

Forming a Company

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Topics

- Choice of Entity
- Keeping your house in order
- Shareholder / Operating Agreements
- Securities Law Basics
- Equity Incentives
- Employment Law Basics
- Contracts

Why Establish an Entity?

- Divide the pie
- Allow for transfer of ownership
- Agree on governance rules
- Achieve immortality (sort of)
- Limit personal liability

The Choices

- Sole Proprietorship (aka “d/b/a”)
- Corporation
 - An S-corporation is a tax election, not a different type of entity
- Limited Liability Company

Ignore:

- General Partnership
- Limited Partnership

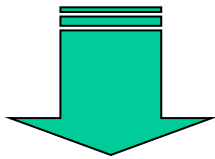
Sole Proprietorship

- Simplest form of business – not an entity at all
 - Alter ego (“d/b/a”) of owner
- Single owner has complete control, but also full personal liability
- All income and losses flow through
- When owner dies, business dies

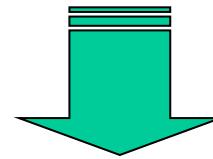
- An entity is usually a better option

Corporation vs. LLC

- Corporation
 - Bylaws
 - Board of directors
 - Officers
 - Double tax (except S corp)
- LLC
 - Operating Agreement
 - Board or not
 - Officers or not
 - Pass through tax



RIGID



FLEXIBLE

Recommendations

- For likely VC-backed, DE C-corp is “gold standard”
 - Pass-through entities create problems for institutional funds
 - Delaware is the most familiar and well-respected body of corporate law
- LLC better if unsure of VC path, or not necessarily growing to exit
 - Relatively easy to convert to a corporation later
- No real advantage (any more) to using S-corp over an LLC

Shareholder / Operating Agreements

- Transfer restrictions (ROFR, no pledging or assignment)
- Repurchase rights/obligations (death, disability, divorce, bankruptcy, bad acts, resignation or termination)
- Governance / Voting agreements
- Deadlock
- Drag-along
- Confidentiality / IP (if not separately addressed)

Founder Vesting

- Reciprocal vesting restrictions on co-founders
- Ownership vests over time
- Unvested shares are forfeited if owner quits
- Acceleration on change of control
- Acceleration if terminated without cause?

Keeping Your House in Order

- A COMMON, AVOIDABLE PROBLEM – if you don't know who owns what, how do you expect an investor to know??
- Cap Table
 - Keep accurate, current info on equity ownership
 - Both issued and fully-diluted
 - Vesting and forfeiture restrictions
- Transfer Ledger
 - Track each individual stock certificate and equity transaction
 - Keep the paperwork documenting each one
- Minute Book
 - Minutes of all meetings (including actions on written consent)
 - Copies of relevant corporate documents (e.g. certificate of incorporation, bylaws, shareholders agreement, option plan, etc.)

Securities Law Basics

- “Security” includes stock, options, warrants, LLC membership interests, promissory notes, bonds, etc.
- General Framework – registration is required unless exempt
 - Must have both state and federal exemption
 - Fortunately, there are lots of exemptions
- Private Placements
 - Generally, an offer and sale not involving a public offering
 - Reg D – certain offerings to “accredited investors” are exempt from both state and federal registration
- Unlicensed Broker/Dealers

Equity Incentives

- A means of incentivizing key employees or advisors
 - Stock Options
 - Restricted Stock
 - Profits Interests
- Tax issues (409A and 83(b))
- Vesting
 - Standard = 4 years with first year cliff then quarterly/monthly

Employment Law – Classifying Workers

- Independent contractors vs. employees
 - Improper classification as independent contractors can lead to serious liability with IRS and state(s)
- Exempt vs. non-exempt (for overtime purposes)

Employment Law - Compliance Basics

- 1+ employees – Fair Labor Standards Act
 - basic wage and hour law that covers minimum wage and overtime pay requirements
- 1+ employees – I-9 Compliance (immigration status documentation)
- 5+ employees – Worker's Compensation Insurance (in TN anyway)
- 8+ employees – Tennessee Human Rights Act
 - no race, sex, age, national origin, religion, or disability discrimination
- 20+ employees – COBRA
 - offer departing employees the option to continue their health insurance coverage at the employee's expense.
- 50+ employees w/in 75 mile radius – Family and Medical Leave Act

Employment Law – Offer Letters

- Specify “at will” employment
- Specify particulars like the start date, compensation terms, position title, location of the work, etc.
- For workers (e.g. executives) who are guaranteed work for a set period of time, or who can only be terminated for limited reasons, or who may be entitled to severance pay, get legal help
- For independent contractors, start with a good form from your lawyer
 - Make sure they are classified correctly
 - Address IP ownership clearly and thoroughly
- Non-competes are enforceable in most states **IF PROPERLY CRAFTED**

What is a Contract?

- A promise supported by consideration
 - Sometimes described as a “bargained-for exchange”
- Example
 - Chris offers Scott \$1000 to buy Scott’s car
 - Scott agrees
 - Chris and Scott have a contract
- “Consideration” can be almost anything of value
 - Money
 - An action
 - An obligation to pay money or do something in the future

The Importance of Written Contracts

- Oral contracts can be enforceable (except when they aren't)
- Proof is the problem
 - Old legal saying: “If it’s not in writing, it didn’t happen.”
- Written agreements provide proof and clarity.
- “Written” does not mean formal.
 - e.g. An email exchange can create a contract.

Contract Fundamentals

- Contracts serve three main purposes:
 1. Documenting the deal
 2. Risk allocation
 3. Legal compliance (not as common as you might think)
- Get it ALL in the contract
 - People turn over
 - “Understandings” are forgotten
- Use the Law of Common Sense
 - “Magic language” is rare

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