JAY D. FULLMAN
A PROFESSIONAL CORPORATION
800 South Beach Boulevard, Suite A
La Habra, California 90631
Telephone (562) 694-6005 or (714) 255-2960
Facsimile (562) 697-7700
E-Mail: jdfullman@mminternet.com

GUIDE TO STARTING A CALIFORNIA CORPORATION

This guide describes certain basic considerations and costs involved in forming a California corporation. Although California law is emphasized, the legal concepts are much the same in other states. Importantly, when starting a company no single business decision should be made in isolation but should be made in the context of other actions. For example, an improperly priced sale of common stock to founders immediately followed by a sale of preferred stock can result in a significant tax liability to the founders. This guide is only an overview, particularly as to tax issues, and is not intended to be a substitute for a professional advisor's analysis and recommendations on individual fact situations involved in forming a corporation.

CONTENTS

A. Selecting the Form of Business Organization
1. Corporation
2. Sole Proprietorship
3. General Partnership
4. Limited Partnership
5. Limited Liability Company

B. "S" Corporation

C. Initial Capital Structure
1. Structure
2. Minimum Capital
3. Legal Consideration
4. Valuation
5. Use of Debt
6. Vesting and Rights of First Refusal

D. Sales of Securities
E. Choosing a Business Name
F. Selecting the Location for the Business
G. Qualifying to do Business in another State

A. Selecting the Form of Business Organization

No single factor is controlling in determining the form of business organization to select but if the business is expected to expand rapidly, a corporation will usually be the best alternative because of the availability of employee incentive stock plans, its ease of accommodating outside investment and greater long-term liquidity for shareholders. It also minimizes potential personal liability. The characteristics of a corporation are described below, followed by an overview of other traditional forms of business organizations. Each of the following factors is described for comparison purposes: statutory formalities of creation, tax consequences, extent of personal liability of owners, ease of additional investment, liquidity, control and legal costs.

1. **Corporation**. A corporation is created in California by filing articles of incorporation with the Secretary of State. Its status is maintained by compliance with statutory formalities. A corporation is owned by its shareholders, governed by its Board of Directors who are elected by the shareholders and managed by its officers who are elected by the Board. A shareholder's involvement in managing a corporation is usually limited to extraordinary matters. Use of the corporate form of business does not require a large number of people. In California, a corporation may have only one shareholder and one director. All three required officer positions, president, chief financial officer and secretary may be filled by one person.

When a California corporation has two shareholders, there must be at least two Board members. When there are three or more shareholders, there must be at least three persons on the Board. Since the Board is the governing body of the corporation, when there are three shareholders, a party owning the majority of the shares can still be outvoted on the Board on such important matters such as sales of additional stock and the election of officers. Removing a director involves certain risks even when a founder has the votes to do so. Thus, a founder's careful selection of an initial Board is essential.

A corporation is a separate entity for tax purposes. Income taxed at the corporate level is taxed again at the shareholder level if any distribution is made in the form of a dividend. The S Corporation election described below limits taxation to the shareholder level but subjects all earnings to taxation whether or not distributed. The current maximum federal corporate tax rate is 35%. The California corporate tax rate is 9.3%.

If the business fails, the losses of the initial investment of up to $1 million (at purchase price value) of common and preferred stock (so-called "Section 1244 stock") may be used under certain circumstances by shareholders to offset a corresponding amount of ordinary income in their federal income tax returns. (An individual may deduct, as an ordinary loss, a loss on Section 1244 stock of up to $50,000 in any one year ($100,000 on a joint return)).

If statutory formalities are followed, individual shareholders have personal liability only to the extent of their investment, i.e., what they paid for their shares. If the corporation is not properly organized and maintained, a court may "pierce the corporate veil" and impose liability on the shareholders. The California Corporations Code permits corporations to limit the liability of their directors to shareholders under certain circumstances. Additional investment is implemented by the sale and issuance of more shares of stock, usually preferred stock when a venture capitalist is investing. Filing fees, other costs and legal fees through the initial organizational stage usually total about $1,500, not including the annual minimum tax.

2. **Sole Proprietorship**. The oldest and simplest form of business is the "sole proprietorship," when an individual operates a business on his own. The individual and the business are identical. No statutory filings are required if the sole proprietor uses his own name. If a different business name is used, a "fictitious business name" statement identifying the proprietor must be filed with the county clerk of the county where the principal place of business is located and published in the local legal newspaper. A sole proprietor has unlimited personal liability to creditors of his business and business income is taxed as his income. Because of the nature of this form of business, borrowing is the usual method of raising capital. The legal cost of forming a sole proprietorship is minimal.

3. **General Partnership**. When two or more individuals or entities operate a business together and share the profits, the enterprise is a "partnership." Partnerships are either general partnerships or limited partnerships (described below). Although partners should have written partnership agreements which define each party's rights and obligations, the law considers a venture of this type as a partnership whether or not there is a written agreement. No governmental filings are required. A California partnership not documented by a written agreement is governed entirely by the California Uniform Partnership Act.

In the absence of an agreement to the contrary, each partner has an equal voting position in the management and control of the business. Each partner generally has unlimited liability for the debts of the partnership and is legally responsible for other partners' acts on behalf of the business, whether or not a partner knows about such acts.

The partnership is a conduit for tax purposes: profits (even if not distributed) and losses flow through to the partners as specified in the partnership agreement. There is no federal tax at the entity level. Some partnerships contemplate raising additional capital, but accommodating future investment is not as easy as in a corporation. The legal cost of establishing a partnership is minimal if no formal written agreement is prepared. The cost of preparing such an agreement begins at about $900 and depends on the number of partners, sophistication of the deal and other factors.

4. **Limited Partnership**. This is a partnership consisting of one or more general partners and one or more limited partners which is established in accordance with the California Revised Uniform Limited Partnership Act. Like the corporation, this entity has no legal existence until such filing occurs. The limited partnership is useful when investors contribute money or property to the partnership but are not actively involved in its business. The parties who actively run the business are the "general partners," and the

passive investors are the "limited partners." So long as the limited partnership is established and maintained according to law, and a limited partner does not take part in the management of the business, a limited partner is liable only to the extent of his investment. Like a general partnership, however, the general partners are personally responsible for partnership obligations and for each other's acts on behalf of the partnership.

For tax purposes, both general partners and limited partners are generally treated alike. Income, gains and losses of the partnership "flow through" to them and affect their individual income taxes. A properly drafted limited partnership agreement apportions profits, losses and other tax benefits as the parties desire among the general partners and the limited partners, or even among various subclasses of partners. The costs associated with forming a limited partnership are usually comparable to, or exceed, that of forming a corporation.

5. **Limited Liability Company**. This form of business organization is now available in about 45 states including California. It is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions identified below. The limited liability company can be used for closely-held businesses but not for companies that want to be publicly traded. The formation costs are usually the same, or higher, than costs for formation and organization of a corporation. Limited liability companies cannot be used for construction contractors or other business that must be licensed under the Business and Professions Code.

B. “S” Corporation

A California corporation may be an “S” corporation and not subject to federal corporate tax if its shareholders unanimously elect S status for the corporation on a timely basis. An “S” corporation is a tax law label; it is not a special type of corporation under California corporate law. Like a partnership, an “S” corporation is merely a conduit for profits and losses. Income is passed through to the shareholders and is generally taxed only once. Losses are also passed through to offset each shareholder's income to the extent of his basis in his stock.

A corporation must meet certain conditions in order to be an “S” corporation, including the following: (1) it must be a U.S. corporation, (2) it must have no more than 35 shareholders, (3) each shareholder must be an individual, estate, or a specified type of trust, (4) no shareholder may be a nonresident alien, (5) it may not have any 80% or more owned subsidiaries, and (6) it can have only one class of stock outstanding.

California now recognizes the “S” corporation for state tax purposes, which can result in additional tax savings. Because of the one class of stock limitation, however, a corporation contemplating a venture capital financing in which preferred stock will be sold close to the time of founding usually should not elect to be an “S” corporation. Under the 1993 tax law, the 50% exclusion from gain for certain small business stock does not apply to shares held in an “S” corporation. Another disadvantage of S status is that undistributed earnings retained as working capital are taxed to a shareholder.

C. Initial Capital Structure

1. **Structure**. The capital structure should be kept as simple as possible and appear "normal" to a potential outside investor for credibility purposes. After initial sales of corporate shares to founders, shares can be sold to outside investors. Thus, a founder should purchase all of the units of stock he desires at the time of founding. A founder will generally lose control over further issuances and stock splits, particularly once a venture capital financing occurs. In addition, the purchase price will usually increase.

2. **Minimum Capital**. The California Corporations Code does not require a minimum amount of money to be invested in a corporation at the time of founding. The initial amount of capital, however, must be adequate to accomplish the purpose of the startup business in order for shareholders not to have personal liability. For example, a corporation which will serve only as a sales representative for products or a consulting operation requires less capital than a distributor or dealer who will stock an inventory of products. A dealership or distributorship will require less capital than a manufacturing operation.

3. **Legal Consideration**. A California corporation must sell its shares for legal consideration, i.e., cash, property, past services or promissory notes under some circumstances. A founder who transfers technology or other property (but not services) to a corporation in exchange for stock does not recognize income at the time of the transfer (as a sale of such property) under Section 35l of the Internal Revenue Code if all of the parties acquiring shares at the same time for property (as opposed to services) own at least 80% of the shares of the corporation after the transfer. Because of this limitation, Section 351 is generally available at the time of founding but not later. A party who exchanges past services for stock must recognize income in the amount of the value of the stock in the tax year in which the stock is received.

4. **Valuation**. The per share value at the time of founding is determined by the cash purchases of stock and the number of units issued. For example, if one founder buys stock in exchange for technology and the other founder buys a 50% interest for cash, the value of the technology and the fair market value per share is dictated by the cash purchase since its monetary value is certain. Thereafter, value is determined by sales between a willing seller and buyer or by the Board of Directors based on events and financial condition. Value must be established by the Board at the time of each sale of stock or grant of a stock option. Successful events cause value to increase. Such determinations are subjective and there is no single methodology for determining current fair market value. Sales of the same class of stock made at or about the same time must be at the same price or the party purchasing at the lower price will likely have to recognize income on the difference.

5. **Use of Debt.** Loans may also be used to fund a corporation. For example, if a consulting business is initially capitalized with $20,000, half of it could be a loan and the remaining $10,000 used to purchase common stock. Using debt enables the corporation to deduct the interest payments on the debt, makes the repayment of the investment tax-free and gives creditor status to the holder of the debt. If a corporation is too heavily capitalized with shareholder's loans, as opposed to equity (usually up to a 3-1 debt/equity ratio), however, these loans may be treated as additional equity for tax and other purposes. Debts owed to shareholders may be treated as contributions to capital or a second class of shares and subordinated to debts of other creditors. Eligibility for S corporation status is lost if a loan is characterized as a second class of shares.

6. **Vesting and Rights of First Refusal**. Shares sold to founders are usually subject to vesting and rights of first refusal in order to keep founders on the corporate team and to maintain control over ownership of the corporation. Such safeguards are essential to securing a venture capital investment. By designing and implementing a vesting scheme themselves, a founders group may forestall an investor from doing so on the investor's terms.

A right of first refusal is the corporation's option to repurchase shares when a third party makes an offer to purchase shares. This type of restriction can be used by itself or as a backup to the repurchase option to maintain control over stock ownership once vesting occurs. The corporation may repurchase the shares on the same terms as the offer by the third party. Rights of first refusal are implemented by stock purchase agreements, including under stock option plans, or in the corporation's bylaws.

D. Sales of Securities

In most instances, the sale of an interest in a business constitutes the issuance of a "security." Complex and restrictive federal and state laws govern offers and sales of securities. The general rule under these laws is that full disclosure must be made to a prospective investor and that registration or qualification of the transaction with appropriate governmental authorities must occur prior to an offer or sale. At a minimum, the investor will be able to get his money back if these rules are not followed.

Offers and sales of stock in a corporation, certain promissory notes and loans, certain partnership interests and other securities are subject to the requirements of the Securities Act of 1933, a federal law, and of state securities laws, so-called "Blue Sky" laws. The Corporate Securities Law of 1968 governs in California. An offer or sale of securities by a California business to a purchaser in another state requires compliance with that state's law as well. Exemptions from the registration and qualification requirements are usually available for offers and sales to founders, venture capitalists and foreign parties but offers and sales to other potential investors, even employees, are not legally possible without time consuming and expensive compliance with such laws.

Even when an exemption is available for the sale, full disclosure must be made of facts material to a prospective investor in deciding whether to invest. There are severe civil and criminal penalties for material false statements and omissions made by a business or its promoters in offering or selling securities.

The stock purchased in a sale exempt from federal registration and state qualification requirements may not be freely transferable. In addition to contractual restrictions, resales must satisfy federal and state law requirements. Shareholder liquidity occurs through Securities and Exchange Commission ("SEC") Rules 144 or 504, an initial public offering ("IPO"), other public offerings or other exempt sales.

E. Choosing a Business Name

The name selected must not deceive or mislead the public or already be in use or reserved. Neither "Inc.," "Corp." nor "Corporation" need be a part of the name in California. Name availability must be determined on a state-by-state basis and in California is determined with the Secretary of State. Several alternative names should be selected because so many businesses have already been formed. An available name may be reserved with the California Secretary of State for 60 days for $10. Once the Articles of Incorporation have been filed, the Corporation has the presumptive right to use that name in the State of incorporation, and can usually prevent other businesses from using the same name.

F. Selecting the Location for the Business

This decision is driven by state tax considerations and operational need, for example, to be near customers or suppliers or in the center of a service territory. A privately held corporation cannot avoid California taxes or the application of California corporate law if it is operating here and has most of its shareholders here. For example, Delaware law allows Board members to be elected for multiple year terms and on a staggered basis rather than on an annual basis. A privately held corporation, however, cannot gain the benefits of these Delaware laws or any other state's corporate law if it is actually operating in California and more than 50% of its shareholders are here.

G. Qualifying to do Business in Another State

A corporation may need to open a formal or informal office in another state at or near the time of founding. This requires a "mini" incorporation process in each such state, and the consequences of failing to do so range from fines to not being able to enforce contracts entered in that state. The cost of qualifying is approximately $1000 per state.