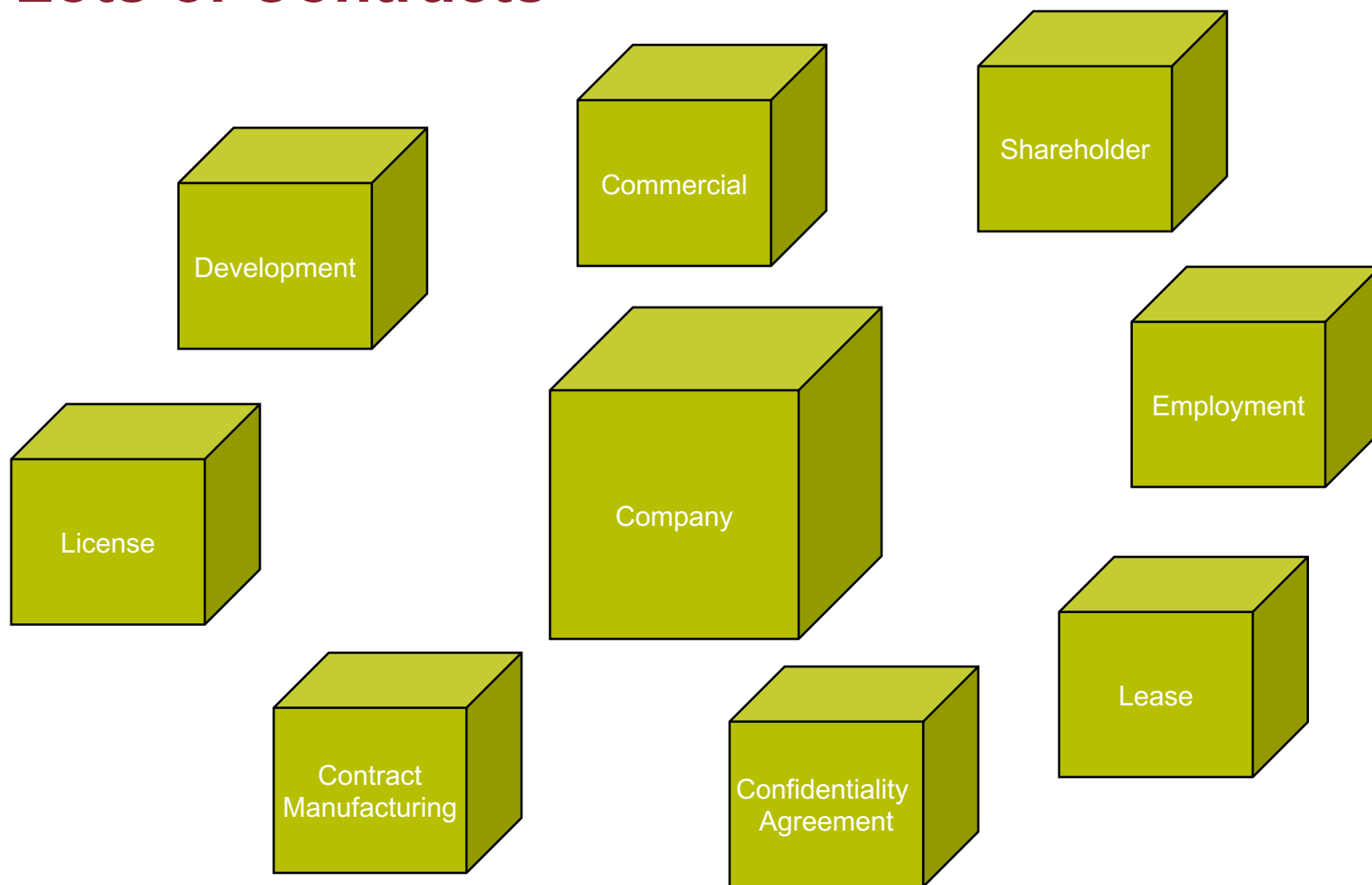
- Vesting Arrangements
  - Amount of vested stock
  - Length of time of vesting
  - Buy-back arrangements
  - Effect of termination and/or sale of company
- Decision-Making/Management
  - Who decides who decides?
  - Directors/Managers
  - Officers
- Restrictions on Transfer
  - Absolute prohibition or Company consent
  - Rights of first refusal

## Contracts - What not to do!

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## Lots of Contracts



## Beware of Oral Contracts

Oral contracts are enforceable – with limited exceptions (Statute of Frauds). Exceptions include:

- Promises to marry
- Suretyships/guarantees
- Sale of land
- Agreements that can't be performed within 1 year
- Contracts for the sale of goods valued in excess of \$500 (note: course of conduct exception)

## Beware of Oral Contracts (cont.)

Examples of contracts that are not exceptions:

- Employment Agreements and the terms
- Equity arrangements (promises to give equity)
- Investment agreements
- Short-term debt instruments
- Licenses or promises to license

## Importance of Clarity for Start-ups

Start-ups cannot afford ambiguity

- They need the performance (e.g., employment)
- They can't afford litigation
  - Legal fees
  - Distraction
- Ambiguity during dispute
  - Cloud on title – **Can't sell**
  - What are the rules
- Potential liability





## Formation- Clarity of Obligations

Who is doing what and when? 

- Employment Agreements – Role and compensation
- Vesting of options – When and how much?
- Lease – What premises and when? Who is constructing the premises and when?
- Convertible debt – When will it convert into equity, how much equity and into what equity?
- License – What technology is being licensed? Improvements?

**DON'T LEAVE THIS TO THE LAWYERS!!!**

## Other Considerations

- Who can assign the Agreement and to whom?
  - Minimize consents on a sale of the Company
  - On the flip side, the start-up may want to know its partners.
- Tracking Contracts (Importance for due diligence)
  - Easy Access
  - Deadlines

## Failure of performance

- Remedies
  - Termination (e.g., out-license)
  - Damages (e.g., failure to manufacture)
  - Injunctive relief/specific performance (e.g., reseller)



## Dispute Resolution (continued)

- Where does the fight occur?
  - Venue
  - Forum
    - Arbitration v. Court
    - 1 arbitrator v. 3 arbitrators
- Governing Law
- Who pays for the fight?
- What happens during the fight?



## Non-Disclosure Agreements (cont.)

Key concerns for start-up company: 

- Importance of having NDA's – Due Diligence
- Definition of Confidential Information
- Term of Confidentiality (note: trade secrets)
- Remedies/cost of enforcement
- Alleged possession/use of third party Confidential information – Bilateral



## Non-Disclosure Agreements (cont.)

Key lessons for start-up company:

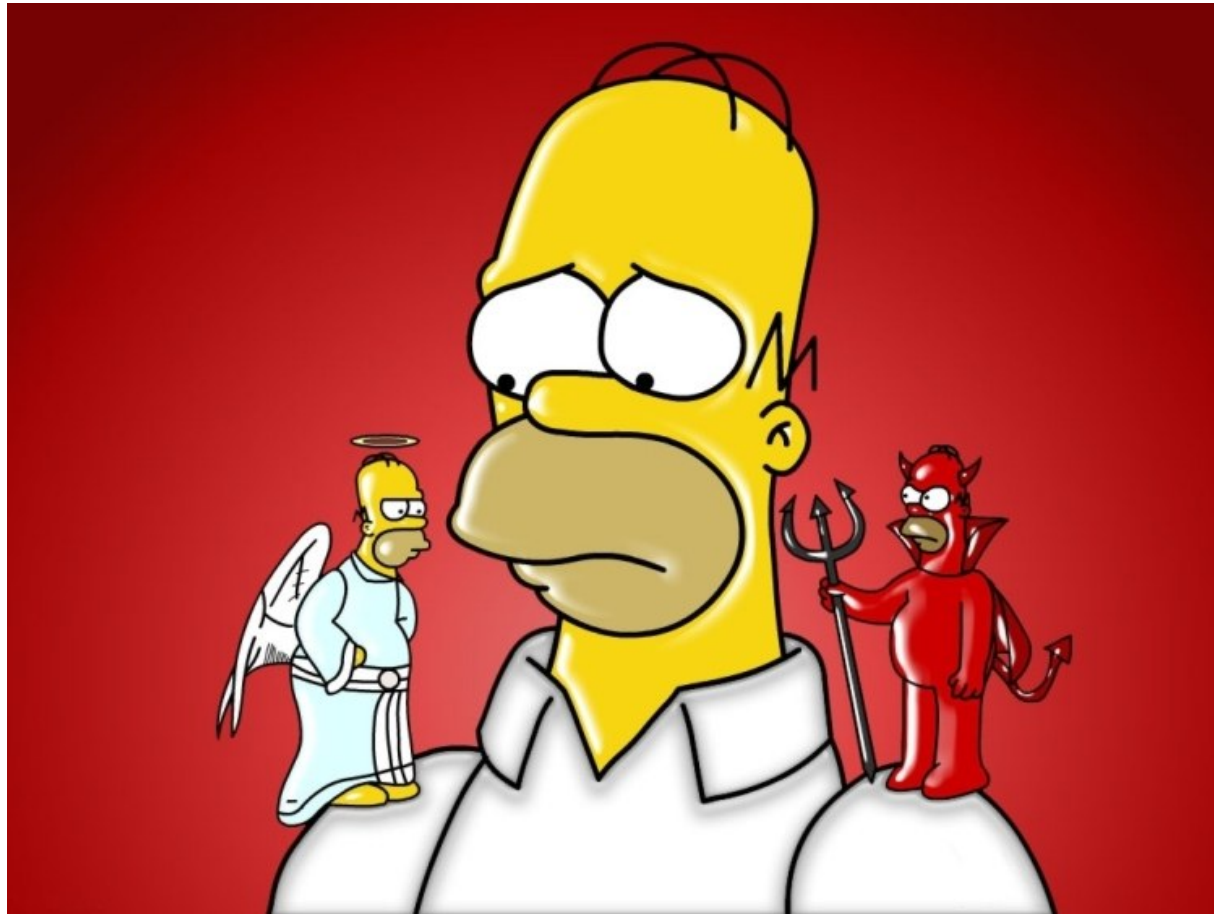
- Don't rely on confidentiality agreement
- Stage disclosure
- Obtain NDA's (Remember third parties)
- Beware of NDA's for third party information
- Pay attention to the term of the agreement
- Consider remedies (collection of legal fees, etc.)



## The Big Three Intellectual Property Questions

1. Does the start-up own its intellectual property?
2. Does the start-up infringe on a third party's intellectual property?
3. What is the start-up doing to protect its intellectual property?

## Why bother?





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## Roadblocks

- Previous intellectual property assignments
  - Agreements
  - Policies
- Non-competition/non-solicitation
- Confidentiality agreements
- Fiduciary duties



## Intellectual Property Assignments

Why are they necessary?

- Current
- Prospective

Employee v. Independent Contractor

Post-employment

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## Intellectual Property Protection

- Patents
  - Copyrights
  - Trade secrets
  - Trademarks
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- Keys: **Develop a Plan**



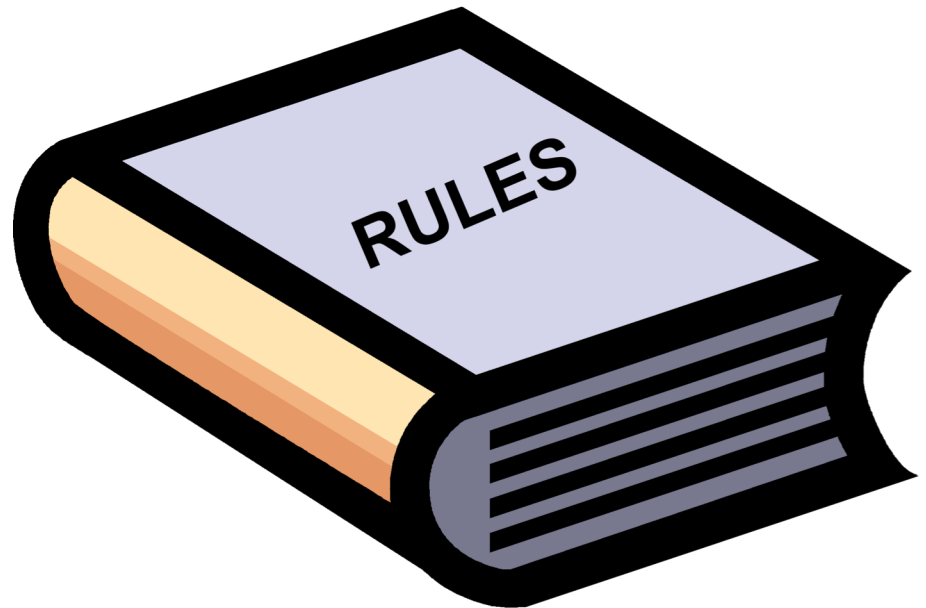
## Employment/Consulting Arrangements

- Importance of writing
- Term or at-will
- Intellectual Property Assignments—critical
- Restrictive Covenants
  - Confidentiality – no limitation
  - Non-compete
  - Non-solicit (employees and customers)



## Non-Competition Obligations

- Length of time
- Substantive scope
- Geographic scope
- Consideration
- Reasonableness





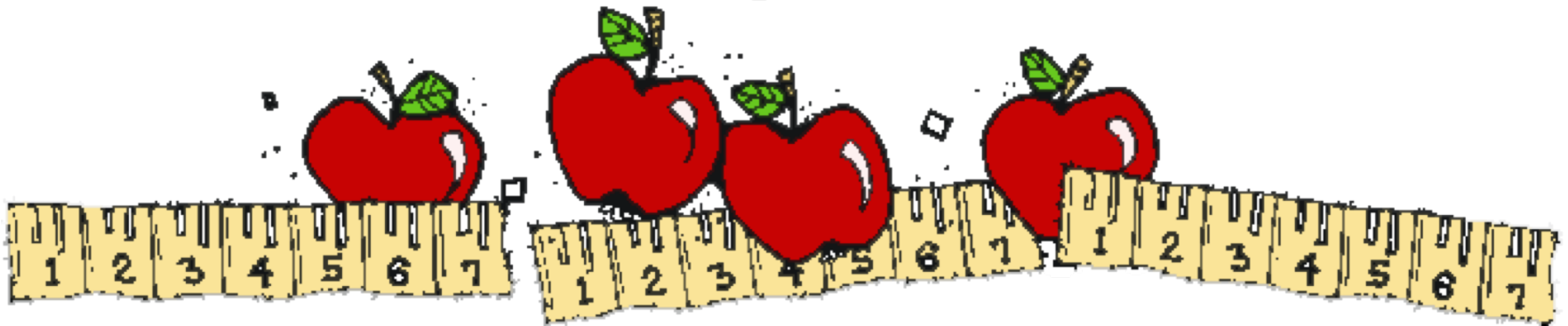
## Equity Arrangements - Vesting

- Amount of stock subject to vesting
- Vesting arrangements
  - Time – Based
  - Performance - Based
- Buy-back arrangements
  - Unvested stock
  - Vested stock
- Effect of termination and/or sale of company

## Consider Regulatory Implications of Business

- Federal, State and Local
- Licenses and permits (consider Uber)
  - These can be assets if handled correctly
  - They can be a huge issue if NOT handled correctly

# Know the Rules



## Sales of securities are regulated

- Different levels
  - Federal
  - States
- Exemptions from registration are available, BUT there are requirements
  - Limitations on means of sale – general solicitations
  - Limitations on purchasers (accredited v. non-accredited)
- Filing for Federal and State

## Caution on raising capital:

- Talk to a lawyer before:
  - Advertising in any manner (including websites)
  - Taking any money from third parties

