Guide to Starting a Corporation

FENWICK & WEST LLP

Fenwick
FENWICK & WEST LLP

About the Firm

Fenwick & West LLP provides comprehensive legal services to high technology and biotechnology clients of national and international prominence. We have approximately 300 attorneys and a network of correspondent firms in major cities throughout the world. We have offices in Mountain View, San Francisco, Seattle and Boise.

Fenwick & West LLP is committed to providing excellent, cost-effective and practical legal services and solutions that focus on global high technology industries and issues. We believe that technology will continue to drive our national and global economies, and look forward to partnering with our clients to create the products and services that will help build great companies. We differentiate ourselves by having greater depth in our understanding of our clients' technologies, industry environment and business needs than is typically expected of lawyers.

Fenwick & West is a full service law firm with nationally ranked practice groups covering:

- Corporate (emerging growth, financings, securities, mergers & acquisitions)
- Intellectual Property (patent, copyright, licensing, trademark)
- Litigation (commercial, IP litigation and alternative dispute-resolution)
- Tax (domestic, international tax planning and litigation)

Corporate Group

For 30 years, Fenwick & West's corporate practice has represented entrepreneurs, high technology companies and the venture capital and investment banking firms that finance them. We have represented hundreds of growth-oriented high technology companies from inception and throughout a full range of complex corporate transactions and exit strategies. Our business, technical and related expertise spans numerous technology sectors, including software, Internet, networking, hardware, semiconductor, communications, nanotechnology and biotechnology.

Our Offices

801 California Street
Mountain View, CA 94041
Tel: 650.988.8500

555 California Street, 12th floor
San Francisco, CA 94111
Tel: 415.875.2300

1191 Second Avenue, 10th floor
Seattle, WA 98101
Phone: 206.389.4510

950 W. Bannock Street, Suite 850
Boise, ID 83702
Tel: 208.331.0700

For more information about Fenwick & West LLP, please visit our Web site at: www.fenwick.com.

Guide to Starting a Corporation

Introduction

This guide describes certain basic considerations and costs involved in forming a Delaware or California corporation. Although Delaware and California law are emphasized, the legal concepts are much the same in other states. One important tip is that you should avoid making business decisions in a vacuum. Instead, consider how a decision may impact future alternatives. For example, an improperly priced sale of common stock to founders immediately followed by a sale of preferred stock may result in a significant tax liability to the founders. Another example is that converting a limited liability company into a corporation immediately before the business is acquired, rather than at an earlier time, may prevent the transaction from being tax-free.

This guide is only an overview, particularly as to tax issues and cannot substitute for a professional advisor's analysis and recommendations based on your individual fact situations when establishing your business.

A. Selecting the Form of Business Organization

No single factor is controlling in determining the form of business organization to select, but if the business is expected to expand rapidly, a corporation will usually be the best alternative because of the availability of employee incentive stock plans; ease of accommodating outside investment and greater long-term liquidity alternatives for shareholders. A corporation also minimizes potential personal liability if statutory formalities are followed. The characteristics of a corporation are described below, followed by an overview of other traditional forms of business organizations. Each of the following factors is described for comparison purposes: statutory formalities of creation, tax consequences, extent of personal liability of owners, ease of additional investment, liquidity, control and legal costs.

1. Corporation

A corporation is created by filing articles of incorporation with the Secretary of State in the state of incorporation. Corporate status is maintained by compliance with statutory formalities. A corporation is owned by its shareholders, governed by its Board of Directors who are elected by the shareholders and managed by its officers who are elected by the Board. A shareholder's involvement in managing a corporation is usually limited to voting on extraordinary matters. In both California and Delaware, a corporation may have only one shareholder and one director. A president/CEO, chief financial officer/treasurer and secretary are the officer positions generally filled in a startup and, in fact, are required under California law. All officer positions may be filled by one person.

The reasons for using a Delaware corporation at startup are the ease of filings with the Delaware Secretary of State in financings and other transactions, a slight prestige factor in being a Delaware corporation and avoiding substantial reincorporation expenses later, since many corporations which go public reincorporate in Delaware at the time of the IPO. Delaware corporate law benefits are of the most value to public companies. However, if the corporation's primary operations and at least 50% of its shareholders are located in California, many provisions of California corporate law may be applicable to a private Delaware corporation and such a company would pay franchise taxes in both California and Delaware. These considerations may result in such a business choosing to incorporate in California instead of Delaware. Another reason for keeping it simple and using a California corporation is the current non-existent IPO market which makes an acquisition a more likely exit for a start-up.

There is more flexibility under Delaware law as to the required number of Board members. When a California corporation has two shareholders, there must be at least two Board members. When there are three or more shareholders, there must be at least three persons on the Board. Under Delaware law, there may be one director without regard for the number of stockholders. Most Boards stay lean and mean in number as long as possible to facilitate decision-making. Since the Board is the governing body of the corporation, when there are multiple board members, a party owning the majority of the shares can still be outvoted on the Board on important matters such as sales of additional stock and the election of officers. Removing a director involves certain risks even when a founder has the votes to do so. Thus, a founder's careful selection of an initial Board is essential. You want board members whose judgment you trust (even if they disagree with you) and who can provide you with input you won't get from the management team.

A corporation is a separate entity for tax purposes. Income taxed at the corporate level is taxed again at the shareholder level if any distribution is made in the form of a dividend. The S Corporation election described below limits taxation to the shareholder level but subjects all earnings to taxation whether or not distributed. The current maximum federal corporate tax rate is 35%. The California corporate income tax rate is 8.84% and the Delaware corporate income tax rate is 8.7% but Delaware income tax does not apply if no business is done in Delaware and only the statutory office is there. There is also a Delaware franchise tax on authorized capital which can be minimized at the outset but increases as the corporation has more assets.

If the business fails, the losses of the initial investment of up to $1 million in the aggregate (at purchase price value) of common and preferred stock (so-called "Section 1244 stock") may be used under certain circumstances by shareholders to offset a corresponding amount of ordinary income in their federal income tax returns. An individual may deduct, as an ordinary loss, a loss on Section 1244 stock of up to $50,000 in any one year ($100,000 on a joint return).

If statutory formalities are followed, individual shareholders have personal liability only to the extent of their investment, i.e., what they paid for their shares. If the corporation is not properly organized and maintained, a court may "pierce the corporate veil" and impose liability on the shareholders. Both California and Delaware law permit corporations to limit the liability of their directors to shareholders under certain circumstances. The company can raise additional capital by the sale and issuance of more shares of stock, typically preferred stock when an angel or venture capitalist is investing. Though rare, the power of a court to look through the corporation for liability underscores the importance of following proper legal procedures in setting up and operating your business.

Filing fees, other costs and legal fees through the initial organizational stage usually total about $3,500 to $5,000, with a Delaware corporation being at the high end of the range.

2. Sole Proprietorship

The simplest form of business is the "sole proprietorship," when an individual operates a business on his own. The individual and the business are identical. No statutory filings are required if the sole proprietor uses his own name. If a different business name is used in California, a "fictitious business name" statement identifying the proprietor must be filed with the county clerk of the county where the principal place of business is located and published in the local legal newspaper. A sole proprietor has unlimited personal liability to creditors of his business and business income is taxed as his personal income. Because of the nature of this form of business, borrowing is the usual method of raising capital. The legal cost of forming a sole proprietorship is minimal.

3. General Partnership

When two or more individuals or entities operate a business together and share the profits, the enterprise is a "partnership." Partnerships are either general partnerships or limited partnerships (described below). Although partners should have written partnership agreements which define each party's rights and obligations, the law considers a venture of this type as a partnership whether or not there is a written agreement. No governmental filings are required for a general partnership. A partnership not documented by a written agreement is governed entirely by the versions of Uniform Partnership Act in effect in California and Delaware.

In the absence of an agreement to the contrary, each partner has an equal voting position in the management and control of the business. Each partner generally has unlimited liability for the debts of the partnership and is legally responsible for other partners' acts on behalf of the business, whether or not a partner knows about such acts.

The partnership is a conduit for tax purposes: profits (even if not distributed) and losses flow through to the partners as specified in the partnership agreement. There is no federal tax at the entity level. Some partnerships contemplate raising additional capital, but accommodating future investment is not as easy as in a corporation. The legal cost of establishing a partnership is minimal if no formal written agreement is prepared but not having a written agreement may cause disputes over the economic benefits, intellectual property and assets of the partnership. The cost of preparing such an agreement begins at about $2,000 and depends on the number of partners, sophistication of the deal and other factors.

4. Limited Partnership

This is a partnership consisting of one or more general partners and one or more limited partners which is established in accordance with the California and Delaware versions of the Uniform Limited Partnership Act. Like the corporation, this entity has no legal existence until such filing occurs. The limited partnership is useful when investors contribute money or property to the partnership but are not actively involved in its business. The parties who actively run the business are the "general partners," and the passive investors are the "limited partners." So long as the limited partnership is established and maintained according to statutory requirements, and a limited partner does not take part in the management of the business, a limited partner is liable only to the extent of his investment. Like a general partnership, however, the general partners are personally responsible for partnership obligations and for each other's acts on behalf of the partnership.

For tax purposes, both general partners and limited partners are generally treated alike. Income, gains and losses of the partnership "flow through" to them and affect their individual income taxes. A properly drafted limited partnership agreement apportions profits, losses and other tax benefits as the parties desire among the general partners and the limited partners, or even among various subclasses of partners subject to certain requirements imposed by U.S. tax law, i.e., the Internal Revenue Code (the "IRC").

5. Limited Liability Company

This form of business organization is available in Delaware and California as well as many other states. It is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions identified below. An LLC has fewer statutory formalities than a corporation and is often used for a several person consulting firm or other small business. An LLC does not provide the full range of exit strategies or liquidity options as does a corporation. It is not possible to grant stock option incentives to LLC employees in the same manner as a corporation. Further, an acquisition of an LLC generally may not be done on a tax-free basis and the expenses of formation are higher than for forming a corporation.

B. S Corporations

A corporation may be an "S corporation" and not subject to federal corporate tax if its shareholders unanimously elect S status for the corporation on a timely basis. "S corporation" is a tax law label; it is not a special type of corporation under state corporate law. Like a partnership, an S corporation is merely a conduit for profits and losses. Income is passed through to the shareholders and is generally taxed only once. Corporate level tax can apply in some circumstances to an S corporation that previously had been a "C" corporation for income tax purposes. Losses are also passed through to offset each shareholder's income to the extent of his basis in his stock and any loans by the shareholder to the S corporation. The undistributed earnings retained in the corporation as working capital are taxed to a shareholder.

A corporation must meet certain conditions in order to be an S corporation, including the following: (1) it must be a U.S. corporation, (2) it must have no more than 100 shareholders, (3) each shareholder must be an individual, certain trusts, certain charitable organizations, employee stock ownership plans or pension plans, (4) no shareholder may be a nonresident alien, and (5) it can have only one class of stock outstanding (as opposed to merely being authorized). As a result, S corporation status will be terminated when a corporation sells preferred stock or sells stock to a venture capital partnership, corporation or to an off-shore investor.

California and Delaware recognizes the S corporation for state tax purposes, which may result in additional tax savings. California, however, imposes a corporate level tax of 1.5% on the S corporation's income and nonresident shareholders must pay California tax on their share of the corporation's California income. In addition, only C corporations and noncorporate investors are eligible for the Qualified Small Business Corporation capital gains tax break. The benefit of this tax break is that if the stock is held for at least 5 years, 50% of any gain on the sale or exchange of stock may be excluded from gross income. This benefit may not be as important because of the reduction in the capital gains tax rate.

C. Choosing a Business Name

The name selected must not deceive or mislead the public or already be in use or reserved. "Inc.," "Corp." or "Corporation" need not be a part of the name in California but must be part of a Delaware corporate name. Name availability must be determined on a state-by-state basis through the Secretary of State. A corporate name isn't available for use in California merely because the business has been incorporated in Delaware. Several alternative names should be selected because so many businesses have already been formed. Corporate name reservation fees range from approximately $10-50 per state for a reservation period of 30-60 days. Exclusive state rights in a trade name can also be obtained indefinitely through the creation of a name-holding corporation, a corporation for which articles of incorporation are filed but no further organizational steps are taken.

D. Selecting the Location for the Business

This decision is driven by state tax considerations and operational need, for example, to be near customers or suppliers or in the center of a service territory. A privately-held corporation cannot avoid California taxes and may not be able to avoid the application of California corporate law if it is operating here and has most of its shareholders here. For example, Delaware law allows Board members to be elected for multiple year terms and on a staggered basis rather than on an annual basis. A privately held corporation, however, may be able to have the benefits of these Delaware laws or any other state's corporate law if it is actually operating in California and more than 50% of its shareholders are here.

E. Qualifying to do Business in Another State

A corporation may need to open a formal or informal office in another state at or near the time of founding. This requires a "mini" incorporation process in each such state. If a California business is incorporated in Delaware it must qualify to do business in California. The consequences of failing to do so range from fines to not being able to enforce contracts entered in that state. The cost of qualifying is approximately $1,000 per state. Some states, like Nevada, also charge a fee based on authorized stock, so the fee could be higher in such states.

F. Initial Capital Structure

1. Structure

The capital structure should be kept as simple as possible and be within a range of "normalcy" to a potential outside investor for credibility purposes. A common initial structure is to authorize 10 million shares of common stock and 4 million shares of preferred stock. Not all authorized shares of common stock are sold at the founding stage. After initial sales to founders, there are usually only about 3-5 million shares issued and outstanding and about 1-2 million shares reserved in the equity incentive plan. This is referred to as the "1X model" below.

While at the outset there may not seem to be any difference between owning 100 shares or 1 million shares, a founder should purchase all of the units of stock he desires at the time of founding. Thereafter, a founder will generally lose control over further issuances and stock splits, particularly once a venture capital financing occurs. In addition, the purchase price will usually increase.

The number of shares issued and reserved in the initial capital structure are driven by a desire to avoid a later reverse stock split at the time of an IPO because of excess dilution. The number of shares outstanding at the time of an IPO is driven by company valuation at IPO, the amount to be raised in the IPO and IPO price per share range (usually $10 to $15). The "pattern" for the business value at the time of the IPO can be reached by forward or reverse stock splits. For example, if a corporation has a market valuation at IPO time of $200 million, it would not be feasible for 40 million shares to be outstanding. A reverse stock split is needed. Reverse stock splits reduce the number of shares held. On the other hand, forward stock splits add shares to holdings. Neither changes the percentage ownership, but seeing the number of shares held decrease because of a reverse split is still hard on employee morale.

Because of the great demand for engineers during the Internet bubble, many corporations used a multiple of this 1X model in order to have more equity units available for employees. The immediate need for employees to increase the possibility of business success outweighed the potential consequence of a later reverse stock split. Currently, most startups use a 1X or 2X model to avoid excessive dilution.

2. Minimum Capital

Neither Delaware nor California law require a minimum amount of money to be invested in a corporation at the time of founding. The initial amount of capital, however, must be adequate to accomplish the purpose of the startup business in order for shareholders not to have personal liability. For example, a corporation which will serve only as a sales representative for products or a consulting operation requires less capital than a distributor or dealer who will stock an inventory of products. A dealership or distributorship will require less capital than a manufacturing operation.

3. Legal Consideration

A corporation must sell its shares for legal consideration, i.e., cash, property, past services or promissory notes under some circumstances. A founder who transfers technology or other property (but not services) to a corporation in exchange for stock does not recognize income at the time of the transfer (as a sale of such property) under IRC Section 351 if the parties acquiring shares at the same time for property (as opposed to services) own at least 80% of the shares of the corporation after the transfer. Because of this limitation, Section 351 is generally available at the time of founding but not later. Since a party who exchanges past or future services for stock must recognize income in the amount of the value of the stock in the tax year in which the stock is received, it is the prefered practice to issue the shares at a low valuation for cash or property.

4. Valuation

The per share value at the time of founding is determined by the cash purchases of stock and the number of shares issued. For example, if one founder buys stock in exchange for technology and the other founder buys a 50% interest for cash, the value of the technology and the fair market value per share is dictated by the cash purchase since its monetary value is certain. Sales of the same class of stock made at or about the same time must be at the same price or the party purchasing at the lower price may have to recognize income on the difference.

Thereafter, value is determined by sales between a willing seller and buyer or by the Board of Directors based on events and financial condition. Value must be established by the Board at the time of each sale of stock or grant of a stock option. Successful events cause value to increase. Such determinations are subjective and there is no single methodology for determining current fair market value. There are pitfalls of hedging on the timing of forming corporation to save on expenses. The longer the delay in incorporating, the more difficult it is to keep the founders price at a nominal level if a financing or other value event is imminent.

A general objective is to keep the value of common stock as low as possible as long as possible to provide greater stock incentives to attract and keep key employees. Tax and state corporate laws generally require option grants to be made at current fair market value. IRC Section 409A has increased the diligence needed in determining pricing for stock option grants.

5. Use of Debt

Loans may also be used to fund a corporation. For example, if a consulting business is initially capitalized with $20,000, half of it could be a loan and the remaining $10,000 used to purchase common stock. Using debt enables the corporation to deduct the interest payments on the debt, makes the repayment of the investment tax free and gives creditor status to the holder of the debt. If a corporation is too heavily capitalized with shareholder's loans, as opposed to equity (usually up to a 3-1 debt/equity ratio is acceptable), however, these loans may be treated as additional equity for tax and other purposes. Debts owed to shareholders may be treated as contributions to capital or a second class of shares and subordinated to debts of other creditors. Eligibility for S corporation status is lost if a loan is characterized as a second class of shares.

6. Vesting and Rights of First Refusal

Shares sold to founders are usually subject to vesting and rights of first refusal in order to keep founders on the corporate team and to maintain control over ownership of the corporation. Grants of options under an equity incentive plan also have such "stickiness" restrictions. Such safeguards are essential to securing a venture capital investment. By designing and implementing a reasonable vesting scheme themselves, founders may forestall an investor from doing so on the investor's terms. Vesting also assures investors that the founders and others are committed to the corporation and not just looking for a quick pay day. The corporation typically retains the option to repurchase unvested shares at the initial purchase price at the time of termination of a shareholder's employment. Vesting usually occurs over 4 years, i.e., if the employee remains employed by the corporation for the entire period, all shares become "vested" and the repurchase option ends. A common pattern is for 25% of the shares to vest after 12 months and the remainder to vest monthly over the next 36 months. Vesting is implemented by stock purchase agreements. An IRC Section 83(b) election must be filed with the Internal Revenue Service by a party buying unvested shares within 30 days of the date of purchase in order to prevent taxable income at the times such shares vest.

A right of first refusal is the corporation's option to repurchase shares when a third party makes an offer to purchase shares. This type of restriction can be used by itself or as a backup to the repurchase option to maintain control over stock ownership once vesting occurs. The corporation may repurchase the shares on the same terms as the offer by the third party. Rights of first refusal are implemented by stock purchase agreements, including under stock option plans, or in the corporation's bylaws. Rights of first refusal (but not rights of repurchase on termination of employment) terminate upon an IPO or acquisition.

G. Sales of Securities

Offers and sales of stock in a corporation, certain promissory notes and loans, certain partnership interests and other securities are subject to the requirements of the Securities Act of 1933, a federal law, and of state securities laws, so-called "Blue Sky" laws. While some state laws are preempted by federal securities laws in some cases, an offer or sale of securities in multiple states generally requires compliance with each state's law. The general rule under these laws is that full disclosure must be made to a prospective investor and that registration or qualification of the transaction with appropriate governmental authorities must occur prior to an offer or sale. An investor can demand its money back if securities laws are not followed. There are also severe civil and criminal penalties for material false statements and omissions made by a business or its promoters in offering or selling securities. Legal opinions regarding exemptions are not possible if securities are sold without regard for such laws. An opinion may be required in venture capital investments or an acquisition.

Exemptions from the registration and qualification requirements are usually available for offers and sales to founders, venture capitalists and foreign parties but offers and sales to other potential investors, even employees, are not legally possible without time consuming and expensive compliance with such laws. State laws have relatively simple exemptions for option grants and stock issuances under a formal equity incentive plan, which is why a plan should be the source of equity for employees and consultants.

The stock purchased in a sale exempt from federal registration and state qualification requirements will not be freely transferable. In addition to contractual restrictions, resales must satisfy federal and state law requirements. Shareholder liquidity occurs through Securities and Exchange Commission Rules 144 or 701, an IPO, other public offerings or other exempt sales.

www.fenwick.com

Lawyers who get IT.™