

UCLA Anderson School of Management
Entrepreneurship Course

Legal Issues for Startups
Guest Lecturer: Stephen P. Rothman

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Choice of Entity

- Corporation
 - Subchapter C / Subchapter S
 - Delaware / California
- Limited Liability Company
- Sole Proprietorship
- Partnership (General or Limited)



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Sole Proprietorship

- Cheapest, fastest
- Tax pass-through
- No liability protection
- Only lasts as long as you do
- Only for a solely-owned entity
- Concern that it invites more tax audit scrutiny



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C Corporation

- Exposes only assets of the business to liability (but careful re "piercing the corporate veil")
- Unlimited life
- Multiple owners
- Separate entity for income tax purposes ("double taxation" - may be avoided to some extent in solely owned entity by paying out excess cash as "reasonable compensation" rather than dividends)
- Initial losses not usable by investors, but accumulate as NOLs
- "Tax-free" reorganizations possible
- Some VCs insist on conversion to a C corporation



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Pass Through Entities S Corporation, LLC, Partnership

- S corporation, limited liability company and partnership are all "pass-through" entities, not separately taxed (except by states); instead income or loss flows through to owners
- If company has taxable losses in its early years, each owner reports a share of these losses
- Owners with taxable income from other sources can offset it with their share of the flow-through deductions, but only if they have invested cash in the company or otherwise have "basis."
- Once company is profitable, profits subject to single tax (except state tax on S corp) not double tax like C corporation



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S Corporation Pros and Cons

- Pro - Corporations, including S corporations, can issue stock options. Employees understand "stock options" and may not understand LLC "profits interests." There is a cost to educating employees and recruiting in having a non-corporate form.
- Pro - Eligible to use tax-free reorganizations, such as stock-for-stock merger (LLCs and partnerships not eligible)
- Pro - no self-employment tax on money paid out to active employees as a dividend rather than a salary, subject to reasonable allocation between salary and dividend (in LLC if a member is an active employee his share of profits up to \$87,900 is subject to 15.3% social security and Medicare taxes and beyond \$87,900 2.9%)
- Con - California 1.5% tax on S corporation income, but not on LLC
- Con - Cannot include share of entity debt in tax basis (could in LLC or partnership)
- Con - There cannot be more than 75 shareholders in an S corporation, and no shareholder can be a C corporation or non - U.S. person
- Con - S corps may not have more than one class of stock; can't have over 80% owned subsidiary
- Con - All gains and losses have to be passed through proportionate to the shareholder's stock stake in the company.
- Elect S corporation status by filing IRS Form 2553, California FTB Form 3560



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LLC Pros and Cons

- Pro - No California 1.5% tax
- Pro - Can include share of entity debt in tax basis
- Con - No stock options; instead less familiar profits interests
- Con – if a member is an active employee there is a 15.3% self-employment tax on their share of profits up to \$87,900 and 2.9% above that, whereas in an S corp only the amount paid as salary but not as dividend is subject to the self-employment tax
- Con - Not eligible to use tax-free reorganizations



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Comparison of C and S Corporations

(assumes income not "zero'd out")

	C Corporation	S Corporation
Net Income	\$100.00	\$100.00
California franchise tax (8.84% C; 1.5% S)	\$8.84	\$1.50
Federal corporate tax (@ 34%)	\$30.99	
After-tax income	\$60.17	\$98.50
Dividend	\$60.17	\$98.50
Calif tax on div. or on share of S corp inc. (@ 9.3%)	\$5.60	\$9.30
Fed tax on div. or on share of S corp inc. (@ 35%)	\$19.10	\$31.22
Net income to shareholders	\$35.47	\$57.98



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Why VCs like C Corporation

- Venture funds themselves are often structured as LLCs or limited partnerships; the VC fund therefore passes through its taxable income or loss to its partners; many of the investors in VC funds are tax exempt (pension funds, university endowments)
- Pass-through of early stage losses by startup give no benefit to tax-exempt investors in VC fund; They'd rather see the NOLs accumulate and later benefit the company
- When an otherwise tax-free entity owns equity of an operating LLC, it becomes taxable on its share of pass-through income ("unrelated business taxable income" or UBTI), so in later stage the VC fund investors may have taxes to pay
- For these reasons, many VC funds have written into their partnership agreements that they cannot own interests in LLCs or partnerships



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Jurisdiction of Incorporation

- Delaware, California or other
- If not funded yet, California is slightly cheaper because no extra Delaware fees to pay (paying in California anyway due to residence)
- If funded by VCs, they may insist on Delaware
- California law amended 2004 to permit (as does Delaware) electronic notices, meetings and records, which save time and money



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Hiring and Paying Employees

- Employment Agreements / Offer Letters
- Workers Compensation Insurance
- Wage and Hour Issues
- Payroll Withholding; Employee Posters
- Termination of Employment



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Employment Agreements – Offer Letters

- Employment at will, versus for a specified term; hybrid – at will but with specified severance upon termination
- Offer letter can contain acknowledgement of at-will status or other basic terms
- See attached samples of employment agreement, offer letter, and invention assignment / proprietary rights agreement, all of which may be customized



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Workers Compensation Insurance

- California requires all employers to have workers comp insurance (certain large employers can self-insure)
- WC system is a compromise – compensation to employee for medical expenses and lost wages due to any work-related injury, regardless of fault; employer free of negligence suits
- Failure to get required insurance is a misdemeanor punishable by a fine of up to \$10,000 or jail up to a year or both (Cal. Labor Code §3700.5)
- Obtain private insurance through an insurance broker; there is also a state insurer.
- More info: California Department of Industrial Relations, www.dir.ca.gov



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Wage and Hour Issues

- Main issue: whether employees must be paid overtime pay for work over 40 hrs/week or 8 hrs/day
- Need to designate all employees as either "exempt" (from overtime) or "non-exempt"
- Most managers and high-level administrators will be exempt; clerical employees generally non-exempt
- Special rules exist for some highly trained computer employees -- see <http://www.dir.ca.gov/lwc/IWCArticle17.pdf>
- More information at <http://www.dir.ca.gov/DLSE/dlse.html>



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Payroll Taxes I

- Withhold where required
- Pay to government
- Report
- Can outsource to payroll service (such as Paychex)
- If you fail to withhold for federal and state income tax and state disability insurance, you can be liable for the taxes anyway, as well as penalties and late charges
- Federal – Employer's Tax Guide, Publication 15, Circular E, <http://www.irs.gov/publications/p15/index.html>
- California Employment Development Department, Employer's Guide: <http://www.edd.ca.gov/taxrep/de44.pdf>



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Employee Equity / Stock Options

- Internal Revenue Code §83 – transfer of property in exchange for services
- Tax treatment – “Incentive Stock Options” qualified under Internal Revenue Code §422 versus “nonqualified” options taxed under IRC §83
- Accounting treatment
- Vesting and acceleration
- Sizes of grants



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IRC Section 83

- Applies to transfer of property in exchange for services
- Property may be stock or “restricted stock”
- Excess of fair market value at vesting over amount paid (if any) included in gross income upon vesting - §83(a)
- May surprise a consultant who agrees to take payment ½ in stock (e.g. \$20,000 fee, \$10,000 cash, \$9,000 tax at 45% combined rate)
- 83(b) election – May file a short document with IRS within 30 days after transfer to elect taxable event at transfer date without regard to vesting restrictions
- If property is subsequently forfeited, no deduction allowed
- Holding period for capital gains starts at vesting



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Restricted Stock Example 1

Sale of 20,000 Shares Restricted Stock, at FMV of \$0.10 per Share								
4 year vesting, IPO at end of 4th year at \$20 per share								
Sale at end of 5th year at \$25 per share								
Grant Anniversary	Value per Share	Spread per Share	Aggregate Spread	Portion of Spread Vesting	No 83(b) Election		83 (b) Election	
					Ordinary Income Tax (@ 45% combined)	Capital Gain Tax (@ 24% combined)	Ordinary Income Tax (@ 45% combined)	Capital Gain Tax (@ 24% combined)
1	\$0.10	\$0.00	\$0	\$0	\$0.00		\$0.00	
2	\$0.20	\$0.10	\$2,000	\$600	\$225.00			
3	\$7.00	\$6.90	\$138,000	\$34,500	\$15,525.00			
4	\$20.00	\$19.90	\$398,000	\$99,500	\$44,775.00			
5	\$25.00					\$87,240.00		\$119,520.00
Subtotals					\$60,525.00	\$87,240.00	\$0.00	\$119,520.00
Total Tax Bill						\$147,765.00		\$119,520.00



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Stock Options – Size of Grants

- Grants to individuals tend to be larger in earlier stage of company's life and progress downward, both due to increasing value of company and increasing sophistication
- Employee pool usually 15 – 20%
- Non-founder CEO: around 5 – 8 %
- Next tier (CTO, CFO, Senior VP or top person in departments such as sales, manufacturing): 1% - 2.5%
- Next tier – VP or director level – 0.4% - 0.75%
- Plan out tiers in advance and be consistent
- Agreements should always state number of shares, not percentages, and where possible employee statements may also be phrased in terms of number of shares



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Employee Equity – Timing of Grants

- If you are certain you want to give employees equity, don't wait until you have a term sheet from investors
- If price charged to employees is low compared to value implicit in financing, this causes "cheap stock" problem
 - Would disqualify a supposed ISO
 - Can't do early exercise of a NQSO without incurring a tax
- Companies funded with convertible preferred stock – common stock option exercise price often set at 10% - 20% of preferred stock price, with difference justified by reference to liquidation preference and other rights of preferred



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Equity Compensation in LLC

"Profits Interest"

- If company were to liquidate immediately after grant, employee is not entitled to share in distribution (may require book up of capital accounts to accomplish)
- Holder is entitled to share a specified percentage of the company's appreciation in value after grant of the interest
- Grant of a profits interest does not result in U.S. federal income tax to recipient
- Federal tax treatment of compensatory options in LLC or partnership uncertain

(Rev. Proc. 93-27, 1993-2 C.B. 343 and Rev. Proc. 2001-43, 2001-2 C.B. 191)



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Financing – Securities Laws

- Federal
 - Reg D private placement safe harbor
 - No general solicitation
 - Rule 504 or Rule 505 or Rule 506 – alternative dollar and purchaser limitations
 - For Rule 505 and 506, if any purchasers are not accredited, must make prepare a substantial disclosure document, with the exact scope depending on offering size
 - File Form D with SEC (simple)
- California or other state requirements may also apply

Reg. D - <http://www.law.uc.edu/CCL/33AcRIs/regD.html>



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Regulation D Detail

Purchaser and Dollar Limits

- Rule 504: \$1 million limit (in a 12-month period); must be registered under a state's securities laws, or, if state-exempt, then must be only to "accredited investors;" no prescribed disclosures (other than anti-fraud rules)
- Rule 505: \$5 million limit (in a 12-month period); 35 purchaser limit (not counting accredited investors)
- Rule 506: no dollar limit; 35 purchaser limit (not counting accredited investors); non-accredited purchasers must have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment



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Accredited Investor Definition

- A person with a net worth (or joint net worth with spouse) over \$1,000,000
- A person with an income in excess of \$200,000 for the last 2 years (or joint income with spouse over \$300,000) and a reasonable expectation of reaching the same income level in the current year
- Most institutional investors, corporations with total assets over \$5,000,000, and directors and officers of the company issuing the securities

Accredited investor definition - <http://www.law.uc.edu/CCL/33AcRIs/rule501.html>



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State Securities Laws

- If offering meets the Federal Rule 506 exemption, the most any state can require is a post-offering notice filing and a fee (National Securities Markets Improvements Act of 1996)
- Otherwise, look for registration exemption in each state



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California Private Placement Exemption

California Corporation Securities Law §25102(f)

- Sales to not more than 35 persons (including outside California)
- All purchasers either have a preexisting personal or business relationship with the company or with its officers or directors, or by reason of their business or financial experience could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction
- No advertisement
- File Form 25102(f) (can do online now)

More info: <http://www.ccorp.ca.gov/pdf/25102f.pdf>



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Leasing Real Estate

- Lease terms usually negotiable, though this depends on the market
- Flexible term – ask if landlord will agree - one-year term with tenant options to extend for several one-year periods
- Check what rent includes:
 - “gross lease” - landlord pays for property tax, insurance for the building, repairs and maintenance (not insurance for your property or your liability exposure)
 - triple net lease - in addition to base rent, tenant pays a share of landlord’s operating costs for the building, including taxes, insurance, repairs and maintenance, allocated based on square footage
- Improvements – will the landlord pay for some or all? (will depend partly on the duration of the lease, the rent and other factors)
- Improvements at your own expense - make sure the lease permits the changes you plan, and is clear regarding what you can or must remove at the end of the term, and any obligation to repair resulting damage
- Go over the insurance provisions of the lease with your insurance broker, before you sign the lease (recommendations re changes; advice re availability and costs of required coverage; help arranging for coverage once lease is signed)



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Miscellaneous

- General Liability Insurance – covers personal injury or property damage if you or employees are negligent, for example a visitor to your premises falls on a slippery floor; injured person can claim mental anguish as well as physical injury; also covers libel, slander, defamation
- Trademark – basic name search can be done at <http://tess2.uspto.gov/bin/gate.exe?f=tess&state=tdq9m.1.1>; online application for registration at <http://www.uspto.gov/teas/index.html>
- Confidentiality agreements with parties to whom technology is disclosed (sample attached)
- If selling or leasing goods, need California seller's permit from State Board of Equalization, www.boe.ca.gov
- Check whether any licensing or permit requirements exist for your chosen business line, <http://www.calgold.ca.gov>



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Choosing Attorneys

- Get a referral from another entrepreneur, a lawyer whom you already know who perhaps is in another field or can't represent you due to conflicts, or someone else you trust.
- Interview
- Basic biographical information (age, college, law school, admission to bar) may be available at www.marindale.com or a firm web site
- Nothing wrong with asking for references from other clients, though these should be positive

Think about:

- Compatible personality
- Reasonable responsiveness in returning phone calls
- Willing to use alternatives to straight hourly cash billing, such as part equity; per project fees; partly deferred collection; or temporarily reduced rates in the early stage of the business;
- Who will actually do the work (person you are interviewing or an associate; if an associate, you should be interviewing the associate)
- Big firm / small firm / individual

Overrated:

- Knowledge of your industry (maybe somewhat helpful, but not essential, except in the case of a patent prosecution lawyer's knowledge of the technology)
- Networking potential to sources of funding, new business, other professionals, employees



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Managing Legal Fees / Services

- Discuss with attorney what legal matters you can handle yourself without unreasonable risk; Nolo books, www.nolo.com
- Discuss how to compensate attorney with less cash up-front; equity, partly deferred payment; lower rates in early stage; offer incentives in return
- Ask for an estimate, and if not a fixed cap, ask what factors would make the fee higher than estimated
- Can you reduce the attorney's time?
 - By insisting the other party use your pre-drafted form NDA
 - By caving in on minor issues
 - By doing some work yourself
- Be sensitive to the attorney's time; try to anticipate needs and give a heads-up in advance rather than calling with a crisis
- Invite feedback from the attorney on whether there are ways for you to improve the working relationship, and feel free to offer similar feedback



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Sample Forms



Employment

- [Offer Letter](#)
- [Employment Agreement](#)
- [Proprietary Information and Inventions Agreement](#)
- [Separation Agreement and General Release](#)

Other

- [Bylaws, Delaware, Private Company](#)
- [Certificate of Incorporation, Delaware, Private Company](#)
- [Nondisclosure Agreement - Mutual](#)
- [Nondisclosure Agreement - Unilateral](#)
- [Purchase Terms](#)
- [Sale Terms](#)
- [Uncertificated Shares - Notice of Issuance](#)

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