The American Bar Association
Section of Business Law Committee
on Middle Market and Small Business,
Committee on Private Equity and Venture Capital,
General Practice, Solo and Small Firm Division and the
ABA Center for Continuing Legal Education
Present

Start Smart

What Start-Ups Should Know (and How to Tell Them) About Choice of Entity, Owners' Agreements, and Funding

Defending Liberty
Pursuing Justice

CLE

American Bar Association
Center for Continuing Legal Education
321 North Clark Street, Suite 1900
Chicago, IL 60654-7598
www.abanet.org/cle
800.285.2221, select option 2

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Choice of Entity. . .

Legal Structures for Your Small Business

Jean L. Batman, Esq.
Tel. (415) 462-5514
Fax. (415) 680-2346
JLBatman@LegalVC.com

Legal Venture Counsel, Inc.
1045 Sansome St., Ste. 110
San Francisco, CA 94111
www.LegalVC.com

Entity Choices. . .

- Sole Proprietorship (DBA)
- General Partnership (GP)
- Limited Partnership (LP)
- Limited Liability Company (LLC)
- Limited Liability Partnership (LLP)
- C Corporation
- S Corporation

(There are others, such as non-profits and real estate investment trusts to discuss on another day!)

Preliminary Considerations

- Do the parties need limited liability?

Liability Limited?

	Yes	No
Sole Proprietor (dba)		X
General Partnership (GP)		X
Limited Partnership (LP)	X	X
Limited Liability Company (LLC)	X	
Limited Liability Partnership (LLP)	X	
C Corporation	X	
S Corporation	X	

Preliminary Considerations continued

- Do the parties want profits and losses to pass through to their personal income tax returns?

Pass through tax treatment?

	Yes	No
Sole Proprietor (dba)	X	
General Partnership (GP)	X	
Limited Partnership (LP)	X	
Limited Liability Company (LLC)	X	X
Limited Liability Partnership (LLP)	X	X
C Corporation		X
S Corporation	X	

Preliminary Considerations continued

- Will all of the parties be actively involved in management?

All owners active?

	Yes	No
Sole Proprietor (dba)	X	
General Partnership (GP)	X	
Limited Partnership (LP)		X
Limited Liability Company (LLC)	X	X
Limited Liability Partnership (LLP)	X	X
C Corporation	X	X
S Corporation	X	X

Preliminary Considerations continued

- Considerations for capital structure:
  - How much capitalization is needed?
  - How much will be raised from third parties?
  - Debt or equity?
  - Likely sources?
  - What would the parties providing capital expect in return?
  - Is there a form of entity that the funding sources would prefer or, alternatively, would avoid?
  - What level of corporate formality is possible or desired?
  - What is the expected length of the investment/venture and what is the exit strategy?

The C Corporation Bias

- Where the parties envision raising venture capital;
- Making a public offering of stock (IPO);
- Dealing with certain licensors/licensees;
- Building up value in the entity;
- Benefiting from IRC Section 1202 - the exclusion of up to 50% of the gain on sales of stock in certain types of C-corporations held for more than five years; and/or
- Offering equity incentives to key employees;

The C corporation may be the best choice.

Definitions

- Sole Proprietorship (dba)

  Def. A business owned by one person.

  If you open your own business, but don't choose an entity, you will be a sole proprietor by default.

  A fictitious business name filing is required if the business is conducted in any name other than the individual's, e.g. Jean L. Batman dba Southern California Fruit. Filings are recorded at the County recorder's office in the County where the business is located and must be renewed every five years. Publication is also required.

Definitions continued

- General Partnership (GP)

Def. A business enterprise entered into for profit which is owned by more than one person, each of whom is a "partner."

A general partnership may be created by a formal written agreement, but may be based on an oral agreement or just a handshake.

This is also a default category that may govern where no entity is chosen. A written agreement can prove to be critical.

(May also require a fictitious business name filing.)

Definitions continued

- Limited Partnership (LP)

Def. A limited partnership is a partnership which limits the responsibility of certain partners for debts beyond their investment. The investing "limited partners" enjoy limited liability, but cannot participate in management and are limited to specific percentages of profit.

A limited partnership requires a written agreement between the business management, who is the general partner or partners, and all of the limited partners.

Limited partnerships must make a filing with the Secretary of State.

Form LP-1 Certificate of Limited Partnership is available online at www.ss.ca.gov/business/lp/forms/lp-1.pdf.

Definitions continued

- Limited Liability Company (LLC)

  The Beverly-Killea Limited Liability Company Act of 1994 authorized the formation of Limited Liability Companies (LLCs) in California (we were one of the last states to adopt an LLC Act). Subsequent legislation permitted the formation of single-member LLCs in California.

  LLCs combine traditional corporate and partnership characteristics. This is a very versatile form of entity. However, certain types of businesses cannot be conducted as LLCs.

  A written operating agreement can be critical.

  Form LLC-1 Articles of Organization are available online at www.ss.ca.gov/business/llc/forms/llc-1.pdf.

Limitations on LLCs

- Does the business require a license under the California Business and Professions Code?

  Businesses requiring licensure under the B & P Code include General Contractors, Health Care Providers, Pharmacies, Veterinarians, Lawyers, Accountants, Architects, Locksmiths, Funeral Directors, Real Estate Appraisers, and others. . .

  If so, the LLC is not a permissible form of doing business.

Forming an LLC

- File Articles of Organization on a prescribed form with the Secretary of State's Office and pay the required filing fee.
- A written Operating Agreement is also recommended.
- Fewer formalities may be required in managing an LLC as compared with a corporation.
- The LLC is a very flexible entity and is less formal than the corporation – members, managers, preferred returns (i.e. different classes of owners), etc.
- For more information about organizing or registering an LLC in California, visit the Secretary of State Website: www.ss.ca.gov.

The LLC Annual Fee

- In addition to the $800 Annual Tax, LLCs classified as partnerships or disregarded entities are also subject to an annual fee based on their total income.
- Effective January 1, 2007, LLCs calculate the annual fee on an apportioned basis based on "total income from all sources derived or attributable to this state."
- The LLC fee is due on the original due date of the return, which is the 15th day of the fourth month following the close of its taxable year.
- Because of the Annual Fee, the S Corp. can be a more attractive alternative where LLC flexibility is not required.
- LLCs classified as a corporation file corporate estimated tax forms and California corporation franchise or income tax returns.

Calculating the LLC Fee

If the LLC's Total Income is: Equal to or More Than:	And Less Than:	For 2001 and After The Fee Amount is:
$250,000	$500,000	$900
$500,000	$1,000,000	$2,500
$1,000,000	$5,000,000	$6,000
$5,000,000 or more		$11,790

Definitions continued

- Limited Liability Partnership (LLP)

In California, LLP's can only be used for the practice of law, architecture, or public accountancy, or a related business.

Form LLP-1 for Registered Limited Liability Partnership Registration is available online at www.ss.ca.gov/business/llp/forms/llp-1.pdf.

Definitions continued

- C Corporation

  Def. An organization formed with state govt. approval to act as an artificial person to carry on business, which can sue or be sued, and can issue shares of stock to raise funds.

  One benefit of a corporation is that its liability for damages or debts is limited to its assets, so the shareholders and officers are protected from personal claims, unless they commit fraud.

  For information about the minimum statutory requirements for Articles of Incorporation to be filed with the California Secretary of State and filing instructions, see www.ss.ca.gov/business/corp/pdf/articles/corp_artsgen.pdf.

Corporate Organization:

- Articles of Incorporation (Certificate of Incorporation) are filed with the Secretary of State to establish the number of authorized shares, classes of stock, par value, agent for service of process, etc.
- Incorporator Action (Statement of Incorporator) adopts Articles and Bylaws and appoints initial Directors
- Bylaws – provisions dictated largely by the Corporations Code, setting forth corporate governance provisions
- Board Resolutions (by meeting or written consent) – appoint officers, authorize the issuance of stock, etc.
- Shareholders elect members of the Board of Directors

Definitions continued

- S Corporation

  Def. A small corporation whose owners have elected to be treated as a partnership for tax purposes by the Internal Revenue Service under "subchapter S".

  There are quite a few restrictions on the number and type of owners and classes of stock permissible in the S Corp (discussed below).

  However, in most ways, the S Corp is just like the C Corporation.

Limitations on S corporations:

- No more than 100 Shareholders;
- Shareholders can be only individuals, estates, tax exempt organizations and certain trusts (but not all);
- No non-resident alien shareholders;
- Only one class of stock (voting and non-voting okay);
- No banks, thrifts, insurance companies, possessions corps, or domestic international sales corps; and
- Must have a permissible tax year – December 31.

To make an S Corporation election, use Form 2553 available online at www.irs.gov/pub/irs-pdf/i2553.pdf.

Selecting the State of Formation:

- To what extent is the law of a particular state a benefit?
- Is choice of law an issue?
- While some states have well developed corporate law, others have focused on particular areas of home concern – e.g. water rights, oil and gas leases, etc.
- The state of incorporation may be freely chosen, but choice of law for a limited partnership must bear at least a reasonable relation to the business.
- If a particular entity, say an LLC, is selected as the best fit, which of the available state laws have the most favorable default rules for the business structure?
- **Avoid unnecessary taxes and regulations!**

Some Other Legal Requirements

- Annual Statement of Information (officers, directors, and agent for service of process) and filing fee to Secretary of State (except sole proprietor and general partnership);
- Taxes: Annual Franchise Tax Fee (except sole proprietor and general partnership), State and Federal tax returns, sales and use taxes (Seller's Permit – State Board of Equalization), personal property taxes (some counties);
- Local Business License, Professional Licensing;
- Federal Employer Identification Number (FEIN);
- Insurance – unemployment and workers' compensation, liability, etc.
- Qualification to do business in other states.

Owners' Agreements

Worth the time and effort to define:

- Relative duties and contributions of the parties;
- Relative benefits or returns to the parties;
- Intellectual property rights (competition, trade secrets);
- Rights of first refusal;
- Buy-sell provisions (e.g. covering retirement or death);
- Procedure or formula for valuation;
- Deadlock provisions (planning for discord); and
- Dispute resolution, jurisdiction, choice of law, venue.
- Revisit the agreement periodically!

Thank you for coming.

Nothing in this presentation should be considered legal or tax advice or be considered to have created an attorney-client relationship. The information contained herein is necessarily incomplete and is not tailored to the specific circumstances of any individual situation. Please consult your own advisors for legal, tax or other advice unique to your situation.

START SMART: WHAT CLIENTS NEED TO KNOW
(AND HOW TO TELL THEM) ABOUT ENTITY SELECTION,
OWNERS' AGREEMENTS AND FUNDING

"Carried Interest" Update

L. Andrew Immerman

Alston & Bird LLP

andy.immerman@alston.com

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Equity for Services: Corps

- An employee or other service provider is taxable on the receipt of C Corp or S Corp stock as compensation for services, although the tax can be deferred until the stock is vested. § 83.

Grant of Equity for Services: LLCs

- A service provider is generally not taxable on receipt of a vested or unvested "profits interest" in an LLC as compensation for services to or for the LLC. See Rev. Proc. 93-27, 1993-2 CB 343; Rev. Proc. 2001-43, 2001-2 CB 191.
- ***LLC is assumed here to be classified as a partnership for tax purposes; we won't distinguish between LLCs and partnerships here.***

Grant of Equity for Services

"Capital Interest" =

- Any interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value, and the proceeds distributed in a complete liquidation of the partnership.

"Profits Interest" =

- Any partnership interest other than a capital interest.

Current Law: Rev. Proc. 93-27

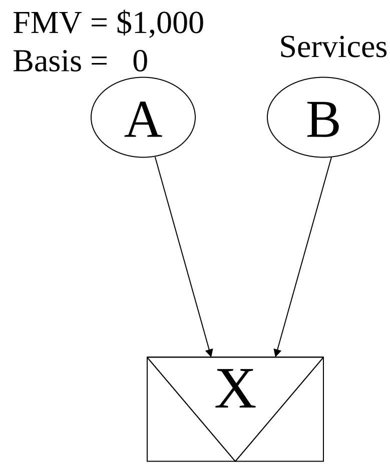
- IRS will accept that the receipt of a profits interest in exchange for services is not a taxable event for the partnership or the recipient, if:
  – The interest isn't related to a substantially certain and predictable stream of income from partnership assets.
  – The interest is not disposed of within two years.
  – The interest is not a limited partnership interest in a publicly traded partnership.

Current Law: Rev. Proc. 2001-43

- Rev. Proc. 93-27 applies to a profits interest that is subject to substantial risk of forfeiture *if* partnership and recipient treat the recipient as the owner of the partnership interest from the date of grant.
- Section 83(b) election is *not* required, although is often recommended as a protective measure.

Example:
Equity for Services

- A and B form X. Each has an equal interest.
- A contributes property with a fair market value of $1,000 and a basis of zero.
- B contributes future services that he will perform for X, and receives an unrestricted interest in X.



Equity for Services:
If X is a Corp

- A and B both have taxable gain.
- A has gain, equal to $1,000, because he is not in control of X immediately after the exchange (and is not part of a control group).
- B has taxable ordinary income equal to $500 (assumed to be the value of his interest in X).
- However, X may have a $500 deduction for the compensation to B.

Equity for Services: If X is an LLC

- A has no taxable gain.
- In general, B also will have no taxable gain, provided he receives only a *profits interest* in X.

Carried Interests: Current Law

- Carried interest = "carry" or "promote."
  - A kind of profits interest issued for services.
- The holder of a carried interest ("Manager") typically participates in a *percentage* of the LLC's future profits (for example, 20%), after some return to the cash investor.
- Manager may put in cash (perhaps 1% - 10% of the total equity), but the carried interest is not granted for the cash.

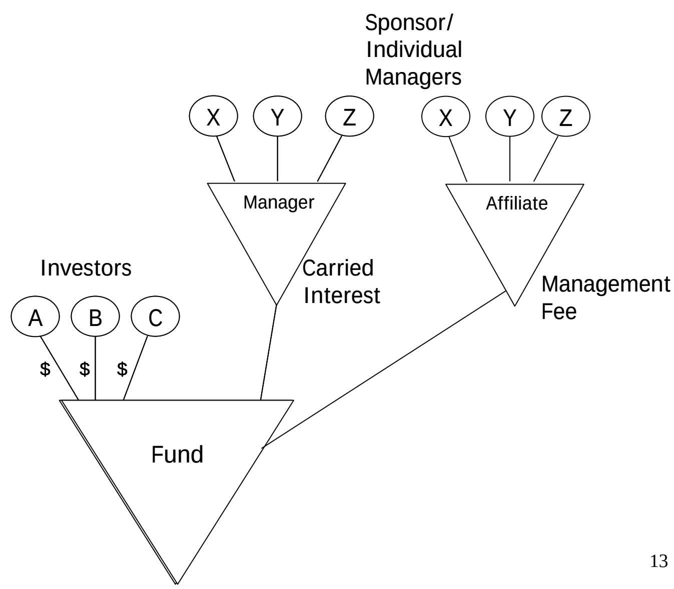
Carried Interests: Current Law

- Manager reports its distributive share of income, gain, loss, deduction and credit.
- No one deducts any amount as wages, compensation or otherwise with respect to Manager's share of income.
- *If the LLC recognizes long-term capital gain, Manager (or individual owners of the Manager entity) is taxed on its share of the gain at capital gain rates.*
- Maximum long-term capital gain rate for individuals is generally 15%, rather than 35%.

Carried Interests

- Carried interests have been around for decades.
  - They suddenly spawned controversy in 2007 because of publicity surrounding private equity managers' huge capital gains (and lavish spending).
- If the LLC has ordinary income, Manager's share is ordinary as well.
- In addition, Manager or an affiliate of Manager has a service contract providing for a management fee (for example, 2% of assets).
  - Management fee is conceded to be ordinary income.
  - However, sometimes the management fee is "converted" into a profits interest, which arguably converts the ordinary income into capital gain.

Simple Carried Interest Structure



Proposed Regulations

- Proposed regulations on partnership equity granted for services were issued more than four years ago.
  - REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).
- Treasury reportedly is ***not*** working on finalizing the regulations, but – quite reasonably – is waiting to see what Congress does.

Carried Interest Proposed Legislation

- Several bills have been introduced in Congress to add new "Section 710" to the Code.
- There are differences among the bills but all would:
  - Characterize allocations attributable to many carried interests as ordinary income, subject to:
    - Ordinary income tax rates *plus*,
    - Self-employment tax.
  - Apply to many investment entities besides private equity funds.
  - Deny any compensation deduction to the other LLC members.
  - Continue to permit carried interests to be received free of initial tax.

Carried Interest Proposed Legislation

- All versions have some exception for invested capital.
  - To the extent managers receive a return on their own invested capital, Section 710 does not apply.
  - However, exception is narrow.
- "Rangel Bills."
  - Passed twice by the House, but not enacted.

Carried Interest: 2009 Proposals

- Obama Administration "Green Book"
  - Treasury Department General Explanation of the Administration's Fiscal Year 2010 Revenue Proposal (May 2009).
  - Would be effective for taxable years beginning *after December 31, 2010*.
  - Would not affect income reported in 2009 or 2010.
  - However, presumably would affect income reported in later years, *regardless of when the carried interest was granted*.
  - Might be intended to apply to *all* carried interests for services, even for day-to-day managers of active businesses.

Carried Interest: 2009 Proposals

- "Levin Bill"
  - HR 1935, introduced April 2, 2009, by Congressman Levin.
  - Would add a version of Section 710.
  - Would also amend Section 83.
    - Value of a carried interest equal liquidation value.
    - Automatic election under Section 83(b) unless the recipient elects *out*.
  - No effective date stated.
  - Conventional wisdom says it *can't* be effective any time 2009 (but conventional wisdom is unreliable).

What Can Managers Do?

- Some techniques that might work under some versions of Section 710 are prohibited under others.
- Be skeptical of news reports suggesting that managers are rushing en masse to restructure their carried interests.
- For example, under Green Book, it won't work for the managers to:
  - Borrow from the cash investors to make a bigger capital investment in the LLC.
  - Take convertible or contingent debt, options, or derivatives, with respect to the LLC.

What Can Managers Do?

- A business owner who can borrow from a *third party* – not related to the other investors, if any – can still get capital gains, creating a perverse incentive for debt financing if you can get it.
- Some managers have tried to accelerate capital gains into 2008 or 2009 by, *e.g.*, *selling* their carried interests (and having the LLCs make "Section 754" elections).
- Some managers are structuring new arrangements as corporations rather than LLCs in anticipation of Section 710, which may or may not make sense.

Single-Member LLCs: New Employment Tax Rule

- Most single member LLCs are classified as disregarded entities for federal income tax purposes.
- *New rule:* Effective January 1, 2009, disregarded LLCs will be treated as *corporations* for federal employment tax purposes.
  - Treas. Reg. § 301.7701-2(c)(2)(iv), as amended by TD 9356, 2007-39 I.R.B. 675.

Single-Member LLCs: Employment Tax

- If the single-member LLC has employees, it must report and pay federal *employment taxes* under its own name and have its own taxpayer identification number.
  - New rule covers FICA, FUTA, and income tax withholding on wages.
  - New rule does *not* cover self-employment tax (when single-member LLC is owned by an individual).
- *Income tax treatment of single-member LLCs is not affected.*
- Previously, Notice 99-6, 1999-1 CB 321, gave taxpayers two choices:
  - Treat single-member LLC as employer.
  - Treat single-member LLC's owner as the employer.

	LLC/Partnership	S Corporation	C Corporation
Limited Liability	Generally yes for all members (with LLCs, LLPs, and LLLPs).	Yes for all shareholders.	Yes for all shareholders.
Levels of Federal Income Tax	One	Generally one, unless it was formerly a C corporation or acquired C corporation assets tax-free.	Two. Currently rates on many dividends to individual shareholders are low.
Number of Owners	At least two. May be taxable as a corporation if publicly traded, or treated as a tax nothing if only one member.	One to 100 (with some family members counted as one owner)	No restrictions.

	LLC/Partnership	S Corporation	C Corporation
Types of Owner	No restrictions.	Generally limited to U.S. individuals, certain U.S. trusts, and tax-exempt entities.	No restrictions.
Classes of Ownership	Multiple classes permitted.	One (but differences in voting rights are permitted).	Multiple classes permitted.

	LLC/Partnership	S Corporation	C Corporation
Tax-Related Transfer Restrictions	Generally no. May be taxable as a corporation if publicly traded. Technical "termination" on certain transfers.	Yes. Transfer to an ineligible shareholder terminates S status. Cannot exceed 100 shareholders.	No
Tax Restrictions on Converting to Other Form	Generally can convert tax free (but must comply with Section 351).	Generally can convert tax free only to C corporation.	Generally can convert tax free only to S corporation (if eligible).

	LLC/Partnership	S Corporation	C Corporation
Participation in Tax-Free Corporate Mergers/ Acquisitions	No	Yes	Yes
Employment Tax on Owner/ Employee	Self-employment tax on share of business income to general partners, and to limited partners on guaranteed pay for services. Unclear treatment of LLC members.	Owner-employees are subject to FICA/FUTA.	Owner-employees are subject to FICA/FUTA.

	LLC/Partnership	S Corporation	C Corporation
Tax on Distributions	Nontaxable to the extent of a member's tax basis (with some exceptions).	Cash distribution: Generally nontaxable to the extent of the shareholder's basis. Property distribution: Generally one level of tax.	Cash distribution: Generally taxable to the shareholder. Property distribution: Generally taxable to both corporation and shareholder (two levels of tax). Tax to individual shareholders generally low under current law.

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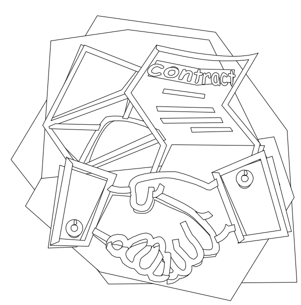
START SMART: WHAT CLIENTS NEED TO KNOW (AND HOW TO TELL THEM) ABOUT OWNERS' AGREEMENTS

Erik L. Kantz
Arnstein & Lehr LLP
120 S. Riverside Plaza, Suite 1200
Chicago, Illinois 60606
(312) 876-6671
elkantz@arnstein.com

OVERVIEW OF OWNERS' AGREEMENTS

- What are they?
- Who needs them?
- Why should clients have them?
- Where should you start?
- How should they operate?



WHAT ARE THEY?

- Owners' agreements are contracts among business owners governing one or more aspects of their business relationship and the operation of the business. Owners agreements can take many forms, including:
  - Partnership agreement
  - Shareholder agreement
  - Limited liability company operating agreement
  - Buy-sell agreement
  - Stock restriction agreement
  - Joint venture agreement
  - Stock option or stock grant agreements

STATUTORY AUTHORITY

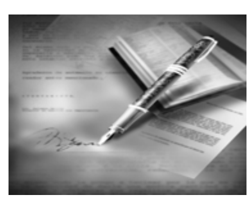
- Authority for shareholder agreements under corporate governance statutes (Section 218(c) of DGCL, Section 7.71 of the Illinois BCA)
- Authority for operating agreements granted by limited liability company statutes
- LLC statutes (and in particular, Delaware's Act) create flexible schemes for crafting agreements
  - Consult with an accountant or tax attorney

INTERPLAY BETWEEN OWNERS' AGREEMENT AND CORPORATE STATUTES

- Regarding shareholder agreements, be mindful of statutory provisions which must be set forth in the articles of incorporation or bylaws.
- In drafting limited liability company operating agreements, owners are given broad latitude to vary statutory default provisions, although many states have a list of "untouchables" which may not be varied or eliminated by the operating agreement.

WHO NEEDS THEM?

- Every business can benefit from owners' agreements, and in particular any business with multiple stakeholders, whether those are the present owners or potential future owners, who intend to make a significant return on their investment in the business.
- Ideal "one-stop" contract



USES FOR OWNERS AGREEMENTS

- Create a well-defined organizational structure
- Create effective leadership, management and compensation systems
- Improve owner relations by determining relative rights, duties and benefits
- Improve management relations by clearly defining duties and responsibilities
- Manage expectations and conflicts among stakeholders before they ripen into costly litigation
- Define and manage non-competition arrangements

USES FOR OWNERS AGREEMENTS

- Protect intellectual property and trade secrets
- Protect from external threats, such as:
  - Risk from failure of business partners
  - Risk of litigation against business partners
  - Risk of extension of corporate liability to directors, officers and managers.
- Succession planning
- Ensure a market for the owners' interests in the business through buy-sell provisions

WHERE DO YOU START?

- Organization is the best time to start (with a clean slate), but can be done as changes occur in the business as well.
- In operating businesses, pay particular attention to existing corporate governance documents and contracts, including those of any subsidiaries and affiliates.

ADDRESS CONFLICTS OF INTEREST

- "Who is the client" is the first and key question when drafting owners' agreements. Oftentimes, attorneys are asked to represent multiple owners and the business, and therefore conflicts of interest must be discussed and waived IN WRITING.
- Rule 1.7 Conflict of Interest, Current Clients

FERRETING OUT CONFLICTS

- Be mindful of who brought you into the business and why. How well do you know the person? What prompted the client to seek an attorney? What issues has the person identified? Are there others?
- Who is active in the business? Are there financial owners and "sweat" owners?
- Who holds the authority? Who holds leverage?
- Evaluate each person's goals and expectations.

CONFLICT WAIVER

- The conflict waiver should (i) acknowledge the conflicts, (ii) explain the possible consequences of multiple representation (including that the parties may need separate counsel in the future at additional cost), and (iii) consent to the representation.
- Include an acknowledgment in the agreement as well, for example:

  The parties acknowledge that Arnstein & Lehr LLP has prepared this Agreement in its capacity as counsel to the Company, and each Member has been provided the opportunity to retain separate legal counsel as he or she deems appropriate to represent the Member in connection with this Agreement and the transactions contemplated herein. Each Member has the right to retain separate legal counsel, and the fees and expenses of such separate counsel shall be at the expense of such Member.

HOW SHOULD THEY OPERATE?

- While owners' agreements are far from one-size-fits-all, generally speaking, an owners' agreement should at a minimum address the following issues:
  - Capital contributions and distributions
  - Corporate governance and management
  - Business opportunities and conflicts of interest
  - Restrictions on transfers of ownership
  - Purchase and sale of interests (buy-sell provisions)
  - Valuation

CAPITAL CONTRIBUTIONS

- Inadequate capitalization is a leading cause for businesses, particularly start-ups, to fail. The agreement should balance the business' need for capital against the owners desire not to throw good money after bad, or suffer unfair dilution.

CAPITAL CONTRIBUTIONS

- In the event of a capital call:
  - Who makes the call? Board? Owner Approval?
  - Does non-participation lead to dilution? If so:
    - Should the business be required to first seek financing if it is available upon reasonable terms?
    - Provide a clear procedure to specify the amount of capital required and timing of contributions
      - Typically in proportion to ownership
      - Larger the amount, the more time to comply

CAPITAL DISTRIBUTIONS

- For corporations, generally in accordance with share ownership subject to preferences
  - S-Corporations, must be pro rata or risk loss of S-Corp status
- For LLCs, may structure distributions in any manner
  - Be sure that allocations of profit and loss comply with IRS rules and regulations
  - Beware of "capital shifts"
- For LLCs and S-Corporations, provide for tax distributions to the owners

CORPORATE GOVERNANCE – KEY MATTERS FOR APPROVAL

- Owners' agreements should address key governance matters such as:
  - Amendment of governing documents
  - Nomination and election of directors and managers
  - Removal of directors and managers
  - Filling vacancies of directors and managers
  - Issuance of shares or membership interests
  - Contributions of capital
  - Payment of dividends or distributions
  - Salaries and other compensation

CORPORATE GOVERNANCE – KEY MATTERS FOR APPROVAL

- Significant corporate expenditures
- Corporate borrowing
- Major contract approvals
- Employment matters, including hiring and firing
- Corporate re-structuring or merger
- Sales of assets outside the ordinary course
- Related-party transactions
- Sales of stock or membership interests

CORPORATE GOVERNANCE – KEY MATTERS FOR APPROVAL

- In each case:
  - Whose approval is required?
  - Threshold for approval?
    - Majority, super-majority, weighted voting or approval of certain owners
- Regarding appointments, certain owners may appoint certain directors and managers
- Extend agreements to subsidiaries and affiliates when appropriate

CORPORATE GOVERNANCE – DEALING WITH DEADLOCK

- Mediation
- Arbitration
- Referral to advisory board or third-party arbiter
- Officer casts deciding vote
- Trigger of buy-sell provisions
- Dissolution (rare)

CORPORATE GOVERNANCE – FIDUCIARY DUTIES

- Most common ground for disputes among owners are allegations of breaches of fiduciary duties. Owners should understand them and the agreement should address them.
  - Duty of loyalty – act in a manner that the person reasonably believes to be in the best interest of the company and its owners
  - Duty of care – perform duties with the knowledge, judgment, skill, diligence and timeliness that an ordinarily competent person in a like position would use under similar circumstances

CORPORATE GOVERNANCE – FIDUCIARY DUTIES

- Most LLC statutes allow owners to define the parties' fiduciary duties, and even eliminate them in some instances.
- At a minimum, the agreement should address:
  - Whether the owners will (must) actively participate in the business
  - Whether the owners may invest and/or actively participate in other businesses
  - Whether the owners are expected to offer opportunities in the same line of business before pursing them independently
- The agreement also should address restrictive covenants:
  - Non-competition
  - Non-solicitation
  - Use of confidential information

TRANSFER RESTRICTIONS – PURPOSES

- Protect against transfers to unwanted business partners (avoid threats by minority)
- Protect value of ownership (avoid threats by the majority)
- Maintain S-Corp status
- Maintain professional corporation status
- Protect against third-party agreement defaults (such as mortgages with change of control provisions)
- Protect against violations of local licensing laws

TRANSFER RESTRICTIONS

- Transfer restrictions should address:
  - Approvals required to transfer ownership
    - Generally, transfers permitted for estate planning purposes
  - Documents to be delivered upon approval
    - Joinder to the owners' agreement
    - Copies of governing documents of entity owners
    - Opinion of counsel
  - In LLCs, whether withdrawal is permitted, and if so, the member's rights upon withdrawal
    - Is the member entitled to his or her capital account?
- Caution – transfer restrictions are strictly construed, so draft carefully!

BUY-SELL PROVISIONS - OVERVIEW

- Identify the purchaser
- Identify the triggering events
- Identify the form of the transaction
- Identify price and payment terms

BUY-SELL – PURCHASER

- Company (Redemption)
  - Limitation on payment if insolvent following the sale or exceeds the amount payable to corporate shareholders with preferential rights
  - Tax considerations
    - Potential for dividend treatment in certain cases
    - Potential Alternative Minimum Tax (AMT) and accumulated earnings exposure for C-Corps
    - No step-up in basis
- Other owners (Cross-purchase)
  - Consider potential shifts in voting power – opportunity to purchase should be proportionate to then-current ownership
  - Administration of life insurance more complex with multiple owners
- Trust of escrow
- Other purchasers (employees)
- Combination (first right in company, and then in the owners)

BUY-SELL – TRIGGERING EVENTS

- Death
- Disability
  - Standard for determining disability
    - Social security (6 months)
    - Insurance (90 days – one year)
  - Use of company physician – HIPPA waivers
  - Continuation of compensation and benefits
    - Beware of "continuous liability"
- Retirement
  - Age requirement (mandatory or voluntary)
- Resignation or withdrawal (voluntary or involuntary)

BUY-SELL – TRIGGERING EVENTS

- Involuntary transfer (bankruptcy, divorce)
- Dissolution of entity owner
- Changes in control of entity owners or changes in trust ownership
- Merger, sale of assets or similar transaction
- Breach of fiduciary duties, restrictive covenants
- Offer of purchase
- Irreconcilable differences
- Desire to exit
- Etc., etc., etc.

BUY-SELL – FORM OF TRANSACTION

- Option to purchase, Right of First Refusal
  - Who holds the option?
  - How long does it remain open?
  - What is the procedure to exercise?
  - If there are multiple purchasers, what rights does an owner have in the event some owners choose not to participate?
  - What happens after option expires?
- Option to sell (Put)

BUY-SELL – FORM OF TRANSACTION

- Drag Along-Tag Along
  - Drag-Along - majority can force a sale in the event of a bona fide offer
    - Consider dissenter rights to avoid claims of breaches of fiduciary duty
  - Tag-Along - minority can participate in bona fide offers to majority
- Shootout, Russian Roulette, Cut-Throat
  - Provides that an owner may offer to buy-out the other owners, provided that the owner also offers to sell his or her interest at the same price and upon the same terms
  - Encourages reasonable offers, but consider whether there are unfair advantages for certain owners and draft protections accordingly
    - Active owners may need less time to consider an offer
    - Wealthy owners may need less time to close the deal
- Combination of the above

BUY-SELL – PAYMENT TERMS

- Lump Sum
  - Commonly financed with insurance
- Installment Sale
  - Evidenced by note
  - Security for obligation
    - Vote of part or all of the shares
    - Other limitations
- Periodic liquidations or Redemptions

BUY-SELL – VALUATION

- Methods:
  - Agreed price with periodic amendment
    - Advantage – simple, cheap
    - Disadvantage – ripe for disagreement (Mitigate with back-up method)
  - Book value
    - Based upon balance sheet, typically determined by company accountants
    - Major disadvantage – does not reflect current value as a going concern
      - Particular concern for service businesses with little assets
    - Management may control the value
  - Appraisal
    - Provide for specific appraiser, time period and method of valuation
      - Willing to "bet the ranch" that the appraiser is right?
    - Provide for selection by approval of owners
  - Formula based upon revenue, earnings or other criteria
    - Consider weighted averaging and adjustments for nonrecurring items (abnormal years, unusual business conditions, changes in business operations, owner compensation)
    - Consult with business broker to determine an appropriate multiplier
    - Specify <u>who</u> will make calculations
  - Combination

4

Start Smart –

What Start-Ups Should Know (and How To Tell Them) About Choice of Entity, Owners' Agreements, and Funding

Eric Koester
Cooley Godward Kronish LLP

Overview

- **Goals:**
  - Identify the role a lawyer plays in assisting his or her client
  - Understanding business and legal issues with startup financing
  - Discuss funding trends
  - Provide some creative options for financing
- **Structure:**
  - Initial Considerations
  - Preparing the Company
  - How to help your clients with Funding Issues in a down economy
    - Has the Model Changed?
    - Government Grants, Loans and other programs

About me

- **A bit about me:**
  - Corporate Attorney, focusing primarily on technology companies (technology, life sciences, clean technology)
  - Incorporation, Funding/Financing, IP, M&A, Securities (Public/Private)
  - Previously in finance, marketing & accounting (reformed CPA)
  - My Blog: www.MyHighTechStartup.com
  - My book: What Every Engineer Should Know About Starting a High Tech Business Venture

Key Considerations for Fundraising

- Important to prepare the company.
- Range of necessary actions may vary depending on financing alternatives.
- Some sources of capital may be deterred from investing in – or even considering – the company if certain issues exist.
- Consider and resolve them early.

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Key Considerations for Fundraising

- What is the venture's status?
  - Business plan only
  - Pre-Revenue
  - Limited revenue
- What are the venture's funding needs?
  - How much truly needed?
  - Proposed use of proceeds?
- Does the venture have tangible assets?

Key Considerations for Fundraising

- What financial experience / sophistication do the founders have?
- Who are the venture's other advisors?
  - Accountants
  - Investment Banker / Finder / Broker
  - Others

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Key Considerations for Fundraising

- What is the business plan?
- What is the founders' background?
  - Industry experience
  - Start-up experience
- What are the key challenges and risks?
  - Technology risk v. execution risk
- What is the current equity and debt capitalization?

Preparing the Company

- Important to prepare the company.
- Range of necessary actions may vary depending on financing alternatives.
- Some sources of capital may be deterred from investing in – or even considering – the company if certain issues exist.
- Consider and resolve them early.

Preparing the Company

- Matters to consider and resolve:
  - Business Plan and Projections
  - Financial Statements
  - Employee NDA's and Invention Assignment Agreements
  - Employee Non-competition Agreements
  - Contractual Limitations / Consent Rights

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Preparing the Company

- Matters to consider and resolve (continued):
  - Capital Structure
  - Ownership of / Rights or Royalties to IP
  - Corporate Records
    - Particular focus on stock records
  - Litigation / Contingent Liabilities
    - If can't resolve, attempt to limit and quantify and be prepared to tell the story in detail

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Preparing the Company

- Matters to consider and resolve (continued):
  - Employee Compensation Arrangements
  - Equity Incentive Plans / Employee Stock Issuances – Structure and Documentation
  - Equity Incentive Plans / Employee Stock Issuances – Tax Matters – Valuation of Awards
    - Income Tax Issues on Issuances to Employees
    - Section 409A
    - ISO/NSO Rules (options)
    - 83(b) Elections (restricted stock)

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Advising Startups in 2009

- **What has changed?**
  - Valuations down
  - Time to close has grown
  - Inside Rounds are tougher
  - More bridges…
  - Angel Groups are being targeted by more advanced companies

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Advising Startups in 2009

- **Are we out of the woods yet?**
  - Probably not.
    - Tough to raise a Fund (decrease in returns, fewer funds, etc.)
    - IPO window is still shut
    - M&A is still largely involved in distressed or “stressed” assets
    - Debt markets are a mess
      - Trying to do a deal involving debt (restructuring, as a component of the financing, etc.) is VERY difficult
  - *However*, March/April 2009 saw a visible “uptick” in activity (term sheets, discussions of priced rounds, mergers, etc.)
    - Lots of money is still undeployed (and some big players raised funds in 2006-2008)

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Advising Startups in 2009

- **What is the right strategy?**
  - Is it worth trying to raise VC or Angel Money now?
    - Perhaps – early stage investments remain strong; later stage are still soft
  - To Bootstrap or Not
  - Capital Efficiency is the “In” phrase

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Advising Startups in 2009

- **How do lawyers roles change?**
  - Becoming more important in board and management discussions
  - Understanding need to “parallel track” all options
  - Interpreting “Investor Director” speak
  - Creativity
  - Watching for risky behavior
  - Ensuring formalities
  - Monitoring litigation risk
  - And (less important, but still important) ensuring legal bills can or will be paid

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Advising Startups in 2009

- **American Recovery & Reinvestment Act of 2009**
  - Clients want to know if they can get access
  - Answer: It depends
  - Billions in new spending and loan guarantee programs
  - 18 months to deploy
    - How is it going to be deployed? Not sure yet
    - Agencies have seen their budgets balloon
    - Lacking expertise in some areas
    - Still catching up to prior programs

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Advising Startups in 2009

- **American Recovery & Reinvestment Act of 2009**
  - Tips:
    - Recommend partnerships
    - Research, research, research
    - Don't try and do the application alone (lawyers are now helping with grants, which is somewhat of a change)
    - It isn't a lobbying game – it is an execution game
    - Start now (recent application for DOE grant was 1,800 pages…)

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Advising Startups in 2009

THANK YOU

Any Questions?

Eric Koester
Cooley Godward Kronish LLP
ekoester@cooley.com
206.452.8759

Cooley GODWARD KRONISH LLP

5

WHAT EVERY ENGINEER SHOULD KNOW ABOUT

STARTING A HIGH-TECH BUSINESS VENTURE

Eric Koester

CRC Press
Taylor & Francis Group
Boca Raton London New York

CRC Press is an imprint of the
Taylor & Francis Group, an **informa** business

9

Raising Money

When I finished school, I took my entire life savings—$5,000—and invested it in a business. I was young. I was inexperienced. But I was an entrepreneur, and I was proud. And in six weeks, I was broke.

Mark Warner
Cofounder of Capital Cellular Corporation,
Former Governor of Virginia

What to Watch For

Starting any new business will require money. According to research by Edward Roberts, approximately 74% of high-tech startups surveyed obtained their initial capital from the founders of the business. For high-technology businesses, there is a greater likelihood that the business will require money from a variety of sources as a result of increased capital needs. These sources may include initial monies invested by the founder or founders, money from family or friends, private investors (oftentimes called angel investors), bank loans, venture capital (VC) funds, government grants, bootstrapping (money earned from the business itself), or countless other sources.

The fact that successful companies raise money from so many different sources is a positive and a negative. The positive is that you can attempt to match funding sources to the company and the current needs of the business. The negative is that it may be difficult to sort through the numerous options to determine the right or best course of action for fundraising.

Fundraising serves as a key gating item for companies. Without necessary funding, a company may be unable to make strategic hires, conduct research and development initiatives, enter into license agreements, and exploit business opportunities. As a result, the fundraising process is integral to the success or failure of many businesses.

Raising money for your business is a process that may be new to an entrepreneur and may involve skills, knowledge, or experiences that a new business owner may not have. As a result, it is often a challenge.

WHY DO FUNDRAISING EFFORTS FAIL?

Perhaps the best way to approach the fundraising process is to consider what causes most fundraising efforts to be unsuccessful. The list below offers the top reasons why fundraising efforts for startup businesses most often fail:

- Little or no experience in fundraising
- Failure to find funding sources
- Lack of knowledge or understanding about a particular funding source
- Not matching your business to the most appropriate funding source
- Failure to focus on fundraising
- Focusing too much energy and effort on operating the business
- Starting fundraising too late or allowing too little time
- Lack of well-defined goals
- Failing to consult with outside assistance

What an entrepreneur should notice about the list above is that many of the items are within their control, from defining goals and consulting with experts, to understanding funding sources and focusing on the fundraising process. The key to a successful fundraising strategy is putting in place a set of fundraising goals and objectives and dedicating the time and energy to achieve these goals. With the right approach, reaching out toward the appropriate funding sources can provide necessary capital for the business to succeed.

Why Do You Need to Raise Funds for Your Business?

There may seem to be an obvious answer to this question, but many businesses fail to adequately understand the real needs of the business and the timetable required to raise the funds necessary for the operations of the business. Raising funds represents a marketing and sales effort for the business as a whole, and it represents an important effort for nearly every new business.

As discussed previously, Jessie Hagen of U.S. Bank found that, among small businesses that had gone out of business, 82% listed one of the causes as poor cash flow management skills or a poor understanding of cash flow, whereas 79% listed starting out with too little money. Many other researchers who have studied the success factors of high-technology businesses have found that an integrated business and fundraising strategy is crucial to the growth of a new business venture.

Determining what amounts or types of funding you need at various points is much more of an art than a science; many companies begin by casting a wide net with respect to various options and then begin to focus their efforts as they find which sources will best match the business.

What Are Investors Looking For?

Depending on the stage of your business, investors will be looking for different things. For instance, an investment by a family member into an early-stage business may be based largely on the reputation of the founder with little focus on the technology. A bank may look into credit histories of the founders and the cash flow of the business. An investment by an established venture fund may place a greater emphasis on your current market penetration and the experience of the management team in further exploiting the opportunities.

WHAT DO PROFESSIONAL INVESTORS LOOK FOR?

In general, the key aspects that most investors (from angels, to banks, to grant funds, to venture capitalists) evaluate in a potential investment are as follows:

- Team
- Technology
- Market potential

Investors will evaluate each of those three key areas to make a determination as to the likelihood that, given the right conditions, the business can be a significant success. More specifically, investors will look at the following:

- Experience of management team
- Relative skills of management team (including complementary nature of skills)
- Strategy of management team
- Stage of product development
- Protections of the technology
- Product market potential
- Current and likely customers
- Future financial needs of the business

The reality is that each investor will analyze the business and its future prospects through its own lens. What one investor sees as a futile idea without a strong management team, another investor may see as a surefire success. Therefore, businesses should cast a broad net to find investors that understand the technology, appreciate the relative experience of the management team, and believe in the market potential.

THE "REALITY CHECK"

One of the pitfalls for some technology entrepreneurs is falling in love with the eBay, Google, Yahoo!, etc. startup funding path. Let's just call it, the venture capital model. That is, take an interesting technology, get a couple angels to invest early, then find a venture capital firm to kick in several millions along the way until you can get acquired or go public. Although this model worked well for some notable successes (Apple, Google, and Microsoft), not every successful idea has grown from venture investments.

Nationwide, institutional venture capital firms typically make only between 2,500 and 3,500 investments annually (and only about one-third of those are initial investments in startups, whereas many of those are follow-on investments). With more than 1 million small businesses started each year, the chances of getting one of those coveted VC investments are extremely small.

Even still, technology entrepreneurs are oftentimes surprised to learn that their technology just isn't the type that traditionally gets funded by an institutional investor. Perhaps the company's market isn't large enough or the investment required is too great for VCs to be interested. Yet many technology entrepreneurs will spend 100% of their time looking to raise a Series A round from venture capital firms. For many companies, the venture capital model may be either unlikely or impossible, or perhaps the venture capital model won't work for the company until after several years of growth or development.

The reality is, many companies just don't fit the venture capital or institutional investor model. The venture capital model attempts to identify companies that will yield big returns in a short time period, usually in the form of revenues of at least $25 million in three years and $50 million in five years. Generally, the model involves a company with a technology familiar to the VC fund, a business that the VC can easily understand and explain to others, and has a revenue model that can be grown rapidly. VC firms usually want to see proprietary technology, substantial barriers to entry for potential competitors, and a management team with a proven track record.

As a company begins the process of considering the most likely funding alternatives, it is important to do a "reality check" to see whether the type of company being developed is a likely funding candidate for traditional institutional venture capital. If not, the company should identify alternative sources of funding for the company's growth plans.

> In the next chapter on venture capital, we've included a short questionnaire to help companies identify whether their idea and business concept is a likely VC funding candidate. Use it as a reality check to determine whether your company represents a viable candidate at your current stage and under your current model.

Determining What You Need

For most high-technology businesses, the company will usually require some amount of funding to move the business from the idea stage to a functioning business entity, albeit an entity that is still an early-stage venture. The early-stage funding is likely to come from personal savings, family and friends, a grant program, or perhaps angel funding. For most first time entrepreneurs, they will find out how quickly startup capital will evaporate and how fast expenses will be incurred.

In *Founders at Work* by Jessica Livingston, Arthur van Hoff, the cofounder of Marimba, which had grown into a 300 person software distribution company by the time of its IPO in 1999, highlighted the importance of living cheaply during the early days of a startup. Said van Hoff, "Initially we all put in a little bit of money, I think $25,000 each. If you don't take a salary, that can last you a long time. . . . We spent about $1,400 to furnish the entire office, including equipment like a fax machine and printer. We all used cell phones at first, and we had no Internet access for the first couple of weeks, just the whiteboard."

Once a business moves beyond the need for startup or seed fundraising into the need to secure more sizeable funding (typically from venture capital firms or other more significant investors), more questions will arise regarding the amount of funding to secure. There are different schools of thought regarding raising funds for a high-technology business. Some experienced entrepreneurs believe that the biggest risk to any company is undercapitalization and missing the narrow window of success a startup will have. Therefore, these entrepreneurs will encourage others to be certain to have adequate funds available for the business.

Other experienced entrepreneurs will urge caution in accepting funds from outside investors for fear of losing control of the business. For some founders that have taken significant payouts from investors, they have soon found that these funds were not without strings, strings that were much shorter than the founder initially realized. As such, these entrepreneurs will urge future entrepreneurs to be cautious with their fundraising and to explore nondilutive funding mechanisms such as bank loans and government grants and loans.

More considerations are discussed in the following chapter with regards to the process for determining the amount of funding to request from venture capital firms.

Matching Your Business with an Investor

Raising funds is a time-consuming process that will require you to "put many lines into the water to hook a few fish." Therefore, it is important for an entrepreneur to recognize the funding sources that are most available to the company depending on the growth stage of the company.

At different stages of a company's growth, certain funding sources will be more applicable than others. Early-stage companies most often rely on funds from personal savings, private investors, government grants, angels, and bootstrapping, whereas mid-stage and advanced-stage companies are more likely to pursue funds from venture capital sources or through investment bankers.

Business stage	Typical investors
Experienced founder and business plan	Founders; family and friends; government grants; angels
Experienced founder and prototype/beta product	Government grants; angels; early-stage VC
Experienced team and developed product and customers	Later-stage VC; strategic investor
Experienced team and sustained revenue growth and profitable in 12–24 months	IPO or strategic merger/acquisition

Startup Capital

Starting a business requires capital. The vast majority of new businesses require some initial investment from the founders to begin the business. Typically, this initial cash will be used to move the business from an idea or concept into a functioning business.

How Much Should a Founder Plan on for Startup Capital?

According to the 2004 financing report from the *Global Entrepreneurship Monitor*, the average amount needed to start a business was $53,673. For businesses that were necessity pushed (driven by a currently unmet need in the industry), the average startup only required $24,467. Depending on the industry and the specific growth plans, each business may require more or less to startup their business.

Where Do Founders Get This Startup Capital?

According to the *Global Entrepreneurship Monitor* report, more than 65% of the startup phase funding comes from personal savings, credit, and informal investors such as family and friends.

The perception may be that startups open their doors after receiving a big investment from an angel or a VC. However, this is far from the truth. In fact, it is very uncommon for a startup business to open its doors with venture capital funding in hand (fewer than 1 of 10,000 startups have VC money in the bank when they open for operations).

Seed and Angel Funding Rounds

Many emerging companies raise money in the first instance not from institutional investors but from "angels" (friends, family, and high-net-worth individuals) in a seed or angel round. In doing so, they need to decide whether to structure the seed round as a "bridge" (convertible debt) round or a "priced" (preferred or common stock) round.

Bridge Round versus Priced Round

If a company finds an early-stage investor who wants to invest capital into the business, how should the company decide what percentage of the company that investment is worth? It is a tough question to value a company without much to go on.

As a result of this uncertainty, a company will need to decide whether to issue convertible debt that will convert at a future point (usually when a larger financing occurs) or issue equity interest based on a current estimate of the value of the company. For a company, certain seed or angel funding is a first-step funding mechanism to be followed by a larger round that will involve a valuation of the company at that time, and a bridge round may be the right course of action. For a company that is uncertain whether or when it may raise a larger amount of money, potential investors may be wary to take convertible notes.

BENEFITS OF A "BRIDGE"

Some experts encourage early-stage startups to raise money involving seed financings with a convertible note with a discount that increases over time up to a certain cap. Others encourage the company to go with a priced round. So what are the pros and cons of doing a bridge round?

PROS

- **Doesn't require a valuation:** In early stage investments, the valuation is difficult to settle on or much lower than the company would like.
- **Preparing financing documents for a bridge financing are much simpler:** Simpler documents results in a quicker turnaround time (faster money in the door) and lower legal fees.

CONS

- **Misalignment of interests:** Strangely enough, a debt investor may actually want a *lower* premoney valuation for your eventual Series A round because it would *increase* their ownership percentage.
- **Unfavorable terms on the convertible notes:** Although the terms of the notes may not require a valuation, investors may insist on terms that are unfavorable to the company, such as founders' personal guarantees, heavy penalties in an event of default, grants of security interests in the company's assets, and others.

Discuss the pros and cons of the priced versus bridge round with your mentors, other entrepreneurs, and your attorney. There isn't a single "right" approach that will be the best approach for your business.

Bridge: Convertible Debt

At least for companies that anticipate doing a full-fledged financing in the near term (say, 6–12 months), a bridge round is considered to be more company favorable and is the easier, faster, and cheaper approach of the two. In this case, the investment is in the form of a promissory note that converts into equity on the terms set in a future "qualified financing" (in which the qualified financing typically is defined by having a minimum amount, say

$2 million, of total investment). The note will convert at a discount to the price per share set in the qualified financing (usually between 10 and 30%), will have warrant coverage (usually in the neighborhood of 20% of the dollar amount invested by each investor), or occasionally both. This discount and/or warrant coverage gives the angel investors some additional ownership in exchange for taking the early risk.

You can find a sample term sheet for a convertible note bridge financing at the end of this chapter.

Priced: Preferred or Common Stock

A priced seed or angel round is the more involved route, because it (1) requires that the company and the investors agree on a valuation during a time in the company's life cycle when pegging a valuation is inherently difficult and (2) involves drafting and negotiating a somewhat more comprehensive and complicated suite of investment documents. Occasionally, the investment is in the form of common stock, but more often it is known as a "light Series A": preferred stock that is similar to that a venture investor will get but usually with less complex, detailed, or complicated terms because of the relatively low valuation associated with it. If the company does not contemplate raising additional funds from venture or other institutional investors and will only be relying on additional small angel-type investments, the priced approach is usually more appropriate for the investors, because they'll more clearly be participating in the upside on terms that are agreed to early in the life of the company.

HOW TO DECIDE WHETHER TO RAISE A BRIDGE OR PRICED ROUND

Many early-stage investors lament the fact that valuations for an early-stage business are often unrealistic (or even downright "crazy" to some investors). Deciding to do a bridge round removes the requirement to set a valuation on an early-stage business. How can you determine if a bridge round is appropriate?

- Are you planning to raise additional funds from venture capital or other institutional investors?
- Are you planning to raise these funds in 6–18 months?
- Have you received positive responses or inquiries from potential institutional investors?

If you answered yes to each of these questions, a bridge round may be appropriate. Ultimately, a bridge round is an effective tool when it is a "bridge" to a later financing event. If you aren't planning on such an event or are unlikely to reach it, then consider a priced round.

Bridge Loan

The bridge loan can be used by angels, VCs as a short bridge until a pending VC round, or between VC financings to extend the financing until the next round is finalized. A bridge loan is an advance of funds by a proposed investor in a company, toward a planned future (usually between 3 and 12 months but sometimes as long as 18–24 months) equity closing, using an interest-bearing promissory note or similar device. In the event in which a bridge loan has been made and the equity financing never occurs, it is referred to as a "pier financing."

A bridge loan may be made in the case in which a company is actively pursuing venture capital funding or in the case in which indications are that a venture capital firm or firms are interested in funding a company but the process is going slower than expected or the venture capital firm and the company are unable to agree on the valuation and are looking to find another investor (a "validating investor"). In addition, a split Series A/B preferred round can serve the same function.

Typically, the transaction uses a straightforward promissory note, which may be secured or unsecured, has a due date 3–12 months later (or longer depending on the terms agreed on), and has a low interest rate. The promissory note provides that, if a company does an equity financing above a certain amount (say at least $2 million) before the due date of the note, the principal and interest under the note automatically convert at the equity closing into whatever is being issued (this is usually referred to as series next preferred or Series A preferred, if this represents a first round of funding), at a discount to the price per share as cash investors. If there are multiple lenders with notes outstanding, usually the notes will all rank equally as to payment and security priority.

Fundraising Process

Raising funds for a new business is usually not accomplished in a single event, nor do most businesses look to the same funding sources at the early stages as they would when they've reached a particular stage of maturity. For most entrepreneurs, you will spend personal savings or rely on friends and family to raise the startup capital. After this initial money, the business will likely need additional infusions and will need to incorporate fundraising plans into overall business planning. Therefore, entrepreneurs should look at fundraising as a process in which the business will acquire funds from a particular source or sources to allow the business to continue on its path of growth.

The following section provides an example of matching certain funding options with particular stages of the business. Most successful startups look to multiple sources to obtain funding. Different sources usually participate at different times in the startup process, and, to help understand the process of funding a new business, the following section follows the germination of an idea into a venture-backed enterprise. Not every company goes through each of these rounds, but it is a helpful exercise to consider. For example, if your company doesn't plan to pursue venture funding, replace that with another source in this exercise, perhaps an expanded angel financing strategy, Small Business Administration (SBA) loans and grants, or a slower growth plan. Ultimately, the aim of this exercise is meant to give you an example (albeit an example that is somewhat traditional for some in the technology space). More information on the specifics of certain types of fundraising methods can be found later in this chapter.

Founder Funding

Estimates show that nearly 90% of company founders will invest some amount of personal money into the business at the early stages of the business, with an average investment by each founder of $10,000. Startup capital tends to come from the initial founders. These investments can range from a few hundred dollars and the founder's time to several tens of thousands of dollars, with the average company requiring more than $50,000 in initial investments (oftentimes from founders or friends and family). Generally, this investment will be exchanged for initial ownership of the business.

SAMPLE FUNDRAISING PROCESS

High-Tech Startup Inc.: Founder Funding

The following boxes, each entitled SAMPLE FUNDRAISING PROCESS, represent a fictional example of the fundraising process for a fictional company: High-Tech Startup Inc. For the purpose of this exercise, assume that the founder funding is simply the initial investment by the founder or founders in deciding whether to pursue the business. These expenses may be incurred to determine whether it makes sense to start the business. The founder funding in this exercise could be used to purchase business planning software, to purchase research reports, to obtain licenses for development software or laboratory equipment, to attend conferences, or for business lunches with key contacts.

Seed Funding

Once the founder has decided to move forward with the business, the business may require some initial funding to move from an idea or concept to a business. This stage of fundraising requires the business to raise enough money to allow the entrepreneur and the initial founding team to commit the time and energy necessary to build a business. Seed money will generally involve raising additional funds from the founders or from outside parties, which include a variety of sources from family or friends to government grants or angel investors. (In this exercise, we've separated this "seed" round from an "angel" round, but these terms are interchangeable in practice and deal with similar issues.)

For some companies, raising seed funding may involve raising money from angel investors (discussed below in a separate section), but, for the purpose of this exercise, we'll assume that an effort to raise additional capital will follow. In this exercise, the business will just be raising a single seed investment necessary to move the business forward while the company is looking to raise a larger amount of money from angel or other seed investors.

After deciding to form a business and taking steps to begin the growth of the business, many entrepreneurs will need to understand how to migrate from the relative security of a job or schooling into the uncertain world of a new business venture, oftentimes with no assets apart from their ideas. Although some businesses are initially built by a team "on the side" or while continuing their current employment, most startups will eventually require more than a part-time effort to succeed in competitive markets. To most startups, the term "seed money" means an investment that will cover the first few months of startup costs and living expenses for the founders. Some businesses may only require a small seed investment from the founders, whereas others may require outside capital of several thousands of dollars to validate the business concept.

SAMPLE FUNDRAISING PROCESS

High-Tech Startup Inc.: Seed/Angel Funding

So, let's suppose that you and two cofounders start a business, High-Tech Startup Inc., and your initial injection of seed money comes from your wealthy brother Mike, who happens to be an accredited investor. Because Mike has done well for himself and wants his little brother or sister to have the same opportunities he did, Mike is willing to give you $20,000 for a 5% stake in common stock of the business. You and the other two founders will each receive 25% of the common stock of the company, and you agree to reserve 20% for an option pool to attract future employees.

Shareholder	Number of shares	% Ownership
Founders	7,500,000	75%
Brother Mike	500,000	5%
Option pool	2,000,000	20%
Total	10,000,000	100%

The approach above is a priced round because you are essentially selling Mike 5% of the company in exchange for his $20,000. The sale of 5% at this price means the that overall value of the company after the investment would be $400,000 (to calculate this, simply divide the cash amount of $20,000 by the percentage purchased of 5%). This $400,000 represents the postmoney valuation, and the value less the $20,000 investment ($380,000) would be the premoney valuation.

Another alternative aside from issuing stock in the company in exchange for early-stage investments by friends or family is to issue promissory notes. These notes can be structured in such a way as to convert to equity of the company at a certain point or to be repaid at a particular date or time. The benefit is that a promissory note will provide the company with additional flexibility to pay off the promissory note or to convert the investment into stock of the company while ensuring that all the stock of the company remains in the hands of the founders.

In either case, the seed money from Mike pays for you to purchase some software and hardware that you'll likely need to build a prototype and test the concept and should give you some additional cash to help with the first six months of living expenses for you and your cofounders. For the early days, this will mean lots of Ramen noodles and living on the savings that each of you have without drawing much of a salary. If you are fortunate enough to have one or more of the founders continuing their employment, a spouse to provide support, or more extensive savings, you may be able to upgrade from Ramen noodles to a higher-end meal!

As a startup company at this stage, your business (and your life) will most likely be governed by three simple rules: live cheaply, work fast, and find more money. It may seem as though six months gives you plenty of time to get started on product development, but you'll need a constant stream of money for your business to grow, and it always takes longer than you think to find the right investors and close the deal. So you'll need to work hard both on the product you're developing and the financing necessary to make it a reality.

At this early stage, thriftiness is crucial. Remember, the more money you save, the more options you have. If you burn through money in the initial stages, you'll likely be forced into deals that you don't like later on. Working cheaply early in the process can actually preserve your equity stake, translating into huge rewards down the road if your company becomes a success. You may also discuss with Mike the opportunity for additional investments into the business as you meet certain milestones or continue to develop the business.

In this exercise, these first six months will need to be used to raise additional funds and to continue product development or undertake future research. To have the startup business primed to close the next round of funding (before the six months of seed funding disappears), fundraising for additional funding will need to begin as soon as possible. This means developing your business plan, researching potential funding sources, applying for loans or grants, and making contacts with angel and venture capital investors. The thought and care that goes into your business plan will partly determine your success in attracting investment in your startup, and an effective plan will guide management by focusing planning efforts and setting milestones. However, remember that a good business plan alone isn't enough; you will also need to network and build connections to get your business plan to the right investors and contacts.

Angel Funding

The purpose of the seed money provided by Mike has been to help move your business from a simple concept into a plan for a high-growth business with a plan for future product development. At this stage of the company's growth, you will need to begin looking for another outside infusion of cash to continue the growth of the business. After spending some time developing your product and preparing a business plan and presentation, you and your cofounders are running low on seed money, and your team has been out meeting with potential investors.

Some companies will look to grants or loans from government agencies for this additional infusion of cash. Other companies will look to more family and friends for additional investments or perhaps will discuss with Mike whether he is willing to make a larger investment into the business. Depending on the business concept, you may find that venture capital firms are hesitant to make an investment into a business at this early stage of growth; many firms are looking for more maturity in the companies in which they are willing to invest. Therefore, one of the key sources of capital for startup companies at a relatively early stage of maturity is angel funding.

At the point, you'll be looking for angel funding, you'll probably need more funding to hire some help, further your product development, and maybe even acquire some operating space. Angel funding represents a major source of capital for startup ventures. According to the Center for Venture Research at the University of New Hampshire and the MIT Entrepreneurship Center, more money is invested annually by angels ($23 billion) than venture capital firms ($21.9 billion).

CHECKING THE SERVICE PROVIDER BOX

What could happen

You want to get a meeting (or a follow-up meeting) with some top-tier venture capital investors or a local angel forum. Why would they be asking you to provide them the name of your bank, your accountant, your attorney, your intellectual property attorney, and your other outside service providers?

Watch out for

As your mother once told you, you are judged by the company you keep. Certain investors will take comfort in the service providers you have chosen to employ. They may be less comfortable that you have been properly accounting for revenues if you don't use an outside accountant. They may question your intellectual property protections if they aren't familiar with your intellectual property lawyers. They may wonder about your employment policies if you (as CEO/founder) run the human resources for your company.

If you haven't selected a bank, accountant, or human resources support provider yet, make sure you can name a list of parties that you are considering. Although it may simply be a perception issue, be prepared to show that you've considered each of these areas.

TIP: Be prepared to inform potential investors of possible third-party service providers for your business.

Angel investors are simply individuals who back emerging entrepreneurial companies. Generally, angels are willing to invest at an earlier stage of the business and will contribute money to help move the company to a stage at which it can attract venture capital investment or generate sustainable cash flows. Funding levels vary greatly but usually range from $50,000 to $2 million. Oftentimes, certain industries or regions will have groups of angels that meet together to listen to presentations of startup businesses to give angels opportunities to decide whether to invest in any of the businesses.

SAMPLE FUNDRAISING PROCESS

High-Tech Startup Inc.: Seed Angel Funding

You've been able to attend an angel investment forum and meet a group of angels interested in investing in your business. After a successful pitch, you find an angel willing to invest $250,000 at a premoney valuation of $1 million in exchange for shares of common stock.

So your company issues $250,000 in new shares of stock, which you give to the angel. If you had 10 million shares of common stock before the angel investment (with 500,000 to Mike, 2 million to future employees, and 7.5 million for the founders), this deal would generate 250,000 additional shares. Now the angel owns 20% of the shares of the company, and all of the previous shareholders' equity ownership is diluted by that 20%. Here is what your capitalization table would look like after the transaction:

Shareholder	Number of shares	% Ownership
Founders	7,500,000	60%
Brother Mike	500,000	4%
Angel investor(s)	2,500,000	20%
Option pool	2,000,000	16%
Total	12,500,000	100%

As with Mike's deal before, this investment would be a priced round, in which the angel investor would be purchasing 20% of the company for $250,000 for a post-money valuation of $1.25 million.

A deal of this size will generally be more intricate than your brother Mike's investment. Although the angel might just pay for the stock in cash, the company or angel investor might instead choose to make the investment in the form of a promissory note that is convertible into stock of the company. This would provide the angel with more protection against equity dilution in later funding rounds. The angel might also demand preferred stock, which would give him certain additional rights over the owners of common stock, including vetoes over major decisions, the right to get the investment back in the absence of an exit strategy, and protection against equity dilution, and there's always a chance that the angel will want a seat on the board of directors. A deal of this size may require several weeks to close and could cost the company several thousands of dollars in legal fees (which is why it oftentimes makes sense to group the angel investors together into a single transaction to get all angels to invest on the same terms). Sometimes, an angel will agree to pay these fees for both sides if the startup is short on funds. If you find yourself in this situation, make sure that you are getting fair representation.

Once you have received an investment from an angel, you will be able to continue to grow the business and should be able to undertake key initiatives. With this $250,000 in the bank, you can afford to hire employees and purchase inputs that will bolster your product development process. Perhaps you can now hire a very talented engineer as your first employee. This employee may agree to a low salary plus 3% of the company in stock options or in restricted stock. Restricted stock is a lot like a stock option, only that instead of earning the right to buy the stock, you get the stock up front and earn the right not to relinquish it. Some startups have replaced stock options with offerings of restricted stock, yet the "option pool" would still be the source of these shares (so, after this deal, the option pool would have only 13% remaining to be issued and 3% outstanding).

Determining the proper amount of stock to provide to early employees is difficult for new entrepreneurs. Much more information is found in the later chapters on employees. In general, the stock option calculation is a function of the value of the employee and the stage at which they join the business. If you think someone is going to contribute as much to the success of your company as a founder (and you sign him or her really early), you might even give them an equivalent amount of stock. As your company ages, you should offer employees less and less stock.

Venture Capital Funding

Angel funding is oftentimes a precursor to venture funding. Angels may be able to assist you with introductions to venture capital firms and may provide added credibility with these firms. Unlike angel investors, venture capital firms tend to require companies to have greater maturity levels (some venture firms do invest in early-stage companies, but that is not the norm).

Venture capital has been an important source of funds for many high-technology companies, but not every startup will require venture capital funding. The decision to pursue venture funding should be based on a careful examination of the business and consultation with outside experts. In the event these initial discussions are positive and if your startup is undercapitalized and needs to invest in infrastructure, hire a sales or marketing staff, or put a product into mass production, you will probably need another big injection of capital that could come from the venture capital industry.

For a lucky few companies, venture capital firms might come to you, but most likely, you'll have to approach VCs through your contacts. You'll find more information on the process for finding and dealing with VCs in the following chapter.

SAMPLE FUNDRAISING PROCESS

High-Tech Startup Inc.: Venture Capital Funding

Let's suppose your company is one of the lucky few that has been able to find a VC firm or firms prepared to invest in your company. The VC will most likely offer you a term sheet summarizing what the deal terms will be. In some cases, VCs will want you to agree to avoid negotiations with other VCs for some period of time after you accept the term sheet. During this period, the VC will do its due diligence on your startup in an attempt to uncover any serious risks or barriers to success that might bubble up. If they don't find any fatal flaws, the VC will proceed with the deal.

Your VC has offered you a $2 million investment at a premoney valuation of $4 million dollars. Under this scenario, the VC will would get 6.25 million shares of stock of the company (generally, a VC investment would be for preferred stock, but that stock is convertible into common stock of the company). After this investment, everyone else's percentage of equity ownership would decrease by approximately one-third. Because the VC understands that you'll need to continue to hire new employees and will need additional stock options to attract quality candidates, the VC will permit you to expand the company's option pool by 1.25 million shares.

The postmoney valuation of the company after the transaction would be $6 million dollars ($4 million pre-money valuation plus $2 million of new money). The capitalization table and option pool would now look like this:

Shareholder	Number of shares	% Ownership
Founders	7,500,000	37.50%
Brother Mike	500,000	2.50%
Angel investor(s)	2,500,000	12.50%
VC investor	6,250,000	31.25%
Total option pool	3,250,000	16.25%
Total	20,000,000	100.00%

Options	Number of shares	% Ownership
Issued		
Engineer	375,000	1.88%
Other employees	625,000	3.12%
Available for issuance		
Original pool	1,000,000	5.00%
New pool	1,250,000	6.25%
Total	3,250,000	16.25%

Although this hypothetical deal helps give you an idea about the process of equity dilution, it is only simplified example. Companies may require several stages of investment from VCs to grow the business. More details about the specifics and process for VC investments follow this chapter.

At this stage, you will most likely do significant amounts of hiring while you further your product development. You also might prepare for more rounds of funding, hopefully at higher and higher valuations. If your company is extremely successful, you may even have the opportunity to go public through an IPO. Hopefully, your company will avoid a down round or a funding round at a valuation lower than the previous round. Common stock holders usually take a hit during down rounds, and many deals with VCs will include antidilution provisions in their deals to protect themselves.

The previous exercise is designed to provide you with an overview into the fundraising process and how each funding stage will affect your company and its allocations of ownership. Remember that timetables, trends, and funding courses will vary in the case of different industries, technologies, founder teams, and businesses. Many highly successful high-technology businesses will never go public and will focus their fundraising efforts on areas other than angels or VCs.

Funding Sources for Your Business

There are a number of sources from which a new startup can obtain the money that it will need to grow. There is not a one-size-fits-all strategy for funding a business; it often depends on numerous factors, many of which may be out of your control. Entrepreneurs can often self-finance the initial capital outlays for their business through personal savings, second mortgages, credit cards, and traditional bank loans. Some startup founders can also "bootstrap" their startup by using profits from early sales to grow the business. This approach works especially well in the service industry, in which startup expenses are sometimes low and the need for employees may initially be minimal. Most entrepreneurs, however, require at least some amount of additional money from alternative sources to fully capitalize their business, and this section explores some of the major sources of funding for new ventures:

- Friends and family
- Angel investors

- Government and public sector
- Seed funding firms
- Joint ventures and strategic alliances
- Venture capital firms

Each of these alternatives has its advantages and disadvantages, and they all require your company to form some sort of relationship with an investor or financier. While sorting through these potential sources for funding, you should consider the amount of control you want to retain, the amount of equity dilution you and your investors are willing to bear, and the rate of growth you want to achieve. You should also be mindful that the funding choices you make in one round can have downstream effects later. Without proper planning, due diligence, and careful negotiation of such partnerships, you may inadvertently miss opportunities or relinquish future rights to valuable assets in pursuit of immediate funds. All startup companies exploring these alternative forms of financing should obtain sound advice from an attorney, accountant, and financial advisor before entering into a definitive agreement.

Summary Details of Various Funding Sources

	Founder	Friends/family	Angel investors	Bootstrapping	Bank loans	Government grants/loans	Joint venture/ strategic	Venture capital
Typical maturity of companies	Early	Early	Early	Early/mid	Mid/mature	Early	Mid/mature	Mid/ mature
Time to obtain funds	Fast	Fast	Fast/medium	None	Medium/slow	Slow	Medium/slow	Medium
Amount of funds awarded	Small	Small	Small	N/A	Medium	Medium	Medium	Medium/ high
Likelihood of utilizing	High	Medium	Low/medium	Low	Low	Low/medium	Low	Low/ medium
Costs of funds	Low	Medium	Low	Low	Medium	Low	Medium	High
Comments	Typical for most startup companies	May be difficult to manage; may not provide strategic value	May require high degrees of effort to obtain	Unlikely in early stage companies	Unlikely in early stage companies; less favorable terms than equity	May be difficult and slow to obtain; not all companies will be eligible	May be difficult to obtain and be slow to close; can affect strategy choices	Typically requires a high growth company; may limit control of founders

Private Individual Investors

Private investors are a popular source of funding for new ventures in the early stages of their development process. Investments in this category range from small loans from friends and family to large injections of capital from angel investors. Stock offerings to private investors typically take the form of preferred stock, whereas founders traditionally hold shares of common stock.

> **CAN YOU HAVE TOO MANY INVESTORS?**
>
> **What could happen**
>
> You've told a family friend about your business. This friend is a stockbroker and he's lined up 15 of his clients to each invest $5,000 into your venture.
>
> **Watch out for**
>
> Although it may seem counterintuitive to turn down any investors (or lenders if you arrange for small loans with a number of parties) into your business, remember that you add another relationship to manage with each new investor. Investor relations takes time and may cut into your ability to run your business. Be judicious about adding new partners to the venture, particularly if those investors are not savvy or you perceive may not be satisfied with infrequent communications. Consider the size of the investment relative to expectations this investment will create. If a new investor is not savvy about investing in startups and will create headaches with respect to getting out of the investment or getting information on the investment, you should consider whether it is the right source of investment dollars. In addition, always consider the securities law implications of adding nonaccredited investors.
>
> **TIP:** Treat each investor or lender as a partner; each relationship will take ongoing time and energy to maintain and cultivate.

Founders

The majority of startup companies will require an initial investment from a founder or founders. This investment will oftentimes take the form of cash, purchase of company goods, services, or assets with personal funds or may represent a deferral of salary:

- For founders that own their own homes, some have taken out home equity loans to fund their startup business.
- Founders have also used personal credit cards to infuse initial capital into the business. There are some zero interest, deferred payment cards that can provide a founder with a mechanism to purchase goods or services for the business and defer payment (without interest) for 6–12 months. Use of personal credit cards should only be used as a short-term alternative and should be transitioned to a more traditional bank loan or other financing device as the business matures.

In some cases, these investments by the founders will be made in exchange for additional common stock of the company. In other cases, the founders may choose to issue promissory notes for these investment amounts to be converted into additional stock or returned on availability of capital to repay such amounts.

Friends and Family

Friends, family, neighbors, and colleagues might be some of the first sources you consider early in the funding process for loans and the purchase of stock. Garnering investments from the people close to you offers a few advantages: you won't need to expend valuable time and effort making connections and establishing trust, and friends and family are more likely to offer favorable rates on loans. These friends and family members also might be more forgiving if their investments fall through.

Yet there are several important considerations for your business to discuss before accepting investments from friends and family. First, unless these investors have more than $1 million in assets or an income of more than $200,000 a year ($300,000 if the person is married), they may not qualify as an "accredited investor." The SEC imposes lower regulatory burdens if a company's shareholders are accredited investors. Taking money from unaccredited investors can restrict your options and create major headaches down the road. If your startup goes public, the SEC will carefully study all previous issuances of stock and demand that your company take immediate action to cure any past violations of securities law arising out of investments from unaccredited investors. Although it may seem like a good idea to give stock to these unaccredited friends or family members initially, it may cause expensive and time-consuming problems later in your startup's life cycle. Even if you haven't violated any laws, SEC investigations can waste time and money. You should consult an attorney before accepting or soliciting money from unaccredited investors.

Second, in most circumstances, friends and family members will lack industry-specific connections and business sophistication, two prized qualities of investors. Every investor represents a potential wellspring of information that can help guide your company to success, and the knowledge and experience that your investors bring to the table can be very important assets. Other investors in future rounds of funding (such as angel investors and venture capital firms) will look closely on how you valued the equity given to your friends and family and may be turned off if they fear SEC complications or inexperienced decision-making.

INVOLVING FAMILY AND FRIENDS

What could happen

To get your business started, you are considering taking money from a collection of family and friends. You are also considering employing a family member in the business.

Watch out for

Family and friends can be a valuable source of initial startup capital or talent for your business, but remember that your family and friends may not understand the time horizons of a startup business or the applicable risk. Be careful about using money from family and friends unless you have a strategy for repayment and a time horizon that is realistic. Starting a business is stressful enough without adding interfamilial conflicts into the mix. In addition, be especially cautious with unaccredited investors (especially family and friends). Remember that unaccredited investors can cause future problems for compliance with securities law exemptions.

TIP: Be cautious about involving family and friends in your startup (especially in financing aspects).

Moreover, financial relationships with friends and family members carry extra emotional burdens. You may not want your loved ones' financial futures riding on the success of your startup or their constant input on how to run your business. To minimize any potential strain on these relationships, it is important to be as upfront as possible about your realistic expectations for growth and the inherent risks of investing. If you do want to accept money from friends and family, make sure to have an attorney draft a letter of agreement that outlines the funding terms and cancellation policies, if necessary.

Angel Investors

Angel investors (or simply angels) are affluent investors (typically accredited) who provide capital for startups early in the development process, usually in exchange for an equity stake. (The term came from individuals who would invest in Broadway theater productions as unnamed donors and became commonly referred to as "angels" for their roles in saving productions that had overrun their budgets.) Many successful startups in their infancy have been bankrolled by private sales of debt or equity securities to angel investors. Angels typically look for businesses that have solid management teams and strong growth potential in industries that they know well.

INVESTMENT BY ANGEL INVESTORS

According to the Center for Venture Research at the University of New Hampshire and the MIT Entrepreneurship Center, angels invest in nearly 50,000 ventures each year, representing annual investments of more than $23 billion.

Angels will normally invest larger sums of money than your friends and family, but these greater sums come with somewhat higher levels of expectations. Angels want to get their investments returned so will usually only consider funding companies that have valid exit strategies. Although it is unusual for a venture capital firm to invest amounts under $1 or $2 million, the majority of angel investments will fall under this level, providing a company with a source of funds to further develop the product and grow the company, without necessitating a $5 million outside investment.

An added benefit many companies look for in angel investors is relevant industry or investing experience. Angels are oftentimes wealthy from their own previous entrepreneurial or investment success, and the contacts and experience that they can bring to your startup can be as valuable as the capital. Taking money from an angel that has previously invested in successful startups within your industry is a particularly good idea. Besides being able to offer insights and advice, knowledgeable angels can make your company much more attractive to other private investors and VCs, as well as customers, suppliers, and employees. The ideal angel would have previous experience in marshalling young companies in your industry to success, would buy into your vision and long-term goals, and would bring both contacts and credibility to your business.

Some startups try to attract eminent angels who can provide guidance by letting them invest in their company when it has a low valuation. The lower the valuation for your company, the cheaper it is for an investor to acquire an equity share. Early in the funding process, it's hard to peg down an accurate valuation for a startup, because the number is just a byproduct of the respective investments of everyone involved. For example, if an angel pays $100,000 for a 10% stake of your startup, the startup has an implicit valuation, in theory, of $1,000,000. As a company gets more established, its valuation approaches its actual market value, and startups' valuations are expected to rise over time. It is impractical (and potentially illegal) to adjust your startup's valuation for the purposes of attracting individual investors, so if you want to entice eminent angels with cheap stock, do it early in the funding process when it's natural to have a low valuation. You and your angels will have to agree on a premoney valuation of your startup before they invest. The premoney valuation is as simple as it sounds: the agreed-on worth of your company before an investment. The lower the premoney valuation, the more equity an angel can acquire.

Finding the right angel or angels to invest in your startup can be a difficult, time-consuming process. Some angels organize themselves into groups to share research and pool capital, which makes them easier to find. The Angel Capital Association is a good source for finding a group near you. These groups can be found in most large cities, but the bulk of them reside in Silicon Valley, Seattle, Boston, Austin, Denver, New York City, and other similar cities or regions with a track record of developing new ventures. Bear in mind, however, that most angels (especially the prominent ones) don't belong to a group. Also note that you should carefully research any angel group that tries to charge you money just to pitch your idea. Many groups do not charge for presenting to their group, whereas some groups do have a fee. If the group has a fee, ask around to ensure they are reputable.

RESEARCHING ANGEL INVESTORS

- **Angel Capital Association (http://angelcapitalassociation.org):** North America's professional alliance of angel groups provides information on the more than 265 angel associations across the country.
- **vFinance Inc. (http://vfinance.com):** Offers paid searching tools to find angel investors based on net worth on the individual, industry that the angel will invest in, and location of the investor. Customized searches for $1.00 to $2.50 per contact.
- **Angelsoft (http://angelsoft.net):** Offers web-based software tools for entrepreneurs to identify angels and angel groups and submit information to these groups online. More than 2,000 investors are standardized on this platform. Free trial of the tools; $250 for full access.

The best way to meet individual angels is through industry contacts. Although cold calling occasionally works, angels will pay more attention to investment opportunities recommended to them by someone they respect and trust. Your accountant, lawyer, or entrepreneurial friends might possess the contacts you need. Once you've established contact with an angel, you need to present your company in the best light possible.

Angels will look for a strong executive summary and management team, a "need-to-have" product or service, industry contacts to support your claims, and the aforementioned exit strategy. Angels will also be attracted to a legally sound business plan free of any significant downstream problems (such as intellectual property conflicts or securities issues).

There aren't any generally accepted standards for dealing with angels, so deal terms vary greatly. Some will require intricately structured arrangements rivaling those of venture capital firms, whereas others (especially those investing very early in the process) will be content with simpler agreements. Angels without significant investing experience may not even know exactly what terms they want. Although you might sometimes want to wait for the angel to draft the agreement on their terms, you can always have your lawyer draft a model agreement that meets your expectations. Many angels will appreciate this savings of time and expense.

Because angels are primarily concerned with getting a return on their investment, most will not demand an active role in the business. This means that, unlike most venture capital firms, angels will seldom insist on board representation or veto rights over employee decisions. Angels may only require the right to veto significant changes to the business plan, management salary levels, and the amount of equity available for employee incentive programs. Angels are also free from some of the restrictions that bind venture capital firms. For instance, angels will sometimes allow founders to cash out partially by selling some stock directly to investors during a funding round. Venture capital firms will rarely allow such a transaction because of concerns it will cause the founder to be less committed to the enterprise.

One of the risks of accepting investments from individual angels, rather than through an angel group or investment firm, is that you may have less knowledge about the potential investor. Angels may also be somewhat more likely to drag their feet before writing you the big check, insisting on lower investment amounts or a multistage investment. Sometimes, the only way to get one investor to commit is to have another investor lined up to invest to increase the sense of urgency.

Bootstrapping

Some startups will plan to avoid or postpone the need to find outside investors for as long as is possible. Such an approach allows the founders and other stockholders to avoid diluting their ownership interests and build the company with the profits of the company. Even startup companies that plan to take funds from outside investors will engage in some amount of bootstrapping to limit the amount of funds they need to take and limit dilution.

This approach may be difficult for some high-technology businesses that are capital intensive or require funding to get the product to market. However, companies may decide to bootstrap for a period of time to extend the burn rate of cash for the company.

How does a company bootstrap itself? Generally, this approach will be done by limiting expenses to maximize cash flow for the company. In the case of bootstrapping, cash really is king. A company may choose to offer a basic product or service for sale to customers while developing a richer product offering or providing consulting services while developing the ultimate product offering.

WHAT DOES "BOOTSTRAPPING" ENTAIL?

Here are a few examples of approaches to bootstrapping:

- Providing consulting services related to the product you are developing
- Licensing your technology for an alternative application
- Factoring your accounts receivable
- Leasing equipment or buildings
- Using trade credit (purchases made on net 30-, 60-, or 90-day terms, for example)
- Requiring upfront payment from customers
- Developing favorable relationships with key vendors
- Entering into a sale-leaseback arrangement in which a third party will purchase corporate assets such as computers, furniture, or other company equipment for cash and lease them back to you

Bank Loans

Although many startup companies seek equity financing instead of debt financing, entrepreneurs may still find it helpful to consider the various bank loans available.

Bank loans can be classified according to whether the loan is short term or long term and whether the loan is secured or unsecured. Short-term loans are generally used to finance the company's inventory needs, accounts payable, and general working capital. Interest rates are typically lower on short-term loans than long-term financing. Long-term loans typically require a larger amount of collateral to secure the financing far into the future. They are usually used to finance fixed assets, such as the company's property, plant, and equipment.

Loans may also be secured or unsecured. Unsecured loans are simply promises to pay a debt. If the borrower defaults on the loan, the lender's only recourse is to sue the borrower. In such a situation, the lender will not have any priority claim to a particular piece of the borrower's property. Consequently, businesses have a difficult time obtaining unsecured loans unless they have a strong credit history. Secured loans are also promises to pay a debt, but the promise is "secured" by the property of the debtor (called "collateral"). If the borrower defaults on the loan, the creditor can recover his losses by seizing the property that was collateral for the debt.

For companies that are unable to obtain banking loans from traditional large financial institutions, some startup companies will choose to work with community or local banks. These banks may offer a complete banking relationship and be willing to provide financial products with more varied minimum amounts, payment plans, or interest rates. Startups also may benefit from microloans, which have begun to be an important tool for newly established small businesses. These loans can range from several thousands of dollars to up to $35,000. Microloans are funded by the SBA through grants to nonprofit community lenders that oversee the lending process to business borrowers. The unique feature is that the lending and credit decision is made locally by the community lender. Each community lender will have individual credit and lending requirements, but the maximum term of these loans is six years. The microloans will require the borrower to provide a personal guarantee and some form of collateral. Additionally, the community lenders will require the borrower to complete a business planning and training program before issuance of the loan, but the tradeoff is that microloans are easier to obtain than a traditional bank loan.

LOAN PROGRAMS FOR STARTUPS

Some examples of the types of loans available to entrepreneurs and start-up businesses are as follows:

1. **Working capital lines of credit:** Under a line of credit, a party may borrow funds as needed, up to a specified maximum amount. The line of credit is used to fund the working capital and cash needs of the business. To secure the loan, the bank will sometimes use the company's accounts receivable or inventory as collateral. The term of the loan may vary and is often renewable. Borrowers will pay interest on the outstanding balance of the line of credit.
2. **Short-term commercial loans:** Short-term loans are usually given for a specific expenditure, such as a piece of equipment. Interest is paid on the lump sum of the loan and is often a fixed rate, so businesses usually do not face much risk of rising interest rates. Short-term loans may be as short as 90–120 days or may extend from one to three years. The loan is typically secured by collateral, such as accounts receivable, inventory, or a fixed asset of the business. Most loans to startup companies and new small businesses are short term, and the lending agency will review the company's cash flow and credit history before providing funds.
3. **Long-term commercial loans:** Long-term loans (those with terms longer than one to three years) are more difficult for new businesses to obtain because the risk that the new business will default increases with the length of the loan. The length of the loan usually ranges from five to seven years, although loans secured by real estate may extend much longer. Long-term loans are generally used for business expansions and to fund major plant and equipment purchases. Lenders usually require that the loan be secured by the asset being acquired. In addition, the lending agency will review the company's business plan and cash flow to determine whether the company will be able to repay the principal and interest over the term of the loan. Lenders may also require insurance to protect the collateral.
4. **Small business credit cards:** Small business credit cards offer an alternative to working capital lines of credit. They provide a quick source of limited funds when cash flow is tight. The interest rates are typically only slightly less than the interest rate on individual consumer credit cards and may not have very high spending limits. Small business owners who are considering this option should also be aware that they may have personal liability for the credit card, at least until the business has an established credit history of its own and the business owner can negotiate a new arrangement. If the credit history of either the business owner or the business itself is less than flawless, the credit card company may also require that the business deposit a specified amount of cash as collateral for securing a credit line.

5. **Letters of credit:** Businesses engaged in international trade frequently use letters of credit as a method for making payments. In these situations, the buyer and seller will arrange a contract for the sale and shipment of goods. The buyer will then deposit money (or take out a loan) at his local bank in the amount of the letter of credit. The buyer's bank will issue the letter of credit to the seller's bank in the foreign country. The letter of credit will specify certain documents that must be presented for buyer's bank to transfer the funds. Such documents frequently include a commercial invoice, the bill of lading for the shipment of the goods, and insurance documents. The seller's bank will then notify the seller that a letter of credit was opened in his favor and that the goods may be shipped. Once the goods have been sent, the seller will present the requisite documents to his local bank for approval. If the documents conform to the letter of credit, the issuing bank will transfer the money to seller's bank and the money will be deposited in the seller's account.

   Letters of credit are beneficial for both parties to the transaction for a couple of reasons. First, by requiring certain documents in the letter of credit, the buyer is offered some protection that the goods were sent on a particular date and that they were shipped in a particular condition. Second, the seller is offered protection that he will be paid, because the buyer's bank is required to honor the letter of credit on presentment of conforming documents. The flipside of these advantages, however, is that parties must be exceptionally precise when filling out the letter of credit and presenting the required documents. Even if the goods arrive on time and in the required condition, the issuing bank will not be obligated to make a payment if the documents do not conform to the letter of credit or if they are not received on time. Thus, the parties must pay very close attention to detail and must be as accurate as possible in their terminology.

Seed Funding Firms

Seed funding firms typically invest small amounts of money in startups, almost exclusively in the early stages of a company's development. Usually, the goal of seed funding is to cover the operating expenses of a startup until it reaches the point at which it produces something impressive enough to raise money on a larger scale. Seed funding firms come in many different forms. Some seed firms primarily provide funding and advice, whereas other firms will also provide operating space and even employee and legal help. This latter type of seed firm is sometimes referred to as an incubator, and, according to the National Association of Business Incubators, there are about 800 incubators operating in the United States.

Early-stage investments are particularly risky, and, in many instances, seed firms have very little information on which to base their funding decisions. Because many young startups radically change their business plan early on, seed firms care as much about the founders themselves as the strength of their ideas. Seed firms look for motivated, driven entrepreneurs that appear highly motivated. Occasionally, they will even invest money before a business plan has been developed or a management team has been put in place. Seed firms are conditioned to dealing with startups in their infancy, so they will be able to offer valuable advice about early-stage decision-making and later-stage financing. Given the risks involved, however, you shouldn't expect large amounts of funding from a seed firm.

One advantage of seed firms is that they are easier to find and reach than individual angels. Seed firms are established companies with websites and public contact information; reaching them is as simple as sending them an email. Although a personal introduction to a seed firm through a trusted contact would certainly help your chances of getting your foot in the door, it may not be as important as it is with angel investors or venture capital firms. Arranging deals with seed firms might also be easier than with an angel, because many seed firms have standardized investment processes with set deal terms they use for every startup they fund. Standardized deal terms certainly expedite the process, but be aware they might not be so favorable to you, so consult with your advisors. If other successful startups have signed deals with a seed firm using the same terms offered to you and are satisfied with the results, it is a good sign that those terms are sufficient.

Government Funding and Public Sector Support

Federal and state governments offer grant, loan, and technical assistance programs designed to promote emerging businesses. Competition for these forms of public sector funding can be fierce, and the application process is oftentimes quite arduous. Additionally, the funds usually come with burdensome restrictions on what you can do with the money. Nevertheless, some startups effectively use government funds to advance their business development, so these funding sources shouldn't be dismissed without some research and review.

Many federal agencies participate in the government's SBIR and Small Business Technology Transfer (STTR) programs. The SBIR and STTR are funding programs designed to stimulate technological innovation and fulfill the research needs of the federal government. Businesses are required to meet several criteria to be eligible for grants under either program, including U.S. ownership, for-profit status, and restrictions on number of employees. The SBIR and STTR programs differ in two major ways. First, under the SBIR program, the principal investigator listed on the SBIR application must be employed by the small business at the time of the grant and for the duration of the project. Under the STTR program, there is no such employment requirement. Second, unlike the SBIR, the STTR program requires the small business to be engaged in a collaborative relationship with a nonprofit research institution located in the United States.

For SBA loan guarantee programs (the SBA will not actually give you the loan but will guarantee a loan made through a traditional commercial lender), there is not a maximum loan amount and companies are eligible for loan terms that can be up to 25 years. SBA loan guarantee applications tend to approve applicants in which the founders have good credit scores, a strong business plan detailing the use of the proceeds from the loan, and evidence that the founder or founders have made personal financial investments.

The SBA 504 loan program (sometimes called a "development loan") is designed to assist small businesses with financing of fixed assets, including the purchase of buildings, land, and certain types of equipment. Private institutions will provide the financing for the assets through certified development companies (CDCs). Loans made under the 504 program are generally made at a fixed-rate, long-term basis. The way the development loan works is that the private lender institution will lend the company 50% of the total project, a CDC will lend 40% (guaranteed by the SBA), and the company will be responsible for the remaining 10% of the total project cost. The uses are somewhat limited: inventory, debt service, short-lived equipment, and machinery aren't eligible. However, for various projects, including building, construction, and facility renovation or retrofitting, these programs will be an option.

Companies in the importation and exportation business may be eligible for import-export bank programs, supported by the SBA. Loans for working capital of up to $1.1 million ($1.25 million if combined with an international trade loan) can be guaranteed by the SBA. This program is typically only available for U.S. companies that have been in business for one full year, operate at a profit, and do not exclusively rely on the loan to support the business operations.

Some federal agencies also run venture funding groups. Rather than awarding grants, these groups make investments in emerging businesses. For example, In-Q-Tel is a venture fund run by the Central Intelligence Agency that invests in high-tech startups, typically that look to develop technology related to the intelligence community. These venture funds normally produce good returns, and approaching them may be easier than their private sector counterparts.

Many U.S. states also offer financial assistance and other support to new startups. These funding programs are usually run through specific agencies or departments based on the relevant subject matter. You should be cautious with state funding initiatives requiring your startup to locate to an area that lacks other entrepreneurial support organizations and companies. Although free money is enticing, it certainly shouldn't be considered free if it hamstrings your business by forcing you into an unsupportive location.

Joint Ventures and Strategic Alliances

Although less common than the other forms of funding mentioned previously, strategic alliances and joint ventures can be rewarding sources of financing for a startup. These sorts of arrangements typically occur when an established company and a startup share complementary needs and objectives.

Transactions like these can come in all sorts of shapes, sizes, and structures. For example, if a funding-hungry startup was developing a product that had a good chance of succeeding in an established company's business, the parties might be willing to share in the risks and rewards on an alliance in which both parties co-develop and co-sell the product, sharing in the proceeds equally. If a startup company has two good products, applications, or ideas, the startup may want to consider selling one idea or product to another party. After the sale, the startup company can use the proceeds to fund the second idea or application. Some larger companies have investment arms that provide direct funding to interesting companies or technologies. This allows the larger business to "outsource" research and development activities without weighing on profitability numbers for the entire corporation. As you can see, there are numerous ways for a startup to ally with an established company.

How do parties structure these relationships? One method is for the parties to come together and form a separate joint-venture entity, sharing resources, facilities, and information. This is a great way for a startup to get access to equipment, personnel, manufacturing capabilities, distribution channels, and sales forces that would be otherwise unavailable. Strategic alliances with a high-profile established business might also provide validation for the startup's vision and business acumen, facilitating future funding from other sources.

Established businesses look for joint venture partners that will provide significant business benefits. Typically, they will only be interested in your product if it can increase their sales 15% to 25% or if it provides them with a market advantage over their competitors. They will also prefer partners that have firmly established intellectual property rights. To find the right business partner, you must first develop your understanding of the market. Partnering with a larger entity may involve some creative thinking to ensure the parties' interests are aligned.

Where can you find potential corporate partners? Read the trade journals, talk to firms up and down the distribution chain, and find out which businesses in your industry are the early adopters of new advances. When you've found a potential suitor, make sure to push for a formal agreement as early as possible to establish your rights in the relationship. Above all, be reasonable in demands for profit sharing; asking for too much is an easy way to repel established businesses.

Finally, licensing arrangements may represent the simplest way for a startup to profitably ally with an established business. The parties might reach a licensing arrangement wherein the established company agrees to fund a startup's product development for the right to exploit that product for their own benefit. Alternatively, the parties might agree to cross-license each others' technologies. Startups can profit handsomely from these arrangements by collecting upfront or access payments, milestone payments and royalties, research funding, and loans and equity investments. It is crucial to consult with an attorney about your intellectual property rights and the optimal scope and span of your licenses before discussions with potential business partners.

Venture Capital Financing

There are a number of examples of highly successful companies that used venture financing: Amazon.com, America Online, Amgen, Apple Computer, Cisco Systems, Compaq, DEC, Federal Express, Genentech, Google, Intel, Lotus, Netscape, Oracle, Seagate, Sun Microsystems, 3Com, and Yahoo!. Because of the importance of venture capital as a financing source for many high-technology companies, Chapter 10 takes a closer and more thorough look into the process for obtaining venture financing, details on the venture capital financing transaction, and understanding a term sheet and other deal points in a venture capital deal. The section below provides an introduction and a broad overview into venture capital firms and financings.

Public perception is that VCs only fund high-tech companies. However, the truth is that VCs will fund a variety of companies that fit their investment profile and provide returns consistent with their internal metrics. Although firms may invest in industries outside of high-technology fields, it is still typical that a firm will focus its investments into certain fields, industries, or technologies. This focus is the result of the ability of the firm to understand the technology, market, and potential of any investment, as well as to allow the firm and its partners to offer its portfolio companies ongoing value as an outside advisor.

Likewise, the perception exists that venture capital firms only invest in mid-stage or advanced-stage companies. Although there are many firms that will focus their investments on mid-stage and advanced-stage companies, firms do choose to invest in early-stage companies. Matching the typical investment stage and technology or market focus of the venture capital firm is integral to obtaining funding from a venture firm.

HOW DOES THE VENTURE CAPITAL PROCESS WORK?

From a company's standpoint, here is how the whole venture financing transaction and relationship looks:

- The company starts up and needs money to grow. The company seeks venture capital firms to invest in the company.
- The founders of the company create a business plan that shows what they plan to do and what they think will happen to the company over time. The business plan should include how fast the company will grow, how much money it will make, who the key managerial leaders will be, and other relevant information.
- The VCs look at the plan, and, if they like what they see, they invest money in the company. Very often the most important aspect of the plan is a clear articulation of who is running the company. VCs deeply value leadership and management success when dealing with startup companies that all begin to look alike. Good management is a key differentiator.
- The first round of investment is typically called the Series A round, and the company will receive cash in exchange for equity ownership, which is usually given in the form of preferred stock of the company. Over time, a company will oftentimes receive three or four (more or less depending on the needs of the company) rounds of funding before going public, getting acquired, or going out of business.

In return for the money it receives, the company gives the VCs stock in the company as well as some control over the decisions the company makes. The company, for example, might give each VC firm a seat on its board of directors. The company might agree not to spend more than $X (say $250,000) without the VC's approval. The VCs might also need to approve certain people who are hired, loans that are made, and other key decisions.

In many cases, a VC firm offers more than just money. For example, it might have good contacts in the industry or it might have a lot of experience it can provide to the company. The value an experienced VC may add to a startup company often may transcend mere financing.

One big negotiating point that is discussed when a VC invests money in a company is, "how much stock should the VC firm get in return for the money it invests?" This question is answered by choosing a valuation for the company. The VC firm and the people in the company have to agree how much the company is worth. This is the premoney valuation of the company. The VC firm then invests the money in the company and creates a postmoney valuation. The percentage increase in the value determines how much stock the VC firm receives. A VC firm might typically receive anywhere from 10 to 50% of the company in return for its investment. More or less is possible, but this represents the typical range for a first-round investment. The original shareholders are diluted in the process. If the situation exists in which the shareholders own 100% of the company before the VC's investment, then following an investment by the VC firm in exchange for 50% of the company, the original shareholders' shares would now represent the remaining 50% ownership in the company.

After several rounds (each round involving a new series of stock) of financing, the company and the investors will usually be looking for liquidity for their investment. Private companies without a market to buy or sell their shares usually have few opportunities for an investor to "cash out" their stock. Therefore, most VC-backed companies will look to do some type of a liquidity event such as an IPO or an acquisition event. At or after either event, the VC firm and company will look to end or scale back the relationship. However, to be fair, reaching such a point often will involve three to seven years, multiple rounds of financings, and a substantial amount of time to find and finish such a transaction. To satisfy its investors, a VC will ultimately need to be able to extract its investment (plus a healthy return) to return the funds to its investors. For example, in many e-commerce companies or biotechnology, it isn't uncommon that a group of institutional investors have invested between $50 and $100 million before an IPO.

Most VCs will look at a highly successful return on their investment if they are able to return 10 times or more of their investment back to the fund. The odds of this happening are low, so having one homerun in the investment portfolio can pay off the numerous low-performing investments. VCs are still happy with returning two to three times the investment on a company. If a VC has 10 portfolio companies it has invested in with one big winner (10 times), one or two medium winners (two to three times), one or two breakevens, and the rest losers, the fund could wind up a success for the investors and the venture partners. Venture capital firms operate in a very risky game in which they hope to find one Google or Apple and avoid investing in too many Webvans (a famous Web-based grocery delivery company that once had about $800 million in venture capital but ended up with $830 million in losses and just $40 million on hand when it closed up shop) or Kozmo.com (a small-goods delivery service that raised more than $250 million only to be forced to liquidate in 2001).

To download a copy of the sample terms for a convertible note and warrant term sheet, visit the book's website at http://www.myhightechstartup.com.

SAMPLE TERMS FOR A TERM SHEET

Convertible Note and Warrant Financing

MEMORANDUM OF TERMS FOR THE PRIVATE PLACEMENT OF SECURITIES OF HIGH-TECH STARTUP INC.

This term sheet summarizes the principal terms of the proposed financing of High-Tech Startup Inc. (the "Company"). This term sheet is for discussion purposes only; there is no obligation on the part of any negotiating party until a definitive note and warrant purchase agreement is signed by all parties. This term sheet is subject to the satisfactory completion of due diligence. This term sheet does not constitute either an offer to sell or an offer to purchase securities.

Amount to be raised: $250,000

Type of security: Convertible promissory notes (the "Notes").

Warrants:

Warrants to purchase securities issued in the Company's next equity financing having an aggregate exercise price equal to 20% of the principal amount of the Notes.

- OR -

Warrants to purchase Common Stock having an aggregate exercise price equal to 20% of the principal amount of the Notes.

Interest rate:

Prime plus 2% per annum.

- OR -

6% per annum.

Maturity:

Principal and accrued interest shall be converted on or before December 31, 2009 into equity securities issued in the Company's next equity financing in an aggregate amount of at least $5,000,000 (including conversion of the Notes) (the "Next Equity Financing").

If the Next Equity Financing does not occur on or before December 31, 2009, principal and accrued interest shall be payable upon demand of the Holder.

- OR -

If the Next Equity Financing does not occur on or before December 31, 2009, principal and accrued interest shall be due and payable on such date.

- OR -

If the Next Equity Financing does not occur on or before December 31, 2009, principal and accrued interest shall be payable in four equal quarterly installments.

Conversion discount [only used if the Company will provide the Note Holder the ability to convert at a discount]:

Each Note will convert at a 10% discount to the price in the Next Equity Financing.

- OR -

Each Note will convert at a 10% discount (the "Conversion Discount") to the price per equity security paid by investors in the Next Equity Financing, as adjusted as follows: For each full month that the Notes are outstanding, the Conversion Discount shall be increased by 2.5% up to a maximum of 35%, as set forth in the table below.

Month 0 = 10.0%
Month 1 = 12.5%
Month 2 = 15.0%
Month 3 = 17.5%
Month 4 = 20.0%
Month 5 = 22.5%

Month 6 = 25.0%
Month 7 = 27.5%
Month 8 = 30.0%
Month 9 = 32.0%
Month 10 = 35.0%
Month 11+ = 35.0%

Subordination: The notes will be subordinate in right of payment to all current and future indebtedness to banks and other financial institutions.

- OR -

The notes will be subordinate in right of payment to certain indebtedness to banks and other financial institutions.

- OR -

None of the above (no subordination).

Security interest:

The Notes will be unsecured.

- OR -

The Notes will be secured by all of the Company's assets.

- OR -

The Notes will be secured by certain assets of the Company, including computer equipment, network equipment, and electronic storage equipment.

Investors:

	Principal Amount of Note
Jane Angelita	$100,000
John Familia	$75,000
Joe Entrepreneur	$25,000
ABC Ventures LP	$50,000
	$250,000

Closing Date: The closing of the sale of the Notes will occur on or before March 31, 2009.

6

WHY NOT FORM A NEW BUSINESS AS AN LLC?

L. Andrew Immerman
Ethan D. Millar

An LLC can give tax advantages that make it particularly attractive to new businesses.

WHEN FORMING A NEW BUSINESS, ask yourself: Why not a limited liability company ("LLC")? The question is not rhetorical. The LLC form is not always the best choice for a new business. An LLC is the right choice, however, in a majority of cases. Accordingly, an LLC should be the first form to consider for a new business.

Although state LLC statutes vary greatly, an LLC may now be formed under the laws of any state or the District of Columbia. Most (not all) multi-member LLCs are classified as partner-

L. Andrew Immerman, a partner at Alston and Bird LLP in Atlanta, is a frequent author and speaker on domestic and international income tax issues. **Ethan D. Millar** is an associate with Alston and Bird. The authors thank Saba Ashraf for helpful comments on this article.

ships for federal income tax purposes under the Internal Revenue Code of 1986, as amended (the "Code"). *See* Treas. Reg. §§301.7701-1 to -4. Accordingly, except as otherwise stated, we will treat "LLCs" and "partnerships" as equivalent. Many of the advantages discussed in this article are advantages that LLCs have over S corporations, rather than over partnerships. The liberalization of the S corporation rules by the Jobs Creation Act of 2004 only slightly reduced the disadvantages of S corporations as compared to LLCs. The LLC will still be the preferred entity in most cases.

The tax differences between partnerships and multi-member LLCs are relatively minor compared to the differences between S corporations and multi-member LLCs. A multi-member LLC may differ from a state law partnership in various respects, such as the degree of liability protection, flexibility in governance, and waivability of fiduciary duties, as well as in aspects of state, local, federal, or foreign tax treatment. For purposes of this article, however, the differences between LLCs and state law partnerships will mostly be ignored.

This article is not intended as a comprehensive analysis of the pros and cons of various forms of entity. Our purpose, rather, is to encourage you to think first of the LLC. From that starting point, you may nevertheless find compelling reasons to choose another form of entity.

YOU CAN PAY ONE TAX INSTEAD OF TWO • An LLC is generally treated as a partnership for federal income tax purposes. Accordingly, the LLC itself is not subject to federal income tax, and all of its income, gain, loss, deduction, and credit are passed through to its members. §701 (All section references are to the Code unless otherwise indicated). Thus, operating a business through an LLC means one level of federal income tax, at the member-level.

By contrast, a C corporation is subject to an entity-level federal income tax on its income, and amounts distributed to shareholders are generally subject to an additional federal income tax at the shareholder level. §§11, 301. Accordingly, income earned by a C corporation and distributed to its shareholders is generally subject to two levels of taxation. S corporations are generally not subject to a corporate-level tax, except when the S corporation was formerly a C corporation, or when the S corporation acquired a C corporation in a tax-free transaction. *See* §§1374, 1375.

C corporations often attempt to "zero out" income by deducting salary, rent, interest, and other expenses. Depending on the circumstances, however, it can be difficult or impossible to "zero out" a C corporation's income. A plan to "zero out" a C corporation's income is especially prone to failure if the C corporation has assets that appreciate in value. Real estate is the classic example of an appreciating asset. But less obvious examples—including goodwill—can create massive tax liabilities. The limits of a strategy based on "zeroing out" income often become painfully apparent on a sale or other disposition of the business. Even a business formed as an S corporation can face difficult problems in these situations.

Example—Business Develops Goodwill

A and B form consulting firm X. X operates for several years without paying any corporate-level tax. X builds up valuable goodwill among customers. A and B then join Y LLC, a larger consulting firm, and take along the goodwill developed by X. A and B receive equity in Y LLC, but no upfront cash payment.

• *If X is a C Corporation*: Assuming that the goodwill is an asset of X, X is taxable as if it sold the goodwill at fair market value in a liquidating transaction. A and B are taxable as if X distributed the goodwill to them.

• *If X is an S Corporation*: In this case, X's gain on the deemed sale of the goodwill is passed through to A and B who are taxable on such gain. In addition, A and B will be taxable on the deemed distribution to them, to the extent the distribution exceeds A's and B's tax bases in the S corporation stock. §1368(b).

• *If X is an LLC*: X has no taxable income, and in general neither does anyone else. The transaction should be characterized as a partnership merger under section 708(b)(2)(A) and Treas. Reg. §1.708-1(c).

In the foregoing example, X might have been able to avoid corporate-level tax on its operating income for a long period, but faced a day of reckoning when A and B tried to join another firm.

The example is biased in favor of the LLC form. If the acquirer is a corporation instead of an LLC, A and B might be able to receive acquirer stock in a tax-free corporate reorganization described in section 368(a)(1). Moreover, even if X is a corporation, and the acquirer an LLC, it may be possible to argue—in the right circumstances—that the goodwill is a personal asset of A and B (i.e., is owned by A and B individually, rather than by X), so that corporate gain is not triggered on a deemed disposition of the goodwill. *See Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

The adverse impact of the double tax was reduced under legislation enacted in 2003. Most C corporation dividends to individual shareholders are taxable at long-term capital gain rates (normally, a maximum of 15 percent). The special tax rate on dividends, which is scheduled to last through 2008, reduces, but does not eliminate, the disadvantages of double tax. The adverse impact of double tax is also mitigated by the ability of C corporations to accumulate earnings without paying dividends. The ability to accumulate earnings is constrained, however, by the personal holding company tax and the accumulated earnings tax. §§531, 541.

YOU CAN CAPITALIZE IT ANY WAY YOU WANT • An LLC has nearly unlimited flexibility in the types of equity and debt interests that it may issue to its members. An LLC may issue all manner of common interests, preferred interests, vested or unvested interests, debt, and options to acquire any of the above. By comparison, an S corporation cannot have more than one class of stock, although differences in voting rights are permitted and an S corporation may issue multiple classes of debt. §1361(b)(1)(D). The "one class of stock" requirement for S corporations precludes the complex economic sharing arrangements among equity owners that business deals often demand, and that LLCs can accommodate. Moreover, creativity in structuring debt may be fatal to S corporation status, since in some circumstances a debt instrument or obligation may be treated as an impermissible second class of stock. Treas. Reg. §1.1361-1(l)(4)(ii). The operating rules of S corporation tax are simpler than those that apply to multi-member LLCs, but this simplicity is in large part a reflection of the inflexible requirements of S corporation capitalization.

Although a C corporation may have multiple classes of both debt and equity, the fact that a deduction is available for interest but not dividends tends to favor debt capital over equity capital, at least when the C corporation's shareholders are not entitled to a dividends-received deduction. The tax advantage of debt may distort capitalization decisions for C corporations, creating higher debt to equity ratios than would otherwise make sense. Tax considerations influence financing decisions for an LLC as well, but often not to the same extent as for a C corporation.

YOU CAN PASS THROUGH LOSSES • Losses incurred by a C corporation do not pass through to its shareholders. Accordingly, shareholders do not receive a direct tax benefit from a C corporation's losses, as may shareholders in an S corporation or members in an LLC. Although the pass-through of losses of both LLCs and S corporations is limited by the bases of the owners (§§704(d), 1366(d)), the liabilities of an S corporation (unlike the liabilities of an LLC) are not included in the owners' bases. The exclusion of entity-level liabilities from the basis of S corporation shareholders reduces the amount of losses that can flow through to the shareholders. (As explained below in connection with distributions, this basis rule also tends to make the distribution of financing proceeds taxable to the shareholders.) Nevertheless, despite the inclusion of LLC debt in the bases of the LLC members (§752), there are numerous restrictions on the deduction of losses that are passed through from an LLC. *See, e.g.*, §§465, 469 and 704(d).

ANYONE CAN OWN AN LLC • Any type of person—whether an individual or an entity—may be a member of an LLC. This is not necessarily to say that LLCs may engage in any type of business, although there are relatively few limits. State law or professional ethics requirements sometimes prevent professionals (*e.g.*, doctors, attorneys or accountants) from operating in LLC form. Conversely, certain states have specifically limited membership in limited liability partnerships to licensed professionals in the same discipline.

An S corporation imposes the tightest restrictions on membership—it cannot have as a shareholder a person who is a nonresident alien, or a person other than an individual, an estate, or one of certain types of trusts or tax-exempt corporations specified in the Code. §§1361(b)(1)(A), (B) and (C); 1361(c)(2) and (6). In principle, just one ineligible shareholder of an S corporation, such as a partnership or a corporation, will cause the S corporation status to terminate. The restrictions on S corporation membership arise under the tax rules rather than under state business entity principles. "S corporation" is strictly a tax concept. An S corporation need not even be a "corporation" under state law. *See* Treas. Reg. §301.7701-3T(c)-(1)(v)(C); Pvt. Letter Rul. 200450012 (Aug. 26, 2004).

There is no minimum or maximum number of LLC members. Entities formed as partnerships under state law, however, require at least two members. S corporations cannot have more than 100 shareholders, although all members of a "family" can be treated as one shareholder. §1361(b)(1)(A). This limit on the number of S corporation shareholders, effective for tax years beginning after December 31, 2004, is a liberalization of the prior rule. Before the American Jobs Creation Act of 2004, the upper limit on S corporation shareholders was 75, and only a husband and wife could be treated as one shareholder. (The 2004 Act eased several other S corporation rules, but the changes were generally minor. These changes perhaps have the greatest impact on community banks. Banks cannot be classified as partnerships for tax purposes, and so for them the potential advantages of partnerships over S corporations are irrelevant. To achieve pass-through tax treatment, a bank must qualify as an S corporation.)

Although anyone may own an interest in an LLC, there are some practical limitations. For example, if ownership of the interest would cause an LLC to be classified as a publicly traded partnership for federal income tax purposes, the LLC may be taxed as a corporation. §7704(a). In general, an LLC will be treated as a publicly traded partnership if interests in the LLC are traded on an established securities market, or are readily tradable on a secondary market or the equivalent. However, interests in an LLC will generally not be treated as readily tradable on a secondary market if the LLC does not have more than 100 members at any time during a particular tax year. Treas. Reg. §1.7704-1(h)(1)(ii). In addition, pass-through of income to members of an LLC may be unattractive to some investors, such as certain foreign persons or tax-exempt entities. Most individuals (other than lawyers and accountants) also generally prefer to be treated as "employees" rather than as "partners" for tax purposes. (One reason for preferring "employee" status, as discussed briefly below, is the avoidance of self-employment tax.)

YOU CAN EASILY MAKE TAX-FREE CONTRIBUTIONS • In general, neither the LLC nor any of its members will be required to recognize any gain on the transfer of property to an LLC in exchange for an interest in the LLC. §721(a). However, contributions of property to C corporations or S corporations by their shareholders only qualify for tax-free treatment if the transferring shareholders control the corporation immediately after the transfer. §351(a). For this purpose, "control" is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. §368(c).

Example—Contribution By Minority Owner

A and B contribute property to newly formed X. Some time after X has been formed, C comes along, and contributes appreciated property with a basis of zero and fair market value of $100,000 to X in exchange for 20 percent of the equity of X.

- *If X is a C Corporation or S Corporation:* C will have $100,000 of taxable gain because C is not in control of X immediately after the exchange, and is not part of a control group with A and B.
- *If X is an LLC:* C has no taxable gain. There is no 80 percent control requirement for LLCs.

If the property transferred to a corporation is subject to a liability, then, even if the transfer would otherwise be tax-free because the transferring shareholders meet the control requirement, the transferor will generally be required to recognize gain equal to the excess of the amount of the liability over the transferor's basis in the property transferred. §357(c). By contrast, if a member of an LLC transfers encumbered property to the LLC, the member is generally not required to recognize any gain if a sufficiently large portion of the debt is allocated to the member under section 752.

Example: Liability In Excess Of Basis

A and B form X. A contributes $200,000 in cash to X in exchange for a 50 percent interest in X. In exchange for the other 50 percent interest in X, B contributes property to X with basis of $500,000, and fair market value of $1 million, but subject to an "old and cold" liability of $800,000. X assumes the liability and each of A and B guarantees 50 percent of the liability.

- *If X is a C Corporation or S Corporation:* B will recognize gain of $300,000 (the excess of the amount of the $800,000 liability over B's $500,000 basis).
- *If X is an LLC:* B would generally recognize no taxable gain. However, because B is relieved of half of the $800,000 liability, B is treated as receiving a $400,000 cash distribution from X, which reduces his basis in his interest in X from $500,000 to $100,000. *See* §§705(a), 722, 752.

However, even when X is an LLC, transferring property—especially encumbered property—can be tricky. Besides the debt allocation rules, the possible application of the disguised sales provisions should be taken into account when making a choice of entity decision (§707-(a)(2)(B) and Treas. Reg. §§1.707-3 to -9).

YOU DON'T PAY TAX ON THE OTHER OWNER'S BUILT-IN GAIN • In general, if a member of an LLC contributes property with a built-in gain or loss to an LLC, the built-in gain or loss is specially allocated to the contributing member upon a later taxable disposition of the property by the LLC. §704(c). C corporations and S corporation have no corresponding principle. Thus, a shareholder of a corporation may be required to bear the tax burden of built-in gain property transferred to the corporation by another shareholder.

Example—Tax On Built-In Gains

A and B form X. Each has an equal interest. A contributes property with a fair market value of $1 million and a basis of zero. All $1 million is depreciation recapture. B contributes property with a fair market value of $1 million and a basis of $1 million. Shortly afterwards, X sells the property contributed by A for $1 million.

- *If X is a C Corporation:* Neither A nor B has taxable income on the contribution. X has $1 million of ordinary income on the sale of the property contributed by A. B suffers a decline in value in his share of X's stock because of the tax payment, but B never enjoyed the gain on which the tax is paid.
- If X is an S Corporation: Neither A nor B has taxable income on the contribution. Each of them has $500,000 of ordinary income on the sale of the property contributed by A. Economically B has no gain; B is paying tax on $500,000 of A's economic gain.
- If X is an LLC: Neither A nor B has taxable income on the contribution. A has $1 million of ordinary income on the sale of the property contributed by A; B has no income. §704(c). A pays tax on his own gain.

The distortion caused by the S corporation form in this example, however, could be an advantage if the parties actually wanted B to bear A's tax liability (although in that case the IRS might invoke anti-abuse principles in an effort to prevent the distortion).

YOU CAN GET TAX-FREE EQUITY FOR SERVICES • In most instances, if a person provides services to an LLC in exchange for a vested or nonvested "profits interest" in the LLC, neither the LLC nor the service provider is taxable on the exchange or, in the case of a nonvested interest, on the vesting date. Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191. The IRS may attempt to tax the receipt of a profits interest, however, if the profits interest relates to a substantially certain and predictable stream of income from the LLC's assets, if the service provider disposes of the profits interest within two years of receipt, or if the LLC is a publicly traded partnership.

On the other hand, if a person provides services in exchange for a "capital interest" in the LLC, this exchange is generally a taxable event. Treas. Reg. §1.721-1(b)(1). A capital interest is defined for this purpose as any interest that would give the holder a share of the proceeds if the LLC's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the LLC. A profits interest is any interest in the LLC other than a capital interest. Rev. Proc. 93-27, 1993-2 C.B. 343.

By contrast, if a person provides services (either past or future) to a corporation in exchange for stock in the corporation, the receipt of stock will generally be taxable to the service provider. Treas. Reg. §1.351-1(a)(1)(i). In addition, if multiple parties transfer property and provide services to a corporation in exchange for stock, the issuance of stock to the service providers may cause the shareholders transferring property *not* to have the requisite control of the transferee corporation immediately after the exchange. In that case, the entire exchange (*i.e.*, both to the service providers and the property transferors) may become taxable.

Example—Equity For Property And Services

A and B form X. A contributes property to X, with a basis of zero and a fair market value of $1 million, in exchange for a 50 percent interest in X. B contributes future services that he will perform for X, and he receives an unrestricted 50 percent interest in X.

- *If X is a C Corporation or S Corporation:* A will have taxable gain equal to $1 million because he is not in control of X immediately after the exchange, and is not part of a control group. B will have taxable ordinary income equal to $500,000 (or whatever other amount B's interest in X is valued at). However, X should have a deduction for the compensation paid to B.
- If X is an LLC: A has no taxable gain. B will also have no taxable gain, provided he receives only a profits interest in X.

YOU CAN TAKE TAX-FREE DISTRIBUTIONS • Distributions of cash or property made by an LLC to its members are never taxable to the LLC. §731(b). (We stress again that, unless stated otherwise, we are treating "LLC" and "partnership" as synonyms. An LLC classified as a corporation for tax purposes of course faces vastly differently consequences.) In addition, such distributions are usually not taxable to the LLC's members, because the LLC members are taxable as the LLC earns income, whether or not the income is actually distributed. §§731(a), 702. There are exceptions for certain distributions of cash, marketable securities, property previously contributed to the LLC with a built-in gain, and distributions that cause a member's share of the LLC's liabilities to decrease. *See* §§731(a), 731(c), 704(c), 737, 752(b). Moreover, not every amount a member receives from an LLC is a "distribution." For example, a member may receive interest on loans to the LLC, or the proceeds of the sale of property to the LLC, or guaranteed payments for services or capital provided to the LLC. §707(c).

The distributee member generally takes a transferred basis in the distributed property, and must reduce his outside basis by any cash received plus the basis taken in the distributed property. §§732(a), 733. In a liquidating distribution, the distributee will not have an outside basis after the distribution. Accordingly, the distributee's basis in the property distributed is determined not by reference to the partnership's inside basis for those assets, but by reference to the distributee's outside basis (as reduced by any cash distributed). §§732(b).

By contrast, a corporation generally recognizes taxable gain when it distributes appreciated assets to shareholders. §§311(b), 336. In the case of a C corporation, the corporation itself is taxable on the gain. In the case of an S corporation, the gain generally passes through to the shareholders and is taxable to them. The amount of the gain is calculated as if the property distributed was sold for its fair market value.

The shareholders of a C corporation generally recognize taxable income when they receive distributions. §§301, 302, 331(a). Like a member of an LLC, however, an S corporation shareholder is generally only taxable on distributions to the extent the distributions exceed the shareholder's tax basis in his S corporation stock. §1368(b). However, if the S corporation was formerly a C corporation (or acquired a C corporation in a tax-free transaction), distributions may be subject to tax to the extent of the S corporation's accumulated earnings and profits (after the S corporation's "accumulated adjustments account" has been reduced to zero). §1368(c).

Example—Distribution Of Property

A and B are equal owners of X. Each of A and B has a basis of $100,000 in his interest in X. X owns real property with a fair market value of $1 million and a zero tax basis, and also has $1 million in cash. X distributes the cash to A and the real property to B.

- *If X is a C Corporation:* Each of A and B has $900,000 of taxable gain. In addition X itself also has $1 million of taxable gain. (X presumably would have to reduce the amount of distributions made to A and B so that it could pay its tax.)
- *If X is an S Corporation:* Each of A and B has $900,000 of taxable gain, which consists of (i) his $500,000 share of the $1 million gain recognized by X when X disposes of the property (under section 336 for liquidating distributions or section 311 for non-liquidating distributions), which $500,000 gain increases each of their bases from $100,000 to $600,000, and (ii) an additional $400,000 of gain ($1 million less $600,000 basis) on the $1 million distribution to each (whether in cash or in property). *See* §1367.
- *If X is an LLC:* There is no gain to X. B has no taxable gain because he receives no cash or marketable securities. However, A still has $900,000 of taxable gain. *See* §731(a).

Furthermore, to the extent that an LLC incurs debt, the LLC members' basis in their membership interests will be increased by their share of the debt incurred. §752(a). However, the liabilities of an S corporation are not included in its shareholders' basis. §§1366-(d)(1), 1367(b)(2). Accordingly, a debt-financed distribution by a corporation may be taxable, when it would be tax-free if made by an LLC.

Example—Debt-Financed Distribution

A and B form X, A contributes $1 million in cash to X in exchange for a 50 percent interest in X, and B contributes property to X with a zero basis and a fair market value of $1 million in exchange for a 50 percent interest in X. X borrows $500,000 on a nonrecourse basis from an unrelated lender. Although X has zero net income, X makes a distribution of $100,000 to each of A and B.

- *If X is a C Corporation or S Corporation:* A can receive the distribution tax-free, although it reduces A's basis in X from $1 million to $900,000. B, however, has taxable gain on the $100,000 distribution because he has a zero basis in his interest in X.
- *If X is an LLC:* Neither A nor B is taxable on the distribution. A's basis would decrease from $1.25 million (i.e., A's $1 million basis from the cash contribution plus A's share of the $500,000 debt) to $1.15 million and B's basis would decrease from $250,000 (i.e., B's share of the $500,000 debt) to $150,000.

YOU CAN "STEP UP" YOUR SHARE OF INSIDE BASIS • The buyer of an interest in an LLC takes a cost basis in that interest. The buyer inherits the seller's capital accounts and the seller's share of inside basis. In almost all cases, this will result in a disparity between the buyer's outside basis and his new share of inside basis unless the LLC makes (or has previously made) an election under section 754. If this election is made, the new member is entitled to a special basis adjustment that is intended to eliminate this disparity. §§743(b), 754, 755. A buyer of an interest in an S corporation, however, has no comparable means of eliminating such a disparity.

The seller of an interest in an LLC generally recognizes gain or loss on the sale of the interest equal to the difference between the amount realized and the seller's outside basis. §741. The character of that gain will be capital except to the extent that it is attributable to certain ordinary income assets. §751. By contrast, the seller of an interest in an S corporation (or C corporation) generally recognizes capital gain on the sale of that interest, despite the presence of ordinary assets in the corporation. (A notable exception is where the buyer and seller agree to, and are eligible for, an election under section 338(h)(10), which causes a stock sale to be treated more like an asset sale.) Although the added potential for capital gains is a benefit of S corporation status, this benefit needs to be weighed against other problems, including the inability to step up inside basis within an S corporation.

Example—Gain On Sale Of An Interest

A and B are equal owners of X. They have held their interests longer than one year, and have zero tax bases. X owns depreciated equipment, which originally cost $1 million. The equipment still has a fair market value of $1 million, but a zero tax basis. B sells his interest in X to C for $500,000.

- *If X is a C Corporation or S Corporation:* B has capital gain. The maximum federal capital gain rate for individuals is 15 percent. B's federal tax is $75,000.
- *If X is an LLC:* B has ordinary income because the value of his interest is attributable to "depreciation recapture" property. The maximum federal ordinary income rate for individuals is generally 35 percent in 2005. B's maximum federal tax is $175,000, more than twice as much than the tax if X is an S corporation.

Example Continued—Subsequent Gain On Sale Of Assets

In the same example, one week after C buys its interest for $500,000, X sells its zero-basis equipment for $1 million.

- *If X is a C corporation:* X has $1 million of taxable income, all of which is ordinary income. Assuming the maximum corporate tax rate (in 2005) of 35 percent applies, X will pay $350,000 of tax. C suffers a decline in value in his share of X's stock because of the tax payment, but C never enjoyed the gain on which the tax is paid.
- *If X is an S Corporation:* C has $500,000 of taxable income (50 percent of total), all of which is ordinary income. Economically, however, C has enjoyed no income or gain. C paid $500,000 for his interest and his interest is still worth just $500,000. If C understands the problem, C will be much less likely to pay $500,000 for his interest in the first place.
- *If X is an LLC:* If X makes an election under section 754 to adjust basis, C has no taxable gain. *See* §743(b).

YOU CAN CHANGE YOUR MIND LATER

- In general, converting from an LLC to a corporation is not a taxable event. *See* Rev. Rul. 84-111, 1984-2 C.B. 88. Such a conversion is normally treated as a contribution of the LLC's assets to a newly formed corporation in exchange for its stock, followed immediately thereafter by a distribution of the stock to the LLC's members in liquidation. Accordingly, care must be taken in such a conversion to ensure that the former LLC's members have control of the newly formed corporation immediately after the conversion. §§351(a), 368(c).

By contrast, converting from a C corporation to an LLC is generally taxable to both the corporation and its shareholders. The conversion is generally treated as a liquidation of the corporation, taxable under sections 331 and 336, followed by a nontaxable contribution of assets by the former shareholders to the newly formed LLC under section 721. If the conversion is of a corporate subsidiary, the deemed liquidation may be tax-free under sections 332 and 337. The conversion of an S corporation to an LLC normally triggers at least one level of tax. §336.

LLCS CAN BE "TAX NOTHINGS" • A single-member LLC generally can be disregarded as an entity separate from its member for federal income tax purposes—a "tax nothing," equivalent to an unincorporated branch or division. *See* Treas. Reg. §301.7701-3. An LLC classified as a tax nothing is one of the exceptions to the rule that LLCs and partnerships are equivalent for tax purposes, since a tax nothing is not a partnership.

Single-member LLCs—permitted now under almost all LLC statutes—are commonly used to insulate assets from liabilities, without any federal tax consequences. For example, a "contribution" to a tax nothing is essentially ignored for tax purposes as is a "distribution" from a tax nothing, so there is no transaction, and no gain (or loss) realized. No state permits a single-member partnership, and it is more cumbersome to structure state law partnerships as tax nothings. A state law corporation almost always must be recognized as a separate entity for tax purposes.

THE U.S. FEDERAL GOVERNMENT IS NOT THE ONLY TAXING JURISDICTION • Despite the treatment of an LLC as a partnership or disregarded entity for United States federal tax purposes, an LLC will sometimes be treated as a separate entity for state or local, or foreign, tax purposes. Although most states classify LLCs for state income tax purposes consistently with their federal tax treatment, certain states, such as Texas, treat LLCs (single-member or multi-member) as corporations for income tax purposes. Tex. Tax Code §§171.001-(a), 171.110(d) (2004). Other state s, such as Montana, do not permit a single-member LLC to be disregarded as separate from its owner for state income tax purposes, and treat such an LLC instead as a corporation. *See* Mont. Admin. R. §42.23.702 (2004).

Furthermore, states often treat single-member LLCs as separate entities for purposes of taxes other than income tax, such as sales/use tax and real property transfer tax. These differences can generate planning opportunities as well as pitfalls.

Example—Pitfall

If A transfers real property to its wholly owned LLC, then A may be subject to real estate transfer taxes on the transfer, even though the transaction will have essentially no federal or state income tax consequences. This pitfall, however, may turn into an opportunity. All subsequent transfers of the LLC interest may be excluded from real estate transfer tax, depending on state law, since an LLC interest is personal property, whereas multiple transfers of the real property normally would trigger multiple transfer taxes.

Example—Planning Opportunity

Suppose X is formed in State 1, operates a store in State 2, and sells items to A in State 2 through X's Internet business. X is generally required to collect use tax on the sale to A, because X has nexus with State 2 through its store in State 2. However, if X forms a wholly owned LLC in State 1 (which is treated as a separate entity for sales/use tax purposes) to operate X's Internet business, then the LLC may not have to collect use tax on the sale to A, because the LLC does not have nexus with State 2, even though the LLC is disregarded for income tax purposes. Some states may attempt, however, to attribute X's sales tax nexus with State 2 to the LLC.

Similarly, an LLC that is treated as a partnership or a disregarded entity for U.S. federal tax purposes may be treated as a corporation for foreign income tax purposes.

Even states that do treat LLCs as partnerships or disregarded entities for income tax purposes may impose taxes or fees on LLCs. For example, California currently imposes an annual fee of up to $11,790 on the California-source "total income" of an LLC (generally, its gross income plus the cost of goods sold in connection with the LLC's business). Cal. Rev. & Tax. Code §17942(a) (2005). In addition to this annual fee, California imposes an $800 annual minimum tax on all LLCs and partnerships doing business (or qualified to do business) in California. Cal. Rev. & Tax. Code §§17941(a) and (b)(1) (2005). By comparison, California imposes a 1.5 percent tax on the net income of S corporations doing business in the state, subject to an $800 minimum tax. Cal. Rev. & Tax. Code §§23802(a) and (b)(1) (2005).

SELF-EMPLOYMENT TAX AND OTHER POSSIBLE DISADVANTAGES • Although this article tries to explain why an LLC should be the first form of entity to think of when forming a new business, choosing the right form of entity can be a complicated task and there is no universally correct solution. One concern, as discussed above, is that the LLC may be operating in a jurisdiction (either state or foreign) that treats LLCs unfavorably, either for income tax purposes or for some other tax purpose (*e.g.*, sales/use, real estate transfer tax, etc.).

In addition, LLCs are not eligible for certain tax benefits available under the Code to other types of entities. Notably, as suggested above, corporations may engage in tax-free "reorganizations" (including certain mergers and acquisitions) as defined in section 368(a)(1). LLCs do not have this option. In a tax-free corporate reorganization, stockholders of the target may be entitled to dispose of their shares, without gain recognition, and receive stock of the acquirer—a genuine advantage of corporate status in some instances. The greater ability of LLCs, however, to engage in tax-free contributions and distributions may facilitate tax-free transactions that would be impossible between corporations. Moreover, as discussed above, LLCs often find it easy to convert to corporations tax-free, although a conversion on the eve of a corporate reorganization can be risky.

For many owner-operated businesses, self-employment taxes loom large despite the *relatively* low rates that apply to income above $90,000 (for 2005). Individual LLC members are often subject to self-employment tax on their shares of the LLC's business income. Some advisers recommend S corporations over LLCs as a way of avoiding self-employment tax, and reducing overall employment taxes. Although the possible advantages of the S corporation should be taken seriously, the contrast between LLCs and S corporation is not as stark as is sometimes presented.

The owner/employees of an S corporation are not subject to self-employment tax, but their salary is subject to employment tax (FICA). An S corporation that reduces employment tax by underpaying owner/employees may find the IRS attempting to recharacterize dividends as compensation.

LLC members cannot reduce their self-employment tax liability by substituting dividends for compensation. Many LLCs attempt to reduce self-employment tax, however, by relying on the rule that "limited partners" are only subject to self-employment tax on "guaranteed" payments for services. *See* §1402(a)(13). The IRS years ago proposed regulations that would have characterized some—but far from all—LLC members as "limited partners." Prop. Treas. Reg. §1.1402(a)-2(h) (1997), replacing a 1994 set of proposed regulations. Because of the extraordinary controversy the proposed regulations stirred up, however, it is unlikely that the IRS will finalize any regulations until Congress signals its position.

In the absence of authoritative guidance, LLC members have adopted widely divergent practices in complying with their self-employment tax obligations. The most conservative position is that an LLC member is simply not a "limited partner" under the federal self-employment tax, since an LLC member is not a "limited partner" under state law. Other LLC members are far more aggressive, arguing that all LLC members come within the meaning of "limited partner" for purposes of section 1402-(a)(13), even if they are not technically "limited partners" under state law. Many take a middle position, often, but not always, based on the 1997 proposed regulations.

AN LLC IS MORE OFTEN THAN NOT THE RIGHT CHOICE, BUT IS IT RIGHT FOR YOU? • Overall, the LLC form offers many tax advantages, besides flexibility and limited liability. There are circumstances in which an LLC may not be the preferred choice, but the LLC generally ought to be the first form of entity that comes to mind for a new business.

PRACTICE CHECKLIST FOR
Why Not Form A New Business As An LLC?

In forming a new business, ask yourself: Why not an LLC? The question is not rhetorical. The LLC form is not always the best choice for a new business. An LLC is the right choice, however, in a majority of cases. Accordingly, an LLC should be the first form to consider for a new business. Why? Subject to some limitations, including the ones discussed in this article:

__ You can pay one tax instead of two, thanks to pass-through taxation.

__ You can capitalize the LLC any way you want.

__ You can pass through losses.

__ Anyone can be an owner.

__ You can make tax-free contributions easily.

__ You don't pay tax on the other owner's built-in gain.

__ You can get tax-free equity for services.

__ You can make tax-free distributions.

__ You can "step up" your share of inside basis.

__ You can change your mind later.

__ Single-member LLCs can be "tax nothings."

7

PREFACE

Advising the Small Business is a guide for general practitioners, small firm attorneys, and young lawyers engaged in providing legal counsel to small, privately-held businesses. It includes general guidance on a number of issues that small businesses commonly face, as well as sample documents, checklists, and resources for obtaining additional forms and information, which can be invaluable to attorneys who do not have access to enough other lawyers or deal flow, or who haven't had enough experience, to know what is "standard" in this area of practice. Although there are many guides available for entrepreneurs, this book speaks to the advisor, not the entrepreneur. *Advising the Small Business* is designed to help counsel provide more effective legal and strategic guidance to small business clients, produce relevant documents, and spot issues that require further research or a specialist. Finally, *Advising the Small Business* is unique in its discussion of both how to approach an issue from scratch (e.g., drafting a contract or forming a corporation) and how to clean up an existing situation (e.g., amending agreements and corporate clean-up).

CONTENTS

The following Chapter is an excerpt from *Advising the Small Business: Forms and Advice for the Legal Practitioner*, by Jean L. Batman, American Bar Association, 2007. An order form is included after the Chapter.

Chapter 5. Legal Structures For Small Businesses

5.1 When Should Your Client Form A Separate Legal Entity For Its Business?

Perhaps the most fundamental benefit of forming a separate legal entity for a business is liability protection; the so-called "corporate shield". Shareholders, limited partners, and limited liability company members, among others, are generally not liable for the liabilities of the company in which they have an ownership interest. However, until a company is formed, the entrepreneur is acting in a personal capacity and is personally liable.

1. Before Taking on Signficant Obligations or Risks.

Before taking on any significant obligations, and before exposing themselves to any significant risks, an entity should be formed.

2. Before Creating Certain Rights.

Certain rights and relationships are intended for the busines and not the individual, such that it often makes sense to establish an entity before such rights or relationships are established, to avoid the necessity of transferring or assigning them later, which can give rise to otherwise unnecessasry expenses and potential complications. For example, an individual founder is not likely to want to personnally engage the services of an employee or independent contractor, and the work product of such employee or independent contractor should belong to the business and not the individual. Non-disclosure agreements, or "NDAs", raise a similar issue. Founders are often in contact with potential strategic partners, advisors, employees and others at the very earliest stages. While the individual founders could, and often do, enter into these types of agreements with third parties prior to the formation of an entity, this arrangement is not ideal, and raises issues regarding enforceability and personal liability for the founders. If the company anticipates it will want to raise money at some point, it should form an entity early in the process and ensure that all significant rights and relationships belogning to the company are appropriately documented.

3. Before Raising Money.

If reasons one and two above haven't triggered entity formation prior to fund raising, an entity certainly should be formed before a business raises money from investors – even from friends and family. In the absence of an entity, investors would likely be considered partners, and the whole arrangement would be subject to the three "M's" discussed in Chapter 4:

- Memory;
- Misinterpretation; and
- Mood.

5.2 What Form Of Entity Should Your Client Choose?

Most entrepreneurs appreciate the many benefits of forming a legal entity for the operation of their new business venture, such as shielding themselves from the liabilities of the business, raising start-up capital, and providing framework for working with co-founders. The most common entity choices for profit-seeking ventures are the following, although there are many others:

1. Sole Proprietorship: A business owned by one person. If your client opens a business, but doesn't choose an entity, he or she will be a sole proprietor by default. A fictitious business name filing may be required.

2. General Partnership (GP): A business enterprise entered into for profit which is owned by more than one person, each of whom is a "partner." A general partnership may be created by a formal written agreement, but may be based on an oral agreement or just a handshake. This is also a default category that may govern a business where no entity is chosen. A written agreement can prove critical in partnership relationships and a fictitious business name filing may be required.

3. Limited Partnership (LP): A limited partnership is a partnership which limits the liability of certain (passive) partners for debts beyond the amount of their investment in the partnership. The investing "limited partners" enjoy limited liability, but cannot participate in management and are limited to specific percentages of profit. A limited partnership requires a written agreement between the business management, who is the general partner or partners, and all of the limited partners. Limited partnerships generally must make a filing with the Secretary of State in their state of formation, such as in California, where a Form LP-1 Certificate of Limited Partnership must be filed and is available online at www.ss.ca.gov/business/lp/forms/lp-1.pdf .

4. Limited Liability Company (LLC): Each state in the U.S. now has adopted a limited liability company act (an "LLC Act"). For example, The Beverly-Killea Limited Liability Company Act of 1994 authorized the formation of limited liability companies in California and was one of the last states to adopt an LLC Act. Subsequent legislation in California permitted the formation of single-member LLCs in California. LLCs combine traditional corporate and partnership characteristics. This is a very versatile form of entity. However, certain types of businesses may not be permitted to operate as LLCs, as determined by state law. For example, in California, if the business is required to have a license under the California Business and Professions Code, it is not permitted to operate as an LLC. Businesses requiring licensure under the California B & P Code include general contractors, health care providers, pharmacies, veterinarians, lawyers, accountants, architects, locksmiths, funeral directors, real estate appraisers, and others. Formation documents are typically available on secretary of state websites, such as the California LLC-1 Articles of Organization, available online at www.ss.ca.gov/business/llc/forms/llc-1.pdf.

Forming an LLC typically involves filing a simple form, such as the California Articles of Organization on a form prescribed by the Secretary of State's Office and paying the required filing fee.

A written operating agreement or LLC agreement is also highly recommended for LLC's with more than one member.

Fewer formalities may be required in managing an LLC as compared with a corporation, but start-up costs can be higher because LLC agreements are frequently cumbersome and complicated.

The LLC is a very flexible entity with few restrictions on ownership (as contrasted with S corporations, for example) and the capacity nearly limitless variations on management and ownership structure (e.g. different classes of ownership, preferred returns, etc.) – note the tendency for higher start-up costs as a result.

Check your local Secretary of State's website for applicable information and forms.

Be aware that some states impose additional fees on LLCs. For example, in California, in addition to the $800 Annual Minimum Franchise Tax, LLCs classified as partnerships or disregarded entities are also subject to an annual fee ranging from approximately $1,000 to $12,000 based on their total income. For purposes of the California LLC fee, "total income" is defined as the sum of worldwide gross income plus cost of goods sold (Calif. Rev. and Taxation Code Section 24271). The LLC fee is due on the original due date of the company's tax return. Because of the Annual LLC Fee in California, the S Corp. can be a more attractive alternative for companies formed or doing business in California where LLC flexibility is not required.

5. Limited Liability Partnership (LLP): This form of entity varies by state. In California, LLP's can only be used for the practice of law, architecture, public accountancy, or a related business. Formation documents are typically available on secretary of state websites, such as California Form LLP-1 for Registered Limited Liability Partnership Registration, available online at www.ss.ca.gov/business/llp/forms/llp-1.pdf .

6. S Corporation: A small corporation whose owners have elected to be treated as a partnership for tax purposes by the Internal Revenue Service under "subchapter S". There are quite a few restrictions on the number and type of owners and classes of stock permissible in the S corporation ("S Corp"). However, in most ways, the S Corp is just like the C corporation (or "C Corp"). Limitations on S Corps include the following:

- There can be no more than 100 Shareholders;
- Shareholders must be individuals, estates, tax exempt organizations or certain trusts;

- There can be no non-resident alien shareholders;
- There can be only one class of stock (although it is okay to have voting and non-voting classes);
- Banks, thrifts, insurance companies, possessions corporations, and domestic international sales corporations cannot be S Corps; and
- S Corps must have a permissible tax year – generally a December 31 year-end.

To make an S Corporation election, use Form 2553 available online at www.irs.gov/pub/irs-pdf/i2553.pdf .

7. C Corporation: An organization formed with state government approval to act as an artificial person to carry on business, which can sue or be sued, and can issue shares of stock to raise funds. One benefit of a corporation is that its liability for damages or debts is generally limited to its assets, so that shareholders and officers are protected from personal claims.

Corporate organizational documents for S Corps and C Corps include:

- Articles of Incorporation (or a Certificate of Incorporation) are filed with the Secretary of State to establish the number of authorized shares, classes of stock, par value, agent for service of process, etc.
- Incorporator Action (Statement of Incorporator) adopts Articles and Bylaws and appoints initial Directors
- Bylaws – provisions dictated largely by the applicable Corporations Code, or General Corporation Law, setting forth corporate governance provisions within the state of formation
- Board Resolutions (by meeting or written consent) – appointing officers, authorizing the issuance of stock, etc.
- Shareholders elect members of the Board of Directors

For information about the minimum statutory requirements and filing instructions for the Certificate or Articles of Incorporation to be filed in the state of formation, check the website of the applicable Secretary of State, such as the California Secretary of State at www.ss.ca.gov/business/corp/pdf/articles/corp_artsgen.pdf .

8. Fictitious Business Names.

A fictitious business name filing is required if the business is conducted in any name other than the individual's or entity's legal name, e.g. Jean L. Batman dba Southern California

Fruit. Fictitious business name filings, or "dba" (doing business as) registrations are typically recorded at the county recorder's office in the county where the business is located, have a publication requirement (e.g. in a local newspaper), and must be periodically renewed. Other forms of doing business in which the business operates under a name other than its legal name must also comply with fictitious business name requirements.

9. How to Choose.

The preliminary questions to ask your client are:

- Do the parties need limited liability?

		Liability Limited?		
		Yes		No
Sole Proprietor (dba)			X	
General Partnership (GP)				X
Limited Partnership (LP)		X		X
Limited Liability Company (LLC)		X		
Limited Liability Partnership (LLP)	X			
S Corporation	X			
C Corporation	X			

- Do the parties want profits and losses to pass through to their personal income tax returns?

	Pass through tax treatment?	
	Yes	No
Sole Proprietor (dba)	X	
General Partnership (GP)	X	
Limited Partnership (LP)	X	
Limited Liability Company (LLC)	X	X
Limited Liability Partnership (LLP)	X	X
S Corporation	X	
C Corporation		X

LLCs and LLPs are shown in both the "yes" and "no" columns above because the owners can elect either tax treatment in those entities. One of the reasons a client may <u>not</u> want profits to pass through to their personal income tax return is if they are using the profits of the business to fund its growth or expansion. The reason for this is that the owners of an entity taxed as a partnership (i.e. one in which profits and losses are passed through to the owners' personal income tax returns, usually by means of IRS Form K-1), will be taxed on their share of the profits, regardless of whether the profits have actually been distributed to them. This phenomenon is referred to as "Phantom Income," because it's income you can be taxed on even though you never received it. One way to avoid this problem in an entity that receives pass-through tax treatment is to include a provision in the entity's operating agreement, partnership agreement, or other owners' agreement that requires minimum annual distributions designed to cover the amount of tax that will be due from each owner as a result of the entity's profits. An example of such a provision is included in the forms at the end of this Chapter.

- Will all of the parties be actively involved in management?

	All owners active?	
	Yes	No
Sole Proprietor (dba)	X	
General Partnership (GP)	X	
Limited Partnership (LP)		X
Limited Liability Company (LLC)	X	X
Limited Liability Partnership (LLP)	X	X
S Corporation	X	X
C Corporation	X	X

10. The Bias Toward Corporations.

The corporation is an old, familiar form of entity. Technology, biotechnology, web-related start-ups, and others hoping to proceed immediately to institutional or venture financing and looking toward the public markets for liquidity, should organize as corporations. The corporate form allows founders to immediately set up a capital structure that is conducive to raising capital from angels and other outside investors. In the corporate format, they can sell shares of stock to investors, and they can structure classes of preferred stock with certain rights and preferences that outside investors may require. If the new business will grow quickly and its owners intend to go to the public markets, it will need to be a corporation because of investor preferences and legal limitations.

The C corporation may be the best choice for your client if they envision any of the following:

- Raising money from venture capitals;
- Making a public offering of stock (IPO);
- Forming relationships with other entities that prefer dealing with corporations;
- Building up value in the entity, rather than distributing profits;

- Benefiting from IRC Section 1202 - the exclusion of up to 50% of the gain on sales of stock in certain types of C-corporations held for more than five years; and/or

- Offering equity incentives to key employees.

However, a client may benefit from initially forming as an S Corp (if eligible), for the tax benefits of receiving pass-through tax treatment, and revoking the S Corp election (thereby becoming a C Corp) when it is ready to issue preferred stock, start using profits to fund growth, etc.

11. Why Some Clients Love the LLC.

The LLC, or limited liability company, is an increasingly popular choice of entity for a new business, because it combines the liability limitation of a corporation with the potential tax advantages of a pass-through entity, such as a partnership. This means there will be no taxation of the business at the entity level; instead, the business's income is "passed through" the entity and taxed to its owners. Where the owners' tax rates are lower than the corporate income tax rate, there are tax savings. And because there is no entity-level tax, the owners avoids the problem of double taxation on monies distributed to owners that occurs in the C Corp. If the new business expects to incur losses during its first year or more of operations, its owners will be able to claim those losses on their personal tax returns, creating a personal tax benefit. The organization and management structure of a limited liability can be less formal and is generally more flexible than a corporation.

On the other hand, forming as an LLC will not avoid taxes completely. The LLC usually will be subject to fees on its organization and annually thereafter, comparable to the fees charged a corporation. Some states impose additional fees on LLCs. California, for example, imposes a gross receipts tax on the revenues of the LLC, which may require the company to pay an additional several thousand dollars each year to the state. This fee has been challenged in California as an unconstitutional "tax", but for now, the fees remain. Some states also have restrictions on the types of businesses which may use the LLC format. You will need to check the LLC Act in your state to determine whether this form of entity is available to a particular client.

5.3 Where Should Your Client's Company Be Organized?

The following questions may be helpful in helping your client select its state of formation:

1. Will Your Client Benefit From the Laws of a Particular State (i.e. Is Choice of Law an Issue)?

While some states have well developed corporate law, others have focused on particular areas of local concern – e.g. water rights, oil and gas leases, etc. Some states may have more favorable default rules for the form of entity chosen (i.e. its LLC Act may have more favorable provisions that apply in the absence of a written agreement to the contrary). Please note that the state of formation for corporations may be freely chosen, but the state of formation for other entities, such as limited partnerships, may be required to bear at least a reasonable relation to the business of the entity.

2. What About Delaware?

For companies pursuing venture capital ("VC") financing or preparing to go public, Delaware is the most common choice because:

- VCs are comfortable with Delaware corporations regardless of where they are based;
- the corporate law of the State of Delaware is generally considered to be more sophisticated, comprehensive and well defined than other jurisdictions; and
- Delaware has developed a business-friendly environment – of which there are numerous legal and administrative examples (it is the most common choice among Fortune 500 companies, regardless of their primary office location).

3. Avoid Unnecessary Taxes and Regulations!

Also known as the KISS method in fancy busines schools ("Keep it simple, stupid"), avoiding unnecessary taxes and regulations should be part of every business strategy. Many entrepreneurs believe it is less expensive to form their new business in a particular state, other than the one in which they operate, or that there may be legal advantages to organizing their new corporation or LLC in another state. However, in a majority of cases, the differences in state laws will not have significant affect on the business. So, if a company incorporates in another state, they are merely doubling their tax and regulatory obligations, as they will also have to register to do business in the state in which they operate, and comply with the fees, taxes, and filing requirements of both states. Moreover, the company will likely be required to pay a corporate agent to represent it as its agent of service of process in its state of formation, if it does not have operations there, adding one more annual expense to its business.

5.4 What If Your Client Does Business In More Than One State?

States universally require a "foreign corporation" (i.e. one not incorporated in that state) to "qualify" before "doing business" in such state. Qualification usually consists of the filing of documents, payment of a fee, and appointment of a resident agent for service of process. "Doing business" is more often defined by the exceptions than by an enumeration of specific acts which are covered by the term. However, in the event the corporation elects to do business (e.g. open an office) in another state, it will be required to qualify in that state. Failure to qualify may result in financial penalties as well as the inability to bring suit in the courts of the state with respect to acts and transactions in the state during the period of noncompliance.

5.5 What If Your Client Is Operating In An Inappropriate Legal Structure?

If you client's legal structure is inappropriate in light of the tax implications of its structure, exposure to liabilty, risks of loss, or other circumstances, there are several alternatives to consider.

1. If your client is a sole proprietor or general partnership, or LLC taxed as a partnership, it is a fairly simple matter to form the appropriate entity and have the owners contribute the business assets to the new enity in exchange for their ownership in the new entity.

2. If you client is a C Corp, but wants to change its tax status, it may be eligible to simply make an S Corp election, even after years of operating as a C Corp.

3. An S Corp client can easily convert to C Corp status by revoking its S Corp election or making itself ineligible for S Corp status.

3. Entity conversions are often fairly simple to accomplish, but vary by state.

4. Mergers can also be used to change a form of entity and many states streamline the process through "short form" merger rules.

Disolution of an entity taxed as a corporation and formation of a new entity is probably the least attractive option for correcting an inappropriate legal structure, as it will result in a taxable event. However, if the assets in the entity to be dissolved are worth less than the owners' basis in the company, this approach (the dissolve-and-start-over approach) may be successfully used to generate a tax write-off for the owners. This might be a good time to consult a federal tax expert.

5.6 What Legal Requirements Apply To All Businesses?

Some of the legal requirements that apply to all (or at least most) businesses include:

- Annual Statement of Information (officers, directors, and agent for service of process) and filing fee to Secretary of State (except sole proprietor and general partnership);
- Taxes: Annual Franchise Tax Fee (except sole proprietor and general partnership), State and Federal tax returns, employment taxes, sales and use taxes, personal property taxes;
- Local Business License, Professional Licensing;
- Federal Employer Identification Number (FEIN);
- Insurance – unemployment and workers' compensation, liability, etc.
- Qualification to do business in other states.

5.7 How Can Your Client's Owners Avoid Personal Liability?

1. Form an Entity.

The first and most important step a client can take to avoid personal liability for the financial obligations of its business is to form an entity that provides such protection (e.g. a corporation, limited liaiblity company, or similar entity). If your client is planning to form an entity and is also in the process of desiging business cards, letterhead, brochures, and other materials, they should plan to include the entity name on their collateral materials so they won't have to their materials reprinted to make sure it is clear to third parties that they are dealing with an entity, not an individual.

2. Avoid Personal Guarantees.

Sometimes clients are faced with a decision: provide a personal guarantee or lose a business opportunity. This frequently arises in the small business arena, where companies don't have established credit or sufficent assets to obtain a loan, commercial lease, etc, without the credit and/or assets of the individuals in the company. However, personal guarantees should be avoided if possible, as they subject the guarantor to individual liability for an obligation they would not otherwise be liability for after the time, money, and effort spent on creating a corporate shield.

3. Observe Appropriate Formalities for the Entity.

In order for shareholders of a corporation to enjoy the benefit of the corporate shield, certain corporate formalities must be adhered to, including the maintenance of separate corporate records and accounts, the holding of annual meetings of the stockholders and directors, and the execution of documents in the name of the company. So long as the corporation observes proper corporate formalities, that is, so long as the directors and officers take the corporation seriously and play by the rules, the shareholders will not be held personally liable for the corporation's obligations and liabilities.

Whenever officers are signing documents or correspondence on behalf of a corporation (or managers are signing on behalf of an LLC, etc), they should take care to include the corporation's (or LLC's, etc) name in the signature block and the title of the officer (or manager, etc.) signing. An example of an appropriate signature block is as follows:

****, Inc.

By: ________________________________
[name of signatory], President

Failure to do so may lead, in the context of litigation involving a signed document, to including the person who signed in his or her individual capacity in the lawsuit.

4. Remit all Taxes Withheld or Collected.

Certain tax obligations, e.g. employment taxes withheld, and sales taxes collected, can give rise to personal liability if not remitted to the government.

5. Carry Insurance.

Clients can be protected from certain obligations for which the corporate shield does not provide protection through insurance. For example, the corporate shield (used in the generic sense to also include the shield provided by LLC's, etc.) will not protect an owner from liability based upon the owner's personal tortious behavior, but in many cases insurance can, such as automobile liability insurance, malpractice insurance, and directors and officers liability insurance.

5.8 Should My Client Get D & O Insurance?

Directors and officers insurance ("D&O" coverage) is great to have, if available and the company can afford it. The directors and officers of a small company are vulnerable to being personally named in lawsuits initiated by investors, employees, and others, because they are typically involved in the day-to-day operations of the company and may be perceived to have a greater net worth than the company.

More and more small companies are being told by prospective board members that they will not serve on the board without insurance coverage.

D&O coverage provides protection against claims of certain types of "wrongful acts" alleged against the directors, officers and employees of the Company. D&O coverage is likened to malpractice insurance coverage for doctors or lawyers, except that it provides protection for the directors and officers of an organization against "management" liability claims.

D&O policies typically address three categories of coverage:

1. Directors & Officers Personal Coverage/ Non-Indemnifiable Loss

This coverage applies when the company is either not permitted by law, or unable due to insolvency, to indemnify the personal liabilities of its directors and officers.

2. Corporate Reimbursement Coverage/ Indemnifiable Loss

This coverage applies where the company does indemnify its directors and officers as permitted, and/or required by law.

3. Entity Coverage

This coverage is provided for the entity, for losses arising from all claims made against the company, as a result of a wrongful act.

A D&O policy covers defense and settlement expenses, and damages (but typically not punitive damages or civil fines) for claims alleging "wrongful acts" defined as actual or alleged negligent acts, errors, misleading statements or omissions, neglect or breach of duty by the directors or officers, individually or collectively.

Typical D&O policy exclusions can be numerous and include:

- Anti-trust claims
- Bodily Injury, Property Damage, Advertising Injury, Libel, Slander, etc.
- Collusive insured vs. insured claims
- Contractual Liability
- Criminal, dishonest or illegal Acts
- ERISA violations and obligations, etc.
- Failure to maintain insurance
- Intellectual Property claims against the Company
- Nuclear and Radioactive
- Personal profit and excess remuneration
- Pollution Liability
- Prior and pending litigation
- Public offerings
- Rendering of professional services
- Wrongful acts committed prior to the retroactive date (if applicable)

One of the biggest mistakes companies make in obtaining D&O coverage is failing to negotiate their coverage. When shopping for D&O insurance, companies would be well-advised to work with an experienced insurance broker who can help them obtain favorable coverage and pricing.

5.9 Sample Documents and Checklists

[Omitted.]

8

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Stimulus Package to Boost Renewable Energy and Clean Technologies Industry

Recovery Act

Background

On February 17, 2009, President Barack Obama signed into law the American Recovery and Reinvestment Act of 2009 (Recovery Act). Many of the provisions in this Recovery Act, which constitutes the largest single economic stimulus program in U.S. history, open up new sources of funding and procurement opportunities for renewable energy facilities, energy infrastructure and energy efficiency programs. The clean-energy provisions are a central piece of the Recovery Act. Out of a total of $787 billion in spending and tax incentives, the Recovery Act directs approximately $43 billion to renewable energy and clean technology-related programs and includes approximately $22 billion in energy-related tax incentives.[1]

Funding levels unprecedented but details "TBD"

While the Recovery Act presents significant opportunities for clean technology companies—including grants for research and development, loans and loan guarantees for commercialization, funding increases for government procurement, tax incentives for investment in clean energy, and tax credits for consumers purchasing clean energy products—many critical details regarding the process for accessing the funds remain "TBD." Recovery Act programs will be administered through multiple federal agencies and, importantly, a large portion of the funds will be distributed through state and local governments. Much of the funding will be funneled through programs that will parallel existing Department of Energy ("DOE") grant programs and funding mechanisms but are likely to involve new regulatory standards, solicitation procedures and reporting requirements.

This *Alert* provides a preliminary roadmap to Recovery Act programs and highlights resources for clean technology companies, investors and other market participants. Table I of this Alert ("Federal Financing Opportunities") describes grant and loan/loan guarantee opportunities relevant to clean technology companies; Table II ("Federal, State and Local Procurement Opportunities") describes opportunities for clean technology companies to sell into the government marketplace; and Table III ("Tax Incentives") describes changes to key federal tax incentives, such as production and investment tax credits.

Since many details regarding Recovery Act programs are yet to be announced, interested parties may wish to register to receive email updates. (See "Where to Register for Announcements and Updates.")

Timing of funding announcements

On February 19, 2009, Secretary of Energy Steven Chu announced a sweeping reorganization of the Department of Energy to expedite disbursement of Recovery Act funds. Secretary Chu noted, "We need to start this work in a matter of months, not years."[2] Further, Secretary Chu wants to accelerate the funding process for programs with existing award pipelines.[3]

The Office of Management and Budget (OMB) has instructed federal agencies to begin posting funding opportunity announcements within thirty days of the enactment of the Recovery Act.[4] These opportunities will be posted at www.grants.gov. To date, a specific timeline for loan and loan guarantee announcements has not been published. Cooley's clean technologies practice group recommends that companies determine how their strategic objectives align with federal policy priorities and be prepared to move quickly to define proposals and projects that map to such priorities. OMB has also instructed agencies to engage in "aggressive outreach" to potential applicants.

Next steps on federal energy policy

The Recovery Act is only an initial step in the Administration's first term energy agenda. The Administration's broader energy plans are expected to include the following:

- California Waiver: The U.S. Environmental Protection Agency (EPA) has been directed to reconsider and is expected by many observers to grant California's request to impose more restrictive greenhouse gas emissions standards.5 More than a dozen other states have adopted or will adopt California's proposed stricter restrictions, which would require automakers to cut emissions by 30 percent in new cars and light trucks by 2016.
- Energy Bill: Congress is expected to pass an energy bill in the second or third quarter of 2009. Provisions under consideration include increased national fuel-efficiency standards and adoption of a national renewable-portfolio standard

requiring utilities to source a certain percentage of their electricity from renewable sources.6

- Climate Change Legislation: The President has signaled his support for a federal cap-and-trade system to reduce greenhouse gas (GHG) emissions and has stated a GHG reduction target of 1990 levels by 2020 and an additional 80% by 2050.7 (These targets are similar to those adopted by the State of California under AB 32—See *Cooley Alert* (December 2008)).

I. Federal Financing Opportunities

PROGRAM	DESCRIPTION	FUNDING
Innovative Technology Loan Guarantee Program Department of Energy	Authorize loans/loan guarantees for renewable energy systems, electric power transmission systems, and leading edge biofuel projects. Projects must commence construction no later than September 30, 2011.	**$6 billion**
Electricity Delivery and Energy Reliability Department of Energy	Support electricity delivery and energy reliability activities to: modernize the electric grid, including demand responsive equipment; enhance security and reliability of the energy infrastructure; increase energy storage research, development, demonstration and deployment; and facilitate recovery from disruptions to the energy supply.	**$11 billion**
Fossil Energy Research and Development Department of Energy	Support carbon capture and sequestration technology demonstration projects, including: ■ $1 billion for Fossil Energy Research and Development programs; ■ $800 million for Clean Coal Power Initiative; and ■ $1.52 billion competitive solicitation for a range of industrial carbon capture and energy efficiency projects.	**$3.4 billion**
Energy Efficiency and Renewable Energy Research Department of Energy	Support energy efficiency and renewable energy research, development, demonstration, and deployment activities to foster energy independence, reduce carbon emissions, and cut utility bills. Includes $800 million for biomass and $400 million for geothermal.	**$2.5 billion**
Advanced Battery Loans and Grants Department of Energy	Support the U.S.-based manufacturing of advanced batteries and components, including advanced lithium ion batteries, hybrid electrical systems, component manufacturers, and software designers. To be awarded to manufacturers of advanced battery systems and vehicle batteries that are produced in the United States.	**$2 billion**
Advanced Research Projects – Energy (ARPA-E) Department of Energy	Support grant program for research and development to overcome the long-term and high-risk technological barriers in the development of energy technologies.	**$400 million**
Electric Transportation Department of Energy	Create new grant program to encourage electric vehicle technologies.	**$400 million**
Research, Development, Test, and Evaluation Department of Defense	Support research, development, test and evaluation into using renewable energy to power weapons systems and military bases.	**$300 million**

II. Federal, State, and Local Procurement Opportunities

PROGRAM	DESCRIPTION	FUNDING	TARGET
Energy Efficiency and Conservation Block Grants Department of Energy	Help state and local governments make investments that make them more energy efficient and reduce carbon emissions.	**$3.2 billion**	**State and local**
Weatherization Assistance Program Department of Energy	Help low-income families reduce their energy costs by weatherizing their homes and making the country more energy efficient.	**$5 billion**	**State and local**

State Energy Program Department of Energy	Assist state energy conservation plans.	**$3.1 billion**	**State**
Alternative Fuel Vehicles Pilot Grant Program Department of Energy	Help state and local governments purchase efficient alternative fuel vehicles to reduce fuel costs and carbon emissions.	**$300 million**	**State and local**
Federal Buildings Fund Department of the Treasury	Support measures necessary to convert General Services Administration facilities to High-Performance Green Buildings.	**$4.5 billion**	**Federal**
Energy-Efficient Federal Motor Vehicle Fleet Procurement Department of the Treasury	Support capital expenditures and necessary expenses of acquiring motor vehicles with higher fuel economy, including: hybrid, electric, and plug-in hybrid vehicles.	**$300 million**	**Federal**
State and Tribal Assistance Grants **Environmental Protection Agency**	Help states and tribes access clean and safe drinking water. Twenty percent of funds are dedicated to green infrastructure, water or energy efficiency improvements, or other environmentally innovative projects.	**$6.4 billion**	**State and tribal**
Diesel Emissions Reduction **Environmental Protection Agency**	Provide grants and loans to state and local governments for projects that reduce diesel emissions, benefiting public health and reducing global warming. Includes technologies to retrofit emission exhaust systems on school buses, replace engines and vehicles, and establish anti-idling programs	**$300 million**	**State and local**
Training and Employment Services Department of Labor	Support research, labor exchange and job training projects that prepare workers for careers in energy efficiency and renewable energy.	**$500 million**	**Federal and state**
Assisted Housing Stability and Energy and Green Retrofit Investments Department of Housing and Urban Development	Provide grants and loans to HUD-sponsored low-income housing for energy retrofit and green investments.	**$250 million**	**State and local**
Operation and Maintenance Department of Defense	Improve, repair, restore, modernize, and invest in energy efficiency for military facilities, including barracks.	**$3.84 billion**	**Federal**
Health Program Department of Defense	Improve, repair, and modernize, and invest in energy efficiency for military medical facilities.	**$400 million**	**Federal**

III. Tax Incentives

TAX INCENTIVE	TARGETED INDUSTRIES	CHANGE UNDER RECOVERY PLAN
§ 45 Production Tax Credit (“PTC”)	Wind	Extended through 2012
§ 45 PTC	Geothermal, biomass, hydropower, marine and hydrokinetic, municipal solid waste	Extended through 2013
§ 48 Investment Tax Credit(“ITC”)	Solar, geothermal, fuel cells, microturbine, small wind, combined heat and power	Eliminates rule reducing credit for financing from subsidized energy bonds or private activity bonds. Removes $4K annual credit cap on small wind property.

§ 48 ITC	Wind, geothermal, biomass, hydropower, marine and hydrokinetic, municipal solid waste	With respect to facilities otherwise eligible for § 45 PTC, allows taxpayers to elect 30% ITC instead.
§ 45 PTC, § 48 ITC, ARRA § 1603	Wind, geothermal, biomass, hydropower, marine and hydrokinetic, municipal solid waste, solar, geothermal, fuel cells, microturbine, small wind, combined heat and power	In lieu of tax credit, authorizes Secretary of Treasury to make grant equal to 30% of credit basis of property otherwise eligible for § 45 PTC or § 48 ITC (10% in the case of geothermal, microturbine, or combined heat and power property).
§ 54C New Clean Renewable Energy Bonds	State and local governments, certain utilities, and clean renewable energy bond lenders	Creates $1.6 billion in new funding to be used in financing renewable energy production facilities eligible for § 45 PTC.
§ 54D Qualified Energy Conservation Bonds	State and local governments	Creates $2.4 billion in new funding and expands program to cover grants, loans, and other repayment mechanisms to implement green community programs.
§ 142(i) High-Speed Intercity Rail Facility Bonds	State and local governments	Expands eligible facilities to include facilities using vehicles capable of attaining maximum speed over 150 miles per hour.
§ 25C Nonbusiness Energy Property Credit	Residential qualified energy efficiency property	Extends provision through 2010, increases credit rate to 30%, replaces lifetime caps with $1,500 aggregate cap for property placed in service in tax years beginning in 2009-10, modifies efficiency standards for qualifying property, and makes expenditures from subsidized energy financing eligible for credit.
§ 25D Residential Energy Efficient Property Credit	Residential solar, geothermal, small wind, and fuel cell property	Eliminates (i) credit caps for solar hot water, geothermal, and wind property and (ii) reduction in credits for property funded from subsidized energy financing.
§ 30C Alternative Fuel Vehicle Refueling Property Credit	Motor vehicles running on electricity or clean-burning fuels	For business property placed in service in tax years beginning in 2009-10, increases maximum credit to $200K for qualified hydrogen refueling property and $50K for other property. For nonbusiness property that is not hydrogen refueling property, maximum credit is increased to $2K. Credit rate is increased from 30% to 50%, except in case of hydrogen refueling property.
§ 30 Credit for Certain Plug-in Electric Vehicles, § 30B Alternative Motor Vehicle Credit, § 30D Plug-In Electric Drive Motor Vehicle Credit	Plug-in, electric drive motor vehicles	Creates new 10% credits for (i) low-speed vehicles, motorcycles, and 3-wheeled vehicles and (ii) certain conversions of nonqualified vehicles into qualified vehicles. Caps § 30B credit at $7,500 regardless of vehicle weight, eliminates credit for low-speed plug-in vehicles and vehicles weighing 14K pounds or more, and replaces aggregate vehicle credit limit with a per-manufacturer vehicle credit limit. Provides that credits may reduce the AMT.
§ 132 Qualified Transportation Fringe Benefits	Employers providing, and employees receiving, qualified transportation fringe benefits	Increases monthly exclusion for employer-provided transit and vanpool benefits to same level as exclusion for employer-provided parking (in 2009, up to $230 per month).
§ 48C Credit for Investment in Advanced Energy Property	Manufacturing of certain renewable energy or energy efficient property	Creates new 30% investment tax credit for property used in a project that re-equips, expands, or establishes manufacturing facility for production of types of renewable energy or energy efficient property. Authorizes $2.3 billion in credits.

If you have questions about this *Alert*, please contact one of the following attorneys:

Elias Blawie	Palo Alto, CA
Jim Fulton	Palo Alto, CA
Gordon Ho	Palo Alto, CA
Craig Jacoby	San Francisco, CA
Jim LInfield	Broomfield, CO
Patrick Mitchell	Boston, MA
Kevin Mullen	Washington, DC

Circular 230 Disclosure

The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230 (21 CFR Part 10). Any tax advice contained in this *Alert* is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.

Notes

1 Website for accountability and transparency of the American Recovery and Reinvestment Act of 2009. Recovery.gov. "Where is Your Money Going?" (accessed February 25, 2009).

2 Press Release from the U.S. Department of Energy. DOE Secretary Chu Announces Changes to Expedite Economic Recovery Funding. February 19, 2009. (accessed February 25, 2009).

3 Interview with Secretary of Energy Steven Chu. Stephen Power. "We've Got to Do This.'" Wall Street Journal. February 6, 2009. (accessed February 25, 2009).

4 Memorandum for the Heads of Departments and Agencies. Peter R. Orszag, Director of the Office of Management and Budget. "Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009." (accessed February 25, 2009).

5 For the President's request for the EPA to assess whether its decision to deny a waiver based on California's application was appropriate in light of the Clean Air Act, see the Memorandum for the Administrator of the Environmental Protection Agency, "State of California Request for Waiver Under 42 U.S.C. 7543(b), the Clean Air Act," January 26, 2009 (accessed February 25, 2009).

6 President's energy plan agenda (accessed February 25, 2009).

7 For example, see the President's remarks to the Bi-Partisan Governors Climate Summit (accessed February 25, 2009).

Where to Register for Announcements and Updates

All federal agencies and departments must post their plans for using Recovery Act funds—as well as announcements for grant competitions, allocations of formula grants, and awards of competitive grants using those funds—on the Recovery Act's official website: www.recovery.gov.

To receive federal government updates:

- Register at www.recovery.gov to receive Recovery Act updates by email.
- Register at www07.grants.gov/applicants/email_subscription.jsp to receive grant announcements by email.
- Email lgprogram@hq.doe.gov to subscribe to U.S. Department of Energy Loan Guarantee Program Updates
- Register at apps1.eere.energy.gov/news/subscribe.cfm to receive updates from the U.S. Department of Energy—Office of Energy Efficiency and Renewable Energy.

Cooley plans to publish additional *Cooley Alerts* as critical new information and developments regarding the Recovery Act arise. To receive *Alerts* regarding major legislative and regulatory developments and event announcements relevant to the Clean Technology sector, register at cooley.com.