THIS IS VOLUME II OF
THE HANDBOOK SERIES

HANDBOOK SERIES

FOR
START-UPS AND EMERGING COMPANIES

"HOW TO"
FOR EARLY STAGE STRUCTURING

A GUIDE FOR ENTREPRENEURS

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Note: This is a brief summary and is not to be relied upon for legal advice. The subject of securities law is arcane and decisions on how to proceed are factually based. The author assumes no responsibility for action undertaken pursuant to this Handbook.

Preface

In order to avoid too much redundancy, this Handbook has been written assuming that, of the other volumes of the Handbook Series, the reader has read at least the "Selection of a Business Entity," "Legal" and "How To" Handbooks, or has them available for reference, and has determined to proceed in the financing of the enterprise.

OTHER HANDBOOKS

Depending on one's needs, there are several volumes that should prove useful to non-lawyers. These are designed primarily for start-ups and emerging companies, executives and interested "angel" financiers. They are:

I. Selection of a Business Entity

II. "How To" for Early Stage Structuring

III. LegaI

IV. How to Offer and Sell Securities

V. Use of the Internet to Sell Securities

The Handbooks were originally written for use in California. They have been slightly rewritten in order to assist clients in other states; however, the emphasis is still on California.

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I. THE SETTING – A TYPICAL SCENARIO

The entrepreneur ("Founder") has toiled long and diligently for almost a year; has forgone salary and invested say, $25,000., in getting a Business Plan written, coming up with schematics of some software and in attracting a team for management. There is a perceived need for, at a minimum, $1 million in this seed stage.

The principal Founder(s) wishes to maintain control of the company, to provide handsome incentive stock options for the management team (despite the fact the options may be expensed) and to avoid high taxes to the fullest extent possible.

The Founder states that, of course, he/she deserves 80% of the equity because he/she has spent one year's effort getting to this critical stage of development. Sober reflection yields a target of at least 60% with a pre-money value of $3 million (see below for the "rest of the story").

The business entity has not been formed, or, hopefully, was not formed too long ago.

The Founder wishes to "exit" with an IPO or sale to a company in a dominant industry position.

The business is located in California.

II. THE STRUCTURE

Please see the Handbook "Selection of a Business Entity" for a more detailed discussion of what follows.

As the Exit Plan is to go IPO or sell, the most logical entity to use is a "C" type corporation. A limited liability company ("LLC") is best for a small, non-emerging, cash-cow type of business. If one wishes to "emerge," the LLC is not the way to go because it robs the business of the tax shelter of the net operating loss carryforward ("NOL") when the business becomes profitable. In an LLC, the loss goes to the owners through the pass-through of the loss. The NOL can be a valuable asset at a time when the business is expanding and needs the shelter to avoid the cash drain of tax payments.

The Founder is also anxious to "do good" for environmental causes and toys with the idea of using either a Flexible Purpose Corporation or a Benefit Corporation. However, upon reflection, it is decided that such use would complicate any future public offering or sale of the company, so it is decided to look to the money to be made by the founding principals for any "do good" endeavors.

So, a "C" corporation it is. Next issue: in which state to incorporate?

This is a most complex issue with many legal and practical ramifications.

Venture capitalists, investment bankers and those east of the Mississippi favor Delaware. The author believes this is based more on tradition than logic. There is a perceived view that California is somehow anti-business and Delaware is not. Delaware does have some pluses: there are fewer situations wherein dissenters' rights apply and there are Chancellery Courts (which handle only business litigation). However, other than the practical consideration that Delaware is favored by the financial community, there appears to be little justification for a California based and primarily owned company to incorporate in Delaware.

Consider: the business will have to qualify to do business in California and pay taxes just as if it were a California corporation; thus, franchise taxes are being paid in two states instead of one. Also, Delaware taxes are based on formulas involving par value which can cause one to have an unconventional par value. Furthermore, most California based start-ups will be subject to Section 2115 of the California Corporations Code, a Section that imposes many aspects of the California laws, such as cumulative voting, on foreign corporations, including those formed in Delaware.

On balance, the author believes the best route is to form a California corporation and then, when and if the VC or investment banker insists on a Delaware corporation (this happens quite frequently), simply re-incorporate in Delaware, a rather simple and inexpensive procedure.

Since California dropped its $800 filing fee (now $100), there is no supportable reason anymore to incorporate in Nevada or Utah. The financial community distrusts this route and it should be avoided.

So, we will have a California corporation. The concurrent issue is the capital structure. It appears naïve to provide, say, 100 million shares of stock; this is an excessively high number. California does not have its tax based on par value, in fact, there is no requirement of par value in California; however, par value can be used to avoid higher taxes in other states and is used for preferred stock pretty universally. A "sensible" standard (if there is such a thing) would be 20 million shares of authorized Common Stock and 10 million shares of authorized "indeterminate" Preferred Stock.

"Indeterminate Preferred Stock" allows the Board of Directors to issue series of Preferred without having to obtain shareholder approval for the series; thus, one can have a Series A $1 par value, a Series B $5 par value, etc. This is a very handy tool that saves time, energy and legal fees.

The respective series are created by filing a "Certificate of Determination" with the Secretary of State. This is tantamount to an amendment of the Articles of Incorporation, but does not require shareholder approval as an amendment would.

Thus, we form the California corporation with 20 million common and 10 million indeterminate preferred. Filing fees are $100, special handling $15 (saves weeks of time), and Minute Book, Corporate Seal and Common Stock Certificates are under $200..

III. THE FOUNDER'S STOCK, ISO'S AND NON-STATUTORIES

The Founder (or Founders) wishes to retain control. Here is a huge tax trap: if the Founder gets common stock (never preferred—see below) for his/her efforts in establishing the company, the value of the stock is taxable to the Founder at ordinary income tax rates. Worse yet, if the income is not reported as income in the year received, the entire amount (when sold) will be taxed at ordinary rates. As Section 2102 of the Internal Revenue Code now waives any taxes for small business capital gain rates after a five-year holding, one has the difference of the tax rate or probably zero versus as much as 39.6% (at ordinary rates). This is substantial enough to plan to avoid the error of taking stock without paying for it. And, when one adds in the state taxes - which are, albeit, complicated in that there are requirement for doing business in California in order to get a tax break – one must definitely avoid the error.

In our example, the Founder has invested $25,000 in start-up costs. He/she has not taken any deduction of business expense from income. Under these circumstances, there can be a tax-free transfer of all assets created by the $25,000 in exchange for, say, 60% of the stock to be outstanding after the seed money is received. At the time of the transfer, the entity has value only as a concept, presumably with no business "proof of concept" and, perhaps, no final technical proof of concept (i.e., one would contend the company has little or no value). This exchange should take place as close to incorporation of the corporation as possible, even a day or two after formation.

In the event the Founder(s) have an invention that they spent verifiable funds on obtaining patents, the Founder(s) can assign the invention or patent in exchange for common stock. The costs that went into getting the invention/patent then become the cost basis for the stock.

Many times the Founder(s) has invested little or no money, but a great deal of time. As noted above, should the Founder(s) take stock in payment for efforts, the value of the stock is regular income and is taxed at ordinary rates.

If there are no assets with ascertainable value that can be exchanged for stock, the stock must be purchased for cash. If this is done immediately after the corporation is formed, the value of the stock (purchase price) can be minimal as the corporation is just an empty shell. Often the price is set as low as $.001 or $.01. The risk is that the Internal Revenue Service could contend that the real value of the stock, in light of the past efforts of the Founder(s) and the contemplated implementation of the business plan, is significantly higher than what was paid with the difference being ordinary income considered to be compensation for past efforts. The author has never seen such an IRS challenge.

Once the exchange is made and/or the funds invested, some time should elapse (the longer the better) before the investor money is received. This is because the investor money will set the fair market value of the stock and, if the Founder paid $.01 per share and the investor the next day paid $1.00 per share, even for preferred, the IRS just might raise a few questions as to income versus capital; in fact, should they audit, they surely would.

To further lower the value of the Founder's Stock, the investors are offered Series A Preferred, say at a par value and price of $1 per share. Generally, the preference runs to liquidation where the Series A has a preference on liquidation over the Common Stock, and, in order to have round two (the Series B round) easier to raise, equal with and pro rata to the further series of the Preferred.

The practice has evolved of valuing the Common Stock at 10% of the Preferred in a rank start-up, e.g., $1 Preferred, $.10 Common. This measure is used, not for the Founder(s) who got in early, but for the Incentive Stock Option Plan ("ISO") for key management. Pursuant to the Internal Revenue Code, ISO's are available for employees only. They are a useful tool to encourage the employee to feel a part of the "team". They usually "vest" (the holder is able to exercise) over a period of years. A good route is no vesting until one year (in case the employee leaves in that year), and then on a monthly basis over two or three years.

Sometimes stock will be sold to non-management insiders (non-employees) concurrently with the issuance of the Founder's stock. As non-employees can't use an ISO, the sale to the non-employee, insider-investor is at the founders' price (e.g. $.01). So, the Insider-Investor obtains 500,000 shares of Common for $5,000. However, in case he/she resigns or is kicked off the Board (or ceases to be a key consultant – tricky stuff), the company wishes to have the right, on a declining basis, of repurchasing the stock at the same price as paid; i.e., $.01.

This is called a "declining right to repurchase", comparable to the "vesting of options".

For example: the right to repurchase the Insider- Investor's 500,000 shares declines 25% at the end of one year (he/she keeps 125,000 shares no matter what) and at one-thirty sixth each month for three (3) years thereafter.

There is a very serious tax trap here: if the Insider- Investor does not file a Section 83(b) notification (this is filed with his return) in the year that he/she makes the deal for the 500,000 shares, each time the right to repurchase lapses, he/she would be taxed on the difference between the price he paid ($.01) and the fair market value of the stock at the time the repurchase right lapsed. If there is a fair market value of $1.01, then the tax would be at ordinary rates on the $1.00 per share gain.

By filing the 83(b) notice, one pays only once on the value of the stock purchased as compared to its fair market value when sold. The Insider- Investor paid fair market value (the $.01 price), so no tax will be levied until he/she sells and then at capital gain rates. It is most important to file the Section 83(b) notice in order to avoid a major tax trap.

So now we have three categories: Founders, insider-investors and key employees. A fourth is needed: non-employee directors and consultants. These may be granted either what are known as Non-Statutory Options under a Combined Stock Option Plan providing for ISO's and Non-Statutories or pursuant to simple warrants. A warrant is an option; however, the term "option" is generally used when a Stock Option Plan is involved and a "warrant" is used when there is no Plan.

At this point the difference between an ISO and a Non-Statutory or a warrant should be noted. In an ISO, the exercise price ("strike price") must be at least fair market value on the date of grant, there is no ordinary or capital tax on exercise (beware: there is an alternate minimum tax, the difference between the exercise price and the fair market value on the date of exercise), there is a tax on sale which is to tax the gain (the difference between exercise price and sales price) at capital gain rates. One hitch though, is that to qualify for ISO tax treatment, the stock may not be sold for one year after exercise or two years after grant, whichever is longer. This requirement can be frustrating in the event the stock price is falling. In the event of a falling price and sale before the required holding period, the difference between the exercise price and the fair market value on exercise is taxed at ordinary income rates, unless the sale of the stock is at a price below the fair market value on exercise.

A Non-Statutory Option or warrant is taxed on exercise and the gain is taxed at ordinary income tax rates. This also holds true for warrants.

In both instances there is a need for careful timing of the sale because in the ISO one must hold for a year and in both the ISO and the non-statutory, Rule 144 would require holding a stock for one year prior to a public sale through a broker. For example: exercise in January 2012, then one has until April 15, 2013 before the tax need be paid.

So now we have all the usual categories: founders, insider-investors, investors, key management and directors/consultants.

IV. PIE-SLICING

Pie-slicing (deciding what percentage of the company each category will get) is an art, not a science. As was seen way back in the 90's, the "dot com's" obtained valuations that were extraordinary, if not just plain crazy. Suffice it to say that valuation, which directly affects pie-slicing, depends on several factors:

(a) the fervency (passion) of the Founder(s);

(b) the quality of the "mouse trap" (product, service) and its intellectual property protection through patents or copyrights;

(c) the quality of the management team;

(d) the size of the market for the product or services;

(e) the anticipated profit as shown in the Business Plan; and

(f) general stock market conditions.

Another exercise that can help determine what slice to give the investor is to take from the Business Plan the anticipated profit (reasonable anticipation, of course) three years out or, with the pressure of the extraordinary gains of the new tech companies, two years out, multiple it by a reasonable price/earnings ratio (10,15,20, etc.) and see what percentage of the company would be required to yield a 200% return to the investor (money back plus 200%); e.g., invests $1 million, after tax earnings of $500,000 times p/e of 15 yields $7.5 million, so to achieve money back plus 200% one needs 40% (40% of $7.5million = $3 million.) Different industries use different measures of value: e.g. 1.5 times revenue. Check your industry's practice if using this method.

These are simple techniques to provide guidelines; "gut" sense enters as does the reality of the marketplace.

In short, valuation is simply what the market (investors) will bear. If VC's or investment bankers are involved, they set the valuation.

In our example, the Founder has set a pre-money evaluation of $3 million. The aim is to try to raise $1 million. The Founder(s) wants 60%, another 20% is "reserved" for stock options and warrants, which leaves 20% for the investors. The valuation of $3 million (see above) would indicate that the investor would get 25% as the investor's $1 Million gives a total of $4 million (post funding) and $1 million is then 25%. So, after the usual back and forth, the Founder(s) go down to 55%, stock options and warrants stay at 20%, and investors of $1 million go to 25% ($4 million post valuation; $1 million equals 25% of $4 million). To meet the 200% return model (above), the company would need to have after-tax earnings in the third year of $800,000 (p/e of 15 x $800,000 yields $12 million times 25% equals $3 million). This is a rather formable challenge, but for this example, we will let it stand. In today's market, it is likely the investor would demand a higher percentage of the equity.

We then have:

	Number of Shares	**Percentage**
Founder(s), Common Stock Issued for the exchange of Assets or minimal cash	5,500,000	55%
Investors, Series A Preferred $.40 par value, issued for $1 million	2,500,000	25%
Stock Options/Warrants, Common Stock Reserved (not issued, in a Plan as simply set aside to be granted)	2,000,000	20%
TOTAL	**10,000,000**	**100%**

This is somewhat typical pie-slice. There are any number of variations. It is simply by way of illustration. Valuation and price-earnings are all over the map, depending on the industry, the product or service, the financial markets and the negotiating skills of the actors

V. THE FUND RAISING

Please refer to the other Handbooks for information covering this subject.

In our example, the seed round would either be a Rule 506 private (or public under the Jobs Act change) offering, if made by the issuer and the issuer had "pre-existing relationships" with many accredited investors (or had a placement agent who did); or it could be a California Section 25102 (f) private offering, which does not require a pre-existing relationship and allows for 35 non-accredited investors; or it could be new Jobs Act offering via the Internet using Crowdfunding with its limit of $1 million, or to accredited investors (verified) under the new Rule 506 (c) using public solicitation or, finally, in the public arena, a SCOR offering ($1 million maximum) which must be cleared in each state where offered, but does allow for advertising to get the word out.

VI. SUMMARY

The author hopes this small Handbook may be of some help to entrepreneurial Founders in the very early stages of their structuring. Frequently we find a Founder with no stock, a desire for much stock, no money of his/her own invested and having already raised some private money. This raises, as noted, sever tax problems and is comparable to an Emergency Room receiving a person with a severe heart attack. It calls for quick, remedial action with the hope the patient can be saved.

Let's hope the reader is able to avoid the legal equivalent of the need for the E.R.