

(non IP) Legal Issues for Startups Stephen P. Rothman

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Topics

- Choice of Entity
- Hiring and Paying Employees
- Employee Equity / Stock Options
- Financing
- Leasing Real Estate
- Miscellaneous
- Legal Services
- Sample Forms
- Mistakes
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Choice of Entity

- Corporation
 - Subchapter C / Subchapter S
 - Delaware / California
- Limited Liability Company
- Sole Proprietorship
- Partnership (General or Limited)

Sole Proprietorship

- Cheapest, fastest
- Tax pass-through
- No liability protection
- Only lasts as long as you do
- Only for a solely-owned entity
- Concern that it invites more tax audit scrutiny

C Corporation

- Exposes only assets of the business to liability (but careful re “piercing the corporate veil”)
- Unlimited life
- Multiple owners
- Separate entity for income tax purposes (“double taxation” - may be avoided to some extent in solely owned entity by paying out excess cash as “reasonable compensation” rather than dividends)
- Initial losses not usable by investors, but accumulate as NOLs
- “Tax-free” reorganizations possible
- Some VCs insist on conversion to a C corporation

Pass Through Entities

S Corporation, LLC, Partnership

- S corporation, limited liability company and partnership are all “pass-through” entities, not separately taxed (except by states); instead income or loss flows through to owners
- If company has taxable losses in its early years, each owner reports a share of these losses
- Owners with taxable income from other sources can offset it with their share of the flow-through deductions, but only if they have invested cash in the company or otherwise have “basis.”
- Once company is profitable, profits subject to single tax (except state tax on S corp) not double tax like C corporation

S Corporation

Advantages

- Can issue stock options. Employees more familiar than with LLC “profits interests.”
- Eligible to use tax-free reorganizations, such as stock-for-stock merger
- No self-employment tax on money paid out to active employees as a dividend

Disadvantages

- California 1.5% tax on S corporation income
- Cannot include share of entity debt in tax basis
- No more than 75 shareholders in an S corporation, and no shareholder can be a C corporation or non – U.S. person
- S corps may not have more than one class of stock; can't have over 80% owned subsidiary
- All gains and losses have to be passed through proportionate to the shareholder's stock stake in the company.

Elect S corporation status by filing IRS Form 2553, California FTB Form 3560

Built – in gain rule.

LLCs

Advantages

- No California 1.5% income tax
- Can include share of entity debt in tax basis

Disadvantages

- California Limited Liability Company Fee based on total income (if over \$250,000) ranging from \$900 to \$11,790.
- No stock options; instead less familiar profits interests
- Self-employment tax on “dividends” to active employees - 15.3% of profits up to \$87,900 and 2.9% above that
- Not eligible to use tax-free reorganizations

C / S Corp. Distributions

(assumes income not "zero'd out")			
	C Corporation	S Corporation	
Net pre-tax corporate income	\$100.00	\$100.00	
California franchise tax (8.84% C; 1.5% S)	\$8.84	\$1.50	
Federal corporate tax (@ 34%)	\$30.99	\$0.00	
After-tax income	\$60.17	\$98.50	
Dividend (or shareholder share of income)	\$60.17	\$98.50	
Calif tax on div. or on share of S corp inc. (@ 9.3%)	\$5.60	\$9.16	
Fed tax on dividend @15%	\$8.19		
Fed tax on share of S corp inc.@ 35%		\$31.27	
Net income to shareholders	\$46.38	\$58.07	

C / S Corp. Sale

	C Corporation	S Corporation
Net price for assets	\$100.00	\$100.00
California franchise tax (8.84% C; 1.5% S)	\$8.84	\$1.50
Federal corporate tax (@ 34%)	\$30.99	\$0.00
After-tax income	\$60.17	\$98.50
Distribution (or shareholder share of income)	\$60.17	\$98.50
Calif ind. tax (@ 9.3% (10.3% if over \$1,000,000))	\$5.60	\$9.16
Fed tax on distribution @ 15%	\$8.19	
Fed tax on share of S corp gain (assuming mostly capital assets) - 15%		\$13.40
Net income to shareholders	\$46.38	\$75.94

Why VCs like C Corporation

- Venture funds themselves are often structured as LLCs or limited partnerships; the VC fund therefore passes through its taxable income or loss to its partners; many of the investors in VC funds are tax exempt (pension funds, university endowments)
- Pass-through of early stage losses by startup give no benefit to tax-exempt investors in VC fund; They'd rather see the NOLs accumulate and later benefit the company
- When an otherwise tax-free entity owns equity of an operating LLC, it becomes taxable on its share of pass-through income ("unrelated business taxable income" or UBTI), so in later stage the VC fund investors may have taxes to pay
- For these reasons, many VC funds have written into their partnership agreements that they cannot own interests in LLCs or partnerships

Jurisdiction of Incorporation

- Delaware, California or other
- If not funded yet, California is slightly cheaper because no extra Delaware fees to pay (paying in California anyway due to residence)
- If funded by VCs, they may insist on Delaware

Hiring and Paying Employees

- Employment Agreements / Offer Letters
- Termination of Employment
- Workers Compensation Insurance
- Wage and Hour Issues
- Payroll Withholding; Employee Posters

Employment Agreements – Offer Letters

- Employment at will, versus for a specified term; hybrid – at will but with specified severance upon termination
- Offer letter can contain acknowledgement of at-will status or other basic terms
- If it is for a term, duration as compared to vesting schedule
- Benefits eligibility (not commitment or particular plans)
- Web site has samples of employment agreement, offer letter, and invention assignment / proprietary rights agreement

Termination of Employment

- Accurate records of periodic written evaluations are useful in rebutting a charge of prohibited discrimination
- If an employer discharges an employee, the wages earned and unpaid at the time of discharge are due and payable immediately (California Labor Code §201)
- Release of claims may be signed by employee in exchange for severance exceeding contractual commitment
- Special rules apply for valid release of age discrimination claim
- Web site has sample form of release of claims

Workers Compensation Insurance

- California requires all employers to have workers comp insurance (certain large employers can self-insure)
- WC system is a compromise – compensation to employee for medical expenses and lost wages due to any work-related injury, regardless of fault; employer free of negligence suits
- Failure to get required insurance is a misdemeanor punishable by a fine of up to \$10,000 or jail up to a year or both (Cal. Labor Code §3700.5)
- Obtain private insurance through an insurance broker; there is also a state insurer.
- More info: California Department of Industrial Relations, www.dir.ca.gov

Wage and Hour Issues

- Main issue: whether employees must be paid overtime pay for work over 40 hrs/week or 8 hrs/day
- Need to designate all employees as either "exempt" (from overtime) or "non-exempt"
- Most managers and high-level administrators will be exempt; clerical employees generally non-exempt
- Special rules exist for some highly trained computer employees -- see <http://www.dir.ca.gov/lwc/IWCArticle17.pdf>
- More information at <http://www.dir.ca.gov/DLSE/dlse.html>

Payroll Taxes

- Income tax (fed and state), unemployment (federal FUTA and Cal. UI), SDI (state disability), California ETT (employment training tax)
- Withhold where required (fed and state unemployment taxes and Cal ETT are employer taxes, not withheld)
- Pay to government
- Report
- Can outsource to payroll service (such as Paychex)
- If you fail to withhold for federal and state income tax and state disability insurance, you can be liable for the taxes anyway, as well as penalties and late charges

Employee Notices

Required by state or federal law to be posted where employees can see them, covering a variety of topics including:

- safety and health (Cal/OSHA)
- workers' compensation
- discrimination and harassment (Cal. Dept. FEH)
- minimum wage; family/medical leave, pregnancy
- whistleblower protection
- equal employment opportunity
- time off for voting
- polygraph protection
- unemployment insurance
- state disability insurance

Get from Paychex payroll service or from the California Chamber of Commerce, <http://www.calchamberstore.com/Store/Products/05RNFAQs.htm>

Employee Equity / Stock Options

- Internal Revenue Code §83 – transfer of property in exchange for services
- Stock grants, restricted stock, stock options
- “Incentive Stock Options” qualified under Internal Revenue Code §422 versus “nonqualified” options taxed under IRC §83
- Accounting treatment
- Vesting and acceleration
- Sizes of grants

IRC Section 83

- Applies to transfer of property in exchange for services; Property may be stock or “restricted stock”
- Excess of fair market value at vesting over amount paid (if any) included in gross income upon vesting - §83(a)
- May surprise a consultant who agrees to take payment ½ in stock (e.g. \$20,000 fee, \$10,000 cash, \$9,000 tax at 45% combined rate)
- 83(b) election – May file a short document with IRS within 30 days after transfer to elect taxable event at transfer date without regard to vesting restrictions
- If property is subsequently forfeited, no deduction allowed
- Holding period for capital gains starts at vesting

Restricted Stock Example 1

Grant of 10,000 Shares Restricted Stock when FMV is \$0.01 per Share							
2 year vesting							
	<u>Value per Share</u>	<u>Number of Shares Vesting</u>	<u>Value Vested (or Sold)</u>	<i>No 83(b) Election</i>		<i>83 (b) Election</i>	
				<u>Ordinary Income Tax (@45% combined)</u>	<u>Capital Gain Tax (@24% combined)</u>	<u>Ordinary Income Tax (@45% combined)</u>	<u>Capital Gain Tax (@24% combined)</u>
Grant	\$0.01	0	\$0	\$0		\$45.00	
1 year	\$1.00	5,000	\$5,000	\$2,250			
2 year	\$10.00	5,000	\$50,000	\$22,500			
Sale	\$20.00		\$200,000		\$34,800		\$47,989
Subtotals				\$24,750	\$34,800	\$45.00	\$47,989
Total Tax Bill				\$59,550		\$48,034.20	

Restricted Stock Example 2

Grant of 10,000 Shares Restricted Stock, when value is \$1.00 per Share						
2 year vesting						
			<i>No 83(b) Election</i>		<i>83(b) Election</i>	
			<u>Ordinary</u>	<u>Capital Loss</u>	<u>Ordinary</u>	<u>Capital Loss</u>
			<u>Income Tax</u>	<u>Deduction</u>	<u>Income Tax</u>	<u>Deduction</u>
<u>Year</u>	<u>Value per Share</u>	<u>Number of Shares Vesting</u>	<u>(@ 45% combined)</u>	<u>(@24% combined)*</u>	<u>(@ 45% combined)</u>	<u>(@24% combined)*</u>
Grant	\$1.00	0	\$0.00		\$4,500.00	
1	\$1.00	5,000	\$2,250.00			
Sale	\$0			\$1,200.00		
Subtotals			\$2,250.00		\$4,500.00	\$0.00
Total Tax Bill			\$1,050.00		\$4,500.00	

*Capital Loss is deducted first against capital gain; any remaining net loss may be deducted against ordinary income, but only up to \$3,000 per year, with the remainder carried forward

Stock Option – Tax Treatment

Nonqualified Options - § 83 and 409A

- No taxable event at grant or vesting as long as exercise price is not less than fair market value at grant
- Taxable event at exercise (assuming exercise occurs at or after vesting)
- Employee has ordinary income equal to the “spread” between value and exercise price on date of exercise (if vested)
- Company has deduction of same amount
- Possible strategy if grant is very early and exercise price very low – exercise immediately and make “Section 83(b) election;” risks exercise price, but no current tax impact if exercise price equals fair value, and enables future capital gain; employee will not get a tax loss with respect to any reported income from the Section 83(b) election if the stock is ultimately forfeited

Stock Options – Tax Treatment

“Incentive Stock Options” qualified under IRC §422

- No tax on grant or exercise (except possible AMT on exercise)
- Employee has capital gain upon sale of underlying stock at spread between sale price and exercise price
- Company gets no deduction (note tax detriment to the company of using ISOs rather than NQSOs may exceed tax benefits to employee)
- Requirements: Exercise price not less than fair market value of stock on date of grant; at least two years elapse between grant of option and sale of underlying stock; at least one year elapses between exercise of option and sale (employee risks exercise price)

Stock Options – Accounting

- FAS 123R
- All companies required to expense options

Stock Options - Vesting

- Vesting periods typically 3 – 5 years, with 4 years the most common
- Often a 1-year cliff and then monthly vesting thereafter
- Acceleration of vesting upon sale of company – full acceleration no longer as common; partial acceleration an alternative

Stock Options – Size of Grants

- Grants to individuals tend to be larger in earlier stage of company's life and progress downward, both due to increasing value of company and increasing sophistication
- Employee pool usually 15 – 20%
- Non-founder CEO: around 5 – 6 %
- Next tier (CTO, CFO, Senior VP or top person in departments such as sales, manufacturing): 0.5% - 2%
- Next tier – VP or director level – 0.3% - 0.75%
- Plan out tiers in advance and be consistent
- Agreements should always state number of shares, not percentages, and where possible employee statements may also be phrased in terms of number of shares

Employee Equity – Timing of Grants

- If you are certain you want to give employees equity, don't wait until you have a term sheet from investors
- If price charged to employees is low compared to value implicit in financing, this causes “cheap stock” problem
 - Would disqualify a supposed ISO
 - Section 409A tax
- Companies funded with convertible preferred stock – common stock option exercise price was often set at 10% - 20% of preferred stock price, with difference justified by reference to liquidation preference and other rights of preferred
- Now some companies getting valuation for IRC Section 409A

Equity Compensation in LLC

“Profits Interest”

- If company were to liquidate immediately after grant, employee is not entitled to share in distribution (may require book up of capital accounts to accomplish)
- Holder is entitled to share a specified percentage of the company's appreciation in value after grant of the interest
- Grant of a profits interest does not result in U.S. federal income tax to recipient
- Federal tax treatment of compensatory options in LLC or partnership uncertain

Financing – Securities Laws

- Federal
 - Reg D private placement safe harbor
 - No general solicitation
 - Rule 504 or Rule 505 or Rule 506 – alternative dollar and purchaser limitations
 - For Rule 505 and 506, if any purchasers are not accredited, must make prepare a substantial disclosure document, with the exact scope depending on offering size
 - File Form D with SEC (simple)
- California or other state requirements may also apply

Regulation D Detail

Purchaser and Dollar Limits

- Rule 504: \$1 million limit (in a 12-month period); must be registered under a state's securities laws, or, if state-exempt, then must be only to "accredited investors;" no prescribed disclosures (other than anti-fraud rules)
- Rule 505: \$5 million limit (in a 12-month period); 35 purchaser limit (not counting accredited investors)
- Rule 506: no dollar limit; 35 purchaser limit (not counting accredited investors); non-accredited purchasers must have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment

Accredited Investor Definition

- A person with a net worth (or joint net worth with spouse) over \$1,000,000
- A person with an income in excess of \$200,000 for the last 2 years (or joint income with spouse over \$300,000) and a reasonable expectation of reaching the same income level in the current year
- Most institutional investors, corporations with total assets over \$5,000,000, and directors and officers of the company issuing the securities

State Securities Laws

- If offering meets the Federal Rule 506 exemption, the most any state can require is a post-offering notice filing and a fee (National Securities Markets Improvements Act of 1996)
- Otherwise, look for registration exemption in each state

California Private Placement Exemption

California Corporation Securities Law §25102(f)

- Sales to not more than 35 persons (including outside California)
- All purchasers either have a preexisting personal or business relationship with the company or with its officers or directors, or by reason of their business or financial experience could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction
- No advertisement
- File Form 25102(f) (can do online now)

Broker – Dealer Registration

- Transaction exemption not enough
- Who is selling the securities?
- Federal and state broker registration requirements
- Exemption for employees of the issuing company, provided that their compensation is not “commission” based
- Pitfalls
 - Individual raising funds is a consultant not an employee
 - Compensation is tied to fund-raising
 - Individual has worked as a stock broker

Leasing Real Estate

- Duration; option(s) to extend
- “gross lease” - landlord pays for property tax, insurance for the building, repairs and maintenance (not insurance for your property or your liability exposure)
- “triple net lease” - in addition to base rent, tenant pays a share of landlord’s operating costs for the building, including taxes, insurance, repairs and maintenance, allocated based on square footage
- Improvements – will the landlord pay for some or all? (will depend partly on the duration of the lease, the rent and other factors)
- Improvements at your own expense - make sure the lease permits the changes you plan, and is clear regarding what you can or must remove at the end of the term, and any obligation to repair resulting damage
- Go over the insurance provisions of the lease with your insurance broker, before you sign the lease (recommendations re changes; advice re availability and costs of required coverage; help arranging for coverage once lease is signed)
- Personal Guarantee?

Miscellaneous

- General Liability Insurance – covers personal injury or property damage if you or employees are negligent, for example a visitor to your premises falls on a slippery floor; injured person can claim mental anguish as well as physical injury; also covers libel, slander, defamation
- Trademark – basic name search can be done at <http://tess2.uspto.gov/bin/gate.exe?f=tess&state=tddq9m.1.1>; online application for registration at <http://www.uspto.gov/teas/index.html>
- Confidentiality agreements with parties to whom technology is disclosed (sample attached)
- If selling or leasing goods, need California seller's permit from State Board of Equalization, www.boe.ca.gov
- Check whether any licensing or permit requirements exist for your chosen business line, <http://www.calgold.ca.gov>

Cost of Legal Services

Task	Approximate Fee
Incorporation (without shareholder agreement)	\$3,000
Inter-founder or shareholder agreement	\$5,000
LLC Formation	\$5,000
Stock Option Plan	\$4,000
VC Financing	\$25,000 for company counsel; \$20,000 for investor counsel
Angel financing	same as above; more if investor counsel not experienced
Patent Applications	Variable – provisional / full U.S. / foreign

Legal Service Strategies

- Before funding, establish relationship, discuss payment openly, consult liberally, document only where essential
- Where might it be essential?
 - Document inter-founder deal?
 - Invention disclosure (deal with OTT)
- Keep it simple
- Avoid heavily documented small financing (\$200,000 convertible debt from unrelated angel)
- Explore using equity to compensate professionals for risk and delay in payment
- Re-establish contact with wealthy uncle
- American Express card

Sample Forms

Available to clients at www.stephenrothman.com

- Nondisclosure Agreement - Mutual
- Nondisclosure Agreement – Unilateral
- Employment Offer Letter (at will)
- Employee Proprietary Information and Inventions Agreement
- Employment Agreement (specified term)
- Separation Agreement and General Release
- Purchase Terms
- Sale Terms

Learn from Others' Mistakes

- Failure to accurately gauge the market, or bad market timing
- Failure to bring in expertise that founder doesn't have
- Starving the business for cash because of unwillingness to share equity (greed)
- Giving away equity without commensurate value, whether to investors or collaborators
- Disregard of cost of goods side of business plan
- Wrong investor
- Hesitation / indecision

Representative University Spinout Clients

AquaNano, LLC (Caltech)
BCN BioSciences (UCLA)
Colloidia LLC (UCLA)
Diatech Oncology, LLC (Vanderbilt)
Fastsoft, Inc. (Caltech)
Gevo, Inc. (Caltech)
Librede LLC (UCLA)
Nidus, Inc. (U. Penn. Medical School)
Phasebridge, Inc. (Jet Propulsion Laboratory)
PrintAmp, Inc. (UCLA)
Silvus Technologies, Inc. (UCLA)
Situs Logic (Caltech)
Unidym, Inc. (UCLA)

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