

Charlotte Venture Challenge

Legal Considerations

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Charlotte Venture Challenge

My Goal:

Provide a brief overview of certain key legal considerations for a start-up company so you can go seek assistance as needed

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Topics We Will Cover:

- Choice of Legal Entity
- Intellectual Property
- Raising Private Capital

Choice of Legal Entity

Entity History

- Sole proprietorships
- Partnerships
- Corporations – a statutory construct to provide limited liability
- S-corporations – limited liability with a tax solution
- Limited Liability Companies – limited liability with a tax solution and more flexibility

Choice of Legal Entity – Social Enterprise

Benefit Corporations (B Corps)

- Several states have adopted; several more (including NC) under consideration
- Allows directors to consider social considerations and the environment
- Statutes are all different; many details (like director liability) are unclear

Choice of Legal Entity – Social Enterprise

Low-Profit Limited Liability Companies (L3C)

- Primary purpose is to achieve socially beneficial objectives and secondary purpose of generating profit
- In order to qualify as an L3C, the company must be organized and operated (1) to accomplish a charitable or educational purpose, (2) so that production of income or the appreciation of property is not a significant purpose of the company, and (3) without seeking to accomplish a political or legislative purpose
- This is really part of a broader goal of facilitating investment by private foundations in for-profit entities (it is a tax issue)
- Social benefit objective can be accomplished in a traditional LLC

Choice of Legal Entity

General Considerations:

- Form the entity early in the process to avoid assigning contracts, etc. and to minimize personal liability
- Observe the “corporate formalities” to maintain limited liability – sign contracts in the name of the Company, maintain separate bank accounts, etc.

Choice of Legal Entity

Advantages of C Corporations

- Start-up companies that intend to engage in offering investment shares broadly to the public or obtain venture capital investments typically are structured as C Corporations due to investors' familiarity and comfort with these entities and for investors' tax reasons.
- Shareholders of C Corporations are not taxed on the earnings of the corporation, but only on dividends and other distributions of cash or assets made by the corporation. Because the highest corporate tax rate is presently lower than the highest individual rate, and because most corporations are taxed at graduated rates, less total taxes may be paid on earnings that are retained by a C Corporation. This would be beneficial if the corporation will make few, if any, dividends or distributions during the growth stage of its business.

Disadvantages of C Corporations

- Double taxation - C Corporations are separate taxpayers: they pay taxes on their own earnings and shareholders pay a second time, at ordinary rates on dividends and typically at capital gains rates on the sale of C Corporation stock.
- C Corporation shareholders receive no direct tax benefit from tax losses incurred by the C Corporation.

Choice of Legal Entity

Generally Avoid an S Corporation

- S Corporation capital structures are not as flexible as those of C Corporations. S Corporations may have only one class of stock. Venture capital funds and other institutional investors may not hold stock in an S Corporation because only individuals, estates, and certain trusts may be shareholders in such entities.
- A dividend or distribution by an S Corporation of assets that have appreciated in value is a taxable event for the corporation's shareholders; a similar distribution by an LLC or partnership is generally not taxable.
- There is no step-up in the tax basis of an S Corporation's assets upon a sale of stock or the death of a shareholder, but such a step-up can be achieved by an LLC that makes the appropriate election under the Internal Revenue Code.
- In contrast to the tax treatment of LLC members, S Corporation shareholders do not include third-party debt in the tax basis of their shares, which limits the shareholder's tax benefit from such losses.
- An employee who receives S Corporation stock is taxed immediately upon the receipt or the vesting of the shares.

Choice of Legal Entity

Advantages of an LLC

- LLCs are very flexible, allowing customized management and economic structures. Unlike an S Corporation, there is no limitation on the type of entity that can be an owner or investor in an LLC.
- Because the LLC is a “pass-through entity” for tax purposes, LLC owners endure only one level of taxation on profits and generally may claim LLC losses immediately on their individual tax returns.
- An LLC can easily merge or consolidate with a corporation, a limited partnership or another LLC. Furthermore, contribution of equity or assets to an LLC can be accomplished more easily for tax purposes than with a corporation.
- Upon a sale of assets by an LLC, the purchaser may receive a “stepped-up basis” in the assets purchased, allowing the purchaser to enjoy greater depreciation deductions, while there is no tax at the LLC level on such gain.

Disadvantages of an LLC

- LLC owners who are also employees generally must pay self-employment taxes and make estimated tax payments.
- Many venture capital funds and institutional investors prefer to invest in corporations, because of the longer tradition and more carefully worked out legal ramifications of ownership, in addition to the hope that the company may eventually sell shares broadly to the public or be acquired by another corporation in a tax-free transaction or for tax reasons – **BUT**, you can convert to a corporation later

Intellectual Property

Agreements With Inventors

- Need to prove the Company owns the invention to raise capital
- Note that generally an individual inventor, not the Company, owns an invention, subject to certain exceptions (such as the “hired to invent” doctrine)
- Do not rely on legal default rules - from the beginning of a project, make sure there are written agreements from all participants that assign the rights to the Company; it is much more difficult to get an agreement once real money is involved

Intellectual Property

Protecting the Name

- *“Common law” Rights* – right to the exclusive use of the mark to identify the identified goods or services within the geographic territory in which the goods or services are sold or offered
- *Registration* – benefits of registering a trademark with the U.S. Patent and Trademark Office (USPTO): may sue in federal court; all persons are presumed to have actual notice of the trademark, so that all subsequent adopters of an infringing mark, no matter what the geographic market, do so at their peril; use of international treaties to extend the protection of the registration to other countries; presumed to be the lawful owner of the mark in the U.S.; after five years of continuous use of the mark, rights become “incontestable” with respect to most grounds for challenge.
- The exclusivity awarded a trademark extends not just to the exact mark and the exact goods identified by it. A trademark owner may exclude others from adopting any mark that, when actually used or applied to be registered, is so similar to the first mark as to likely cause mistake, confusion, or error with respect to the origin, sponsorship, or quality of the goods or services identified by the mark. Thus, protection extends to variations in sound, spelling, and meaning of the mark and also to variations in the design, function or purpose of the product so identified, as long as the total impact is to create a likelihood of confusion between the products.
- *Search before you adopt a name/mark* - Before a company adopts a new trademark, it should retain the services of a trademark lawyer to engage and interpret a full search of existing “common law” trademarks, pending trademark registration applications, and trademarks registered with the USPTO and state authorities. This avoids infringement liability and/or the need to re-brand.

Raising Private Capital

- Section 5 of the federal Securities Act of 1933 (the “1933 Act”) and most state securities laws prohibit the offer or sale of **any** securities without registration, unless there is a specific exemption from the registration requirement.
- The most common exemption is Section 4(2) of the 1933 Act, which exempts transactions by an issuer not involving a “public offering.” Factors examined in determining whether a Section 4(2) exemption is available include (1) the number of offerees, (2) the pre-existing relationship of the offerees to each other and the issuer, (3) the number of units offered, (4) the size of the offering, (5) the manner of offering, (6) the information disclosure or access involved, (7) offeree sophistication, and (8) the absence of redistribution of the securities.
- SEC has over the years issued specific safe- harbor exemption rules. Among other things, these rules include limits on the aggregate amount of equity that may be issued and describe the types of investors who may be involved depending on their wealth and financial sophistication.
- Another over-arching consideration when soliciting investments from your friends and family are the general anti-fraud laws. Both the federal securities laws and most state securities laws impose liability on any person who offers or sells any security where there is fraud, an untrue statement of material fact, or an omission to state a material fact necessary to make statements not misleading. This standard applies to all offerings of securities, both public and exempt private offerings.

Raising Private Capital – New Developments

General Solicitations

- NOT EFFECTIVE YET
- New limited exception: GS permitted so long as issuer takes reasonable steps to verify, and reasonably believes, all purchasers are accredited investors
- SEC's Proposed Rule: Rep from individual not enough



Raising Private Capital – New Developments

Crowdfunding

- NOT EFFECTIVE YET
- New Exemption: Total sales up to \$1 million in any 12 months with individual investor limits
- Regulated sales process—must sell through registered broker or “funding portal”
- Disclosure (including basic business and financial information based on offering size) to be filed w/SEC and made available to investors; post-offering annual reports also required
- Significant increase in potential civil liability for participants in an exempt crowdfunding offering (similar to registered public offering)
- Institutional investors will not deal with lots of small investors



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