



## **Choosing the Best Entity for Your Venture Startup?**

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There are some undisputable facts when one is seeking venture capital:

- No one wants to hear why a product is going to revolutionize your “space”—they want to know how that product revolves around earnings; and
- That no cost is as “*sunk*” as money spent by an entrepreneur to pay down a startup company’s debts.

While item number one might be a surprise to some “newbie” entrepreneurs, most savvy entrepreneurs know that sometimes the better product does not always win the earnings race (see, example BETA vs. VHS). With that being stated, one thing that almost all entrepreneurs have in common despite their experience, is that they often overlook current for future events. In other words, many entrepreneurs do not think about their company’s needs today as they focus on (or more accurately, react to) what a potential investor is expecting to see. This article will focus on one point in this process, namely choosing the right entity to begin your business.

Entrepreneurs are successful for having the foresight and drive to make their vision a reality. Within that vision lies the usual thought processes, beginning with the formulation of an idea to drafting a marketable business plan, putting together a credible management team and securing venture capital. Missing from that vision is how the entrepreneur runs his business in between inception and funding. For example, while most entrepreneurs know enough about operating a business to realize that their company and *big idea* should have some form of limited liability protection, however, most do not understand the ramifications of choosing one entity over the other. Take the choice of a C corporation, it offers a multitude of options for corporate finance and shareholder structure flexibility (*e.g.*, different series of stock, hybrid debt, and a large body of management friendly case law (especially in [Delaware])). While, the foregoing are well reasoned and recognized means for electing to incorporate as a C corporation, and further, as a general rule, most companies that receive venture financing do so as a C corporation (and are usually incorporated in Delaware). However, what most entrepreneurs forget is that it (usually) takes a considerable amount of time to receive financing and during that ramp up period cash losses mount. Thus, unless the company receives funding immediately, the potential for losses to remain trapped inside the company could be an unexpected let down for the entrepreneur and management team.

To start, incorporating as a Delaware C corporation sounds like a great idea because most publicly traded companies are incorporated in Delaware and a substantial number companies

funded by venture capital are incorporated there as well. However, by starting off life as a C corporation (be it Delaware or New York) what many entrepreneurs do not realize is that potential losses that they may be able to use to offset on their income tax return are trapped in that C corporation (how long they are trapped depends on the earnings of the company; however usually this dilemma is irrelevant because by the time the company has cash-flow positive or is in the black the losses are the property of the company).

For instance, when starting a business most entrepreneurs use their own capital to move the business forward (*e.g.*, professional fees, office supplies, leases, employees, equipment, *etc.*). As the sunk costs begin to mount, most entrepreneurs are too busy refining their vision and readying it for the day when the proverbial VC ship comes sailing into port to worry about realizing the losses accruing in the company; it is the rare entrepreneur (or in some cases investor) who recognizes the tax advantages in organizing the new entity in a manner where that entrepreneur could worry about writing down losses on his/her tax return—that is until it's tax season—or until a VC firm elects to invest and tells that lucky entrepreneur “thanks for the sweat equity”.

Today, some (a few) venture funds do not require that a company be a C corporation to place an investment (although, most require that it be a Delaware entity); some venture funds (*if* they have experience with limited liability companies) will provide funding to a company if it is a limited liability company. However, most venture funds will require that the company receiving of funding be a Delaware C corporation.

What is an entrepreneur to do? Well for starters, there is no general rule of thumb for what entity one should choose because each situation provides its own set of facts. For example, is the management team coming off a previously successful venture that might enable the company to proceed directly to go for venture funding; does the company have a market ready product or is it still in trials (does the company even have a product); are the entrepreneurs still figuring out if their *big idea* has enough behind it to create a business model based upon it? Each question will invariably affect how a venture fund receives its funding and as a result the entrepreneur should choose its entity based upon that reasoning. Regardless, what one must remember is that the decision to seek an alternative to a C corporation is a decision that should be given consideration because the decision goes beyond just the basic comparison between entity types (*e.g.*, LLC offers many of the same benefits of a C corporation without the prospect of double taxation and the ability for losses to flow through to the unit holders). Instead, the decision should be focused on a number of different factors including but not limited to how long the company intends to forego venture financing, whether it is going to attempt to raise a small round of financing (*e.g.*, friends and family) and whether the entrepreneur will use equity to attract intellectual capital (*i.e.*, attracting key employees, board advisors, *etc.*).

Determining whether to select a corporation, partnership or limited liability is a weighted analysis of tax, liability and management issues. These issues may help flush out an entrepreneur's vision of where the company will progress in the short term. Planning the capitalization and operation in a particular vehicle will help entrepreneurs crystallize what kind of relationship they may want with investors. Additionally, the entity selection can help create flexibility for the companies that change strategy.

### C Corporations:

- Corporation is taxed a legal separate entity.
- Corporation shareholders are taxed on dividends.
- Corporations have a large body of corporate law in existence.

### S Corporation:

- S Corporation is limited to 100 shareholders.
- S Corporation is not taxed separately.
- S Corporation's income passes to the shareholders.
- Foreigners cannot hold shares of an S Corporation.

### Limited Liability Company:

- LLCs can have unlimited number of members.
- LLCs can have foreigners as members.
- LLC members can participate in management.

One of the primary reasons C corporations continue to be the preferred vehicle of VCs is the significant body of law around them that allows VCs to predict how they will be treated. Statutes, case law, no action letters and administrative case history are much more developed in favor of C corporations over LLCs. Notwithstanding the foregoing, LLCs have still become very popular vehicles for startups but just not with VCs. Although, some VCs have chosen to invest in LLCs, most invest by using a “blocker” corporation or the VC is willing to report the income (or losses) of the LLC.

Since LLCs are structurally impeded from going public they present significant problems for VCs who want to maintain that avenue of exit from the investment. This is one of the real world road blocks for VCs investing in LLCs. C Corporations allow VCs to keep this option available. It may be irrelevant whether the IPO market is flourishing since VCs do not necessarily know how long they will hold an investment. Delaware is very flexible in its laws regarding the conversion of LLCs to Corporations, but these conversions can be expensive depending on the length of operations and the amount of investors already in place in the company. Many entrepreneurs have begun to try and explore the best of both worlds by selecting the LLC and then planning to convert when the VC invests. An entrepreneur should be forewarned however, because this strategy is fraught with peril and entrepreneurs (and their counsel) must keep in mind that conversion can be a transaction that can drain finances and resources of a prospective portfolio company and result in a nullification of the positives originally sought from the LLC.

“Blocker Corporation” – is a corporation added between the investor and Portfolio Company.

“Board of Directors” – is the group of individuals elected by the shareholders to manage a corporation.

“C Corporation” –A legal, taxable entity chartered by a state government. Ownership of a corporation is held by the stockholders and is a corporation that is taxed separately from its shareholders.

“Limited Partnerships” An organization comprised of a general partner, who manages a fund, and limited partners, who invest money but have limited liability and are not involved with the day-to-day management of the fund. In the typical venture capital fund, the general partner receives a management fee and a percentage of the profits (or carried interest). The limited partners receive income, capital gains, and tax benefits.

“LLC” – is a limited liability company where the owners of the company can select to be taxed

“Portfolio Company” – is a company that has received investment from a venture capitalist.

“S Corporation” – A legal, non-taxable entity chartered by a state government and given its pass through status by the federal government and in some cases a state government (e.g., New York State---however, some jurisdictions do not recognize ‘S’ corporation status). Ownership of an ‘S’ corporation is held by the stockholders and is a corporation that is taxed on the shareholder level and passes its income to its shareholders.