The article on the right -
"Structuring and Allocating Equity for startup success"
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- *If you have any questions or comments on this article*

- *If you would like help in the structure of stock, options or other equity in a corporation or LLC*

- *If you have questions regarding whether or what kind of entity to form*

- *Or if you have other questions or issues involving business or tax law for a startup or early stage business*

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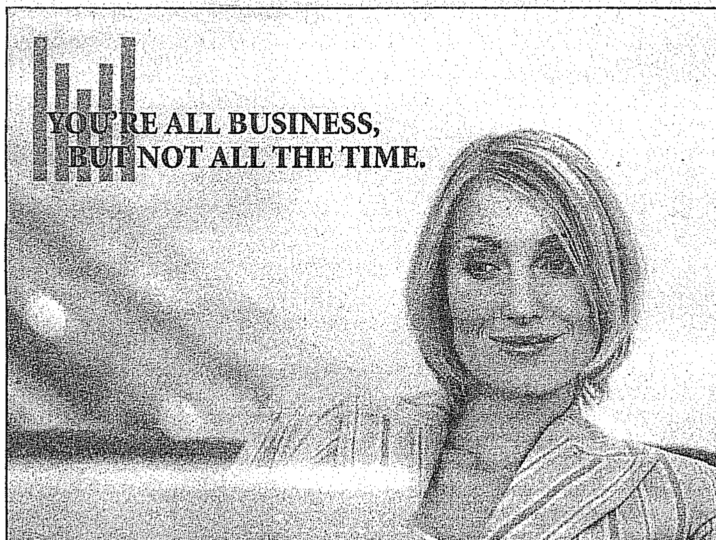

Structuring and allocating equity for startup success

Choice of entity, equity allocation can put a firm on sound footing

Are you one of the founders of a startup company? Has your startup formed a legal entity? Have you divided your equity among the founders?

INSIDER VIEW

Robert A. Adelson

If you or a friend or colleague is in this situation, you may also ask, what is the best way to structure our new venture for success?

Early-stage companies face great hurdles in building management teams, marketing and selling product and keeping and gaining financing for growth. This article discusses two ways in which startup companies can enhance their chances for success: selection of legal entity and allocation of equity among the founding members.

Corporate entity

The creation of a corporation establishes credibility, allows division of equity, sets a series of rules and at the same time provides limited liability for founders, officers and directors. The limited liability company is another entity that startup companies often use. It provides limited liability without the requirements of a corporation.

However, where multiple founders will provide services and they will likely employ others — using company equity to aid recruitment — an S corporation is often a better choice of entity than an LLC. The tax flexibility and centrality of control, benefits of the LLC, are not necessary. However, the legal restrictions and rules and share liquidity that a corporation offers can be quite attractive for service-based entities.

The S corporation offers the single level of tax, which is a benefit of LLCs that S corporations also offer. Yet the rules of S corporations — one share, one vote and equal allocations of tax attributes — give the members a greater feeling that they have a fair and important share in the venture to merit their commitment.

Equity allocation

Founding groups often divide equity equally among the founders. While this seems fair, it misses the chance for non-cash compensation to reward contributions to the startup venture.

Equity awards should instead be structured to reward contribution in the following areas:

- Inventions and technology contributed by founders.
- Facilities and equipment contributed.
- Seed capital and expenses paid for the venture.
- Services including contacts made available to the startup venture.

The award of capital should take into consideration the past services and contributions, the current services and contribution being made, and those expected in the future. It should also take into consideration the capital that will need to be available to incentivise, award and recruit others to the venture.

Vesting of performance-based equity

For future services, the award of equity, whether in the form of stock or stock options, should be conditioned upon the contribution of assets or the provision of services, and also be conditioned on success of the venture.

The structure of equity, whether a stock, options or phantom stock, and the qualities of that equity can have important tax implication. These include important tax elections, such as a Section 83(b) election, which allows the recipient of equity to take his or her shares into income and establish a tax bases. However, such an election also means immediate taxation, so there are various issues that need to be parsed in considering that election, as well as the other tax implications of how the equity is structured.

Other shareholder terms

Additionally, where equity is allotted and shares are issued among the founding members, these two should be conditioned upon the parties entering into a shareholder agreement. Among the issues that should be considered for such an agreement are:

- Disposition of shares on death or disability.
- Right of first refusal on the sale of shares to a third party.
- "Tag along" rights in the event of a third-party sale.
- Rights to financial statements and other information.

The careful documentation of stock issued as well as the existence of the shareholder agreement can become important as a venture grows and seeks outside investment. The position of the original stockholders and the terms of their offering will be disclosed in due diligence and the failure to fully document stock issued or to have appropriate shareholder agreement can cause important delays or eliminate the opportunity for financing.

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