

LEGAL ARCHITECTURE DESIGNED FOR GROWTH

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First Things First – Six Questions

- 1.** Why are you forming a company?
- 2.** How are you funding it?
- 3.** What risks are there with this business?
- 4.** Where is your home base?
- 5.** Will you have partners or investors?
- 6.** What is the exit plan?



State Law Attributes

| | LLC | Corp |
|-----------------------------|-----|------|
| Risk protection for members | ✓ | ✓ |
| Formal Management structure | | ✓ |
| Flexible Economies | ✓ | ✓ |
| Preferred by investors | ? | ? |
| Prestige Factor | ? | ? |
| Multi State | ✓ | ✓ |

Tax Law Attributes

| | LLC | C Corp | S Corp |
|------------------------------|-----|--------|--------|
| Pass through income | ✓ | ✓ | ✓ |
| Pass through losses | ✓ | ✗ | ✓ |
| Multiple Classes | ✓ | ✓ | ✗ |
| Flexible income distribution | ✓ | ✓ | ✗ |
| W-2s to Owners | ✗ | ✓ | ✓ |
| QSBs | ✗ | ✓ | ✗ |
| Can convert to another form | ✓ | ✗ | ✗ |

Mix & Match

Choices for Tax: C Corp, S Corp, Disregarded, Partnership

| | State Law LLC | Tax Law |
|------|---------------|------------------------------|
| LLC | LLC | C Corp, D.R. Partner, S Corp |
| Corp | Corp | C Corp, S Corp |

LLC Vocabulary

- **Member** – Owner
- **Manager** – Big cheese
- **Board of Managers** – Governing board
- **Units** – Fraction of ownership (like shares)
- **Membership Interests** – Ownership interests
- **Preferred Interests** – Money invested with special economic priorities and preferences in the waterfall
- **Founders Interest** – Initial equity issued to Founders
- **Restricted or Incentive Unit** – Equity issued to key persons
- **Profits Interest** – Equity issued without a capital investment
- **Company Agreement or Operating Agreement** – Governing documents

Corp Vocabulary

- **Shareholder** – Owners
- **Director/Board** – Team elected by shareholders to govern
- **Shares/Stock** – Fraction of equity
- **Common** – Initial equity issued to Founder & friends
- **Series A** – equity issued with priorities over Founder's common
- **Series B** – equity issued senior to common and Series A
- **Restricted Stock** – issued to key employees with vesting restrictions
- **Options** – issued to key employees or investors – very hard to manage if you plan to exit in 3–5 years
- **Vesting** – performance milestones or time hurdles
- **Bylaws** – Governance and administration rules for board, officers, & shareholders
- **Shareholders Agreement** – voting and buy–sell rules for shareholders



Investors like LLC Partnership



- Flexible
- Pass-thru losses & income (not double tax)
- Risk Protected

Start-Up Owners Like LLC S Corps



- W-2s
- Pass-thru income & losses
- Simple

QSBS – Shiny Object

Only for corporations.

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First Money Issues

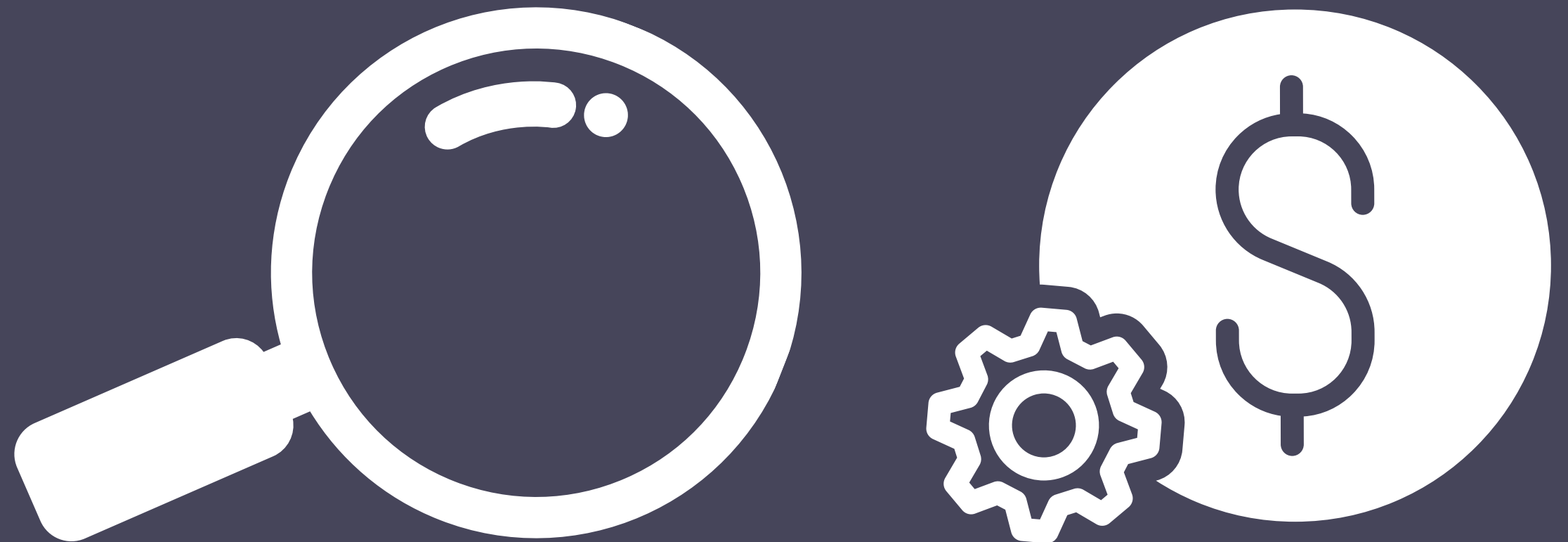
- FFF (common equity) – Friends, Fools, & Family
- Convertible Debt – loan that can be exchanged for equity
- SAFE – Y Combinator product that does not bear interest and does not have equity rights (NOT IRS approved)
- Equity after valuation event





Valuations

- 3rd Party Offer/Negotiated is Gold Standard
- Industry Corps
- Formula for Buy-Sell
- Appraisal



Cap Tables

- Mandatory for LLCs
- Update with each new investment
- Registry of ownership
- Initial tracking of after-tax contribution
- Tracking percent of capital, income, appreciation
- Tack vesting



What is a cap table?

A record of Investment, Waterfall Rights, and Preferences



Example Cap Table

| Owner | Class | Capital Contribution | Ownership Percentage (Sharing Ratio) | Units |
|-----------|-----------------------|----------------------|--------------------------------------|-------|
| Jill | Founders | \$20,000 | 75% | |
| Jessica * | Founders (Restricted) | \$0 | 5% | |
| Javier | Founders | \$6,000 | 8% | |
| Jeremy | Founders | \$10,000 | 10% | |
| Julia * | Founders (Restricted) | \$0 | 2% | |
| | | \$36,000 | 100% | |

* Restricted Units are profits interests and usually vest overtime

Example Cap Table

| Member | Class and Percent of Class | Capital Contribution | Preferred Return | Liquidation Post Payout |
|--------|----------------------------|----------------------|------------------|-------------------------|
| Alicia | 100% Founder | 10 | X | 75% |
| Amy | 100% Preferred | 1000 | 18% on Capital | 25% |

Balance of Power: Founder DM

| Decision | Officer/Current President | Manager | Required Interest* | Unanimous Consent of Members |
|---|---------------------------|---------|--------------------|------------------------------|
| Approve Biz Plan | | | | |
| Approve Budget | | | | |
| Raise Capital | | | | |
| Hire/Fire/Build Leadership Team | | | | |
| Day to Day Business | | | | |
| Extraordinary events like M&A of subsidiaries | | | | |
| Sell the company | | | | |

* Required Interest is Founder plus an Investor Class Representative or a certain percentage of Investor Class

Balance of Power: 4 Guys DM

| Decision | Officer/Current President | Majority | Super Majority | Unanimous Consent of Members |
|---|---------------------------|----------|----------------|------------------------------|
| Approve Biz Plan | | | | |
| Approve Budget | | | | |
| Raise Capital | | | | |
| Hire/Fire/Build Leadership Team | | | | |
| Day to Day Business | | | | |
| Extraordinary events like M&A of subsidiaries | | | | |
| Sell the company | | | | |

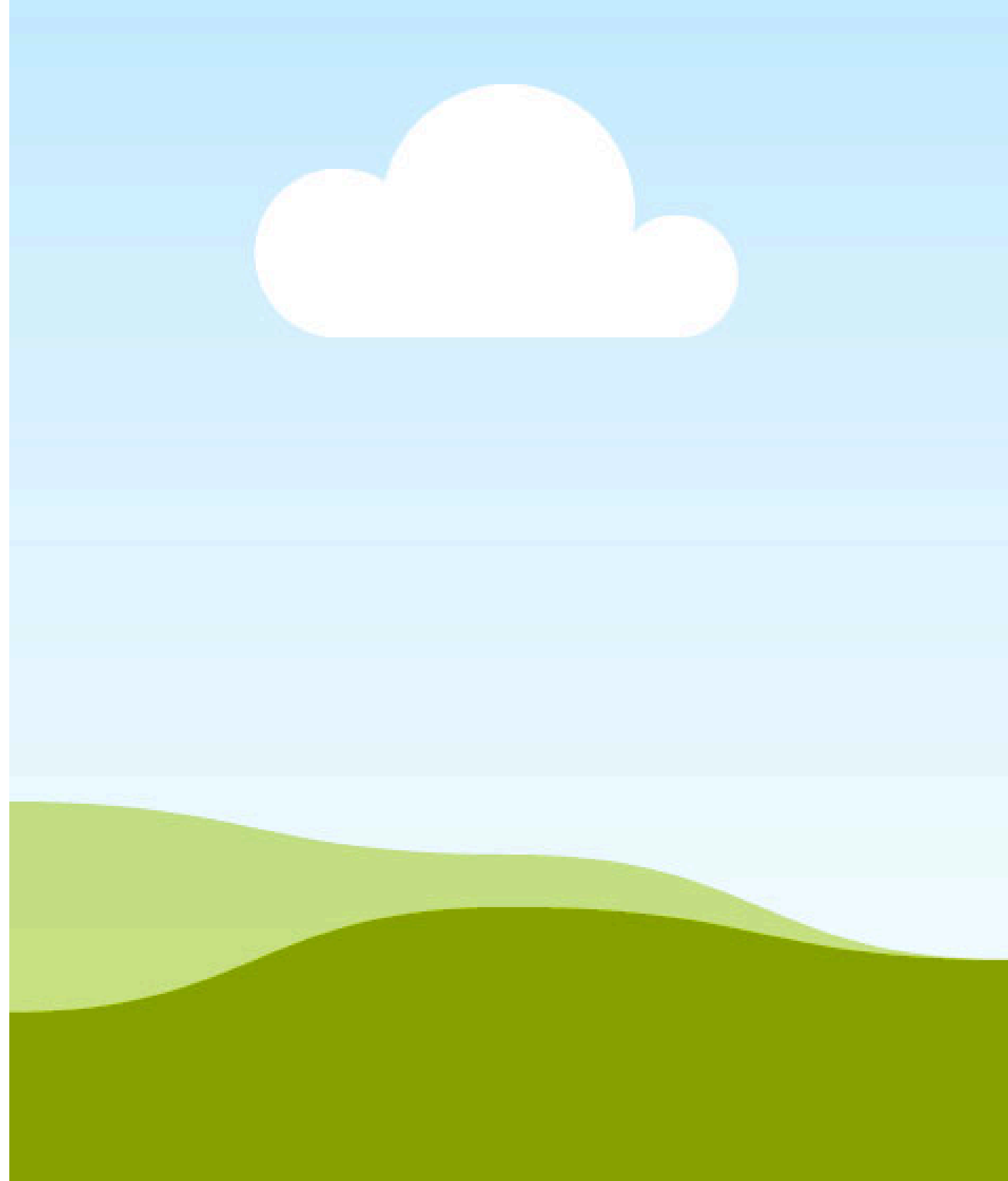
Voting Rights

- In LLCs not necessarily proportionate to contributions
- Can be custom tailored



Buy-Sell

Each class needs its own rules!



Buy-Sell, Big Deal & Big D's Rules

| Decision | Founder | Investor | Valuation Method | Insurance Funded? |
|------------------|---------|----------|------------------|-------------------|
| Death | | | | |
| Divorce | | | | |
| Disability | | | | |
| Dumb Shit | | | | |
| Disappearance | | | | |
| Decrease in Role | | | | |

Buy–Sell Agreements

An “off the shelf” Buy–Sell Agreement doesn’t really exist.

Founders care about the BIG D’s

- Death
- Divorce
- Disability
- Disappearance (Retirement, Resignation etc.)
- Dimwits (termination for Cause)

Investors care about participating in exit and liquidity.

- Tag–Along
- Drag–Along
- ROFR
- Participation in ROFRS



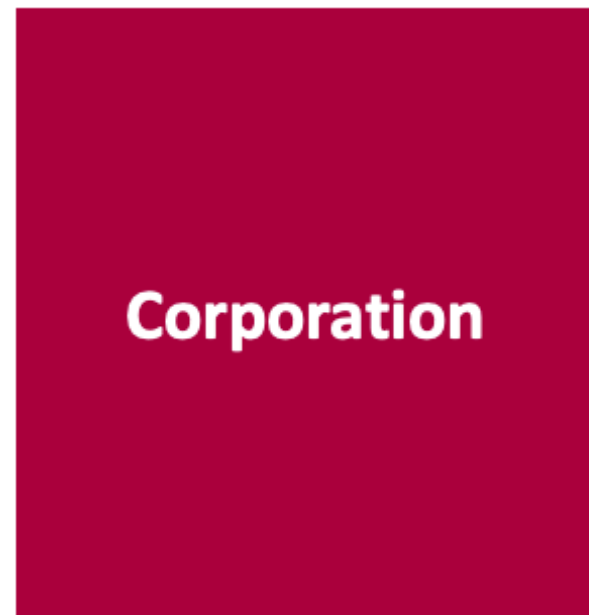
Growing Pains

- Form of Entity might change with growth
- Start simple
- Plan for growth
- Revisit choices each year with lawyer and accountant

Who is on your team?

- GoodBiz.Law
- Accountant with partnership and tax skills
- Bookkeeper
- Outsourced CFO
- Advisory Board





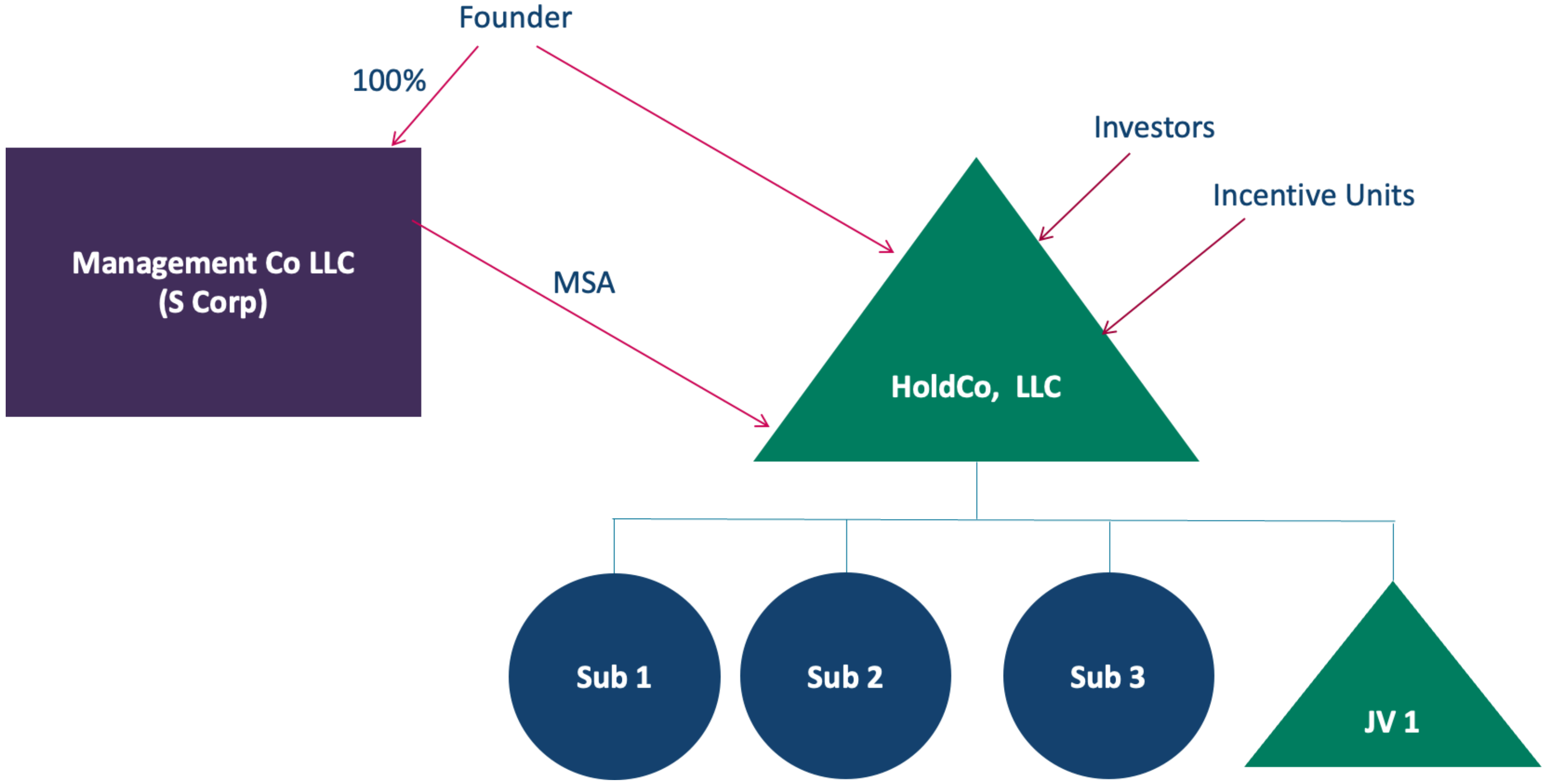
LEGEND

Box = Corporation

Circle Disregarded / Single Member

Triangle = Partnership for Tax Purposed

Rectangle = Legal Manager and not an EQUITY OWNER





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**A STRONG PARTNERSHIP,
A STRONGER STRATEGY FOR
BUSINESS OWNERS.**



Back of the Napkin



Pack Your Bags



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GB Page

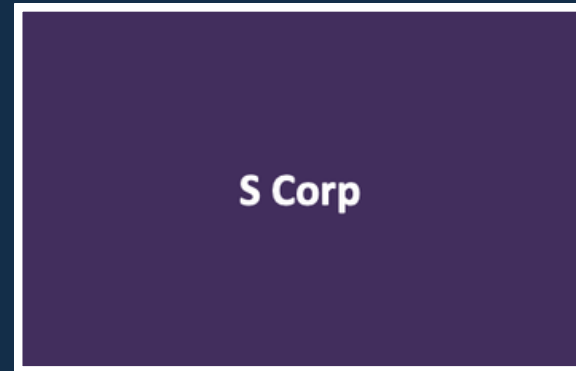
Risk Management Basics

Choose the Right Form of Entity

| | | |
|--|--|--|
|  <p>Corporation (S or C)</p> |  <p>DBA Sole Proprietorship</p> |  <p>LLC or Partnership</p> |
| <ul style="list-style-type: none">• Full liability protection for owners• Formal management structure required<ul style="list-style-type: none">◦ Shareholders◦ Directors◦ Officers◦ Annual Meetings• Too complicated for daily use | <ul style="list-style-type: none">• No liability protection for owner• If multiple owners involved, it could be an “accidental” general partnership• Handshake is sufficient• Not safe for everyday use | <ul style="list-style-type: none">• Full liability protection for owners• Management structure flexible but should be agreed in written contract• Looks easier than it is• But still the best solution for most new companies |

Tax 101

Make the right Tax Election



- Use for Services Companies where the Founders need a W-2
- Use to provide services to a complex group of companies sharing overhead and employee groups
- **DO NOT USE for Operating Companies that will RAISE CAPITAL or SELL TO THIRD PARTIES**

- If owned by single individual, all tax info goes on personal tax return.
- If owned by another company, tax accounting rolls up into parent.

- Tax partnership
- K-1s not W-2s for >2% owners
- Single level of tax
- Need a good partnership tax accountant
- Must have Company agreement

First – Define Client Objectives

- Risk Management around private companies, real estate ownership, recreational properties & private investments
- Continuity of management and ownership
- Tax and estate planning to mitigate future tax liabilities and possible gifting
- Leave a legacy through preservation of community



Thank you!