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Start-Up Corner

Choosing an Entity for Raising Venture Capital Funding in the United States

Jim Ryan*

In this column, the author discusses what start-up founders should consider when deciding on which type of business entity to form.

Start-up founders have a list a mile long of complex choices that will determine whether their new endeavor becomes a successful company. Hiring the right people, designing a memorable logo, perfecting the pitch, and fine-tuning the mission statement tend take the limelight, but one critical choice is selecting the optimal type of business organization for your new venture. While choosing the wrong entity is usually fixable, any distraction from building the business to create the next unicorn can reduce the already razor-thin margin for error.

At the highest level, when deciding on which type of business entity to form, founders should consider issues such as:

1. Legal liability for the business' obligations,
2. Tax treatment,
3. Equity incentivization of employees, and
4. Financing efficiency.

For most founders looking to build a traditional venture-style company, the decision usually comes down to picking either a corporation or a limited liability company (LLC). Aside from deciding the legal entity type, founders in the United States need to decide which state to incorporate in; the choices there typically boil down to either the state the founder is located in, Delaware, or one of Delaware's emerging competitors (as of this writing, Nevada and Texas are in the headlines for these purposes).

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LLCs

An LLC is a legal entity that provides its members, you guessed it, limited liability. Fundamentally, the owners or members of an LLC are generally not liable for the LLC's obligations. Aside from limited liability, this form is attractive to start-up founders primarily because of its flexibility and potential tax benefits.

LLCs have very flexible governance and economic structures, which make them attractive to founders looking to maximize control over their new venture. Later in the company's life, this can be flipped with investors seeking more extensive or creative rights than you might see in a corporation. An example of this flexibility is that fiduciary duties of officers and directors, one of the most fundamental principles in corporate governance, can be waived or essentially eliminated (at least in Delaware and some other common jurisdictions) in an LLC. Financial incentives can also be portioned between different membership types and even between individual members in ways that may be less practical in the case of a corporation.

Beyond the flexibility, LLC operating agreements (unlike the certificates/articles of incorporation for a corporation) are not a matter of public record. The lack of ready access by the public (or journalists) to the terms of an LLC's governance and economics could embolden both founders and investors to ask for rights that they might otherwise be hesitant to attach their names to.

As far as taxation, LLCs are similarly flexible. An LLC is by default a "pass-through" entity, meaning that profits and losses flow through as tax obligations to its members, much like a partnership. This aspect of an LLC structure is disfavored by venture capitalists (VCs) since investors are reluctant to invest in "pass-through" entities where they may be attributed periodic profits without being guaranteed distributions; VC funds are designed to profit from exits of their equity positions, not to deal with day-to-day operating profits and losses of portfolio companies.

Given the taxation and general structure of LLCs, establishing and properly maintaining equity incentives can be significantly more costly and error-prone than in the case of a corporation. Aside from adding transactional drag, the most typical equity awards that the start-up employee base is familiar with may not be available. While you might be able to approximate the economic outcome of an option or restricted stock unit through things like

profits interests, management will at a minimum have to explain the structure to each new grant recipient.

However, the ownership structure of an LLC can get tricky, especially if employees and other service providers find their way onto the cap table (as equity compensation is usually a key incentive to attract high-performing people to work at a start-up). Unlike with corporations, where optionees and stockholders are bound by the certificate of incorporation and bylaws by default, in order to be bound by an LLC's operating agreement, members or equity holders actually need to become parties to the operating agreement. Aside from the logistical complexities and costs, most founders are reluctant to show rank-and-file employees all of the rights, preferences, and privileges that founders and investors may have.

The flexibility of LLCs, and complexity of their equity incentives, can also complicate the terms available to investors. Aside from substance, parties will not be able to avail themselves of the most common industry forms of financing documentation, increasing transaction timelines and expense.

Corporations

On the other hand, corporations provide their owners with limited liability like you would have in an LLC, somewhat less structural flexibility than LLCs, and simpler tax and ownership-management features.

Perhaps most importantly, most VC firms require their portfolio companies to be set up as corporations. Merits aside, if a company's business plan is based around raising venture capital, a corporation is simply the path of least resistance. The seemingly most positive features of LLCs—flexibility and alternative taxation—are the biggest downsides from a VC's perspective.

Aside from fundraising considerations, corporations make incentivizing employees with equity relatively simple. Because most public companies that start-up employees are familiar with are corporations, they are already familiar with the different types of equity that a start-up may offer. The equity incentives available to corporations are, compared to the LLC equivalents, easier to understand and administer.

Flowing from the more straightforward equity compensation, it is also easier for parties to map out how the different economics

of those rights, the common stock held by founders, and preferred stock held by investors all interrelate. In addition, the prevalence of corporations among venture-backed companies means that there are fairly clear and consistent market standards around what terms investors might expect to receive in any given stage and type of deal.

As for taxation, corporations by default get "double taxed," meaning that the corporation itself gets taxed on income, and stockholders also pay taxes on any dividends. However, start-ups and emerging companies rarely pay dividends, and so stockholders generally do not incur tax liability until funds are distributed to them, which usually happens when there is an exit event (other than taxes associated with 83(b) elections and equity compensation). In sum, any concerns of being overtaxed by this "double taxation" feature are not particularly relevant for the average start-up. There are other tax considerations of the choice between LLC and corporation, such as those related to Qualified Small Business Stock, but those are beyond the scope of this column.

While there is not a one-size-fits-all answer, founders who want venture capital financing are likely to be best served by setting up a C-corporation in the state of Delaware.

So, You Mentioned Delaware. Why Delaware?

In addition to choosing which type of entity to form, founders must also pick a state to form/incorporate the company in. While founders are free to pick from any of the 50 states, an overwhelming majority of start-up companies (and public companies) choose to incorporate in Delaware. In fact, about 68.2 percent of Fortune 500 companies formed/incorporated in Delaware, and approximately 79 percent of all U.S. initial public offerings in 2022 were registered in Delaware.

So, why Delaware? One reason is that investors generally prefer Delaware because of its popularity and resulting familiarity among other investors, entrepreneurs, and lawyers alike. Investing in start-ups is a risky business, and unsurprisingly, investors like to reduce uncertainty and transaction friction. Because it provides a familiar playing field for everyone in the start-up space, Delaware has become the de facto state for formation/incorporation.

Another reason Delaware has gained popularity over time is due to its well-developed, familiar, and generally company-favorable

corporate laws. Due to the long-standing history of the Delaware General Corporation Law (the DGCL) and the abundance of precedent from Delaware's Court of Chancery, a special court in Delaware that decides corporate law issues, Delaware law can provide founders and investors stability and predictability in resolving disputes. As it happens, those laws and decisions have turned out to generally be company-/management-favorable, as opposed to stockholder-favorable, further contributing to its popularity.

Apart from familiarity among key players in the space and the state's company-favorable laws, practical considerations, such as simple filings and quick turnaround times, also make Delaware the preferred place to form for sophisticated parties, not to mention that, when structuring preferred equity financings, companies and VCs alike often leverage the NVCA (National Venture Capital Association) forms to help reduce transaction timelines and costs, which are modeled on Delaware corporations.

While Delaware has long held the title of most-popular jurisdiction of incorporation, other states make efforts from time to time to attract some of the market share (and associated franchise taxes). These states cannot claim to have the benefits of familiarity, long-standing and predictable courts, or smooth-running administrative function, and so the most common tactic to attract new companies is to appeal to a different set of stakeholders than Delaware. While Delaware tends to be company-/director- and officer-favorable, some states appeal to being more stockholder-friendly and others more officer-/founder-favorable.

Given the various stakeholders involved and the length of time that Delaware has been the most popular destination for companies of all sizes, any change to its popularity is likely to be slow to occur. For the time being, going back to the premise that start-ups are more likely to thrive when their legal aspects provide as little distraction as possible, it seems that Delaware will continue to take prominence in these discussions.

Note

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