

The Low Down on Start-Ups

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September 04, 2001



A company will never succeed without a strong business vision. And it will never come into existence at all without careful attention to start-up mechanics.

For The Practical Lawyer, September 2001

A successful company always starts with a good idea. Development teams then take the idea and work on proposals for startup. After careful deliberation, the best start-up plan is put into action, and a successful business is born. This is, of course, a vast oversimplification of what really happens. Before any business gets to the start-up phase, the developers have to answer quite a few questions:

- When is the right time to form the company?
- What is the best choice of entity?
- Where should the entity be organized? How should the company be capitalized?
- Is an equity incentive plan a good idea for this particular business?
- Would there be any advantage in trying to get “angel” financing?
- How should the company go about hiring its staff?

This article discusses some of the basic answers to these and the other questions that are critical to a successful start-up.

When To Form the Company

Business development teams are often somewhat fluid, and likely to change before the company is actually launched. There may even be some question about whether the company will be launched at all. As a result, the team members may not be ready to incur the costs of forming the company, and even if they were willing to do that, they might not be comfortable making decisions regarding equity allocation among the founders at such an early stage. While these are legitimate concerns, there are several good reasons to form the company as early as possible.

Holding Periods

The earlier the company is formed, the sooner the stock can be issued and the capital gains holding period begins to run. Upon a liquidity event, stock that has been held for one year or more will be taxed at the long-term capital gains rate, which is generally 20 per cent. Gains on stock held for less than one year are taxable at an individual's ordinary income tax rate which can be significantly higher than the long-term capital gains tax rate.

Cheap Stock Issues

Founders of companies often make the mistake of waiting until they have received a strong indication of interest from an investor before they decide that it is time to incorporate. Forming a company so close in time to raising capital can create a significant tax issue. This issue may be summarized as follows. If founders issue themselves stock at the time of formation for one cent per share (for example), and then within a short period of time outside investors pay \$1 or more per share (for example), it might appear upon an IRS audit that the founders issued themselves stock at significantly below the fair market value per share. The difference between what the founders paid for their stock, and the fair market value of that stock based on the sale to outside investors, may be characterized as compensation income resulting in what could be significant tax liability to the founders. If on the other hand founders' stock is issued with some lead time before investor commitment, and certain significant milestones are achieved in the interim, this risk decreases substantially.

Ability To Contract

The founders may want to establish certain relationships with third parties that require contracts. As an example, there may be an independent contractor that is going to be developing some software code. For the company to own this code, it needs to enter into a work for hire agreement with the contractor. This obviously cannot be done until the company is formed. 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. Although the individual founders could, and often do, enter into these types of agreements with third parties before the formation of the company, this arrangement is not ideal, and raises issues regarding enforceability and personal liability for the founders.

Limited Liability

Perhaps the most fundamental benefit of incorporating is the protection of the corporate shield. Individual stockholders are generally not liable for the liabilities of the company in which they hold stock. Until a company is formed, the individuals are acting in their personal capacity, and may be personally liable. 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.

Choice of Entity

One of the initial decisions founders must make is the form of entity to use for their new company. On the whole, C corporations tend to be the entity of choice for most startups that plan to raise money from the venture capital ("VC") community.

C Corporation

For a company that is going the traditional VC route, it may make the most sense to simply form the company as a C corporation because C corporations are generally preferred by VCs. In addition, by forming the business as a C corporation, the founders position themselves best to take advantage of Internal Revenue Code ("Code") section 1202, which permits the exclusion of up to 50 percent of the gain on sales of stock in certain types of C corporations held for more than five years.

Limited Liability Company

If the founders or investors want to be able to deduct early losses from the business on their personal tax returns, however, they might be tempted to organize the business as an S corporation or limited liability company ("LLC"). S corporations have very strict limitations on

who can be stockholders (for example, non-resident aliens, corporations, and partnerships cannot be stockholders in S corporations). Perhaps more significantly, stock issued while the corporation was an S corporation can not qualify for the favorable treatment of Code section 1202. Thus, if the founders or investors want to be able to deduct early losses from the business and preserve their ability to take advantage of Code section 1202, they may be better off forming the business as an LLC and then converting it to a C corporation at the time of the VC investment. Of course, certain Code provisions may limit the founders' and investors' abilities to use their shares of the company's losses anyway. In addition, LLCs can be cumbersome when it comes to awarding equity participations to employees and consultants.

State of Incorporation

There are basically two states of incorporation that startups based in Massachusetts consider – Massachusetts and Delaware. Although some founders feel a connection to Massachusetts, and will incorporate in Massachusetts for that reason, incorporating in Delaware is the more common practice, for two primary reasons: maturity of Delaware corporate law, and relative ease of taking stockholder actions.

Maturity of Delaware Corporate Law

First, VCs tend to be comfortable with Delaware corporations, regardless of where the venture capital is based. This is because the corporate law of the State of Delaware is generally considered to be the most sophisticated, comprehensive, and well defined. For this reason, many Fortune 500 companies are incorporated in Delaware, even though their primary office location is in another state. Since VCs serve on the board of directors of their portfolio companies, they generally prefer Delaware because the laws regarding fiduciary duties and other matters involving directors are well understood and delineated.

Stockholder Actions

The second benefit to incorporating in Delaware as opposed to Massachusetts has to do with the legal mechanics of stockholder actions. In both Delaware and Massachusetts, stockholder action can be taken either at a meeting at which a quorum of the stockholders vote in person or by proxy, or by circulating what is called a written consent that is signed by the stockholders. It is generally preferable to take actions by written consent if possible because stockholders' meetings typically require prior written notice of at least seven days. The Delaware laws generally authorize action by consent with a simple majority of the stockholders' signatures. However, in Massachusetts consents can only be accomplished with the signatures of all of the stockholders. As a result, it is often much easier to obtain stockholder approval if the company is based in Delaware. In fact, Massachusetts companies often later reincorporate in Delaware for precisely this reason.

Founders' Equity

The subject of founder's equity is one of the more involved aspects of organizing a start-up. Matters to consider include capitalization at time of formation, division of shares among founders, stock restriction agreements, the dilutive effect of the employee pool required by the VCs, and equity budgeting.

Basic Definitions

Basic definitions for understanding the choices facing the founders include the following:

- *Authorized stock* is the total number of shares of capital stock, whether common or preferred, that the company is authorized to issue at any given time;
- *Issued and outstanding stock* is the total number of shares of capital stock that have actually

been issued pursuant to financings, stock options or otherwise, and that are still owned based on the corporate records of the company at any time;

- *Issued and outstanding common stock on an as converted basis* is the total number of shares of common stock that are issued and outstanding at any time, plus that total number of shares of common stock that the issued and outstanding preferred stock (and other convertible securities) would convert into at that point in time were it to convert;
- *Issued and outstanding common stock on an as converted, fully diluted basis* is the total number of shares of issued and outstanding common stock on an as-converted basis, plus the total additional number of shares that would be issued and outstanding if all options and warrants were exercised.

Capitalization at Time of Formation

The total number of authorized shares, and the total number of issued and outstanding shares, at the time of formation of the company is largely arbitrary; and in the end not of high importance. What really matters is the relative allocation of the equity among the founders. The numbers of shares authorized and outstanding can, and often are, adjusted upward through stock splits. Notwithstanding this, there are a couple of guiding factors.

Ability To Make Awards of Large Blocks of Shares. Prospective hires often focus more on the total number of shares awarded to them (either outright as restricted stock or by the grant to them of options to purchase the shares) rather than the percentage of the company that such shares represent. As a result, the company should consider putting in place an equity incentive plan that has a significant number of shares, often between one million and two million shares. At the high end of the range, this will allow the company to make awards in the market range in terms of both percentage and raw numbers (i.e. two percent to three percent for a VP of Business Development, at 50,000 to 70,000 shares). In addition, this allows the company to establish a low issuance (in the case of restricted stock) or exercise (in the case of options) price.

Venture Capital Ranges. VCs often have an opinion about what number of shares of common stock should be issued and outstanding at the time of their investment. They usually run numbers based on an assumed purchase price in the range of \$1 per share for a first or "Series A" round. Some VCs are more concerned about the initial purchase price than others, and will dictate what the capital structure of the company will look like before funding. For the sake of discussion, if we assume that a VC firm is going to put \$5 million into a company with a pre-money valuation of \$5 million in exchange for 50 percent of the stock of the company, and require that 20 percent of the stock be allocated to an employee pool, the founders would need to own three million shares in aggregate for the purchase price in the Series Around to be \$1.

Division of Shares Among Founders. The issuance of stock among the founding group is for the founders to determine, and is typically based on relative contributions to the formation of the company, including:

- The conception of the business idea;
- Leadership in promoting the idea;
- Assumption of risk to launch the company;
- Sweat equity;
- Writing the business plan; and
- The development of any underlying technology.

In addition to pre-formation contributions, the potential for future success in commercializing

the business idea may also be a factor, including the background and experience that each person brings to the task.

Founder Status. There is much confusion over what makes someone a founder, and whether it has any legal significance. “Founder” is really...

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