

Fox Rothschild Podcast

Legally EmpowHERed Podcast

Episode One

Featuring Partner Sahara Pynes with Tamar R. Gubins

Sahara Pynes: Tamar and I are here today to chat about startups and setting up your corporate structure. Thank you so much for being here.

Tamar R. Gubins: It's my pleasure, Sahara. This is not the sexiest topic for entrepreneurs, but it turns out it's really important, so I'm glad to be here to talk about it.

Sahara Pynes: And I'm excited to have you. So, before coming to Fox, I had my own HR consulting business. I never formed a corporate entity, I just operated as a DBA or as an individual. At one point, I wanted to scale and start to hire employees, but didn't really know how to go about doing that. What do you think, was the DBA or sole proprietor a mistake?

Tamar R. Gubins: It's really common for people to start building businesses before they create a legal entity for that business. When you first start a company, you're really concerned about costs and you're really focused on just getting it up and running. You do not have the time, or energy, or resources to pay lawyers and file paperwork and pay fees associated with forming a new business. So, it is perfectly understandable that that's how you started your business.

Why should you form a business though? The most important thing is liability. You do not want to be personally liable if somebody sues you. If you form a legal entity, which is different than a sole proprietorship, you personally, generally, will not have any legal liability. That's really important for you. There are other considerations like taxes, ownership, management and control, investment, things like that, but the most important issue for you is that you don't want to have personal liability.

Sahara Pynes: That makes absolute sense and that's basically why I didn't do it at the time. I want to get back to the cost issue because I know that's a big one for startups, but when should you even begin to start thinking about forming the legal entity in your journey?

Tamar R. Gubins: I'm a lawyer, so the right answer for me is immediately before you do absolutely anything else. But, look, even lawyers understand that this is not practical advice for most people, so I think there are a few different times to consider. If you're a solo entrepreneur, like you were in your HR consulting business, I think the most important "drop dead, you must get this done and form a legal entity for your business," is when you start entering into

agreements or contracts with other people. If you start selling your product or your service. If you start hiring employees or contractors. If you're going to sign a lease. If you enter into an agreement with a third party to produce your product. If you're going to raise money. You definitely, at that point, need to form a legal entity for your business.

It may be, if you are in a business with other people, you might want to form your business earlier than that. Many businesses are started with a few people and an idea, and they're working together to get it running and off the ground. If you don't form a legal entity at that point, it's not clear who makes the decision about the business, who owns what in the business, and whether or not the business owns the intellectual property you're developing as you work with your partners. The last thing you want to do is spend six months with a few cofounders working on an idea and a business, and then all of a sudden the co-founder decides they don't want to be involved, they take the work they've done and they go somewhere else. If you form a legal entity, you minimize that risk because the entity owns any of the work product you've been working on all this time.

Sahara Pynes: So, a little off topic, but then does forming a partnership agreement come into play here, or are these issues solved by the corporate formation process?

Tamar R. Gubins: You can have certain kinds of partnerships that are not legal entities, and that does help a little bit, especially if you have a written partnership agreement. But you have not solved the biggest problem that you want to solve, which is personal liability. That's why you want to end up with one of these legal entities. With those different types of legal entities, you can still have what is effectively a partnership agreement—it might not be called that, but it's still a legal contract by which the founders agree to run their business. You need the legal entity even before you get there because that's the most important thing.

Sahara Pynes: OK, so I don't even know about all the different structure options. There are probably many, many, but can you outline some of the most popular ones for us?

Tamar R. Gubins: Yes. I think, as I've been talking about liability, the two general categories that are most important to understand are the structures that happen where you have not protected yourself against personal liability and that's what you were talking about at the beginning—a sole proprietorship, where you're just running the business and maybe you've made up a name for it, but you haven't created a formal entity. You can do the same thing as well, as we just discussed, with a general partnership, where if you are just one person, partners share the control and the decision making. But in both of those cases, there is still unlimited personal liability for the owners, it's pretty hard to transfer ownership, but the benefit is there are very few formalities, you don't need to file with a state, you don't need to pay taxes.

Sahara Pynes: No taxes? Everybody loves no taxes, right?

Tamar R. Gubins: Everybody loves no taxes as an entity, you still need to pay personal taxes.

Sahara Pynes: Oh darn.

Tamar R. Gubins: I know, I'm sorry about that. There is no getting away from taxes, unfortunately, in the end, but you don't need to pay corporate taxes, or deal with corporate filing fees for having filed with a state. You want to be in the world of limited personal liability, and the two entities that are most applicable to entrepreneurs who are going to be listening to this are corporations and limited liability companies. Both of those are separate legal entities you form under state law and provide that limited liability for the owners. Which one you want depends on a lot of different factors, but the two primary concerns are tax considerations and your fundraising plan.

Sahara Pynes: OK, so can you give us a little bit of an overview of corporations? I know there are different kinds, although admittedly I don't really know the difference between like an S or a C Corp. I feel like a lot of the companies I work with, maybe the smaller companies, are LLCs. I guess, part and parcel of that is, do you ever change your corporate entity down the road, or once you go with it, you pretty much stick with it?

Tamar R. Gubins: Absolutely. There is a lot to unpack there, but we'll start with corporations vs. LLCs. The corporation owners are shareholders and it's generally managed by a board of directors and officers of the company. The corporations have a fairly structured corporate structure, there are a lot of formalities you have to follow that are fairly rigid and usually well laid out under state law, but they're pretty clear what you have to do as long as you have the right advice and advisor. What many people think are a downside of corporations, but as we'll talk about it's not quite so clear, is corporations are subject to double taxation generally. What that means is that the corporation is taxed on its income, and then shareholders are also taxed if profits are distributed to the shareholders. So, the money is taxed when it comes into the corporation as income, and then when that post-tax income is distributed to shareholders, the shareholders themselves are taxed.

There are some types of corporations called S corporations, which is a tax election, which may give you the pass-through taxation benefits, but you have to fulfill a number of requirements to qualify as an S corporation, which makes it not the best startups, particularly if they're going to be taking in outside investments.

Sahara Pynes: I feel like I've heard other attorneys at Fox say that they've kept the corporate minutes for different corporations who are clients and helped them with sort of the corporate formalities. Is that something that you do as well, or that helps business owners, so they don't have to know all the nuances of the laws?

Tamar R. Gubins: Absolutely. We do that for our clients all the time. First, we form the company and we deal with the formalities at the beginning—create bylaws, which are the rules of the company, which I am going to go out on a limb and say 99.9 percent of my clients have never actually read their own bylaws.

Sahara Pynes: Just like my employee handbooks, don't worry about it.

Tamar R. Gubins: Exactly. It's a check the box sort of item, but that's why they rely on us, right? That's the value we add. The corporate formalities with a C-corporation are things like you're going to want to have your board approve certain actions, like if they're going to give away equity—for example, employee options—if they're going to raise money, things like that. Generally, those are the kinds of things are clients come to us for anyway because they need additional help and paperwork to work through that, so we can advise on what formalities they have to follow at the time.

Sahara Pynes: OK, great. So, what about LLCs? How is that different?

Tamar R. Gubins: LLCs are more flexible as a structure and they have many fewer formal corporate formalities that are dictated by law. Instead, LLCs have an operating agreement and their governance is laid out in that operating agreement. It could be that there is very little governance, or it could be that there is lots of governance. It depends on how you lay out your operating agreement.

With LLCs, the tax structure generally is that it is pass-through taxation. So, income tax is only taxed once, but it's paid by the individual owners and not the business. The LLC generally is a more complicated tax structure. Unlike corporations, it's not cookie cutter and there are many different considerations that go in, so you often need more complicated tax advice both from your accountants and from your lawyers, and that means your upfront costs of creating it and getting the best structure are going to be higher.

I want to add that, we've talked about taxation, and double taxation sounds bad, it makes most people think that, of course an LLC would be a better choice, who wants to be taxed twice? It is actually more complicated than that, and your choice of entities depends on many factors. The fact is, corporations are generally easier and cheaper to form, easier to manage, easier to sell and have investors interested because that is what they want to invest in. It's easier to issue equity to employees from a corporation. Dealing with your personal taxes as an owner of an LLC is generally a lot more complicated than if you were simply an owner of shares in a corporation. There are a lot of considerations and tax is only one of them, and it's not even clear that just because one has double taxation and one has pass-through taxation, that an LLC is better. That also depends on what kind of business, whether you're going to distribute profits or reinvest

them, tax rates, which change over time—we had a big tax overhaul in 2018—where the owner lives because state taxes are higher in some places than in others. So, there are a lot of considerations, which leads us to the answer of which is better from a tax perspective? Lawyers' favorite answer: it depends.

Sahara Pynes: It depends, that's right. It always does. I know one of the biggest considerations for startups is always fundraising, so how does that factor into the decision to form a corporation vs. an LLC?

Tamar R. Gubins: This is what drives, frankly, most of my clients to become C-corporations. It depends on what type of business we're talking about. If we're talking about a small, local business with a single owner or two, who never expects to raise money—perhaps a local restaurant, or a salon type business. It might make sense to be an LLC, you'd have to talk about it with your accountant, but that might make more sense.

For my clients, they're all looking to raise outside money, usually from venture capital firms. Venture capital firms almost entirely want you to be a Delaware Corporation. That's what they're used to investing in. There are form documents, which make the paperwork easier on both sides. It's easier to give out equity to employees, like options, which is important for most of my clients. So that's what they want to see. As a result, if a company has formed in a different structure, like an LLC, they often will force them to convert into a corporation before they'll invest. So if you start off as an LLC, even if there are good reasons to do that, if you know that your investors are going to make you switch, it just makes more sense to start off in the form that you know you're going to have to become anyway.

Sahara Pynes: OK, so what's the deal with Delaware? Why is it always Delaware? I know from an employment perspective it doesn't really matter that your corporate formation documents are done under Delaware choice of law. The choice of law is going to depend on where your employees are located and where they're doing business. So, why is that so important, and why do VCs care about it?

Tamar R. Gubins: Well, Delaware is very pro-business and that's why a lot of businesses are incorporated there. They have very clear, detailed statutes about corporate law. They have a lot of case law, so there is a lot of settled business issues. They are also really responsive to business needs because they want all of these companies to be Delaware companies. You are correct, and this comes up a lot, that where employees are located is what matters for a lot of labor laws. But for many other things, the fact that you're a Delaware corporation, you could use Delaware law and that's a benefit, particularly if you're in a state that is not quite so pro-business or is not as easy to operate in.

Sahara Pynes: Hi, California.

Tamar R. Gubins: Exactly. California is definitely on the top of many people's minds. There are things you can't get around. You can get around all of California's laws just by being a Delaware corporation, but there are some things that make it easier. Recently, I had a Delaware company that was in the process of selling itself for \$80 million. For a variety of reasons, they needed to make a filing in a Rocky Mountain state before they could finalize the sale. In Delaware, the same filing would have taken no more than 24 hours and we would have been done. In this state, we couldn't make the filing online, we had to send it in hard copy, it would take then ten days to respond after they received the hard copy, and then after that, when there was a minor error, we had to start the whole process and timeline again. Nobody wants to be told they can't finalize an \$80 million deal for a month because there is a state that won't process a form very quickly.

Sahara Pynes: That's the truth.

Tamar R. Gubins: Delaware tends to be very pro-business that way.

Sahara Pynes: Wow, OK. And what about registering in other states? When do you need to think about filling out paperwork in a different state other than Delaware?

Tamar R. Gubins: This is one of those things where every state wants you to register because that means they get fees and some taxes.

Sahara Pynes: So that's like Secretary of State?

Tamar R. Gubins: What they want you to do is file as what they call a "foreign corporation" in their state. What that means is, you were registered originally in a different state, like Delaware, and so you are foreign to that state in which you are registering in. Now, when do you actually need to do it? We've got 50 states and most entrepreneurs don't want to spend their time and their money filling out forms and doing filing fees.

Sahara Pynes: Right, but especially now when everybody is working from home, I have clients coming and saying, "we basically have employees in all 50 states, what do we need to do here?" It's pretty crazy.

Tamar R. Gubins: That actually is a difficult one, and it's certainly a pandemic issue here. States would like it if you ever even thought about their state and your business in the same thought bubble in your mind, they would like you to file there because, like I said, they want those fees. We generally counsel our start up clients to register as a foreign corporation anywhere where they've got a physical presence, like their main offices, or a store, or a distribution facility, or

something like that. Also, we generally tell them to file where they have employees physically located. As you just brought up with the pandemic, that becomes pretty difficult. This is one area where I think people should work with their payroll providers because I think often their payroll providers will dictate what they have to do. Some will not put employees on the payroll through their service unless you have filed in that state.

Sahara Pynes: Yeah, we've been seeing a large uptick in that area, and people not even realizing sometimes that their employees are working from different states and then want to seek unemployment in that state, or want to collect state disability some reason, or some other state benefit that comes up. Of course, there is the taxation issue, which we're not going to touch with a ten foot pole today.

We talked a little about costs, and it all is seeming very daunting—so much paperwork, so much time, so much effort. What are some resources for entrepreneurs to help get this stuff set up? Is it, like, go to an online website and you register your corporation, or how can we help? And what other resources do we have for startups?

Tamar R. Gubins: Sure. Entrepreneurs can of course go file forms themselves and do these filings in the states. It is not so easy to figure out exactly what you need, and, as I said, some of these things really matter in the long run. There are also services that will essentially send you forms to fill out, and then file them for you. In my personal experience, I tend to spend more time fixing problems from those services once those companies come to me, so I'm not a big fan of most of them because I just don't think they provide enough hand holding or nuance for entrepreneurs to really understand what they're doing and get it set up directly.

Sahara Pynes: Well, it's like garbage in, garbage out, right? If you fill out the wrong stuff on the form, that's what these companies are inputting, which sometimes is the same with these payroll companies that we tend to see.

Tamar R. Gubins: That's exactly right. Fox Rothschild recognizes that this is a difficult process, it's time consuming, expenses can quickly add up, especially with most lawyers who charge hourly fees, so we've created a special startup package to help entrepreneurs launch businesses and we cap it at \$5,000. This package includes initial formation documents to get you started, state filings, your bylaws, which as we just discussed you will probably never read. We help you appoint your board and your officers. We make sure you issue equity to your owners correctly.

Sahara Pynes: So, this is all corporation, right? This is all if you're looking at setting up an S Corp.?

Tamar R. Gubins: If you're looking at setting up a C-corp or an S-corp, it would be the same. The S-corp is just a tax election, so it's unrelated to how you form a company. It's an accounting

issue more than a legal issue. We can frankly do this with LLCs, too, if that's the choice. As I said, my preference, generally, for the kinds of companies that are coming to me and to Fox is to set them up as a C-corp, but we can always talk about setting a company up as an LLC as well, if that's the right choice for the client.

Sahara Pynes: That's great. I know that with the LLCs there are a whole bunch of different questions and different ways that it can be done, so sometimes the one size fits all package may not be the right way to go with it, but it's great to know that at list our firm has options and they can get individualized attention where they are at. I get the do-it-yourself thing is not always the easiest approach.

Tamar R. Gubins: Absolutely. And I think for you, and your practice, you'll be glad to know that we also help with the early employee documents to make sure that any employees have signed documents where they keep your information confidential, that they assign intellectual property to the company—like if they designed your logo, helped formulate your product, or code your software. That's really essential to get right at the beginning because it can become something, often it's fixable but not always.

Sahara Pynes: I agree.

Tamar R. Gubins: So, if you have an employee who moved on, or the relationship went sour, and you then need to try to clean up an IP assignment after the fact, that can be very, very difficult. So, this is definitely one of those things that we want our clients to get right from the absolute start.

Sahara Pynes: Absolutely. So, once the entity is formed, and they've got that under control. What's next, other than operating their actual business?

Tamar R. Gubins: Right, that's the most important thing—go out and operate your business. I think one of the key things that people should work toward is that you actually have to operate your business as a business. Now that you've created this entity, this is not just you working out of your kitchen. This is now a real business, and while forming the business is the most important hurdle for getting that limited personal liability, there are situations where you might be held liable if it looks like there really isn't a separate entity. You formed it, but you're not treating it as if it is separate from you. So, the first thing people should do is go out and open a bank account in the name of the business, pay your bills from that bank account, and don't mix your personal funds and company funds. Other than that, anything you can do that shows that the business is separate from the owners is always a good thing. Things like having a separate office, or a separate business mailing address and phone, having a separate email address from your personal one, using company letterhead, following other corporate formalities like

recording board minutes. Things like that will make it very clear that you are a real entity that is separate from the owners.

Sahara Pynes: If you have two separate entities, how does having multiple entities factor in as well? I know sometimes there is trading of employees, or they use the same documents for multiple entities, and I feel like that could totally create a problem on the liability front.

Tamar R. Gubins: Absolutely it can. The liability in part is that you might not be able to shield one of those entities from liabilities of the other entities if effectively you've made it look like the same entity because they use the same bank account and the same employees, and things like that. In a situation like that, again, have different bank accounts for the different entities. If you are going to share employees, then maybe you need to have an intercompany agreement where you say why you're sharing and if one entity is going to pay for the services of the other entity. Things that make them look like true separate entities and not just something someone set up for liability purposes to shield one from the other.

Sahara Pynes: Yeah, I mean we could talk all day, and I think I'll have to have you come back and maybe talk about equity agreements and stock options and a whole host of other topics. But I thank you so much, Tamar, for joining me for our very first episode of Legally EmpowHERed. I'm so glad that we could share your insights into how startups could set their corporate structures up and provide the advice to get new businesses headed in the right direction.

Tamar R. Gubins: I'm so glad to be here talking to you about these issues. I know that we just spent a fair amount of time talking about in the weeds details that, perhaps, make many entrepreneurs' eyes roll to the back of their heads. But, at the end of the day, you get this done and then they can go out and build their business, which is really what they want to do, and we're here to help protect them as they do that.

Sahara Pynes: Thanks, Tamar.

Tamar R. Gubins: Thank you.