Startup Formation: Entities and Founders

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Disclaimer

- **This presentation is not legal advice.**
- **Consult with your attorney and accountant regarding any decisions specific to you and your business!**

When to Form an Entity

- When You are Creating Potentially Valuable Assets
  - Intellectual property (patents, know-how, trade secrets)
  - When contracts are needed/wanted
  - Business opportunities – accelerators
  - Research grants
- When Business Results Can Lead to Damages
  - Contracts
  - Employees
  - Product Liability
  - Leasing or Owning Real Property
- Multiple Owners (founders)

Choice of Entity

Major considerations

- **Entity level taxation versus flow-thru taxation**
- **International and exempt investors**
- **Venture capital investment**
- **Flexible economic arrangements**

Delaware vs. Colorado

- **Colorado – advantages**
  - Easy to incorporate/modify
  - Low taxes and agent costs

- **Colorado – disadvantages**
  - Few legal precedents
  - Unsophisticated court system

Delaware vs. Colorado

- **Delaware – advantages**
  - Robust corporate code
  - Extensive legal precedent
  - Corporate-only courts

- **Delaware – disadvantages**
  - Higher costs
  - Harder to modify incorporation documents

- **Other states do not provide significant advantages**

- **Offshore incorporation and maintenance are expensive**

Subchapter “C” Corporations

- **Advantages**
  - **Typical public market and venture capital investment vehicle**
  - **No limitations on owners**
  - **More than one class of stock allowed**
  - **Allows companies to use net operating losses to shield future gain**
  - **Robust corporate code and legal precedents**

Subchapter “C” Corporations

- **Disadvantages**
  - **Corporate level tax and second level tax on distributions to shareholders (two layers of tax)**
  - **Limited flexibility on structure**
  - **Stocks grants are taxable**

Limited Liability Companies

- **Advantages**
  - Pass-through taxation
    - Passive losses only helpful if investors have passive income
    - Losses limited to at risk amount and basis
  - No limit on type and number of members
  - Can have multiple classes of equity
  - Flexible management – fewer fiduciary duties
  - Flexible economic arrangements
  - Can issue profits interests to employees and service providers
  - Great for asset sales

Limited Liability Companies

- **Disadvantages**
  - **Operating agreement can be complex**
  - **Limited legal codes & legal precedents**
  - **Venture capital less likely to invest**
  - **Atypical public market vehicle**
  - **Less familiar than corporations**
  - **Dividends to foreign investors may be subject to withholding – foreign investors required to file US tax returns**
  - **Cannot use entity losses to offset gain**
  - **Members with small equity should be classified as K-1 members**
  - **Complexity and uncertainty of convertible notes and SAFEs**

What to do?

- Broadly speaking, if you're anticipating raising significant outside capital soon, you probably want to start as a Delaware C corp.
- Many startups that are less sure of their long-term capital needs start as Colorado LLCs, but beware:
  - SAFEs are complicated/uncertain with LLCs
  - LLC/partnership accounting is more complex generally
    - Hire an accountant that knows what they're doing!
  - Any owner becomes a K-1 member (not a W-2 or 1099)
  - Options don't really work in LLCs
- Other choices are available (S corp, B corp) but are generally less common

Stock versus Options

- Stock is taxable upon issuance
- Options are not taxable until exercised
- Options don’t work very well in LLCs (though profits interests can be used)

How Much Equity to Grant?

- **How much equity to grant?**
  - **Less than 1% for most people you hire**
  - **1% to 5% for significant hires**
  - **Rarely go higher**
- **Vesting is critically important for founders and any personnel that receive equity or options**
  - **Time based (four year vesting with one year cliff)**
  - **Milestone based (sounds simple, rarely is in practice)**
  - **Forfeiture versus repurchase of unvested**
  - **For cause termination – forfeit everything?**

Capital Raising

- **Ways to raise money:**
  - **Equity (investor becomes an actual owner)**
  - **Debt (investor lends money as a loan)**
  - **Convertible note (investor's money starts as a loan that convert into equity down the road)**
  - **SAFE (similar to a convertible note, but with some significant differences)**
    - **SAFEs are particularly common these days, but beware – they're not as simple as you think**
- **How to raise money:**
  - **Start early**
  - **Work your network**
  - **Assume it will take longer and be harder than you think**
  - **Raise money only from accredited investors**

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