

CSE 190: Legal issuers: formation, operational agreements, equity

(Disclaimer: this is not legal or tax advice. Consult lawyers and accountants before making any decisions.)

1. Types of business from a legal point of view

- **Sole proprietorship or partnership** (the person(s) is the business)
- **Limited Liability Corporation (LLC):**
 - legal protection (to owners), pass through taxation, loose operation, limitations with shares
- **S Corporation:**
 - legal protection, pass through taxation, formal operation, restrictions in shares (no more than 100 shareholders who are US citizens/residents, only one class of stock)
- **C Corporation:**
 - legal protection, taxed separately, formal operation, ability to issue shares

Important points:

- The myth of double taxation: C Corporations pay taxes on profit not revenue. Owners can be paid **reasonably** salaries that are not taxed at the corporate level.
- If you have loss, in the LLC, you can reduce your taxes, but for a few years only.
- VCs feel more comfortable with C Corporations from Delaware.

2. Where to incorporate:

- Delaware vs California vs Nevada
- Delaware: Delaware franchise taxes (\$200-400/y), CA franchise tax \$800 (for doing business in CA), Registered agent in Delaware (\$100),
Subtle: California requires a majority share of each class of stock to effect a corporate change like a merger, acquisition, or IPO, whereas Delaware corporate law allows all classes to vote together.
Conclusion: Delaware is preferred by investors and board of directors members.
For "venture" oriented companies, C Corp Delaware.

3. Forming a business:

- E.g. DE: <https://corp.delaware.gov/howtoform.shtml>, CA: <http://www.sos.ca.gov/business-programs/business-entities/forms>
- i) Select type of entity and state, ii) Identify company name – ensure availability, iii) Submit form and required docs and fees
if incorporating out of state (Delaware), you need a registered agent

4. Operational agreement: laws governing the operation.

- LLC is governed by an operational agreement: its founding members can determine its operation.
- C Corp, there are standard operational rules, but bylaws can always be voted and approved:
 1. Shareholders own the stock of the corporation.
 2. Shareholders elect Directors (known as the "Board of Directors").
 3. Directors appoint Officers (President, Secretary, Treasurer, etc.).
 4. Officers run the company (day-to-day operations).

5. Vesting of shares:

- Vesting should always be over multiple years, including for co-founders
- Having a "cliff": minimum time requirement for shares to "vest"
- Tying compensation with milestones
- Decide explicitly what happens on major events: person leaves or is fired, company is sold etc

Resources:

- <https://www.rocketlawyer.com/article/business-formation.rl>
<https://www.rocketlawyer.com/article/c-corp-taxation.rl>

<http://www.bizfilings.com/toolkit/sbg/tax-info/fed-taxes/s-c-corporations-create-different-tax-consequences.aspx>

<http://www.bizfilings.com/learn/s-corporation-vs-c-corporation.aspx>