THE WOMAN UP PROJECT

Five Legal Questions for Start-Ups

By Laurie Bauer

Chicago is a great place for entrepreneurs. A recent study showed that Chicago's start-up ecosystem was the 7th largest overall in the nation. Another interesting statistic: in Chicago's vibrant entrepreneurial community, women constitute 34 percent of all founders, well over the national average and more than double that of Silicon Valley. As a woman and a lawyer who regularly works within this community representing start-up companies and investors, I find both of these statistics to be encouraging, as they are indicators of a healthy and supportive community, with potential for continued growth. As more new companies emerge, founders, new and experienced, face many legal decisions. The following are a few of the common questions that we hear, together with some practical considerations.

1. What entity form should I choose? This question, arising in a company's earliest days, typically involves choosing between a corporation or a limited liability company (LLC). Entrepreneurs may favor an LLC because it can be taxed as a partnership, which means the taxable income of the company is "passed through" to the owners and reflected on their personal income tax returns, and in general, no income tax is owed by the company. However, federal tax reform enacted at the end of 2017 may diminish the overall income tax advantage of an LLC over a corporation, depending on several factors, including the nature of the company's business. Tax considerations aside, a corporation formed in Delaware is the most common selection, especially by founders who will seek to raise money from venture investors. The reasons include Delaware's well-established body of corporate law, efficiencies that result from investors' and advisors' familiarity with Delaware corporations and administrative ease and predictability. Chicago companies formed in Delaware will also generally need to qualify to do business in Illinois and other jurisdictions where they operate. As each company and entrepreneur is different and the analysis must take into account these and many other factors, founders should consult an experienced attorney and tax advisor when making this decision.

2. Who owns the company? When the time comes to form the company and divvy up equity interests, it's best to have a candid discussion about expectations for what role each founder will play and try to allocate ownership with that in mind. An even split is sometimes, but not always the best choice. This discussion may be awkward but is generally better had sooner (when the company has no value) than later. Waiting to issue equity until the company is well established can result in transfers of value to the founder, or require the founder to purchase equity interests. In addition, letting a misalignment linger between founders can create personal and professional rifts that can distract founders from the business of growing a company.

3. Who owns the intellectual property? Intellectual property is often the most valuable asset that an early-stage company owns. It is critical that a start-up company own (or license) all of the intellectual property necessary to run its business, including intellectual property developed by the founders prior to forming the company. Companies should take the simple step to require all founders, employees and consultants to sign a confidentiality and intellectual property assignment agreement to ensure the company owns all intellectual property created by personnel while at work.

4. How will employees be incentivized? Because a significant portion of the compensation start-up companies offer their employees is in the form of equity instead of cash, founders should ensure their equity plan is tax efficient and compliant with securities laws. Corporations typically adopt a plan under which they may issue stock options (and other equity interests). LLCs often issue profits interests or phantom units, which have different tax and other implications. When determining ownership percentages of the company, plan to allocate a percentage to an incentive equity pool.

5. What legal resources are available? There are many free online resources that address these and other common questions, including Latham Drive, at lathamdrive.com. These are great starting points for entrepreneurs looking to gain familiarity with the relevant considerations when starting a business. However, obtaining skilled legal advice tailored to a founder's specific facts and early in a company's life cycle is important and can eliminate costly mistakes and distractions in the future.

Laurie Bauer is a partner in the Chicago office of the law firm of Latham & Watkins LLP and a member of the Emerging Companies Practice. She regularly represents emerging companies with respect to venture financings, general corporate governance matters and day-to-day counseling. She also represents venture funds and family offices on their investments in early-stage companies.