

Setting Up Shop: Creating the Right Business Entity for Your Company

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The Triumphant Tale of The Non-Lawyer Founder Who
Successfully Started a Company, Single-Handedly Solved
All Legal And Accounting Problems, Drafted All Corporate
Documents From Forms Found on the Internet or From
Prior Deals, Had No Shareholder or Employee Disputes
Ever and Spent No Money on Lawyers



The Three Founders, The
Unincorporated Operating Business
& The Mystery of Intellectual
Property Ownership



The Entrepreneur, The Defective
License & The Torturous
Rescission Offer



Eliminate the Drama

- Don't do it yourself
 - > Avoid On-line forms
 - > Be skeptical of Hand-Me-Down forms
- Consider early formation of entity
- The Start-up Trinity
 - > You
 - > Lawyer
 - > CPA
- Corporate janitors are expensive



Hire Counsel Early?

- > Bootstrap Bargain: cost v. risk v. benefits
- > Bad decisions tend to live long, expensive lives
- > Alternative Fee Arrangements mitigate risk
- > Counsel for Founder and/or Counsel for Company
- > Counsel's ethical requirements are more easily solved with early engagement
 - RPC 1.13(g)



Form Company Early?

- Delay usually based exclusively on cost
- Most common justification for delay is to prove concept or business model to investors (risk mitigation)
- Sole Proprietor means personal liability
- Easier to delay incorporation when
 - > There is only one founder
 - > No third-party services (e.g. employees, contractors) are required



Risks of Delaying Incorporation

- Multiple Founders increase risk of disagreement over equity, compensation, titles, responsibilities & strategy
- Documenting oral or poorly written agreements between founders is expensive, messy and time-consuming.
- Ownership of Intellectual Property becomes a growing point of leverage
 - > One or more founders may claim exclusive ownership
 - > Risk of joint authorship
- Delay complicates valuation of founder's equity, particularly if it is issued close to a financing event



The Thought Process

- Business or Industry
- Anticipated capital structure
 - > Number of shareholders
 - > Classes of stock
 - > Equity Incentive Compensation
- Governance and desired flexibility of management
- Jurisdiction
- Limiting Liability
- Tax needs or desires of Founders or Shareholders
- Likely exit scenarios (e.g. M&A, IPO)
- Costs of maintaining entity
- Protecting intellectual property
- State licensing requirements for business activities



What I'll Discuss Today

- Subchapter C Corporation
- Subchapter S Corporation
- Limited Liability Company
- Limited Partnership
- Limited Liability Limited Partnership



Subchapter C Corporation

- Most common entity chosen by startups
- Double-taxation
 - > Tax on corporate income
 - > Tax on dividends or distributions to shareholders
- No limit on number of shareholders
- Multiple classes of stock permitted
 - > Facilitates private equity financing
 - > Ideal form for IPO



Subchapter C Corporation

- Governance structure is well defined by corporate statutes
 - > Board of Directors
 - > Officers
 - > Shareholder participation defined by statute
- Deeper body of legal precedent
- Delaware is a favored jurisdiction, but Washington is just fine.
- Corporate formalities



Subchapter C Corporation

- Limited Liability
- Can offer tax-favorable equity incentive compensation to employees
- Corporations require maintenance



Subchapter S Corporation

- Underappreciated workhorse of small business
- Single Class of Stock
 - > Voting and Non-Voting Classes allowed
- Natural Persons Only
- No “non-resident aliens”
- No more than 100 shareholders
- Single level of tax; pass-through taxation
- Distributions of Profit and Loss allocated to shareholders pro rata



The S Corporation Premium

- S Corporations are attractive M&A targets for C Corporations
 - > Sec 338(h)(10) election
 - > Causes a stock sale of an S Corp by a C Corp to be taxed as if it were an asset sale
 - > Allows C Corp to take a "stepped-up" tax basis in the S Corp's assets, which allows larger tax deductions through re-depreciation, and helps C Corp's cash flow.
 - > C Corp can step up the basis in S Corp's assets
 - > C Corp may be willing to pay a premium to get the benefit of the 338(h)(10) election
 - > All S Corp shareholders must agree



Pitfalls of S Corporations

- Watch the 100 shareholder limit
 - > Stock Option plans
- Single Class of Stock Issues
 - > “...all outstanding instruments evidencing equity ownership confer identical rights to proceeds upon distribution and liquidation.”
 - > Convertible debt can be considered second class of stock depending on terms
 - > Warrants and Call Options can be second class of stock if they are (i) substantially certain to be exercised and (ii) have an exercise price of 90% or less of the stock's FMV measured at issuance or date of material modification.
- Restricted Stock grants without a timely Sec 83(b) election by the employee; IRS deems such stock not to be issued and outstanding; affects distributions and shareholder relations
- Losing S election can be devastating



Limited Liability Company

- Combines some benefits Partnership and some benefits of Corporation
- Limited Liability
- Created by filing a Certificate of Formation
- Some forms are available online
- Managed by Members or Managers
- Governed by statutory default rules and...
- A contract called an Operating Agreement



LLC Advantages

- Permits entity shareholders
- Flexibility in designing capital structure
- Multiple classes of equity permitted
- Pass-through taxation
- Single-member LLC permitted
- Can elect to be taxed as a C corporation or an S corporation



The LLC Paradox

- Flexibility comes with a price
- The Operating Agreement is key
- Importance of thoughtful drafting of Operating Agreement
- Amending the Operating Agreement can be challenging
- Washington's LLC statutes have defects
 - > Dissolved LLCs have 3 years of tail liability, but filing a Certificate of Cancellation eliminates liability
 - > Expect legislative amendments
- Managers and members of a member-managed LLC owe fiduciary duties to fellow members
- All LLC members pay self-employment tax business earnings, whether distributed or not (can be avoided by electing C or S corporation taxation)



LLC Innovations

The Series LLC

- > First appeared in 1996
- > Currently available in Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee Utah and Texas.
- > Allows the owner of an LLC with separate lines of business or asset classes to put each in a separate series and protect the assets of one series from the creditors of another
- > Allows tremendous flexibility in financing and compartmentalizing risk
- > Less expensive than forming multiple LLCs
- > Some States (Illinois, Tennessee) consider each Series a separate entity, some do not (Delaware)
- > IRS considers each series a separate taxable entity for federal tax purposes
- > California Franchise Tax Board has taken the position that each series is a separate entity for state tax purposes; not so clear in other states
- > Unclear how the 42 other states will treat the Series LLC for liability purposes



Limited Partnership

- Usually the choice for private equity funds, not start-ups
- Equity owners are limited partners with limited liability
- Managed by a General Partner with unlimited liability
- Governance determined mainly by the limited partnership agreement and statute



Advantages of Limited Partnership

- Pass-through taxation
- Limited liability for equity owners
- Limited partners can enter and exit the limited partnership without causing dissolution
- Flexibility of capital structure and governance



Disadvantages of Limited Partnership

- Limited partners can face liability if they participate in the control of the partnership
- Addressing unlimited liability of General Partner requires setting up an additional limited liability entity



2010 Will Be Big For Limited Partnerships

- On January 1, 2010, existing limited partnership statutes will be replaced entirely by the Washington Uniform Limited Partnership Act (“WULPA”)
- Represents a major overhaul of limited partnership law
- Eliminates risk of personal liability when limited partners participate in the management and control of the limited partnership
- Introduces the Limited Liability Limited Partnership (LLLP); eliminates need for entity General Partner



2010 Will Be Big For Limited Partnerships

- Clarifies that limited partners have no fiduciary duties to the limited partnership or fellow limited partners.
 - > This is a major advantage over the LLC, where members managing the LLC owe fiduciary duties
- Limits the fiduciary duties of a General Partner to an express statutory duty of loyalty and care that is non-waivable
- Grants limited partners information rights similar to those of shareholders in corporations



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