Morgan Lewis

together

Choosing the Ideal Structure for your Business Entity and Venture Capital Investment in 2010

Columbia University
Entrepreneurial Program

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Outline

I. Overview

II. Choosing the Ideal Structure for your Business Entity

III. Venture Capital Investment in 2010

I. Overview

A. Form of Entity
B. Protect your IP
C. Establish your Management Team
D. Manage your Employees
E. Draft Business Plan
F. Private Company Investment
   - Angel Investment
     - *Usually common stock*
     - *Preferred stock becoming more typical*
   - Venture Capital Investment
     - *Preferred stock*
     - *Convertible securities*

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II. Choosing the Ideal Structure for your Business Entity (continued)

Starting a company is an exciting yet challenging proposition. Countless hours are spent planning and detailing the nature of the business, potential financing sources, and even the name of the company. However, despite the enormous amount of time and energy devoted to launching a company, one of the most important decisions is often overlooked or marginalized as simply a tax-planning decision - choosing how to legally structure the new business.

The choice of legal entity can have a significant impact on the future of the company, ranging from tax and liability implications to the number and types of investors that are eligible to, or willing to, participate. As a result, it is critical to carefully consider the various alternative types of entities in order to choose the most advantageous structure for the particular business venture. Unfortunately, no one legal structure is correct for all companies. However, understanding the advantages and disadvantages of each type of legal entity will help to determine the most beneficial structure for a particular company.

II. Choosing the Ideal Structure for your Business Entity (continued)

There are five common forms of business entities:

1. C corporation
2. S corporation
3. General partnership
4. Limited partnership
5. Limited liability company

The following is a brief discussion of the various entities and some of the primary advantages and disadvantages of each.

II. Choosing the Ideal Structure for your Business Entity (continued)

C Corporation

The C corporation is a simple, familiar type of entity that has the ability to go public. There are no restrictions on the number or type of investors who can be stockholders in a C corporation. In addition, the corporate structure is favorable because, in general, the stockholders are not responsible for the liabilities of the corporation. However, the primary drawback of the C corporation is a double level of taxation. Not only is the C corporation itself taxed on its profits, but also the stock holders are taxed on distributions received from the C corporation and on gains from a sale of stock in the C corporation.

II. Choosing the Ideal Structure for your Business Entity (continued)

S Corporation

The S corporation is similar to the C corporation in that the stockholders are generally not responsible for the corporation's liabilities. However, unlike the C corporation, the S corporation is tax efficient because it is not required to pay taxes on its profits (although certain state franchise taxes may apply). As a result, there is only one level of tax at the stockholder level. A significant disadvantage of the S corporation structure is that the number of stockholders is limited to 75. Additionally, only U.S. residents and citizens and certain trusts are allowed to be stockholders.

II. Choosing the Ideal Structure for your Business Entity (continued)

General Partnership

The general partnership is an association of two or more partners. A general partnership is tax efficient because there is only one level of tax at the partner level. In addition, the general partnership is flexible with respect to allocation of losses and profits and management of the partnership. However, the primary drawback of the general partnership is that all of the partners are personally responsible for the liabilities of the partnership. Thus, rarely will the general partnership be the preferred structure for a sophisticated business.

II. Choosing the Ideal Structure for your Business Entity (continued)

Limited Partnership

The limited partnership is similar to the general partnership in that it is an association of two or more partners. However, the limited partnership must have at least one general partner who is responsible for the general management of the company (note that the general partner may be an entity). The other partners are referred to as limited partners. The limited partnership also is similar to the general partnership with respect to tax efficiency as there is only one level of tax at the partner level. However, with respect to liability, the general partner is fully responsible for the liabilities of the partnership, while the limited partners are generally protected from the partnership's liabilities so long as they do not actively participate in the management of the business.

II. Choosing the Ideal Structure for your Business Entity (continued)

Limited Liability Company

The limited liability company is a hybrid between a partnership and a corporation. The limited liability company is similar to a corporation in that all of the owners are protected from the liabilities of the company, and, in general, there are no restrictions on the number or types of investors who may be owners. The limited liability company is similar to a partnership in that there is only one level of tax at the owner level (although certain state franchise taxes may apply). In the event that the limited liability company wants to go public, it can generally be converted into a corporation. However, there may be additional taxes imposed in the event of such a conversion.

II. Choosing the Ideal Structure for your Business Entity (continued)

Conclusion

Because most life sciences companies will require significant capital, it is also important to consider the needs and desires of potential investors when choosing an entity structure. In particular, most venture capital firms prefer to invest in C corporations over other types of entities for three legitimate reasons:

(i) the limited partner investors of venture capital firms are often tax-exempt entities that have limits on their ability to receive unrelated business taxable income, which is how income from a limited liability company or limited partnership is treated, and therefore may place absolute restrictions on a venture capital investor’s ability to invest in low-through entities;

II. Choosing the Ideal Structure for your Business Entity (continued)

Conclusion (cont'd)

(ii) even if there is no absolute restriction, venture capital investors are often not able to use flow-through losses directly and would prefer for the C corporation to retain any such losses to offset future taxable gains (thus creating lower aggregate tax); and

(iii) a typical venture capital firm will invest in 15 to 20 companies and must provide a Schedule K-1 to its investors within 90 days after the end of the year to account for these investments.

II. Choosing the Ideal Structure for your Business Entity (continued)

Conclusion (cont'd)

As a result, to the extent a venture capital firm invests in limited liability companies or limited partnerships, it must wait for and incorporate the K-1s from its underlying investments, which creates an administrative hassle that often leads to delayed fulfillment of the venture capital firm's K-1 obligations to its investors, as well as unhappy venture capital limited partners.

As a result of the different attributes of the various types of entities, it is important to determine which structure would be most advantageous over the long run for the applicable business venture - not only at the time of formation but also in anticipation of future rounds of investment and a future exit event.

II. Choosing the Ideal Structure for your Business Entity (continued)

Conclusion (cont'd)

The table starting on the next page provides a side-by-side comparison of the different types of entities and sets forth some additional characteristics of each. Please note that the information contained in this table is based upon the state law applicable to companies that are formed in Delaware, which is the most popular jurisdiction for entity formation, but additional considerations may be applicable if a company is formed in a different state.

	DELAWARE C CORPORATION	DELAWARE S CORPORATION	DELAWARE GENERAL PARTNERSHIP	DELAWARE LIMITED PARTNERSHIP	DELAWARE LIMITED LIABILITY COMPANY
Number of Owners	No restrictions on stockholders	One to 75 stockholders	At least two partners	At least two partners	No restriction on members (at least two members required in some states, although DE allows a single member)
Types of Owners	No restrictions	Ownership limited to individual U.S. residents and citizens, and certain U.S. trusts, IRAs, ESOPs, and charitable organizations; UBIT issue for tax-exempt entities	No restrictions; UBIT issue for tax-exempt entities	No restrictions, although must have at least one general partner; UBIT issue for tax-exempt entities	No restrictions; UBIT issue for tax-exempt entities
Classes of Ownership Interests	Multiple classes are permitted	One; however, there can be differences in voting rights	Multiple classes are permitted	Multiple classes are permitted	Multiple classes are permitted
Limited Liability	All stockholders have protection from the corporation's liabilities	All stockholders have protection from the corporation's liabilities	Partners have unlimited liability for business debts; LLP status can limit a general partner's liability for tortious acts of others (unless under such a partner's supervision)	Limited partners generally have protection from the partnership's liabilities, while general partners do not; electing LLP status can limit a general partner's liability for tortious acts of others (unless under such a partner's supervision)	All members have protection from the LLC's liabilities
Participation in Management	No restrictions	No restrictions	No restrictions	Direct participation by general partners only; limited partners may, in increasingly narrow circumstances, lose limited liability if they participate in the control of the business	No restrictions

	DELAWARE C CORPORATION	DELAWARE S CORPORATION	DELAWARE GENERAL PARTNERSHIP	DELAWARE LIMITED PARTNERSHIP	DELAWARE LIMITED LIABILITY COMPANY
Levels of Federal Income Tax	Corporate level and stockholder level	Generally at the stockholder level only	Partner level only	Partner level only	Member level only (assuming partnership treatment obtained)
Levels of State Income Tax	Corporate level and stockholder level	Stockholder level only, except certain state franchise taxes apply	Partner level only	Partner level only	Member level only, except certain state franchise taxes apply
Special Allocations of Income and Loss	No	No	Yes	Yes	Yes
Dividend Income	Can exclude 70% of dividends from taxable income	Flows through to the stockholders and can be taxed as low as 15%	Flows through to the members and can be taxed as low as 15%	Flows through to the members and can be taxed as low as 15%	Flows through to the members and can be taxed as low as 15%
Excess Accumulated Earnings	Accumulated Earnings Tax	None	None	None	None
Deductibility of Losses	Losses are only deductible to offset future corporate gains	Stockholders may generally deduct their allocable shares of the S corporation's losses only to the extent of their tax basis in their S corporation shares. "At risk" rules and "passive activity loss" rules can, however, limit these deductions.	Partners may generally deduct their allocable shares of the partnership's losses only to the extent of their tax basis in their partnership interest, which includes their allocable shares of partnership debt. "At risk" rules and "passive activity loss" rules apply.	Partners may generally deduct their allocable shares of the partnership's losses only to the extent of their tax basis in their partnership interest, which includes their allocable shares of partnership debt. "At risk" rules and "passive activity loss" rules apply.	Members may generally deduct their allocable shares of the LLC's losses only to the extent of their tax basis in their LLC interest, which includes their allocable shares of LLC debt. "At risk" rules and "passive activity loss" rules apply.
Capital Losses	Can only be used to offset capital gains	Flows through to the stockholders	Flows through to the members	Flows through to the members	Flows through to the members
Fiscal Year	Any	Generally calendar	Generally follows fiscal year of majority partner	Generally follows fiscal year of general partner	Generally follows fiscal year of majority member

	DELAWARE C CORPORATION	DELAWARE S CORPORATION	DELAWARE GENERAL PARTNERSHIP	DELAWARE LIMITED PARTNERSHIP	DELAWARE LIMITED LIABILITY COMPANY
Restrictions in Accounting Method	None	Limited to accrual method in some circumstances (e.g., more than 35% of shares owned by persons who do not actively participate in management)	None	Limited to accrual method in some circumstances (e.g., more than 35% of losses allocable to limited partners)	Limited to accrual method in some circumstances (e.g., more than 35% of losses allocable to members who do not actively participate in management)
Effect of Going Public	None	Taxed as C corporation	Never happens due to liability concerns	Taxed as C corporation, except certain grandfathered public limited partnerships in certain industries	Taxed as C corporation
Transferability of Ownership Interests	Any restrictions are imposed by a stockholders' agreement	Any restrictions are imposed by a stockholders' agreement; desirable to restrict transfers only to eligible S corporation stockholders	Any restrictions are imposed by the partnership agreement	Any restrictions are imposed by the partnership agreement	Any restrictions are imposed by the operating agreement
Fringe Benefits	Most favorable tax treatment for owner employees	Less favorable	Less favorable	Less favorable	Less favorable
Fixed Term	Perpetual	Perpetual	Generally, yes	Generally, yes	Generally, yes, but can be perpetual
Cash Distributions	Taxable	Generally nontaxable to the extent of a stockholder's tax basis in his or her stock	Nontaxable to the extent of a partner's tax basis in its partnership interest	Nontaxable to the extent of a partner's tax basis in its partnership interest	Nontaxable to the extent of a member's tax basis in member's LLC interest

	DELAWARE C CORPORATION	DELAWARE S CORPORATION	DELAWARE GENERAL PARTNERSHIP	DELAWARE LIMITED PARTNERSHIP	DELAWARE LIMITED LIABILITY COMPANY
Liquidation	Taxable on gain at corporate level and taxable at stockholder level to the extent distributions exceed a stockholder's basis in the stock	Generally nontaxable at corporate level and taxable at stockholder level through flowthrough of corporate gain realized on liquidating distribution by corporation	Cash nontaxable to the extent of a partner's tax basis in its partnership interest; any remaining tax basis allocated among noncash assets received in distribution	Cash nontaxable to the extent of a partner's tax basis in its partnership interest; any remaining tax basis allocated among noncash assets received in distribution	Cash nontaxable to the extent of a member's tax basis in member's LLC interest; any remaining tax basis allocated among noncash assets received in distribution
Primary Advantages	Simple, familiar; entity can go public; no UBIT created; low administrative cost to stockholders; losses carried forward and shared by all and valued upon IPO	Corporate familiarity; single taxation	Most flexible	Tax efficient; limited liability for investors; clear authority of general partner	Hybrid; tax efficient; limited liability for all owners
Primary Disadvantages	Double taxation of cash flow in excess of reasonable compensation to principals and upon sale of substantially all of the assets of the business	Limitations on owners; one class of stock; all stockholders must consent to the Subchapter S tax election	Liability of owners for all of the debts of the business	More complex tax and accounting issues than corporations; general partner has unlimited liability; negative image due to 1980s tax shelters	Hybrid (Note: LLCs with principal place of business in PA are subject to PA State Franchise Tax); generally, venture funds do not desire K1 or UBIT; in certain instances, later conversion to corporate form may be taxable
Documents (including Federal Employer Identification Number application)	Certificate of Incorporation publicly filed and bylaws	Same as C corporation; authorize Subchapter S tax election in organizational minutes	Partnership Agreement and, if applicable, Statement of Registration as LLP publicly filed	Certificate of Limited Partnership publicly filed and Limited Partnership Agreement	Certificate of Formation publicly filed and Operating Agreement

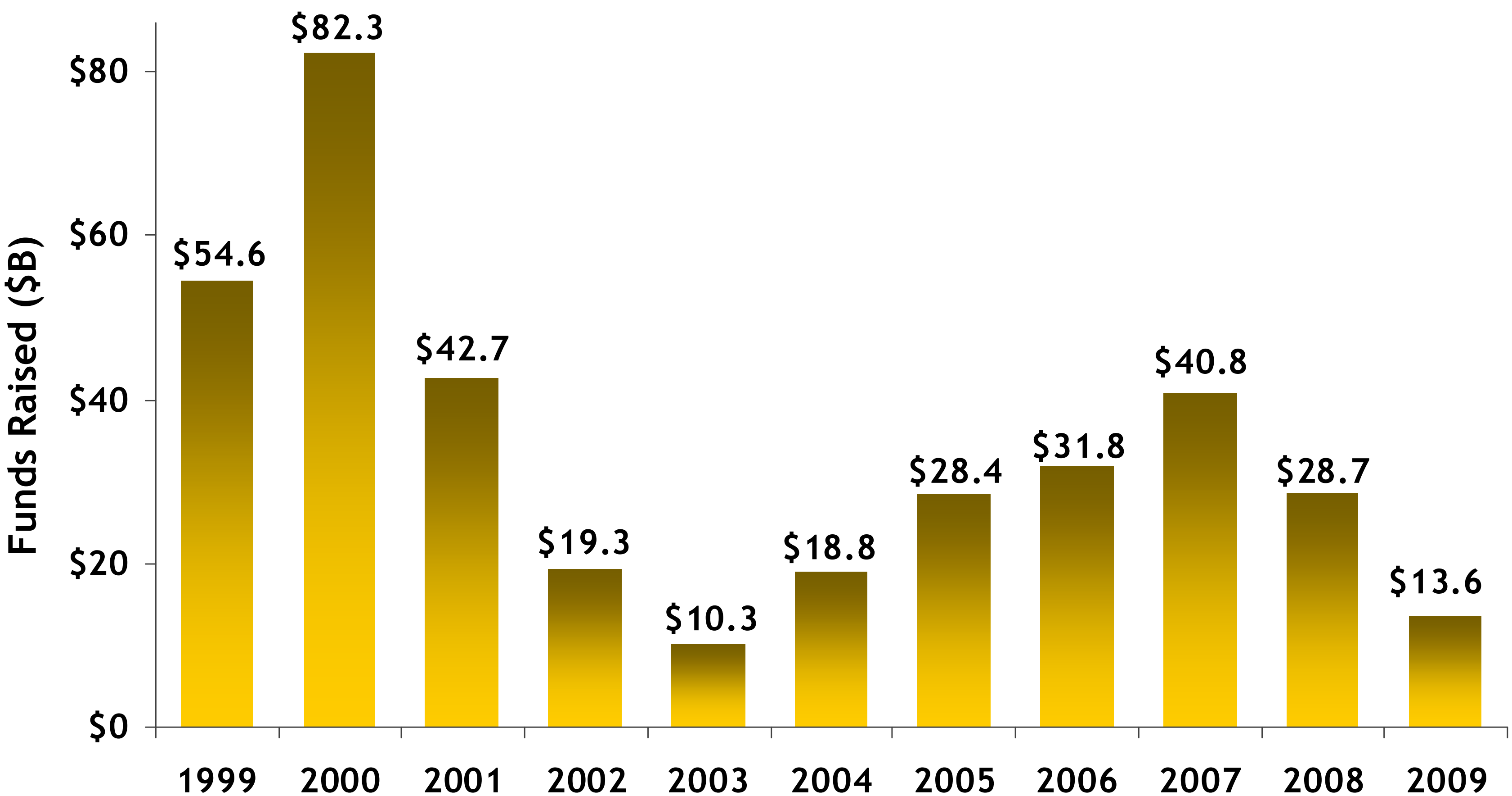
III. Venture Capital Investment in 2010

- Statistics
- Challenges
- Lessons Learned
- Opportunities

U.S. VC Fundraising Drops in 2009

Commitments to Venture Capital Funds

(based on multiple closings)



Source: Dow Jones VentureSource

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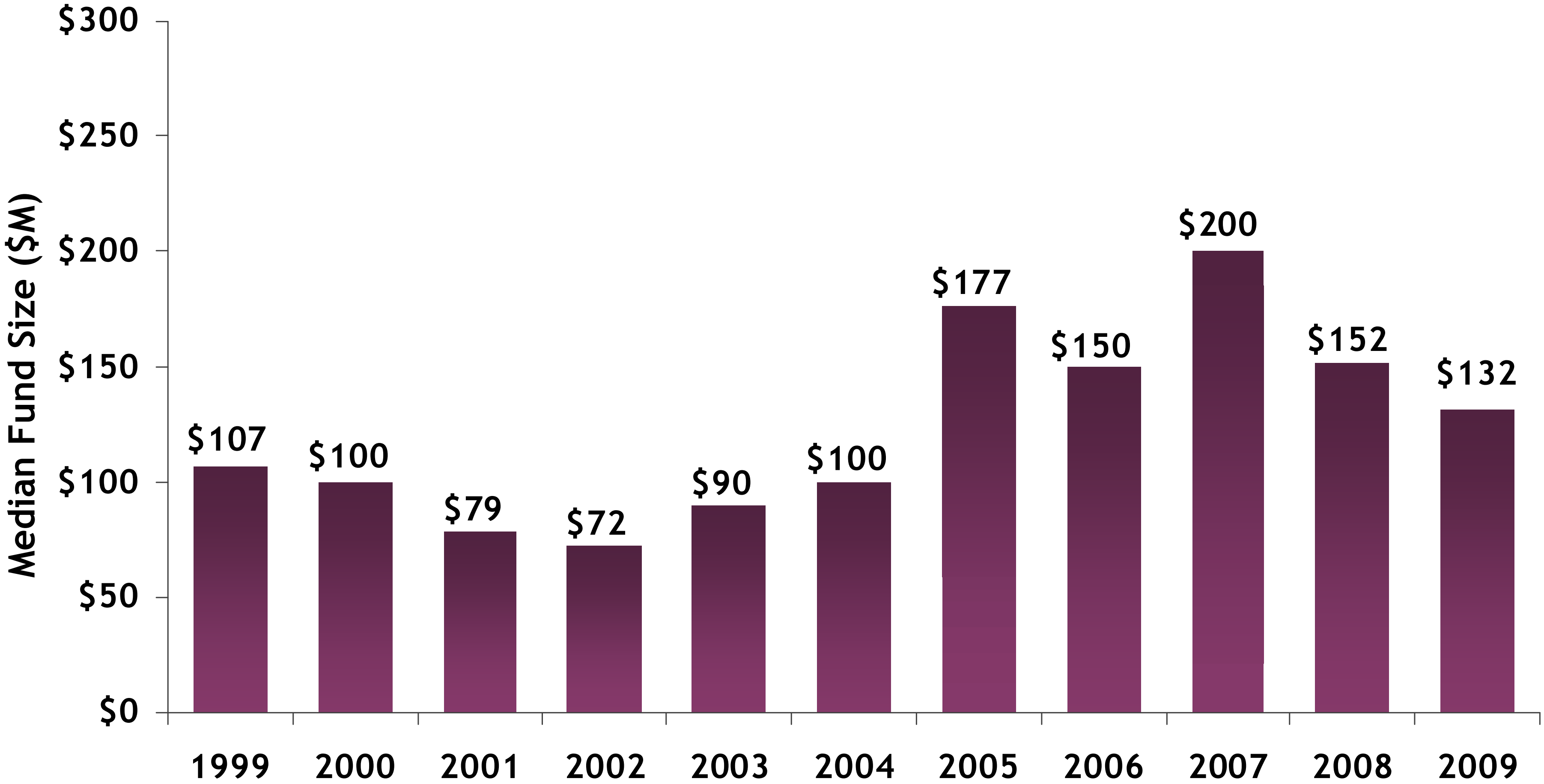
Median VC Fund Size Lower in 2009

Median VC Fund Size

(based on final closing and for funds greater than $20M)



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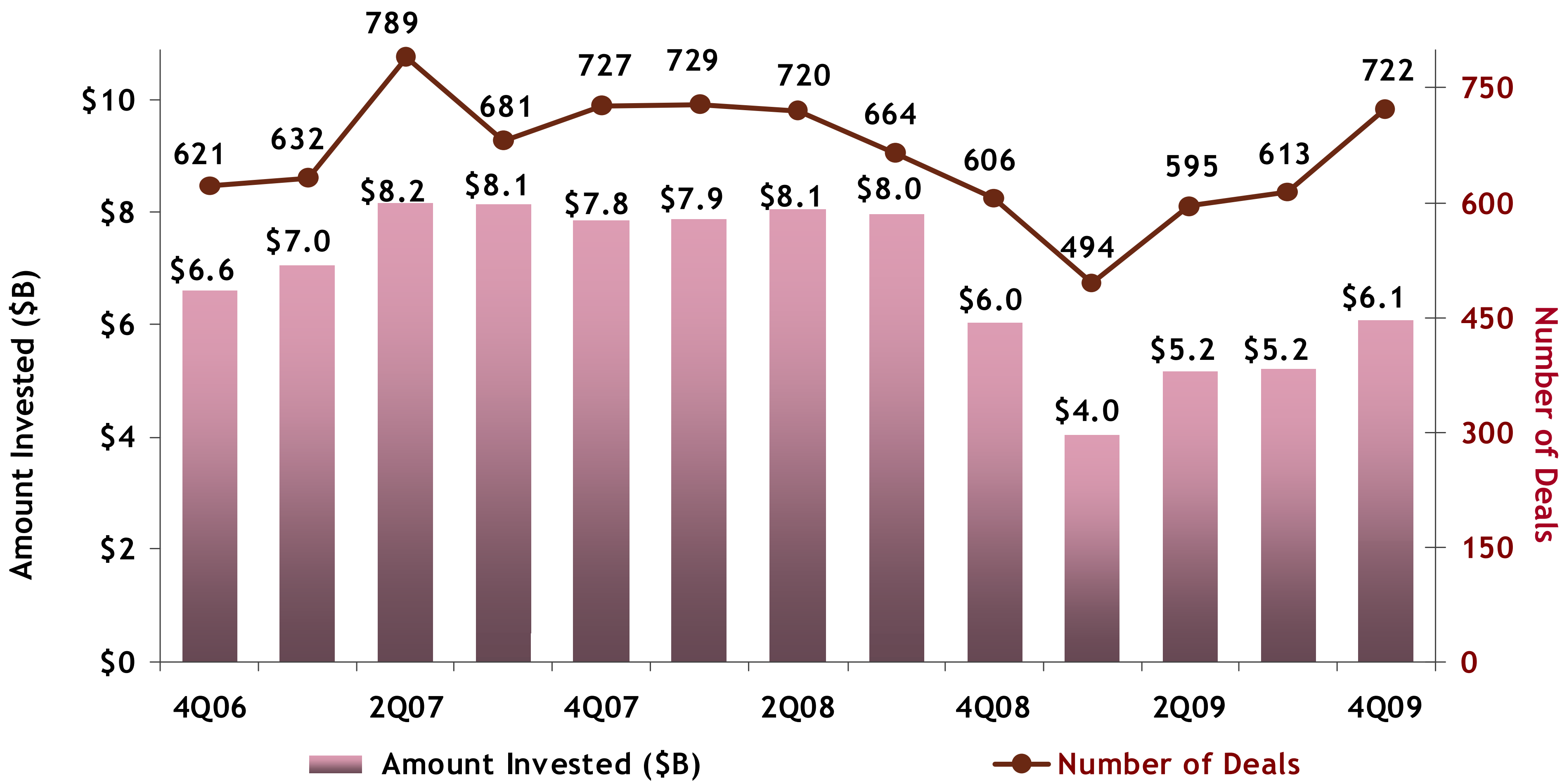
Source: Dow Jones VentureSource

VC Deal Flow Rises in 4Q '09

Equity Investment into Venture-Backed Companies, VC Rounds Only



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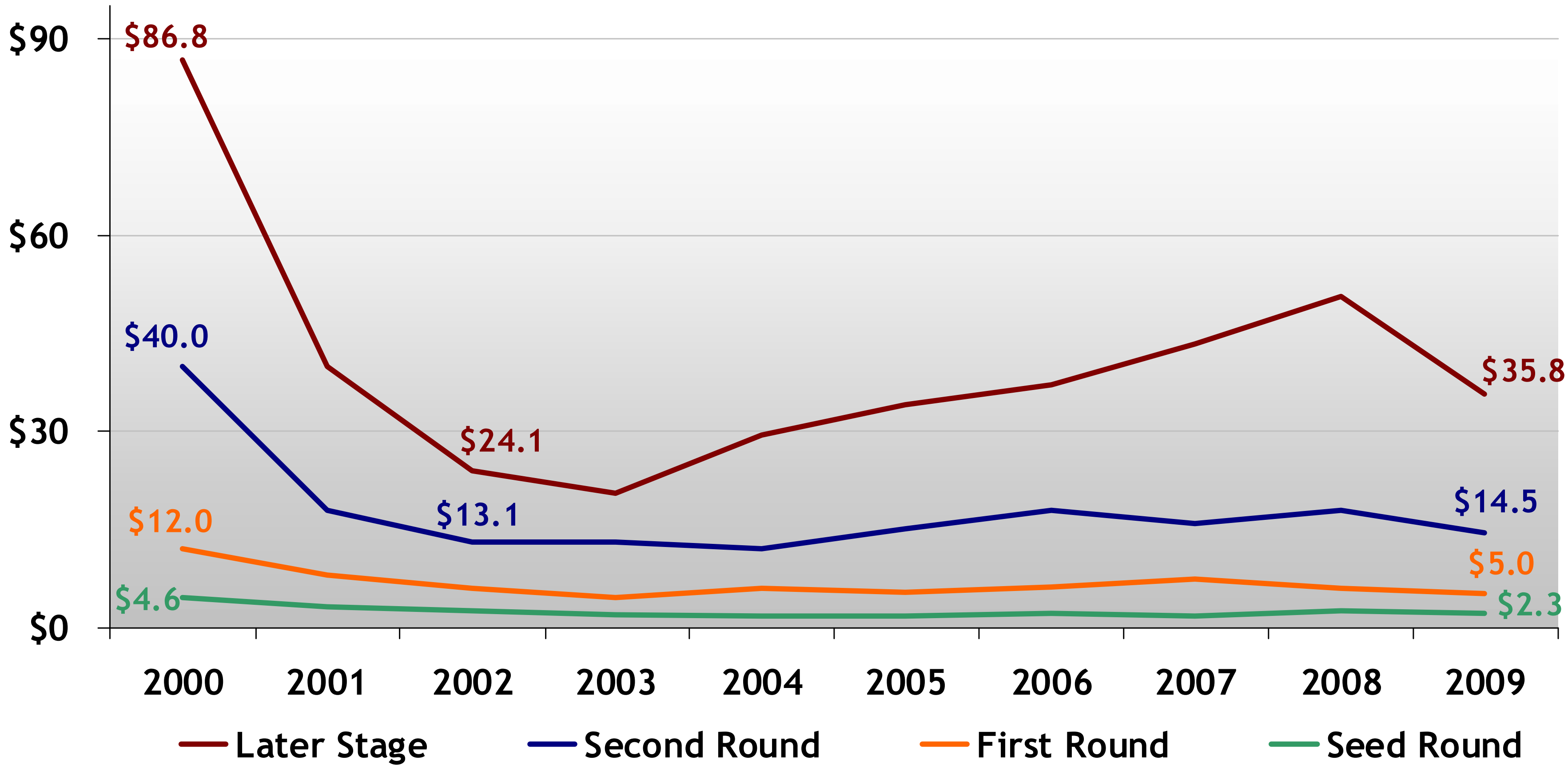
Source: Dow Jones VentureSource

Later Stage Median Valuation Falls in 2009 vs. 2008
Median Premoney Valuations by Round Class (Annual)



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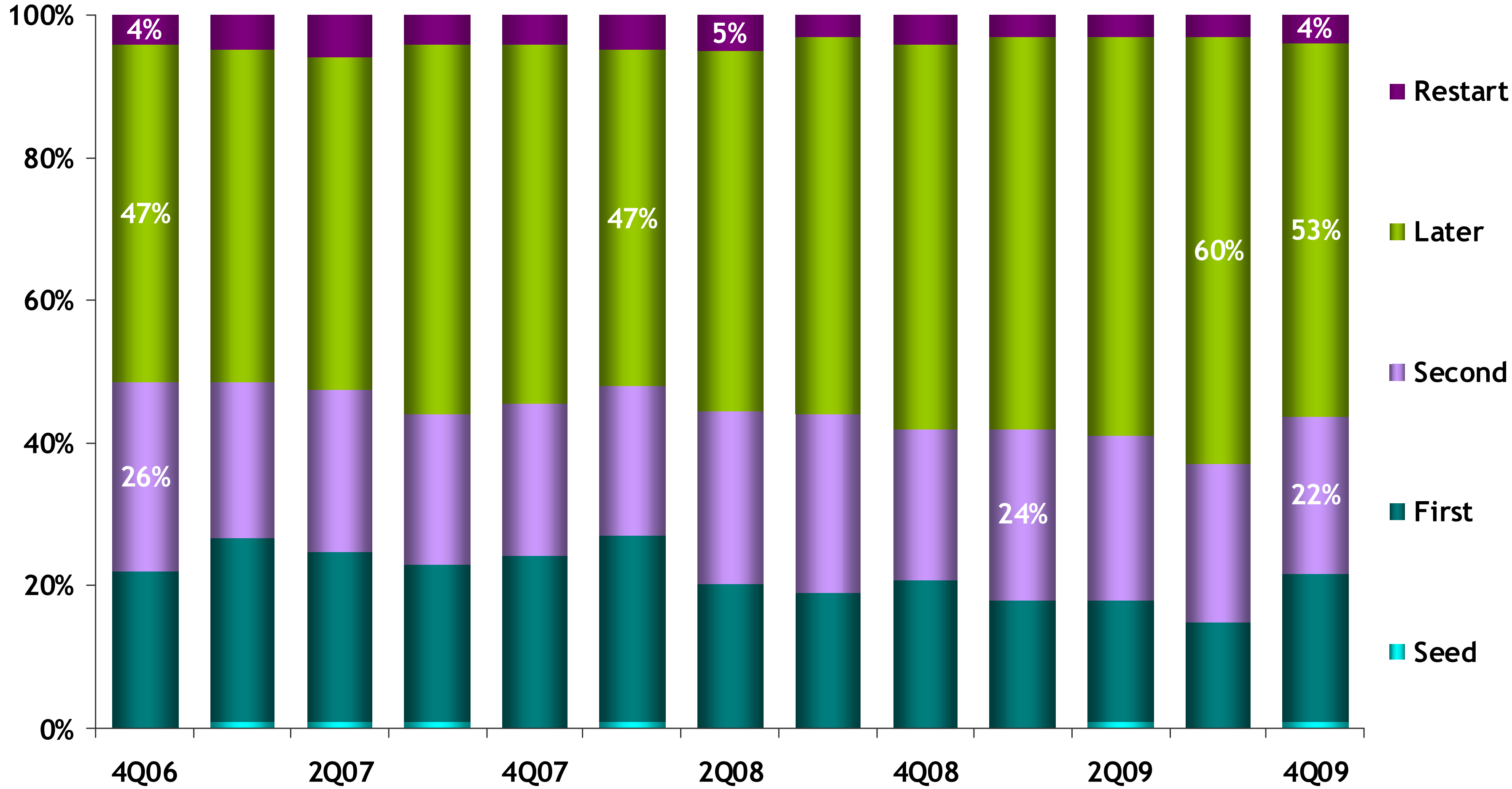
Source: Dow Jones VentureSource

Later Rounds Continue to Receive Most Dollars

Investment Allocation by Round Class



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Source: Dow Jones VentureSource

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Emilio Ragosa is a partner in Morgan Lewis's Business and Finance Practice.

Mr. Ragosa focuses primarily on securities, mergers and acquisitions, corporate transactions and technology transactions. He represents both private and public high technology and biotechnology companies, as well as venture capital firms and underwriters. Mr. Ragosa also has handled numerous corporate transactions ranging from corporate formations/restructuring and private placements to public offerings.

Prior to joining Morgan Lewis, Mr. Ragosa was a junior partner with a prestigious national law firm. While in law school, he worked at the New York Stock Exchange; prior to law school, he was an intern with Merrill Lynch.

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