LECTURE 3: MECHANICS OF STRUCTURING A COMPANY

Office of the Vice President for Research
Technology Commercialization Partners
Why Create a Separate Entity?

- Allows for in-license of technology
- Apply for funding (SBIR)
- Limits personal liability of founders, officers
- Entity can enter into other agreements, e.g., NDA, employment, obtain domain names
- Be taken more seriously by potential investors
- Issue equity to advisors and employees that have real value as valuation increases
Organization

Purpose: Structure should best organize and reward people that help you succeed

• Generally one or two founders with an opportunity/invention
• Assemble team
• Business analysis (for business plan)
• Build organization to implement
• Legal entity needs to incorporate or register with state
Why do I need a team?

• You may be a great inventor/researcher, but you can’t do it all!
• Need to find team to execute plan
• A business colleague can help you evaluate the opportunity with an outside view
• Studies have shown that business advisors help speed commercialization
  ○ They have past experience in industry!
• May allow you to focus on what you do best
Who should be on the team?

#1 As you evaluate your business, make sure you have a **business** person!

- Depending on business, can be just founder(s)
- More likely 2-5 persons with skill/knowledge, but may not need all initially:
  - BUSINESS- in your industry and locally active in your company!
  - Research
  - Product Development
  - Finance
  - Perhaps later: Marketing, Sales, Production
- Do more with less people (less complications, dilution of equity, and more cash)
Management

• Success or failure of enterprise will depend on the competency and adaptability of management team

• Failure often comes from management (even if just 2 founders) not able to agree on:
  o Goals
  o Direction
  o Strategies
  o Allocation of Resources
Management

• ...So, be sure there is clear organizational power and responsibilities to allow the entity to move forward
  o Even if you need to replace some of team
  o Ownership = “Skin in the game” = equity
    • A great way to motivate team for overall success
    • Via Stock Options
  o Some VC’s require management to have equity

• Managers:
  o Plan, Budget, Organize, Staff, control
Board of Advisors

• Constituted to informally provide help, advice and contacts
• Can fill that knowledge gap in management with expertise
  o Can be on the business side (has dealt with potential acquirers)
  o Can help on the technical side (has gotten similar product through regulatory)
  o Can help on the user side (ex. surgeon who may use your product)
• B of A's not required
• Doesn't engage in legal or official action of the corporation
• Doesn't have fiduciary duties
• **Especially with university startups, studies have shown that a business advisor catalyzing business connections with industry greatly increase chance of success.**
Board of Directors

• Responsible for general oversight of the company (approves CEO, by-laws)
• Can be key officers of company or outside members
• Legally responsible to represent the stockholders
• Fiduciary duties to act in best interests of corporation and shareholders
  o Approves financing, major bank transactions
• Usually compensated with stock options that vest over time (in a start-up), later with cash as well
Ownership & Stock Options

Ownership = Equity = Stock

• Founder’s Stock
  o Often splits the ownership of the company upfront
  o Can often be based on inventorship

• Stock options = Option to buy into ownership at a time period
  o Incentive for performance- including founders and others
  o Incentive to “stay”
  o Non-cash substitute for lower initial salaries
  o Attract high-value employees
  o Increased risk of startups
  o More valuable as team increases value of company

• Equity Vesting = The schedule of when you can exercise your stock options
  o is tied to invested time and performance
Stock Options

• Offered under a formal plan under which employees/consultants/advisors
  o Purchase shares of company, but at later date
  o At a fixed (strike) price (usually low because of current value)

• Typically options “vest” over time, ex. 4-5 years
  o So only those really adding value to company share in the increased company worth
  o Example: New hire given 1,000 stock options exercisable at $1 (strike price) per share over 4 years. Can buy 250 shares each year for $250.
  o Example: Student given 1000 stock options that vest after 4 years (Cliff vesting). Can buy 1000 shares after the full 4 years.
What Form of Entity to Choose?

Purpose: Structure should best organize and reward people that help you succeed

Overview
- “C” corporation
- “S” corporation
- Limited Liability Company – LLC
- Partnership
- Sole proprietorship (no separate entity)
- Non-profit charitable corporation or foundation
Which Form of Entity to Choose?

• Answer will depend on:
  o who will be the owners?
  o how will the earnings (losses) be returned to the owners?
  o is business expected to initially generate profits/losses?
  o where will the capital come from?

• Consult with legal/tax advisors
“C” Corporations

• Most common if intending to raise money from outside investors (Venture funds prefer it for tax reasons)
• No personal liability
• Well understood, clear laws and rules
• Initial organization is straightforward
• Exits available (IPO, tax free mergers, etc.)
• Multiple classes of stock standard; employee stock options easy to implement
  o Ideal for high-risk, low cash businesses
“S” Corporations

• A “C” corporation that elects to be taxed as a partnership (pass through tax to owners); cannot carry forward losses like a “C” corp
• Limited liability
• Simple to convert to “C” corp
• Limits on stockholder base (individuals only; U.S. residents; no more than 100)
• VCs won’t invest in
• Limited to single class of stock
LLC

- More informal
- No personal liability
- Profits and losses passed down to personal tax
  - (Pass-through, like a partnership)
- Can have one or unlimited number of owners; no limits on type of owners
- Operating agreement and initial organization can be more complex
- VCs typically don’t invest in but . . .
- Typically requires conversion to C-Corp or other complexities prior to exit (capital account rules; IPO; tax free merger)
Non-Profits, Foundations

- Work best when focused on specific disease or condition
- Must focus on remaining nonprofit status (tax, legal)
- Can’t receive Small Business Innovation Research (SBIR) or Small Business Technology Transfer (STTR) funds directly (can do a joint venture with a for-profit entity)
- Policies of non-profit may limit ability to conduct business and attract investment
- VC investment not an option
- May be easier to obtain funds from government and other foundations
- May be difficult to attract the infrastructure, resources and skills needed to develop the product
- Can always license out or partner with a for-profit entity later if needed to successfully develop and commercialize
Tax Considerations

• C corporations pay federal income tax (Corporate rate)
  o Can use losses in early years to offset later profits
  o Double taxation (After Corporate tax, profits shared as dividends are taxed as income tax to the shareholder.)

• S corporations do not pay federal income tax
  o Pass losses and gains to shareholders
  o Additional tax admin; outside tax support required from the start

• Others that do not pay:
  o General partnerships
  o Limited partnerships
  o Limited liabilities companies

• But beware of state taxes too!
  o i.e., Delaware Franchise Tax
  o CT Entity tax (even if you are a DE company, but reside your business here)
Other considerations

- If not bringing in investors ➤ LLC
- If bringing in investors ➤ C-Corp
- If high-risk, and little cash
  ➤ C-Corp can pay employees/consultants stock options
Which State to Choose?

- Consult with lawyer
- Consider state where company and employees are located
- Delaware has a well known body of case law, clear path
- Legal actions (lawsuits) will take place where you register
- Still need to qualify to do business in state where business operations conducted, and may be treated as a quasi State-specific corporation.
- State franchise taxes annually- where you operate