

Getting Started - Choosing a Form of Entity

WEB Workshop

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Why an entity? And, what are the choices?

- Operating through an entity shields you and other owners (or directors and officers in the case of a non-profit corporation) from personal liability
 - Only the entity's assets – not the owners' or directors' personal assets – are at risk to satisfy the liabilities of the business
 - UNLESS you ignore the formalities of maintaining and operating through an entity (i.e., piercing the corporate veil);
- Allows assets and value to be collected in one enterprise (permits future sale of business, investments, division of ownership, etc.)
- Most all successful businesses are operated through some sort of entity
- Most startup companies are either:
 - Corporations
 - Limited liability companies (LLCs)

Timing Considerations

- When to form the entity?
- Ideas don't generally need an entity
- Cost considerations (filing fees, administrative costs, legal and accounting costs)
- Defining and memorializing rights of owners/founders
- Contracting with third parties and incurring obligations (i.e., vendors, landlords, customers, etc.)
- Legitimacy and protection of rights (IP rights, etc.)
- Consider best option for anticipated plans (C corporation, LLC, S corporation, Benefit corporation, Non-Profit)

Business Corporations and LLCs

- Separate legal existence apart from their owners (unlike sole proprietorship)
- Created under specific state law (i.e., New York, Delaware, etc.)
- For profit entities have owners who hold equity in the entity and are entitled to receive profits (stockholders vs. members)
- Owners have no direct ownership rights in assets of business
- Purpose to conduct business in order to make profits for the owners of the entity
- Management and governance structure (directors, managers, officers, etc.)

Nonprofit Corporations

- Separate legal existence
- Created under specific state law (i.e., New York, Delaware, etc.)
- No owners: no equity and no return of profits
- Tax-exempt purpose: charitable, educational, scientific, literary, religious, etc.
- Management and governance structure (directors, officers, etc.)

Funding Options

- Source of initial funding impacts the choice of vehicle
 - Investors are more likely to want to support a for profit business because of the possibility of a return
 - Impact investors, Angel investors, Venture Capitalists
 - Foundations may be more likely to give only to charities, but there is some flexibility
 - Government grants may be open to charities and businesses
- What is the end goal?
 - An exit with a financial benefit to the founders?
 - Sustain mission with no payout?

Comparing Business Corporations and LLCs

Corporations

- Stockholders own shares of stock
- Formal governance structure with officers and board of directors
- Managed by board of directors; board of directors elect officers to manage day-to-day operations
- Governance procedures (e.g., stockholder and board of director meetings) specified by state statute
- Corporations (other than S corporations) are taxed on net income; stockholders are also taxed on the amount of any dividends distributed to them

LLCs

- Members own membership interests
- Hybrid partnership/corporate structure
- Very flexible governance structure and procedures (freedom of contract in LLC Agreement)
- Can be managed by members, a board of managers (or directors) or a third party manager
- LLCs are “pass-through” entities for federal, and most state income tax purposes; only the owners – not the company itself – pay income tax on taxable income generated by the business

Many startups choose a corporation

- Most VCs and other professional investors prefer to invest in a corporation rather than an LLC
 - Terms for financings in corporations are well settled and, for early stage financings, there is a pretty clear line as to what is market and what isn't
 - VCs – and their investors – do not want the tax consequences associated with investing in a pass-through entity
- LLCs require complex tax reporting and accounting; failure to follow the rules can result in adverse tax consequences to the owners
- In terms of lawyer and accountant time, LLCs are generally more expensive to put in place and maintain
- Stock options and equity incentive plans easier with corporate entity

What about S Corporations?

- C-Corporation – All corporations are, by default, C-corporations when initially formed; most corporations are C-corporations
- S-Corporation – Some corporations elect to be treated as “S-corporations” for tax purposes
 - Typically used for “Mom and Pop” businesses
 - Pass-through taxation is the main advantage for electing S-corporation status
 - S-corporation elections are made on both federal and state levels
 - There are limitations on the number and type of stockholders for an S-Corporation
 - No different classes of stock, no more than 100 stockholders, all stockholders must be U.S. individuals with some limited exceptions for trusts
 - Not generally used for companies raising capital because of ownership limitations and pass-through taxation
 - Can elect to abandon S corp. election at any time

What about Benefit Corporations?

- Benefit corporations are a type of for-profit corporation that typically has a mission or corporate purpose of public benefit or positive societal or environmental impact
 - Organized under special provisions of state law.
 - Board of Directors is either required or permitted (depending on the particular state law) to consider the social purpose of the company in managing the business
 - Board of Directors does not have to manage the business solely for the purpose of making money for the stockholders; instead, the Board of Directors can also consider the social mission of the corporation without breaching their fiduciary duties
 - Some state laws impose additional significant reporting or regulatory requirements on benefit corporations
 - A “B-Corp.” is not a legal entity – it is a certification awarded by B-Labs, a nonprofit industry group that promotes socially responsible businesses
 - To get the legal protection for its Board of Directors, a company must be organized as a benefit corporation under state law; a “B-Corp” certification by B Lab is not enough

Reasons for Benefit Corporation

- Legal protection for the directors of the company
 - Without formalizing the social mission, directors of the company have the duty (“fiduciary duty”) to manage the business exclusively to maximize value for its stockholders; if directors breach that duty, they can be personally liable for losses of the business
 - A benefit corporation allows directors to consider the social mission, interests of employees or the environment when making business decisions
 - This protection is most important when the company has outside investors and is making decisions that affect profits of the business or when selling the company

Reasons for Benefit Corporations

- Marketing advantage
 - May provide a competitive edge to consumer facing businesses
 - May attract a certain types of investors
- Nothing prohibits a corporation that is not organized as a benefit corporation from having a socially beneficial purpose or doing business in a sustainable, socially responsible way
 - Mission-driven for profit corporations have a “double bottom line” – profits for the stockholders AND profits for society

Non-Profit Corporations

- Nonprofit (501(c)(3)) corporations are organized and operated exclusively for a charitable or other “social” purpose; they do not have owners
- Corporations, including benefit corporations, can also be mission-driven, but nonprofit corporations are not driven to make profits for individual owners; profits are not distributed to private parties
- Non-profit corporations can earn fees and make money (i.e., non-profit may be a misnomer)
- The business of nonprofits is exclusively to further the tax-exempt mission; the business of “for profit” corporations (including benefit corporations) is to generate profits for the benefit of the company’s stockholders

5 steps to forming a corporation

- #1: Choose the state in which to incorporate – many founders choose Delaware, which has a well-established body of law relating to corporate governance and stockholders rights
 - Also excellent for forming non-profit, non-stock corporations
- #2: Check your corporate name
 - For terms required by state law (such as “Inc.,” “Corp.,” “Corporation”)
 - Incorporating does not give you IP rights in your company name but it could infringe on someone else’s IP rights in that name

5 steps to incorporating (cont'd)

- #3: For a business: determine the classes of stock and the number of shares of each class
 - Generally, shares are either common or preferred
 - Founders and employees usually own common stock
 - VCs and other investors own preferred stock which carries various rights that give preferred stockholders preferential treatment over common stockholders

5 steps to incorporating (cont'd)

- #3: For a non-profit corporation: Certificate of Incorporation must contain
 - In New York, at least 3 directors
 - IRS language – must limit purposes to one or more 501(c)(3) purposes, i.e., charitable, religious, educational, literary, testing for public safety or scientific
 - Purpose clause is most important
 - Dissolution clause – on dissolution, assets must be distributed only for 501(c)(3) purposes

5 steps to incorporating (cont'd)

- #4: Identify an incorporator – the incorporator:
 - Signs the certificate of incorporation
 - Can be any person of legal age or any entity
- #5: File your certificate of incorporation with the secretary of state and get a returned stamped copy
- Also, don't forget:
 - If your office is located in a different state, you will need to file for authorization to do business in that state
 - Apply to the IRS for a taxpayer identification number

Setting up your corporate management structure

- First: The incorporator signs a simple statement that:
 - Adopts the corporation’s bylaws (the rules by which the corporation is governed)
 - Appoints the initial board of directors
 - A corporation must have at least one director
 - After the initial appointment, directors can then be elected or removed by the stockholders or members
- Second: With the Board of Directors in place, the Board adopts resolutions to elect officers, which may include a president, one or more vice presidents, a treasurer, a secretary and any others specified in the bylaws

Issuing shares of stock in your corporation

- The Board of Directors authorizes the number of shares to be issued and the price and consideration for the shares
 - Stock can be paid for in cash or with property contributed to the corporation; in the case of the founders, the property is usually their ideas or inventions or initial work product
- The corporation should keep records of how many shares of each class of stock are issued
 - The number of shares issued to each stockholder are reflected in a stock ledger
 - The company's capitalization table ("cap table") shows how many shares of each class are issued and to whom, and what percentage of the company is owned by each stockholder

Duties of directors, officers (and stockholders) in a corporation

- Directors owe special duties (fiduciary duties) to the corporation and, in the case of a for-profit corporation, its stockholders
 - A duty of care to exercise an appropriate degree of attention and diligence in overseeing the management of the corporation
 - A duty of loyalty to act in the interests of the corporation and all its stockholders and not in the director's own self-interest
- Officers are responsible for managing day-to-day operations of the corporation; they serve at the pleasure of the Board of Directors and, if they don't fulfill their duties, the Board can remove them
- Stockholders generally don't owe any duty to the corporation or other stockholders unless they hold sufficient stock to control the corporation; in that case, controlling stockholders may have some duties to the other, non-controlling stockholders

Non-profit vs. Tax-Exempt

- Forming a non-profit entity can be very easy
 - in Delaware, it can be done in 24 hours;
 - in New York, it can take longer, as consents may be needed
 - it is just formation under state law, e.g., the New York Not-for-Profit Corporation Law, Delaware General Corporation Law
- Tax-exemption is generally more difficult
 - charitable organizations (i.e., 501(c)(3) organizations) must apply to IRS for recognition of exemption
 - other types of tax-exempt organizations may self-declare, but that is becoming less common