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

Shareholders

Corporation

Members

Limited Liability Company

Managed by Directors/Officers

Managed by Managers or Members
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

<table>
<thead>
<tr>
<th>Entity</th>
<th>Limited Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>Favorable</td>
</tr>
<tr>
<td>Limited liability company</td>
<td>Favorable</td>
</tr>
<tr>
<td>Partnership</td>
<td>Unfavorable</td>
</tr>
<tr>
<td>Limited partnership</td>
<td>Mixed</td>
</tr>
<tr>
<td>Sole proprietorship</td>
<td>Unfavorable</td>
</tr>
</tbody>
</table>
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

Dividend

Entity

Tax

S Corp/LLC

Shareholder/Member

Dividend/Distribution

Entity

Tax

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>Income</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Corporate Tax</td>
<td>$ 21</td>
<td>$ 0</td>
</tr>
<tr>
<td>After-Tax Entity Income</td>
<td>$ 79</td>
<td>$100</td>
</tr>
<tr>
<td>Individual Tax</td>
<td>$ 16</td>
<td>$ 20</td>
</tr>
<tr>
<td>Individual After-Tax Cash</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
  - 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!!!
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!
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?
The Big Three Intellectual Property Questions

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3. What is the start-up doing to protect its intellectual property?
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

- 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

![Image of apples and measuring tape]
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