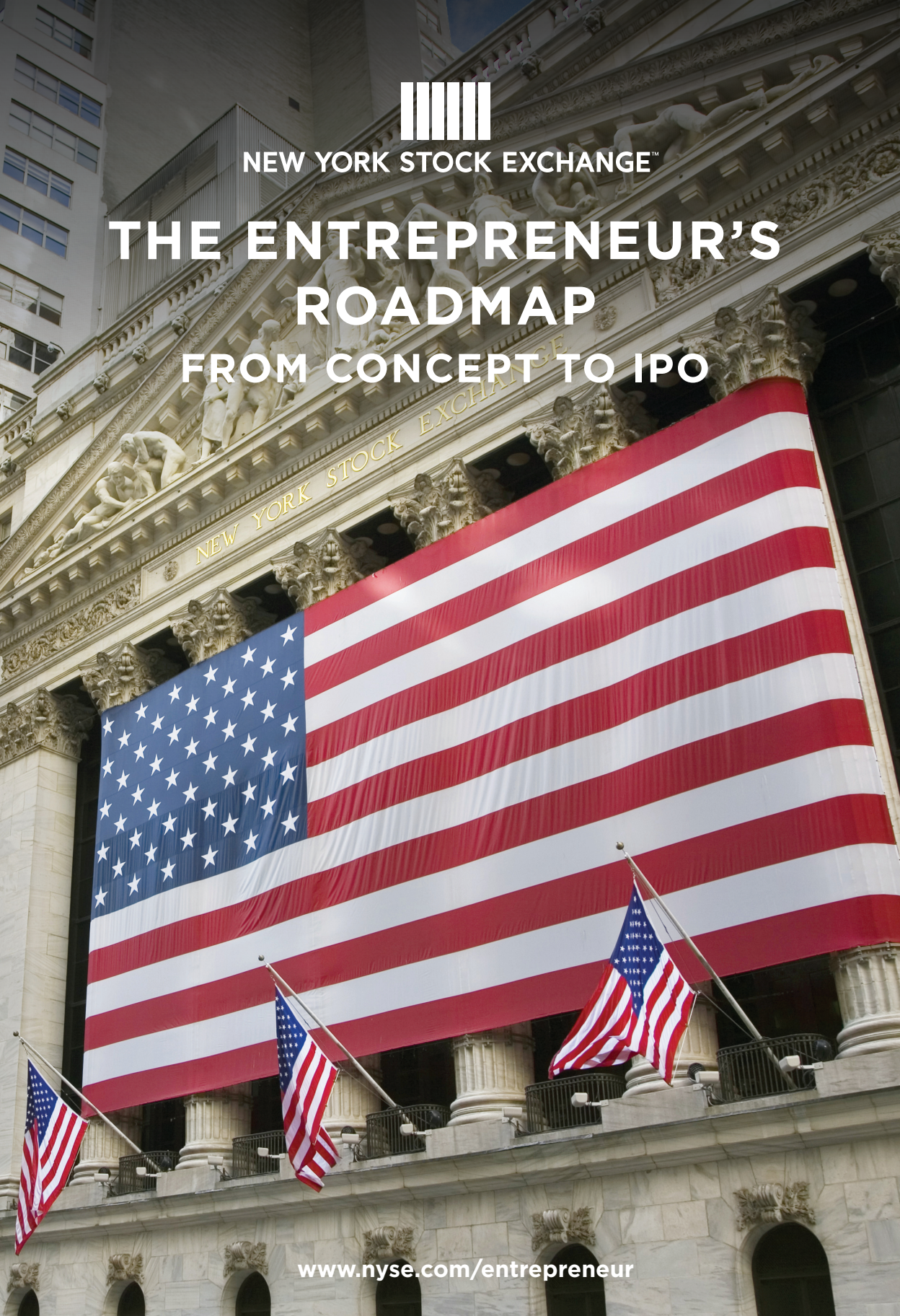
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KEY CONCERNS IN DRAFTING ORGANIZATIONAL DOCUMENTS

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Congratulations. You have decided to start a business.

You will now want to think about:

- when to form an entity through which to conduct the business;
- what type of business entity to form;
- where to form it;
- what to name it; and
- perhaps most importantly, how to document the economic and control agreements you have reached with your cofounders.

In this chapter we share the conventional wisdom on how to proceed if you are building a company that you expect:

- to grow fast;
- will raise capital from angels and venture capitalists; and
- will grant traditional equity awards to its employees and service providers (i.e., stock options and restricted stock awards).

WHY FORM A BUSINESS ENTITY?

First, you might wonder, why form a business entity at all? Certainly it is possible to conduct a business through a sole proprietorship or an unincorporated general partnership, but these are not the best approaches for a number of reasons.

- First, you have to form a business entity if you want to protect yourself and your personal assets from liabilities created by the business. If you form a limited liability entity, you can generally protect your personal assets from the liabilities of the business, as long as you observe some simple operating procedures.
- It is hard to issue equity interests to cofounders and service providers if you haven't formed a business entity.
- If you are forming a tech business, you will want an entity to own the intellectual property created by people working for the company.

- Finally, if you expect to grow fast, raise capital from angels and venture capitalists, and grant stock options to service providers—none of these are easy to do in a sole proprietorship or unincorporated general partnership. You will want to form a legal entity that is set up to facilitate all of these goals.

WHEN TO INCORPORATE OR ORGANIZE YOUR ENTITY

In general, you should form a business entity to conduct your business as soon as there is any risk of liability to third parties. For example, if you are tinkering in your garage by yourself, you probably don't need to worry about protecting yourself from liability to third parties. But as soon as you start to hire third parties to do work for you (to code, for example) or test the software with third parties (e.g., through a beta-user license agreement), you will want to do that through a business entity. If you are uncertain about whether you need to incorporate yet or not, ask yourself—am I doing anything right now that could cause a third party to sue me as a result of my business activities? If the answer is yes, then it is time to protect yourself.

WHAT TYPE OF ENTITY TO FORM?

Entity formation involves both state law (you will form your entity under the laws of a particular state) and federal and state income tax law.

In general, there are two types of entities you can form under state law: a corporation or a limited liability company. (There are myriad other types of entities as well, such as cooperatives, nonprofit organizations, limited liability partnerships, etc. But for purposes of starting a high-growth venture that expects to take in capital, grant equity to workers, and grow fast to be sold or go public, these unusual entity choices are rarely the right choice.)

There are in general three types of entities available under the federal income tax law: (1) C corporations; (2) S corporations; and (3) entities taxed as partnerships (frequently LLCs). [For purposes of this book chapter, when we refer to LLCs we are referring to entities taxed as partnerships for federal income tax purposes.]

FEDERAL INCOME TAX ENTITY CLASSIFICATION

- *C corporations:* A C corporation is an entity that pays its own taxes. A C corporation's income does not pass through to its shareholders. First, the C corporation pays tax on its income. Then, if it distributes cash or property to its owners, its owners will usually pay tax on the amount of these distributions as well. This is what is referred to as the "double taxation" of C corporations. This double tax also occurs if the C corporation sells its assets in an asset sale. In that instance, the C corporation would pay tax on the gain from the sale of its assets. Then, when it distributed the remaining amounts after taxes to its shareholders, its shareholders would pay tax on what they received.
- *LLCs:* An LLC is a pass-through company, meaning its income is taxed at the owner level, not at the LLC level (while it is possible for an LLC to elect to be taxed as a corporation, in this chapter we assume LLCs are taxed as partnerships under the federal income tax law). Each year, the LLC files an information tax return with the IRS and also usually each state in which it does business. The LLC then issues a Form K-1 to each of its owners. The Form K-1 notifies the owners how much of the LLC's income, loss, credit, and other tax items must be reported on the investor's tax return.
- *S corporations:* An S corporation is also a pass-through company, meaning the S corporation itself doesn't pay tax. Its shareholders pay tax on the entity's income. The S corporation files an information return each year and sends its stockholders Form K-1. S corporations are different from LLCs in a couple of significant ways: (1) S corporations typically cannot have nonindividual shareholders; (2) S corporations can have only one class of stock with the same economic rights, preferences, and privileges; and (3) S corporations have to allocate

income, loss, deductions, credits, and other taxes in proportion to stock ownership (they cannot "specially allocate" tax attributes).

With both LLCs and S Corporations, losses allocated to owners may be deductible by the owners on their tax returns.

Almost all early stage tech companies are formed as C corporations.

There are many reasons C corporations are so popular:

- C corporations are usually the entity of choice for angel and venture capital investors. Most angel and venture capital investors do not want to be taxed on the income of entities they have invested in. Investing in a pass-through company can subject you to tax in other jurisdictions. Further, some venture capital funds are prohibited from investing in LLCs by their organizational documents. This can happen, for example, when one of the limited partners in the venture fund is a tax-exempt entity and cannot receive allocations of trade or business income because it would threaten the entity's tax-exempt status.
- C corporations can grant traditional forms of equity compensation, such as stock options. Granting the equivalent of stock options in an LLC taxed as a partnership can be extraordinarily complex and costly.
- C corporations can issue "qualified small business stock" to founders and investors.
- C corporations can go public. For the most part, a pass-through company cannot go public.
- C corporations can engage in tax-free stock swaps with acquirer companies.

WHAT IS QUALIFIED SMALL BUSINESS STOCK?

The Internal Revenue Code provides a significant tax break for investments in qualified small business stock (QSBS). QSBS is stock that if held for 5 years can be sold entirely free from federal income tax (up to a $10 million cap).

To issue QSBS, the entity issuing the stock has to be a C corporation with less than $50 million in assets both before and after the investment and engaged in a qualified trade or business. In general, services businesses cannot issue QSBS, but most tech companies can qualify to issue QSBS. Founder stock can qualify as QSBS.

WHAT ABOUT B CORPS, PUBLIC BENEFIT, OR SOCIAL PURPOSE CORPORATIONS?

A B corp is not a type of state law corporation. A B corp is a business entity that has applied for and received certification as a B corp from B Lab, a nonprofit corporation.

Many states also allow you to form a type of corporation known as a public benefit or social purpose corporation. These are entities that have a mix of for-profit and nonprofit purposes or goals.

If you plan to pursue angel or venture capital investment or you desire to grant traditional forms of equity incentive compensation, you will typically want to form a traditional for-profit corporation. Many investors are leery of investing in public benefit or social purpose corporations.

SHOULD YOU FORM YOUR BUSINESS AS AN LLC?

Many founders get advice to form their business as an LLC. LLCs are easier to form than corporations. (You can file a one-page form over the Internet to form an LLC in most states. You can also make an election for an LLC to be taxed as an S corporation.) For this reason, many tax accountants will advise startup founders to form as LLCs (and perhaps make S elections). Unfortunately, for most high-growth startup businesses an LLC is a poor choice as a form of entity. The reasons are many, but here are the highlights:

- LLCs cause their investors to owe tax on the LLC's annual taxable income, even if the LLC doesn't distribute any cash to its investors. Many venture funds can't invest in LLCs

because they have tax-exempt limited partners who cannot be allocated income from a partnership conducting an active business.

- Granting stock options or the equivalent thereof in an LLC is extraordinarily complex.
- LLCs cannot participate in tax-free stock swaps with acquirer companies. This means that if your startup is going to be acquired by a big public company in exchange for that public company's stock, you will have to pay tax on your receipt of those shares even if they are contractually restricted from being sold for a year. If you operate your company through a corporation, you can do a stock exchange and not have to pay tax until you sell the stock.
- LLCs cannot issue qualified small business stock (QSBS). Only C corporations can issue QSBS.
- If an investor invests in an LLC, that investor will have to pay state income taxes in the states in which the LLC does business.
- If a foreign person invests in your LLC, that foreign investor will have to pay tax in the United States on the investor's allocable share of income from the LLC. The LLC will also have to remit to the IRS a substantial portion of the income allocated to the foreign partner (even if the income is not distributed).
- If you issue equity to your LLC employees, they won't be able to be "employees" for federal income tax purposes; they will be K-1 partners and have to file quarterly estimated tax payments. You would not be able to issue them a Form W-2 and withhold taxes from their wages.

WHEN IS AN LLC A GOOD CHOICE?

An LLC is a good choice of entity in the following limited situations:

- You are forming a venture capital or a real estate investment fund.
- You are forming a company with a limited number of owners and you do not expect the ownership to change over the life of the company.
- You will be the sole owner of the company.
- The company won't raise money from investors or grant stock options or similar equity awards to service providers.

WHAT ABOUT AN S CORPORATION?

If you want to have the losses of your business flow through to your individual tax return, you have two choices: an LLC or an S corporation. Of these two choices, for a high-growth tech venture an S corporation is usually a better choice than an LLC for the following reasons: (1) an S corporation is more easily converted to a C corporation than is an LLC; (2) if you accept a venture capital investment as an S corporation by issuing preferred stock, your S-corporation status immediately terminates; (3) S corporations can grant traditional types of equity compensation, such as incentive and nonqualified stock options; and (4) S corporations can engage in tax-free stock swap acquisition transactions (LLCs cannot).

Be advised though—if you form as an S corporation, your founder stock cannot qualify as qualified small business stock.

WHERE TO FORM YOUR ENTITY

The most commonly used form of entity by startup ventures that expect to take on angel or venture capital investment is a Delaware corporation.

The benefits of Delaware corporations include:

- Widespread familiarity with Delaware law. If you incorporate your business in Washington, California, Nevada, etc., prospective investors may very well ask you, Why didn't you incorporate in Delaware?
- Widespread availability of lawyers able to assist with Delaware corporations (one of the troubles of incorporating in a lesser-utilized jurisdiction, such as Nevada, is that you cannot easily find a Nevada corporate lawyer in major cities in America).

- A well-developed set of case law interpreting the fiduciary duties of the directors and officers.
- A special set of courts that handle only corporate disputes.
- Widespread availability of template document sets frequently used in startup land. Almost all of the really good template documents that various organizations have published are designed for Delaware corporations; for example, the Series Seed documents or the document set the National Venture Capital Association publishes.

Depending on where you are doing business, your home state's corporate laws may be completely suitable. For example, in Washington State, local angels and venture capitalists are comfortable with Washington corporations. Microsoft is a Washington corporation. But even if you are headquartered in Washington, incorporating in Delaware is a good choice. Avoiding potential questions about not incorporating in Delaware is a good idea. In general, you don't want to create any questions for your prospective investors about your legal structure.

WHAT ABOUT OTHER STATES, SUCH AS CALIFORNIA OR NEVADA?

California is a review state, meaning if you file articles of amendment or another similar type of filing with the Secretary of State, the Secretary of State has lawyers on staff who will review and potentially repeal your filing if in the opinion of state counsel it is not correct. This can slow down the closing of transactions. Delaware is not a review state.

Sometimes founders will read about Nevada and how it provides more privacy protections and better tax provisions than Delaware. Be wary of claims of greater privacy protections. Also know that your income tax considerations are not driven at all by where you incorporate but where you do business.

Finally, incorporate in a well-known jurisdiction so you can find a lawyer to help you. If you incorporate in Nevada, you will need a Nevada corporate lawyer. You can find a good Delaware corporate lawyer in any American city, but you cannot find a good Nevada corporate lawyer as easily.

WHAT TO NAME YOUR COMPANY

Taking time to research your contemplated name for your company makes sense. If you are going to invest funds in branding, hire a trademark attorney to help you make sure someone else can't stop you from using your name later.

YOUR COMPANY'S ARTICLES AND BYLAWS

You will want to make sure of several things: (1) that your charter or applicable law allows the shareholders to act by less than unanimous written consent; (2) that cumulative voting does not exist; and (3) that statutory preemptive rights are not included.

COFOUNDER ARRANGEMENTS

If your company is going to have cofounders, you will need to think through what type of cofounder arrangements to put in place. In general, you will want to impose vesting conditions on all shares issued to founders. You will also want to think through how control arrangements work.

Vesting means that the shares issued can be repurchased by the company at the lower of fair market value or the price paid by the founders; repurchase rights lapse over the service-based vesting period.

Vesting is critical because your company will become unfundable if a significant percentage of the equity is held by someone no longer working for the company. This is what is referred to as "dead equity."

In the corporate context, holders of a majority of the outstanding shares of stock elect the board of directors. This means that if your company

has three equal founders, any two can vote to throw the third out of the company at any time, unless the parties enter into an agreement to the contrary.

Sometimes founders enter into a voting agreement to assure each founder a spot on the board. But you will want to be careful if you do this because you will hamstring your company if you can't remove a nonperforming founder.

EQUITY INCENTIVE PLANS

You will typically want to put an equity incentive plan in place at the same time that you organize the company and issue the founder shares. You want to do this at the outset so that you have a plan in place and ready to use when you decide to grant your first stock options to advisory board members or new hires.

DO YOU NEED A SHAREHOLDER AGREEMENT?

Founders usually sign stock-purchase agreements with their companies that give the company the right to repurchase their unvested shares. It is also typical for those agreements to include a right of first refusal in favor of the company, meaning if the founder wants to sell his or her shares, the company has the right to buy them first. Finally, sometimes those agreements allow the company to repurchase vested shares at fair market value.

In general, you do not need a shareholder agreement for buy-sell purposes. The modern practice is to include company repurchase rights in an agreement with each shareholder separately. The exception is a voting agreement if you are trying to establish control arrangements that are unique.

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