START SMART 2.0: Advising Start-Ups on Formation and Early-Stage Organizational Issues

Presented by the Committee on Middle Market and Small Business

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START SMART 2.0: Advising Start-Ups on Formation and Early-Stage Organizational Issues

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BIOGRAPHY

Eric Vendt is Co-Chair of the firm’s Business and Corporate Law Section. He advises middle market and start-up companies on a broad range of commercial and corporate finance issues, including formation, infrastructure, financing, negotiating and consummating mergers and acquisitions, divestitures, business combinations, distribution and license agreements, partnership and LLC agreements and shareholder agreements. He regularly counsels clients in connection with the structure, negotiation and consummation of corporate transactions whether private capital financings, mergers and acquisitions or corporate divestitures and restructurings. He also advises business owners and wealthy individuals in connection with structuring tax-efficient transfers of business interests and other property.

MEMBERSHIPS & ACTIVITIES

- Member: American Bar Association, Member, Business Law Section, Committee of Middle Market and Small Business
- Vice Chair: Middle Market and Small Business Committee of the Business Law Section of ABA (2014 - 2017)
- Membership Committee Member: Small Emerging Construction Advisory Forum (2018)
- Certified Public Accountant: Maryland, 1992 (Inactive)

RECOGNITIONS

- Listed in Best Lawyers in America 2017 – present
Randy McClanahan is a partner with Butler Snow LLP whose practice focuses on corporate law, taxation law, mergers and acquisitions, executive compensation, venture capital and private equity transactions, and the legal aspects of accounting and auditing.

Randy is a Certified Public Accountant (Alabama and Georgia) and a Certified Valuation Analyst. Randy is currently serving a three-year appointment to the National Conference of Lawyers and Certified Public Accountants. He is a past chairman of both the Law and Accounting and the Corporate Documents and Process Committees of the American Bar Association’s Business Law Section.

He obtained his J.D. from the University of North Carolina, his M.B.A. from Duke University, his M.T.A. from the University of Alabama, and his B.S. from Auburn University. Randy is admitted to the Alabama State Bar.
Sara’s dynamic practice focuses on general corporate work for small-to-medium-sized businesses and commercial real estate transactions. Sara advises her clients in all aspects of the business lifecycle including entity formation, financing, general business matters, scaling via capital raise, contractual arrangements, corporate governance, and mergers and acquisitions. Sara also assists clients in acquiring, divesting, leasing, financing, and developing commercial real estate. Sara’s joint MBA and Juris Doctorate degrees uniquely position her to provide the highest quality legal advice seasoned with an exceptional foundation for understanding her clients’ business objectives.

Sara left an equity position at a large law firm in the St. Louis metropolitan area to form Stock Legal; she felt she could better serve what she considers her target clients — small-to-medium-sized businesses — through practice in a small-to-medium-sized law firm. Sara’s passion for these types of clients stems from that which has surrounded her personal life. As a child, Sara’s parents ran the family trucking company out of their home, which Sara’s father and brother continue to successfully run today. Sara has also contributed to the building and growth of other businesses and acted as a fractional COO. Today, Sara is also the co-founder of Legal Back Office to assist small-to-medium-sized law firms, like her own, to enjoy the benefits of a corporate function to more efficiently achieve growth and success.

Sara is active in the American Bar Association’s Business Law Section where she serves as co-chair for the Emerging Companies Sub-Committee (Middle-Market and Small Business Committee). Additionally, Sara sits on the YWCA Board of Directors and the St. Louis University School of Law Business, Entrepreneurship, and Tax Law Advisory Board. In the past, Sara has sat on CREW’s Board of Directors, chaired CREW’s Sponsorship Committee and Ambassador Committee, and assisted in planning the CREW gold tournament benefitting women’s support and community services. Sara is also an active member of ACG St. Louis and sits on the advisory board for a number of institutions, including baking organizations and local companies.
Tarik’s practice covers a range of commercial transactions including mergers and acquisitions, secured financings, joint ventures, securitization and business counseling.

Tarik also focuses on organizational and operational issues related to limited liability companies, limited partnerships and statutory trusts. In addition, he regularly represents sponsors and conflicts committees of master limited partnerships (“MLPs”).

He is involved in the preparation of third-party legal opinions in connection with a range of transactional matters, and he regularly counsels other attorneys domestically and internationally on matters relating to Delaware partnerships, limited liability companies and statutory trusts.

Tarik is a member of the Delaware State Bar Association (“DSBA”) Statutory Trust Committee, responsible for updating the Delaware Statutory Trust Act.

Tarik also serves on the Morris Nichols Executive Committee and Lawyer Development Committee and he chairs the firm’s Diversity Committee.

Professional Activities

• American Bar Association (Business Law Section)
  • Secured Lending Subcommittee of the Commercial Finance Committee (Chair)
  • *Business Law Today* (Managing Editor)
  • Committee on Mergers and Acquisitions
  • Revised Model Asset Purchase Agreement Task Force
  • Joint Task Force on Security Interest in LLC and Other Unincorporated Entity Interest

• American Bar Foundation (Fellow)
• Delaware State Bar Association
  • Statutory Trust Committee
  • Uniform Commercial Code Subcommittee

Community Activities

• Delaware Council of Development Finance
Michael Vargas
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PRACTICE GROUPS AND CLIENT SECTORS:
Financial Services, Corporate, Technology, Universities and Endowments

AREAS OF FOCUS:
Non-Profit Organizations, Employment Law, Mergers & Acquisitions, Securities, Startups & Startup Financing, Cannabis Law

PROFESSIONAL EXPERIENCE

Michael Vargas is an associate in Rimon’s Palo Alto office and a member of the firm’s Corporate practice group. As a member of the Corporate practice group, Michael represents clients in a range of corporate transactions including formation, convertible debt financing, angel financing, venture capital and private equity backed expansion, state and federal securities, employment concerns, and mergers & acquisitions. In this capacity, Michael has represented clients in a variety of industries including robotics, software development, banking, social media, education, and other high technology industries.

Michael also specializes in corporate social responsibility. Michael counsels social entrepreneurs in forming benefit corporations in California, Delaware, and Minnesota, and also represents socially responsible investment funds investing in a new generation of green companies. Michael also supports the expansion of legal expertise

EDUCATION

University of Minnesota
J.D.

University of Southern California
M.Ed.

University of Southern California
B.A.
Entity Choice

Choice of Entity—Planning Without a Crystal Ball

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<table>
<thead>
<tr>
<th>Entities Characteristics</th>
<th>Limited Liability Company</th>
<th>C Corporation</th>
<th>S Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership Rules</td>
<td>Unlimited number of members allowed; no limit on classes of “units/shares”</td>
<td>Unlimited number of shareholders; no limit on stock classes</td>
<td>Up to 100 shareholders, only one class of stock, only individuals or trust, only US shareholders</td>
</tr>
<tr>
<td>Personal Liability of the Owners</td>
<td>Generally no personal liability of the members</td>
<td>Generally no personal liability of the shareholders</td>
<td>Generally no personal liability of the shareholders</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>The entity is not taxed (unless choses to be taxed), profits and losses are passed through to the members</td>
<td>Corporation taxed on its earnings at corporate level and shareholders are taxed on any distributed dividends</td>
<td>The entity is not taxed, profits and losses are passed through to the members</td>
</tr>
<tr>
<td>Key Documents Needed for Formation</td>
<td>Articles of Organization / Certificate of Formation, Operating Agreement</td>
<td>Articles of Incorporation, Bylaws, Resolutions, Stock Certificates, Stock Ledger, Shareholders Agreement, Investor Rights Agreement, Statutes</td>
<td>Same as C corporation plus file Form 2553 with IRS – election to be S corporation</td>
</tr>
<tr>
<td>Management of the Business</td>
<td>Operating Agreement sets forth how the business is to be managed; Member(s) or manager(s) designated to manage business; Officers can have day-to-day responsibility</td>
<td>Board of Directors has overall management responsibility; Officers have day-to-day responsibility</td>
<td>Same as C corporation</td>
</tr>
<tr>
<td>Capital Contributions</td>
<td>Members typically contribute money or services and receive interest in profits and losses</td>
<td>Shareholders typically purchase stock in the corporation, either common or preferred</td>
<td>Same as C corporation</td>
</tr>
</tbody>
</table>

**ENTITY COMPARISON CHART**

**LLC**
- One umbrella governance agreement
- Flexibility/creativity
- Substantial profits
- Profits Interests
- Foreign ownership
- Ownership includes entities > 100 owners
- Distributions ≠ ownership %
- Multiple governance agreements
- Operating at net loss for long time
- Qualifed Small Business Stock
- Want retained earnings
- Don’t want to pay taxes on benefits
- IPO is imminent
- Take all profits out of business
- Owners want to deduct losses
- Avoid double taxation
- Limited personal liability
- Corporate formats
- Annual meeting
- Stock options
- No self-employment taxes (50% tax rate on AGI)
- Also LLC with S Election

**C Corporation**
- Familiar structure of corporation with LLC taxation

**S Corporation**
**Equity Compensation**

**Profits Interests**
- Share in future appreciation from the date of the grant
- Distribution Threshold
- Incentive Unit Plan
- Award Agreement (often in coordination with Employment or Independent Contractor Agreement)
- Grant/Vesting is not a taxable event
- Opportunity for Cap Gains Treatment

**Phantom Equity**
- Contractual right to receive a cash payment equal to the value of unit(s)
- Phantom equity award is outstanding for the period specified in the plan
- Distributions and appreciation payments
- Phantom Unit Plan and Grant Agreement
- Taxed as compensation

**Unit Options**
- Analogous to stock options
- Right to purchase units within a specific period of time at a price ideally below FMV
- Issue – Maintaining capital accounts under 704(b)
- Issue – Allocation of profits and losses
- Likely tax consequence if exercised is ordinary income + cap gains

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Profits Interests

Founders of new companies find themselves in a tough spot – you’re bootstrapping, there’s no budge, you likely don’t have any revenue. To attract top talent, you often need to use equity as an incentive. Clients typically get stuck there, and often think that the right next step is to grant capital units (often voting) to incentivize employees. Granting capital units can have unanticipated tax consequences. As such, we often use profits interests as a tax neutral tool to attract and keep key employees or service provider relationships.

Profits Interests are a great tool for two main reasons:

- Distributions on profits interests are based on a “distribution threshold”, which is the value of the company at the time the profits interests are granted. The recipient of profits interests doesn’t receive a distribution until the other members receive distributions up to the distribution threshold. As such, the profits interest recipient doesn’t receive distributions on his or her profits interests until the company has increased in value from the time of the grant. In this way, profits interests are truly incentive units because they incentivize the holder to increase the value of the company.

- There is no immediate tax consequence for the profits interest recipient. The profits interest recipient is not taxed until he or she actually receives a distribution.

In order to use profits interest in your LLC, you need to have the proper documents in place. There are three primary legal tools needed:

- **Operating Agreement** - The company’s operating agreement must authorize the profits interests and set forth their distribution and other rights.

- **Incentive Unit Plan** – The Company should implement an incentive unit plan and have a written agreement, an award agreement, between the company and the recipient of the profits interests. The incentive unit plan is the umbrella plan governing all issuance of profits interest by the company. Once it is adopted (usually by the board or managing member), the company may start awarding profits interests to employees and service providers. Among other things, the incentive unit plan sets forth the general rules for how profits interests can be awarded by the company and the rights and obligations of the profits interest recipients. One of the most important sections of a properly drafted incentive unit plan establishes the company’s call rights upon termination of the employee or service provider. Call rights give the company the opportunity to force the recipient of profits interests to sell back to the company his or her
profits interests upon termination. This is important because it ensures that if the relationship between the company and an employee or service provider is terminated, the company can cut all ties with the employee or service provider (and not be stuck with a difficult minority member on the company’s cap table forever). The incentive unit plan also sets forth what happens to the profits interests upon a change in control of the company and states that any award of profits interests must be evidenced by an award agreement.

- **Award Agreement** - The Company grants profits interests through an award agreement between the company and the recipient of the profits interests. The award agreement is the agreement between the company and the recipient of profits interests whereby the holder is granted his or her profits interests. It sets forth the number of profits interests the holder will receive, the vesting schedule (if any) and any other provisions that are specific to the holder. The vesting schedule can be key to the success of using profits interests – it allows the company to set vesting milestones (time, sales goals, revenue goals, etc.), which really aligns the profits interest recipient’s performance and compensation with the company’s larger vision. It also contains certain representations and acknowledgements by the holder regarding the rights of the award and an agreement by the holder to sign a joinder, in which the holder agrees to become a party to the company’s operating agreement.
TAX ISSUES IN ADVISING START-UPS ON
FORMATION AND INCENTIVE COMPENSATION
ISSUES

ABA Business Law Section Spring 2019 Meeting
Vancouver, BC

Start Smart 2.0 – Advising Start-Ups on
Formation and Early Operating Issues

Randall D. McClanahan
Butler Snow LLP
Tax Cut and Jobs Act

• The Tax Cut and Jobs Act, passed on December 20, 2017, provided some significant changes to federal tax law. In the areas of choice of entity and executive compensation, some of the changes include the following:

  o lowered corporate income tax rate to 21%
  o lowered highest individual income tax rate to 37%
  o added new Section 199A, which can provide a deduction for up to 20% of qualified business income. The purpose of the section is to try to lower the tax rate on certain types of business income to be consistent with the reduction in corporate income tax rates
  o added new Section 163(j), which limits the deductibility of business interest
  o added new Section 1061, which treats gain from the sale of certain carried interests held for less than 3 years as ordinary income
Common Business Structures For Start-Ups

• Typical Business Structures:
  ○ Corporations (taxed under Subchapter C)
  ○ S Corporations (taxed under Subchapter S)
  ○ Limited Liability Companies (taxed as Partnerships)
  ○ Limited Partnerships
  ○ Single Member Limited Liability Companies

• S Corporations are cumbersome vehicles and often not the best choice for entity for a startup
  ○ S Corporation shareholders do not receive an increase in their basis in S corporation stock by the amount of corporate debt. See Section 1367(a). This is in direct contrast to partnerships.
  ○ S Corporations may only have one class of stock. See Section 1361(b)(1)(D).
  ○ Income of the S corporation must be allocated in proportion to stock ownership. See Section 1366(a)(1).

• The last two factors can make it difficult to structure preferred returns by investors. Accordingly, S corporations are often not an appropriate vehicle for any entity that needs to raise capital. Additionally, the inability to obtain basis for debt in the entity often makes S corporations an inappropriate vehicle for entities that own encumbered real estate.
Corporations – Taxed Under Subchapter C

- Corporations taxed under Subchapter C are subject to a corporate income tax.
- The 2017 Tax Act reduced the tax rate to 21%.
- Shareholders must also pay income tax on dividends distributed by a corporation (one exception being qualified dividends to another corporation). Accordingly, distributed income of a corporation is generally subject to two levels of taxation. This is a major disadvantage to the corporate structure.
- Section 1202 provides for certain relief on the sale of qualifying stock.
Section 1202 Exclusion:

- Exclusion of 100% of gain from the sale of qualified small business corporation stock.
  - limited to 50% of gain for stock issuances prior to February 18, 2009.
  - limited to 75% of gain for stock issuances between February 18, 2010 and September 27, 2010.

- Limitation on Exclusion
  - Greater of $10 million or 10 times the section 1202 stock basis.
Qualified Small Business Corporation Stock:

- originally issued
- held for at least five years
- issued after August 10, 1993
What is a Section 1202 Eligible Corporation?

- C corporation with gross assets of not more than $50 million at all times on or after August 10, 1993 and before and immediately after the stock issuance.

- The corporation must conduct an active trade or business.
  
  - Real estate may not exceed 10% of the corporation's total assets (unless real estate is used to conduct the business).
  
  - Stock or securities may not exceed 10% of the excess of the corporation's assets in excess of its liabilities.

- Ineligible Businesses:
  
  - Personal services corporation
  - Banking, insurance, leasing, financing, investment or similar business
  - Farming
  - Hotel, restaurant or similar business
  - Business where depletion is allowed
Limited Liability Companies:

- Limited Liability Companies taxed as partnerships are the fastest growing business entity.
  - As a tax partnership, LLC’s are flow-through entities. As such, the LLC itself does not pay federal income tax but the LLC’s income, loss, deductions, credits and separately stated items flow-through to the LLC’s members.
  - With certain limitations, LLCs can have disproportionate or special allocations of income. – Section 704(b).
  - LLC members receive an increase in basis for their share of an LLC’s liabilities. – Section 752(a).
  - New Section 199A provides for a 20% discount of certain qualified business income.
Section 199A Overview

• A non-corporate taxpayer may (subject to limitations and conditions) deduct the lesser of:

  o 20% of such taxpayer’s combined qualified business income or

  o 20% of the taxpayer’s taxable income, less net capital gain.
199A Deduction-Eligible Taxpayers

- Sole proprietorships
- Single member limited liability companies
- Sole owner (or tenancy in common owner) of rental real estate
- S Corporation shareholders
- Partnership owners and members of limited liability companies taxed as partnerships
- Trusts (other than grantor trusts)
Section 1999A Limitations:

- If taxable income exceeds a threshold, the deduction for 20% of qualified business income is limited.

- If the trade or business is a specified service trade or business the deduction may even be eliminated.

- The “threshold” is:
  - $157,500 of taxable income if filing a single return, or
  - $315,000 of taxable income if filing a married filing jointly joint return.
Limitations on Section 199A Deduction:

- If income is above the threshold but the trade or business is not a specified service, trade or business, then the Section 199A Deduction is limited to the greater of:
  
  - 50% of the W-2 wages with respect to each trade or business or
  
  - The sum of 25% of the W-2 wages and 2.5% of the unadjusted basis of qualified property immediately after acquisition of the trade or business.
Qualified Business Income

• Section 199A(c)(3) – Income, gains, deductions, and loss to the extent such items are effectively connected with a trade or business within the United States

• QBI does not include:
  o Capital gains or losses
  o Dividends
  o Interest Income
  o Guaranteed payments
  o Reasonable compensation paid to taxpayer for services rendered
Specified Service Trade or Business:

- Health
- Law
- Accounting
- Actuarial Science
- Performing Arts
- Athletics
- Financial Services
- Brokerage Services
- Trade or Business in which the principal asset is a reputation or skill of one or more employees
Comparison of Tax Rates:

- C corporation: (assuming 100% of income reinvested)
  - Corporate tax rate: 21%

- C Corporation
  (assuming income distributed to shareholders)
  - Corporate tax rate: 21%
  - Tax on dividends:
    - Remaining income: 79%
    - Individual income tax: 20%
    - NII tax: 3.8%
    - \[ \times 23.8\% \]
    - 18.80
  - Aggregate tax – 39.8%
LLC Tax Rates

• Highest Individual tax rate: - 37.00%

• Less Section 199(a) deduction 37.00%

\[ \times 0.20 = (7.40\%) \]

• Net tax rate 29.60%
Choice of Entity Global Considerations:

- If pressured to distribute earnings, then an LLC is likely to be the favorable choice.
  - The effect of double taxation resulting from dividends to shareholders is significant.
- If an entity has very little operating profit, then a section 1202 election might be preferable.
- If there is no significant current pressure to generate earnings, the difference between the C corporation tax rate and the flow through individual rate (less the Section 199A deduction) leads to a conclusion that the earnings should be retained in the C corporation for a sufficient period of time to offset the double taxation on the distribution of C corporation dividends.
- If a business does not qualify for the Section 199A deduction, a corporation’s attractiveness increases.
- A wild card is the effect on purchase price of a sale of stock versus a sale of assets. Acquirers may require a discount from purchase price to purchase stock.
  - Lack of basis step-up, including inability of buyer to use new bonus depreciation on used assets under Section 168(k).
  - Assumption of liabilities inherent by purchasing stock may lead to discount in purchase price.
Other Considerations:

- Will Section 199A deduction be extended beyond 2025? The deduction is set to sunset at December 31, 2025.
- Will tax rates change?
- Qualification of business under Section 1202?
- Qualification of business under Section 199A?
Additional Issues:

Section 163(j) – Limitations on Deductibility of Business Interest

- Deductibility of business interest expense is limited to the sum of:
  - Business interest income
  - 30% of adjusted taxable income
  - Floor plan financing

- If average gross receipts of company for last 3 tax years does not exceed $25 million, this limitation does not apply.
Section 163(j) – Planning Considerations

- Section 163(j) can come into play in structuring all entity debt, including loans from members or shareholders.

- Section 163(j) can create situations in which an entity has cash outflow for the interest expense, but for which the interest expense deduction is limited or not allowed.

- Pass-through entities apply the interest expense limitations at the entity level. When structuring debt of a pass-through entity, practitioners will need to consider the effect of Section 163(j).

- Related party rules apply so taxpayers may not structure to avoid limitations.
INCENTIVE COMPENSATION
Forms of Incentive Compensation

Corporations:

- Cash
- Stock
- Restricted Stock
- Restricted Stock Units
- Qualified Stock Options
- Nonqualified Stock Options
- Phantom Stock
- Stock Appreciation Rights
Forms of Incentive Compensation

Limited Liability Companies:

• Cash
• Capital Interests
• Restricted Capital Interests
• Profits Interests
• Restricted Profits Interests
• Phantom Units
Certain Key Tax Principles:

Section 83 – Property Transferred in Connection with Services

• For Section 83 to apply, property must be transferred in connection with the performance of services.

• Recipient recognizes taxable income equal to the excess of the fair market value of the property received over the amount paid for the property.

• General rule – Section 83(a): Income recognized upon the first to occur of:
  (i) the date the property is transferrable or
  (ii) the date the property is not subject to a substantial risk of forfeiture.
Effect of Section 83(b) election:

• Service provider recognizes taxable income in the year the property is received equal to the difference between the fair market value of the property at the time of the transfer and the amount paid for the property.

• Service provider does not recognize any income when the restrictions lapse.

• Employer/Payor has offsetting compensation deduction.

• Election must be filed within 30 days of the transfer.
What is a Substantial Risk of Forfeiture?

Section 83(c) - If rights are conditioned as follows:

- Upon future performances of substantial services; or

- Upon the occurrence of a condition that is related to a purpose for the transfer.
Section 409A

- Post-Enron code section designed to address modifications to deferred compensation plans.

- Violation of Section 409A can result in inclusion in income of deferred compensation under certain nonqualified deferred compensation plans.

- Deferred compensation occurs for purposes of Section 409A when:
  - a party has a legally binding right to compensation;
  - the compensation is payable in a taxable year after it is earned; and
  - the compensation is paid more than 2½ months after the end of the year in which it was no longer subject to a substantial risk of forfeiture.
Consequences of Violation of Section 409A

• Immediate taxation of the value of deferred compensation
• 20% additional tax to recipient
• Non-deductibility of payment by payor
Applicability of Section 409A

- Applies to compensation paid to all service providers including employees, directors, independent contractors and partners.

- It does not apply to independent contractors that provide services to two or more unrelated clients:
  - The services provider must be actively engaged in the trade or business of providing services (other than as an employee or member of board of directors); and
  - The service provider provides significant services to two or more unrelated recipients.

  ▪ Exception is not applicable to the performance of management services.
Types of Compensation by Corporations

• Incentive Stock Options
  
  o If structured properly, no income to recipient on date of grant
  
  o May only be granted to employees
  
  o ISOs have significant restriction requirements - Section 422(b):
    ▪ They must be granted under a plan adopted by the granting corporation
    ▪ The plan must be approved by stockholders within 12 months before or after the corporation adopts the plan
    ▪ They must be granted within 10 years from date plan is adopted or approved, whichever is earlier
    ▪ Options must be exercisable within 10 years from date of grant
    ▪ Option may be exercised only by employee
    ▪ Maximum value of stock exercisable in any one year per employee is $100,000
Incentive Stock Options

• **Tax Treatment:**
  o Upon Grant: Non-taxable
  o Upon Vesting: Non-taxable
  o Upon Exercise: Non-taxable

• **Upon Sale:**
  o If held for two years after exercise, capital gain equal to the difference between the sales price and the exercise price.
  o If stock held more than one year and less than two years, the gain is bifurcated, and stockholder recognizes ordinary income equal to fair market value of the shares on exercise date over the aggregate exercise price. The remainder of gain is capital gain.
Nonqualified Stock Options

- A nonqualified stock option ("NSO") is an option that does not qualify under the federal income tax law as an incentive stock option.

- If the NSO has a readily ascertainable fair market value on the date of grant, then Section 83 would apply.

- If the NSO is traded in on established market, it has a readily ascertainable value.

- An untraded NSO does not have a readily ascertainable fair market value unless:
  
  o The NSO is transferable by the optionee;
  o The NSO is exercisable immediately in full by the optionee;
  o The NSO is not subject to any restriction or condition which has a significant effect upon fair market value of the option; and
  o The fair market value of the NSO is readily ascertainable.
No Ascertainable Value on Date of Grant?

- If an NSO does not have a readily ascertainable value on the date of grant, the award of the option is not a taxable event.

- If Section 83 does not apply to the grant, it will then apply to the exercise of the option.
Applicability of 409A to NSO’s

• Treas: Reg. 1.409-1(b)(5)(i)(A) - NSO’s are exempt from Section 409A if:

  o The exercise price of the option will never be less than the fair market value of the stock on the date of grant;

  o The number of shares subject to the option is fixed;

  o The transfer or exercise will be subject to Section 83; and

  o The option does not include any feature for deferral of compensation except deferral of recognition of income until exercise (or, in the case of restricted stock, until vesting).
Non-Qualified Stock Options

Taxation

• Upon Grant: Generally non-taxable, unless options have a readily ascertainable for market value.

• Upon Vesting: Non-taxable event.

• Upon Exercise: Recipient recognizes ordinary income equal to the difference between the fair market value of the shares and the exercise price.

• Tax on Sale of Stock: Recipient recognizes capital gain equal to the difference between (i) the sales price and (ii) the exercise price plus ordinary income recognized at exercise.
Restricted Stock

- Subject to certain restrictions such as vesting and forfeiture over the vesting period
  - More commonly used for employees
  - Advantages of Restricted Stock over Nonqualified Stock Options:
    - Holding period for stock acquired pursuant to the exercise of a stock option begins upon exercise. Holding period for restricted stock begins upon acquisition.
    - If a recipient makes a Section 83 election, the appreciation during the vesting period will not be taxed as compensation income.
    - Grants of restricted stock are also generally exempt from Section 409A.
Stock Appreciation Rights

• Generally viewed as a form of phantom equity.

• A stock appreciation right is a compensation structure where the corporation promises to pay the recipient an amount equal to the difference between the stock value on the date of grant of the SAR and the value on some future specified date.

  o Some stock appreciation rights pay the provider in stock rather than cash.
Stock Appreciation Rights

• Taxation:

  o Upon Grant: Non-taxable event.

  o Upon Vesting: Non-taxable event if in compliance with Section 409A.

  o Upon Exercise: Recipient recognizes ordinary income equal to the difference between the cash received (if receiving cash) or fair market value of shares received (if settled in stock).

  o Upon Sale of Stock (if settled in stock): Recipient recognizes capital gain equal to the difference between sales price and ordinary income recognized upon exercise.
Restricted Stock Units

• Taxation
  
  o Upon Grant: Not taxable.
  
  o Upon Vesting: Not taxable if in compliance with Section 409A.
  
  o Upon Settlement: Ordinary income equal to fair market value of the stock or cash provided.
Compensation of Capital and Profits LLC Interests

• Capital Interest
  
  o Any interest that would give the holder a share of the proceeds if the LLC’s assets were sold at fair market value and the proceeds distributed in a complete liquidation of the LLC.

• Profits Interest
  
  o Any membership interest other than a capital interest.
Taxation of Capital Interest:

- The grant of an unrestricted capital interest in exchange for services is a taxable event.
  - Recipient recognizes taxable income equal to the fair market value of the interest – Section 83(a).
  - Recipient would become a member of the LLC.

- Since there would be no deferral of compensation, Section 409A should be inapplicable.
Restricted Capital Interest

• Capital interest that is subject to a substantial risk of forfeiture.

• If recipient makes a Section 83(b) election, the recipient should be subject to taxation upon receipt and the taxable income would be equal to the fair market value of interest.

• Similar to an unrestricted capital interest, if a Section 83(b) election is made, future vesting should not be a taxable event.

• Section 409A would not be applicable since there would be no deferral of compensation.
Profits Interest

- IRS has ruled in two separate revenue procedures that the transfer of a profits interest to a service provider is not taxable upon receipt.
  - Revenue Procedure 93-27: IRS generally will not challenge tax-free receipt of profits-only interest.
  - Revenue Procedure 2001-43: A Section 83(b) election is not required. Service provider is not subject to tax on subsequent vesting of non-vested profits interests.

- Necessity of Section 83(b) election?
  - Revenue Procedure 2001-43 provides that a Section 83(b) election is not required. Nevertheless, many practitioners continue to file protective Section 83(b) elections.
Summary of Taxation of Profits Interests:

Upon Grant:

- Taxable upon grant if the Section 83(b) election is made. Generally, this does not result in any tax liability, if structured properly.
- If Section 83(b) election is not made, the issuance will not be taxed at grant.

Upon Vesting:

- If a Section 83(b) election is made upon issuance, then vesting is a non-taxable event.
- If a Section 83(b) election is not made upon grant, then the recipient is taxed upon vesting equal to the amount of the fair market value of the profits interest.

Upon Sale:

- If subject to new carried interest rules in Section 1061, recipient must hold three years to get long-term capital gain treatment.
- Otherwise, recipient must hold one year to get capital gain treatment.
Compensatory LLC Options

• Proposed Regulations issued May 24, 2005 dealt with compensatory options. The rules are extremely complex.

• There are uncertainties regarding when an option holder should be treated as partner for tax purposes.

• The implementation of Section 409A and compensatory LLC options is unclear.
Phantom LLC Interests

• A phantom LLC interest is similar to a phantom stock interest in that the service provider would receive a phantom equity interest in an LLC.

• There is very little guidance in this area – no regulations or proposed regulations, for example. There is no real authority on when a phantom LLC interest holder will be deemed a partner for tax purposes.
  
  o Interest should be unfunded and unsecured.
  
  o Many practitioners advise that the interest should not be based on net income of the LLC.

• Phantom LLC units would be treated as deferred compensation subject to Section 409A, unless the exceptions from Section 409A apply. Practitioners typically structure phantom interests to comply with Section 409A.
Start Smart 2.0 – Advising Start-Ups on Formation and Early Operating Issues

March 28, 2019
ABA Business Law Section Spring 2019 Meeting
Vancouver, BC
Tarik J. Haskins, Partner
Commercial Law Counseling Group
Choice of Entity

- A start-up founder has a number of decisions to make in connection with the formation of the start-up and one of the earliest decisions will be what form of entity to use and where to form the entity.

  - **Entity types**
    - C-Corporation
    - S-Corporation
    - General Partnership
    - Limited Partnership
    - Limited Liability Company
    - Statutory Trust

  - **Places to Form Entity**
    - Location of principal place of business
    - A neutral location, such as Delaware
Choice of Entity

• Factors to consider, include but are not limited to:
  • Potential liability for the business owners
  • Tax considerations
  • Raising capital
  • Ordering the duties and rights among the business owners
  • Whether all business owners will be involved in management
Choice of Entity

corporation

- A corporation is an entity formed pursuant to applicable state law and provides such entity form with the authority to act as a legal person for the purpose of carrying on business.
- The corporate form provides its equity holders with a liability shield, such that claims against the corporation are limited to the corporation’s assets and the shareholders will not become personally liable for the debts or obligations of the corporation.
Choice of Entity

corporation

C- Corporation – A corporation that elects C-Status will have its profits taxed at both the corporate level and the shareholder level.

S-Corporation – A corporation that elects S-Status will be subject to a single level of tax on its profits at the shareholder level. The S-Corporation is subject to a number of limitations that may make it less attractive than other entity forms. The limitations applicable to an S-Corporation, include, but are not limited to:
• No more than 100 shareholders
• Shareholders must be individuals, estates, tax exempt organizations, or certain trusts
• Shareholders cannot be nonresident alien
• There can only be one class of stock
Choice of Entity

*corporation*

- Documents required to form a corporation
  - Certificate of Incorporation
  - By-laws
Choice of Entity

general partnership

• A general partnership is an “association of 2 or more persons formed…to carry on any business, purpose or activity.” See Section 15-202 of the Delaware Revised Uniform Partnership Act.
  • All partners are jointly and severally for all of the obligations of the partnership.
  • A general partnership may be formed by default if the business owners do not otherwise elect a form of entity
    • A general partnership will typically be taxed as a partnership, providing a single level of taxation at the partner level.

Documents Required

• Partnership Agreement
• Statement of Partnership Existence may be filed
Choice of Entity

**limited partnership**

- A limited partnership is a form of partnership that provides a liability shield to its limited partners so long as such persons do not participate in the management of the limited partnership.
- The limited partners enjoy limited liability analogous to shareholders of a corporation so long as such persons do not participate in the “control of the business.”
  - Section 17-303(b) of the Delaware Revised Uniform Limited Partnership Act lists out a number of activities that such persons can engage in without being deemed to have participated in the control of the business.
  - Generally, a general partner of a limited partnership will have the same liability that it would have as a partner in a general partnership.
  - A limited partnership will typically be taxed as a partnership, providing a single level of taxation at the partner level.

**Documents Required:**
- Certificate of Limited Partnership
- Partnership Agreement
Choice of Entity

**limited liability company**

- The limited liability company is a form of entity that combines the favorable taxation provided by the partnership form (i.e. – single level taxation) with the limited liability provided to shareholders of a corporation (i.e. – no personal liability).

- The limited liability company form is flexible allowing for, among other items, (i) management by the members or managers, (ii) multiple classes of equity interests and (iii) favorable tax treatment.

- Members may participate in control of the business without affecting the applicability of the liability shield.

- **Documents Required**
  - A certificate of formation
  - A limited liability company agreement / operating agreement
Choice of Entity

**statutory trust**

- The statutory trust is a juridical entity, that is separate from its trustees and beneficial owners and is considered a legal person capable of doing business in its own name and not in the name of its trustee(s).
  - The statutory trust form is seldom used by startups, although the form is very popular among mutual funds, trusts, real estate investment trusts and asset securitization.
  - The statutory trust form provides its beneficial owners with limited liability similar to shareholders of a corporation.
  - The statutory trust must have a trustee.
  - Flexible taxation allows parties to select the appropriate tax treatment

**Documents Required**
- A certificate of trust
- A trust instrument
Choice of Entity

corporation vs. LLC

• For most startups, the choice of appropriate business form will typically come down to choosing between a corporation or a limited liability company.

• An attorney advising the founders will need to carefully consider the benefits of each form in the context of the current state of the business of the new company and the short-term and long-term objectives of the new company, including the need to raise capital and/or a desire to consummate an IPO.
Delaware Entity Act
Building Blocks

**Flexibility**

- Section 18-1101(b) of the Delaware LLC Act states “It is the policy of this chapter to give *the maximum effect* to the principle of freedom of contract and to the enforceability of limited liability company agreements.” (emphasis added).

- The Delaware LLC Act seeks to provide maximum flexibility to parties forming a business entity to meet the objectives of the parties.
Delaware Entity Act
Building Blocks

Management

• The DGCL provides for one form of management, based upon management by a board of directors with certain consent rights reserved to shareholders.

  • *See Section 141(a) of the DGCL*, which states that “the business and affairs of every corporation shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”

• The Delaware LLC Act provides by default for management by its members, but expressly provides that the LLC Agreement of a limited liability company can provide for others forms of management. *See Section 18-402 of the Delaware LLC Act.*
Delaware Entity Act
Building Blocks

Fiduciary Duties

• Under the DGCL, the members of the board of directors of a corporation, will owe fiduciary duties to the corporation and its shareholders, including the duties of loyalty and care.

• Under Section 18-1101(c) of the Delaware LLC Act, “to the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager …[such] duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”
Delaware Entity Act
Building Blocks

Exculpation

• Section 102(b)(7) of the DGCL generally permits a corporation to exculpate a director for liability arising out of such person’s breach of his or her fiduciary duty of care, but not for a breach of the duty of loyalty.

• Section 18-1101(e) of the Delaware LLC Act states that “A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager…. Provided that an LLC Agreement cannot eliminate liability for a bad faith violation of the implied contractual covenant of good faith and fair dealing.
Delaware LLC Act
Building Blocks

*Implied Covenant*

- Implied Covenant of Good Faith and Fair Dealing
  - In general, the implied covenant of good faith and fair dealing:
    - Protects a party from being deprived of the fruits of the bargain;
    - Is based on the reasonable expectations at the time contract was entered into;
    - Applies to the exercise of discretionary authority.
- To the extent that fiduciary duties are waived, plaintiffs will typically need to bring an action claiming a breach of the implied covenant of good faith and fair dealing.
Limited Liability Company Agreement

• The LLC Agreement for a start-up company should consider how the LLC Agreement will, or will not, address the following items:
  • Identify the members (including whether any early-stage investors should receive debt instead of equity)
  • Set forth the management of the LLC
    • Including rights to vote on certain matters
  • Set forth any waivers or disclaimers of liability and fiduciary duties
  • Elect taxation for the LLC
  • Define the purpose of the LLC, or consider whether the LLC should have a broad purpose
Limited Liability Company Agreement

• Items to be addressed in LLC Agreement (Cont’d):
  • Define record keeping obligations and potential access to records
  • Financing (capital contributions and the requirement to make additional contributions)
  • Distributions
  • Transferability of limited liability company interests
  • Exit Rights
  • Classes of Equity Interests and the rights associated therewith
  • Dispute resolution
Limited Liability Company Agreement

• Management of the Limited Liability Company
  • The flexibility set forth in the Delaware LLC Act permits business owners to tailor the management of the company to suit the needs of all owners.
    • Management authority of the limited liability company can be granted to the members/owners similar to a partnership management structure; or management authority can be granted to one or more managers similar to a corporate structure.
    • Default – Unless the limited liability company agreement provides otherwise, the management will be vested in members and the affirmative vote of members owning more than 50% of the interest in profits shall control. See Section 18-402 of the Delaware LLC Act.
Limited Liability Company Agreement

• Management of the Limited Liability Company Agreement
  • Drafters should consider how to address certain material decisions / actions, and whether to rely upon (i) a general grant of authority to a controller, or (ii) the default provisions of the Delaware LLC Act. Examples of such decisions / actions include:
    • **Distributions** – Who decides when and the amount of distributions.
    • **Dissolution** – Who decides when the LLC shall dissolve.
    • **Amendments** - What is the requisite vote to amend the limited liability company agreement.
    • **Material Transactions** – Entering into financings in excess of a certain amount, a sale of assets, mergers and divisions.
    • **Raising Capital / Issuing Interests** – Raising additional capital and issuing additional limited liability company interests.
    • **Affiliate Transactions** – Entering into transactions with a controlling member.
    • **Change to Business Purpose** – Changing the business purpose.
Limited Liability Company Agreement

• Fiduciary Duties and Exculpation
  • In contrast to the corporate form, a limited liability company can expand, restrict or eliminate any fiduciary duties that a member, manager or other person might have with respect to the limited liability company; provided that the implied covenant of good faith and fair dealing may not be eliminated. See Section 18-1101(a) of the Delaware LLC Act.
  • Unless modified by the limited liability company agreement, the controlling persons will owe the following fiduciary duties:
    • Duty of Care – Unless modified, the duty of care will generally require a fiduciary to inform itself of all relevant facts reasonably available to it when making a decision. The duty of care has been equated with a gross negligence standard.
    • Duty of Loyalty – Generally requires the fiduciary to operate the company solely in the interest of the company and its investors and that the fiduciary not act inconsistently with the company’s best interests to further the fiduciary’s interests
Limited Liability Company Agreement

• Fiduciary Duties and Exculpation
  • The Delaware LLC Act also permits drafters to *limit or eliminate* liabilities for breach of contract or breach of fiduciary duties. *See Section 18-1101(e) of the Delaware LLC Act.*
  • The flexibility of the Delaware LLC Act allows the parties to an LLC Agreement to substantially limit the potential liability of those persons controlling the LLC.
  • Parties to the limited liability company agreement (particularly minority members) should be advised as to the effect any modification or elimination of fiduciary duties will have on their rights, including the right to challenge actions taken by a controlling person. A waiver or elimination of fiduciary duties can have a significant impact on the ability of a court to review challenged actions later in the life of the LLC.
    • If fiduciary duties will be modified or eliminated, the parties should take great care to ensure that the provisions do not conflict and it is clear how the provisions work together.
Limited Liability Company Agreement

- The limited liability company agreement should address whether limited liability company interests will be transferable.
  - By default, a limited liability company interest is freely assignable unless the limited liability company agreement provides otherwise.
    - Particularly if a member is granted special voting rights, the owners will want to consider whether such rights can be transferred without the consent of the other members.
Limited Liability Company Agreement

• Many startup companies do not consider an exit strategy but the parties would be well-advised to consider how the founders and/or other investors will exit the company and/or what happens if there is a deadlock dispute. The exit strategy can consider:
  • Whether a member will have a unilateral right to withdraw from the LLC (under Section 18-601 of the Delaware LLC Act, a member is not entitled to resign from the LLC).
  • Whether members can expel another member (the Delaware LLC Act does not contain a mechanism by which a member can expel another member and continue to run the LLC).
  • Whether a member can cause a dissolution of the LLC.
  • Whether the LLC Agreement should contain tag-along rights, drag-along rights and/or buy-sell provisions.
Limited Liability Company Agreement

- Section 18-1101(b) states that “it is the policy of this chapter to give the maximum effect to the principle of freedom of contract and the enforceability of limited liability company agreements.”

- Consistent with the contractual freedom provided by the Act, is the requirement that the drafters of the limited liability company agreement carefully draft the applicable provisions in the LLC Agreement to ensure that such provisions work as intended.
Tarik’s practice covers a range of commercial transactions including mergers and acquisitions, secured financings, joint ventures, securitization and business counseling.

Tarik also focuses on organizational and operational issues related to limited liability companies, limited partnerships and statutory trusts. In addition, he regularly represents sponsors and conflicts committees of master limited partnerships (“MLPs”).

He is involved in the preparation of third-party legal opinions in connection with a range of transactional matters, and he regularly counsels other attorneys domestically and internationally on matters relating to Delaware partnerships, limited liability companies and statutory trusts.
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AGENDA

1. Founders
2. Friends, Family, and Angels
3. Non-VC Fundraising Options
4. Early Venture Capital
5. Late Venture Capital
1. FOUNDERS

- Who gets stock in the company?
  - All the founders?
- What do they get?
  - Equal shares?
  - Restricted stock? [Don’t forget 83(b)!]
  - Will they also get a board seat?
- When
  - How long will vesting be? Vesting cliff?
  - How do you account for “sweat equity”?
- Why
  - Be ready to explain the pros and cons of all these considerations.
2. FRIENDS, FAMILY, AND ANGELS

- **Common Stock**
  - Pros: simple, easy, people like “ownership”
  - Cons: big cap table, lots of signatures, dilutive

- **Convertible Notes**
  - Pros: not on the cap table, well-established, trusted
  - Cons: might need to repay, interest, extensions

- **Simple Agreements for Future Equity (SAFEs)**
  - Pros: no debt, relatively simple at the beginning
  - Cons: creates complications during first funding round, multiple preferred stock series’, different terms, issues compounded if there are multiple different SAFEs.
SECURITIES LAW BASICS

- **Section 4(a)(2) & Regulation D**
  - Section 4(a)(2) doesn’t require a filing. Only problematic if you get sued, which isn’t really an issue for small offerings.
  - Reg D is the Safe Harbor. Always an option. Usually worth the effort when you are talking about $1M+ deals or deals involving entities or investors with a litigious reputation.

- **State Blue Sky Laws**
  - Don’t forget blue sky laws!
  - Some states require a notice filing (e.g. California)
  - Some states are self-executing (e.g. Wisconsin)
3. NON-VC FUNDING

• Bank or Commercial Loans
  • This is expensive money.
  • Really only an option if you are already generating revenue OR if you need a bridge loan to get you to your next round of financing.

• Donation-Based Crowdfunding
  • Kickstarter, GoFundMe, Indiegogo
  • Good for B2C products, especially if they are trendy, innovative, and/or sexy
  • Learn best practices! Beware common kickstarter mistakes!

• Equity-Based Crowdfunding
  • SeedInvest, AngelList, WeFunder
  • Good for B2C products/services that rely on consumer loyalty and engagement.
4. EARLY VC

- Preferred Stock
  - Liquidation Preference
  - Dividends (rarely)
  - Board Seat
  - Protective Provisions
- Series A ($2M - $5M)
- Series B (5M - $25M)
- Series Seed Round ($1M+)
  - No Board Seat
  - Fewer perks
5. LATE VC

- Series C and Later ($25M+)
- Unicorns ($1B Valuations)
  - Status Symbol
  - Probably not actually desirable
  - Danger of getting so big that you can’t go public at a reasonable price (e.g. Uber)
  - Over-hype and the “fear of missing out” problem (e.g. Theranos)
- Other Dangers
  - Loss of control (multiple VCs on the board)
  - High burn rate
  - Mismatched objectives (VCs versus Founders)
VC ISSUES

• **Practical Issues:**
  - How desperate is the company for $$?
    - More desperate = more power to the VC
  - Are your angels helping or dragging their feet?
  - Are the incentives properly aligned?
    - If you’re not even to prototype, but this VC is looking to get out within 3 years, are they going to be a good partner?

• **Corporate Law Issues:**
  - Do preferred directors have a duty to the common stockholders? Yes.
  - Can preferred stockholders become “controlling stockholders”? Yes.