

On the Road to Entrepreneurship

Organizing and Structuring Your Company

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Introduction

What we will cover today:

- Possible entity forms for your business- entering the entity zoo
- Organizational tax issues - but don't worry they will be brief and easy to understand
- Structuring your company – the devil is in the details
- Agreements among founders – marriage is easy; divorce is difficult
- Management and control issues – it is no fun being in the minority

Why is this so important?

- At the beginning you are writing on a blank slate and have the most choices, but choices are not cookie cutter
- Your choices can affect:
 - Your own taxes as well as the taxes of other participants
 - Your ability to control the direction of the company's business
 - Your right to continue in your position with the company and to be paid a salary
 - Your ability to sell your interest in the company and the price you can get for it
 - Your exposure for the company's debts and other liabilities
 - The ability of the company to attract employees and investors
- Issues may arise at formation or later on

The Entity Zoo

- The major differences
 - Tax treatment
 - Flow through
 - Separate Entity
 - Default management structure
 - Flat
 - Hierarchical
 - Liability for company obligations
 - Limited
 - Unlimited
 - Ability to provide for multiple/varied ownership interests
 - Ability to attract venture capital financing
- Other differences
 - Cost
 - Legal restrictions on ownership eligibility
 - Ability to take public
 - Ability to change form without tax liability
 - Availability of favorable employee incentives



The Animals in the Zoo

- The inhabitants of the zoo
 - Sole proprietorship
 - GP – general partnership
 - LP – limited partnership
 - LLC – limited liability company
 - LLP – limited liability partnership
 - LLLP - limited liability limited partnership
 - C-Corp – a corporation taxed as a stand alone entity
 - S-Corp – a corporation taxed as a flow-through entity
 - Other - For example Massachusetts business trust. An MBT is a legal trust set up for the purposes of business in Massachusetts

Which Animals in the Zoo to Visit

- Sole Proprietorship
 - What – A business owned by one person with no formal entity
 - Why - because you may be working alone at the beginning
- General Partnership
 - What -the association of two or more persons to carry on as co-owners a business for profit, whether or not the persons intend to form a partnership
 - Why -because it is the default if founders are working together without an agreement
- LLC
 - What - An artificial entity created under and governed by the laws of a state. They have some of the structural elements of an GP, some of an LP and some unique to themselves.
 - Why - because it provides for flow through taxation with limited liability
- C-Corp.
 - What- An artificial entity created under and governed by the laws of a state. Delaware is preferred choice for state of incorporation.
 - Why– because it provides for limited liability, well defined hierarchical structure and ability to accommodate VC financing

	Sole Proprietorship	General Partnership	LLC	C-Corp
Tax treatment	Flow through	Flow through	Flow through	Stand alone
Default structure	Kingdom	Flat	Flat	Hierarchical
Liability treatment	No	No	Yes if you follow rules	Yes if you follow rules
VC friendly	No	No	No	Yes
Cost	Very low	Depends	High	Low -except for founders agreement
Ability to take public	No	No	No unless changed to C-Corp	Yes
Ability to change form without tax liability	Yes	Yes	Yes	No
Ability to provide for multiple/varied ownership interests	No	No	No (default)	Yes
Availability of employee incentives	No	Available, but with difficulty and poorly understood by employees	Available, but with difficulty and poorly understood by employees	Yes

Various Tax Problems

- Check the box
- At risk rules
- Passive activity rules
- Taxation of no-cash contributions
- Phantom income



Check the Box

- Because of growing multiplicity of types of entities (LLC's, LLP's and LLLP's), there was some confusion as to their tax treatment.
- Check the box rules were set up to deal with this problem.
- Any unincorporated domestic business formed after January 1, 1997, with at least two members or owners is automatically classified for tax purposes as a partnership
- If the entity wishes to be taxed as a corporation, it simply elects out of the default classification by checking the appropriate box on Form 8832, "Entity Classification Election" and files its election with the IRS.

At Risk Rules

- Applies principally to investments in LLC's (but also LLP's and other flow throughs with limited liability)
- Generally limits the deduction of any losses to the amount the investor has at risk – usually the amount of the investment.
- Amount of limitation can be affected by investor guarantee of company debt

Passive Activity Rules

- Applies to investors in flow through entities (except sole proprietorship)
- Generally limits the deduction of passive activity losses to the amount of any passive activity gains
- If a taxpayer does not materially participate, losses are passive, which means they generally are not deductible in the absence of passive income.
- A taxpayer materially participates in an activity if he or she works on a regular, continuous and substantial basis in operations. Must meet tests in IRS regulations.
- Material participation is time sensitive.

Taxation of Non-cash Contributions

- Applies in various ways to investors in all entities (except sole proprietorship)
- Complicated rules that vary depending on entity
- Applies to contributions (payments for equity) in services or property when other owners have paid for their interests in cash. Applies to contributions in services and property even when there are no cash contributions
- When covered by rules, services contributed for an equity interest create an ordinary income tax liability in the amount of the value of the interest
- When covered by rules, property contributed for an equity interest creates an capital gains tax liability in the amount of the value of the interest
- 83(b) election for securities received for services
 - If the grant of the securities is subject to a substantial risk of forfeiture, default rule is that income is received as and when the risk of forfeiture is lifted – securities valued as of those dates
 - To avoid application of default rule a timely 83(b) election must be filed which will cause all securities to be taxed in the year of issue

Phantom Income

- Phantom income is a specialized case of the contribution of services for equity
- Phantom income arises when an employee or consultant is compensated for his services in whole or in part in stock or other equity
- Generally in such case employee or consultant will have ordinary income tax liability in the amount of the then present fair market value of the equity
- Company must treat such phantom income as cash income in year received for reporting, withholding and social security purposes
- Only way to avoid phantom income is through options or LLC profits interests.
 - An option is the right to buy a given amount of a security for a period of time for a set price (exercise price).
 - There are two types: ISO's and non-qualified
 - Their grant can be tax free.

Structuring Your Company

The Limited Liability Company

The C-Corp.



Remember

This is not a task for an amateur
– don't drop the ball

Laws vary from state to state

Analysis is complicated

Default rules may not work for you

Decisions may have unforeseen consequences

Issuance of any securities are subject to the Federal and State Securities Laws



Structuring the LLC

- Choose the right state
 - Usually Delaware or the home state
 - If not home state remember to qualify
- Default rules typically provide for members rights in proportion to their share interests
- An LLC has two charter documents
 - A short document which is filed with secretary of state
 - Name varies – certificate of formation in Delaware
 - Contains just basic information such as name, address and so on.
- Operating Agreement
 - Detailed agreement
 - Not publicly filed

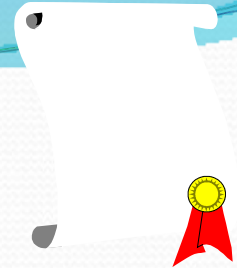
Structuring the LLC Continued

- Operating agreement allows for changes in default rules
- Specifies
 - governance
 - voting rights
 - split of profits, losses and distributions
 - initial and follow-on capital contributions
 - buy-sell rights and obligations
 - liquidation rights and obligations
 - other

Structuring the C-Corp

- Choose the right state
 - Usually Delaware
 - Beware of incorporating in New York or California
 - If not home state remember to qualify
- Prepare the appropriate charter documents
- Set up the right capital structure
- Consider the effect of ancillary agreements
 - Founders agreement/Shareholders agreement
 - Voting trust, proxy, shareholder voting agreement

C-Corp. Charter Documents



- A C-Corp has two charter documents
 - The certificate of incorporation (charter in Mass.) which is filed with secretary of state
 - Name – must include Inc., Corp. etc.; must not be so similar to existing name as to cause confusion
 - Purposes – can be very broad
 - Authorized capital - amount and nature of securities
 - Name and address of register agent
 - Indemnification provisions
 - Other – super-majority voting (in Cal.); cumulative voting (Del.); preemptive rights (some states give them unless otherwise provided)
 - Can only be changed by shareholder vote

C-Corp. Charter Documents Continued



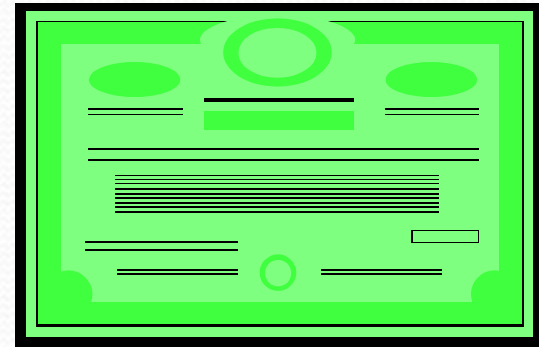
- The by-laws which are an internal document and provides operating rules
 - Procedures for shareholders meetings
 - Number, term and procedures for filling vacancies of the board of directors, procedures for board meetings
 - Description, powers, term and procedures for filling vacancies of the officers
 - Stock matters such as description of certificate, procedures for lost or transferred certificates and so on
 - Procedure for amendment of by-laws
 - Other

Capital Structure – Types of Securities

- Common stock
- Preferred Stock
- Options
- Stock Appreciation Right
 - A right, usually granted to an employee, to receive a bonus equal to the appreciation in the company's stock over a specified period.
- Debt
- Convertible Debt

Common Stock Issues

- Voting Rights
- Equity interests
- Dividend rights
- Vesting



Preferred Stock Issues



- Voting rights
- Dividend rights and preferences
 - Cumulative – skipped dividends must be paid before junior
 - Participating v. non participating - right to receive additional beyond preference amount
- Liquidation rights and preferences
 - Liquidation multiple
 - Participating v. non participating - right to receive additional beyond preference amount

Preferred Stock Issues Continued

- Conversion rights
 - Mandatory – who or what triggers
 - Optional – who triggers
 - Rate
 - Timing
 - All or nothing
- Redemption - Company buy back
 - Mandatory – who or what triggers
 - Optional – who triggers
 - Rate
 - Timing
 - All or nothing



Option and Sar Issues

➤ Options

- Underlying security
- Strike price
- Term
- Vesting

➤ Stock Appreciation Right

- Term
- Vesting

Debt issues

- Interest rate
- Term
- Redemption – Company buy back
 - Mandatory – who or what triggers
 - Optional – who triggers
 - Rate
 - Timing
 - All or nothing
- Conversion rights – convertible debt only
 - Mandatory – who or what triggers
 - Optional – who triggers
 - Rate
 - Timing
 - All or nothing



Founders Agreements

- Pre-formation agreement specifying one or more of the following
 - Roles
 - Contributions
 - Voting
 - Shares
 - Control
 - Compensation
 - Buy-sell or liquidation
 - Other
- After incorporation called shareholders agreement
- Operating agreement serves same purpose for LLC
- Often ignored in the joy of starting the new venture

Management Issues

- Relatively easy – if you are in the majority
- Not so easy – if you are in the minority
- How can minority affect management
 - Different for LLC and C-Corp
 - Contrast preventing with compelling action
 - Capital structure usually only helps prevent actions
 - Voting trusts, proxies, shareholder voting agreements
 - By law and charter provisions
 - Buy-sell etc. agreements

Voting Trusts, Proxies and Shareholder Voting Agreements

➤ Voting Trust

- An agreement by which one or more stockholders deposit stock to anyone (as trustee), to give them the right to vote the stock.
- Must be in accord with statute

➤ Proxy

- An instrument by which a shareholder authorizes another person to act for them.
- Term limited by statute
- Revocable unless coupled with an interest

➤ Shareholder Voting Agreement

- An agreement among shareholders regarding the exercise of their voting rights
- Can include other things such as buy/sell and operational matters

By-law and Charter Provisions

- Staggered board
- Class voting
- Cumulative voting
- Supermajority voting
 - Shareholder
 - Board
- Quorum provisions
 - Shareholder
 - Board
- Direct election of officers (not all states)
- Preemptive rights.

Buy-Sell etc. Agreements

➤ Triggering events

- Sale
- Termination of relationship
- Death or other transfer by law

➤ Types

- Right of first refusal
- Right of first offer
- Anti-dilution provisions (full ratchet or weighted average)
- Shoot-out
- Drag along
- Tag along

Takeaway

Do not underestimate the complexity involved in the organization or governance of your company or the importance of getting it right

Use of canned kits, internet forms, “one-size fits all” services or other “do-it-yourself” aids can be perilous.



Questions?