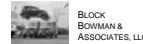

Legal Issues for Entrepreneurs



Topics

- ▶ Contract Basics
 - ▶ Funding Technology Development
 - ▶ Stock Options
-



Contract Basics

- ▶ Key terms
 - Boilerplate

Standard contract terms from which a customized contract is then developed.
 - Breach

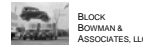
A claim by one party to a contract that the other party has failed to perform as required by Contract
-



Contract Basics - continued

- ▶ Key terms
 - Conditions

Provisions that deal with certain events happening or not happening. Also triggers that when they occur cause some other part of contract to come into effect
-



Contract Basics - continued

- ▶ Key terms
 - Consideration

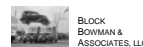
Benefit or right which the parties to a contract exchange with each other in order to form a contract. Can be a promise to do something (pay \$ or lease space to you) or not to do something (lease space to large competitor)

Must be of value!
-



Contract Basics - continued

- ▶ Key terms
 - Damages
 - A type of remedy for the breach by a party of a valid contract. Involve awarding of \$ to non-breaching party
-



Contract Basics - continued

- ▶ Key terms
 - Damages
 - A type of remedy for the breach by a party of a valid contract. Involve awarding of \$ to non-breaching party



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Contract Basics - continued

- ▶ Key terms
 - Recitals
 - Language at the beginning of the contract that describes why the parties are entering into the contract. Set the stage. Not always legally enforceable so significant contract terms should be repeated in the body of the contract following: the parties agree as follows:



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Contract Drafting

- ▶ Take charge of the draft
 - Do not let the other side do the first draft



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Available Entities

- ▶ Sole Proprietorship ("Do Nothing")
- ▶ General Partnership
- ▶ Limited Partnership
- ▶ Limited Liability Company (LLC)
- ▶ C Corporation
- ▶ S Corporation



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Sole Proprietorships & GPs

- ▶ Easiest Entity to Use
 - No formal filing requirements for set-up
- ▶ No liability protection
- ▶ Possibly no continuity of life
- ▶ Only recommended for small, service oriented businesses



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LPs and LLCs

- ▶ LPs must have one general partner so there is some personal liability
- ▶ LLCs have virtually obsoleted LPs
- ▶ Can make LLCs look like C Corporations
- ▶ Both have benefits of flow-through taxation
- ▶ Some investors do not like to invest in flow-through entities
- ▶ Great for technology holding companies



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C Corporations

- ▶ Most common choice of entity
- ▶ Corporation is subject to tax as well as the shareholders on distributions from the corporation (double taxation)
- ▶ Investors understand investments in C Corporations
- ▶ No limit on who can own shares



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S Corporations

- ▶ Entity of choice for many closely-held businesses
- ▶ Benefits of C Corporation with flow through taxation
- ▶ Limit as to who can own an S Corporation as well as how many shareholders
- ▶ Other attractive tax benefits to S Corporations



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Funding Development Expenses

- ▶ Common Methods
 - Equity
 - Government Grants
 - Cross License of Technology
 - Joint Venture
- ▶ Be careful regarding ownership of the technology
 - Some grants provide the recipient rights to utilize the technology and some don't



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A Quick Word about Equity...

- ▶ Equity can be great...
 - Reduces cash needs for acquiring and motivating talent
 - Can be highly tax-efficient manner in compensating workforce
- ▶ In the early stages, make sure adequate controls are placed on equity grants:
 - Buy-Sell Agreements
 - Repurchase Rights
 - Anti-Dilution Provisions



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Stock Options

- ▶ Key Terms & Definitions
- ▶ Incentive Stock Options ("ISOs")
- ▶ Nonqualified Stock Options
- ▶ Restricted Stock



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Talking the Talk ... *Key Terms*

- ▶ Grant Date
- ▶ Exercise Date
- ▶ Exercise Price
- ▶ Sale/Transfer Date
- ▶ Sale/Transfer Price
- ▶ Vesting Period
- ▶ Spread



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Determining Fair Market Value

- ▶ For accounting and tax purposes, per share fair market value is extremely important
- ▶ How do you determine fair market value in a start-up or a privately-held company?
 - Asset value (both tangible and intangible)
 - Market comparables
 - Discounted Cash Flow
- ▶ Can be substantial consequences for failing to establish fair market value



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Incentive Stock Options

The Good

- ▶ No regular tax at exercise
- ▶ No income tax or FICA withholding at time of exercise
- ▶ Entire spread potentially taxed at favorable capital gains rate



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Incentive Stock Options

The Bad

- ▶ Failure to meet holding period (or "disqualifying disposition") results in ordinary income
- ▶ Spread at exercise date is subject to AMT unless stock is sold in the year of exercise
- ▶ Must meet holding period requirement to qualify for capital gain treatment

☹ Market Risk



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Incentive Stock Options

The Ugly

- ▶ Alternative Minimum Tax ("AMT")
- ▶ Separate but parallel tax system
- ▶ Income, deductions and exemptions may be calculated differently for AMT
- ▶ Certain items may create an AMT tax credit
- ▶ Taxpayers subject to AMT are prepaying their future tax liability



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Non-Qualified Stock Options

Good and Bad, but no Ugly

- ▶ No holding period requirement
- ▶ No AMT considerations
- ▶ Spread taxed as ordinary income at exercise date
- ▶ Appreciation from exercise date taxed as capital gain (short or long-term)
- ▶ Subject to income tax and FICA withholding at time of exercise (for employees)



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Restricted Stock

Whose Stock Is It Anyway?

- ▶ Stock which is issued by a company and is subject to that company's right of repurchase (normally at the original purchase price)
- ▶ Repurchase right normally lapses over time
- ▶ Substantial risk of forfeiture



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Restricted Stock

Shapes & Sizes

- ▶ Restricted stock purchase plan
- ▶ Founder's shares
- ▶ Stock option plan with vesting which allows for immediate exercise



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Restricted Stock

The Taxman Cometh ...

- ▣ Ordinary income equal to FMV of the restricted stock when the restrictions lapse less amount paid for restricted stock
- ▣ Income is compensation income to employees and is subject to income and FICA withholding
- ▣ Holding period begins on date restrictions lapse



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Summary of ISOs, NQSOs, Restricted Stock

	ISOs	NQSOs	Restricted Stock
Taxed to Employee on Grant	N	N	Y
Deductible by Corporation on Grant	N	N	Y
Taxed to Employee on Exercise	N	Y	N
Deductible by Corporation on Exercise	N	Y	N
Taxed to Employee as Ordinary Income if sold within one year of exercise	Y	N	N
Deductible by Employee if sold within one year of exercise	Y	N	N
Taxed to Employees as long term capital gains if sold after one year of exercise	Y	Y	Y
Deductible by Corporation if sold after one year of exercise	N	N	N
Must be granted at fair market value on date of grant	Y	N	Y
Can be granted to employees	Y	Y	Y
Can be granted to BOD and non-employees	N	Y	Y
Recipient subject to AMT adjustment on date of exercise	Y	N	N



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