MEDICAL FUNDING
PROFESSIONALS

What is the Best Corporate Structure for Attracting Investors Such as Venture Capital, Angel Investors, High Net-Worth Individuals or Reg A+ Funding?

Selecting the best corporate structure for attracting investors is a very important factor to consider when launching a startup, particularly those in capital-intensive sectors such as BioTech, MedTech, Life Sciences, Pharma, and similar. When firms in sectors such as these need outside capital to scale, reach new markets and customers, or develop and commercialize industry-disrupting new products or technologies, having a corporate structure that is unattractive to investors can create unnecessary headaches or even drive potential investors away from investing in your company.

The basic choices for establishing a new business entity include sole proprietorship, partnership, limited liability corporation (LLC) or corporation (C corporation or Subchapter S corporation). According to the U.S. Small Business Administration, about ¾ of all U.S. small businesses are single-owner sole proprietorships with no employees. The rest are a mix of partnerships, LLCs, C-Corporations or S-Corporations. There are pros and cons of each, particularly if you have future plans to seek outside investment.

For fast-growing firms in capital heavy industries such as BioTech, MedTech, Life Sciences and Pharma—all sectors that generally require a great deal of funding for activities such as new product development, commercialization, scale-up, growth, increasing market share, running clinical trials, and similar—having the best corporate structure for attracting investors is essential.

Most firms raise investment capital through Venture Capital (VCs), Angel Investors (Angels), High-Net-Worth Individuals (HNWIs), Private Equity, Friends and Family Rounds, or some combination of these.

However, a growing number of savvy founders of fast-growing firms in capital-intensive sectors are also using a relatively new fundraising mechanism—Reg A+ funding, which allows firms to raise up to $75 million per year, faster and with fewer regulatory compliance headaches than most other traditional forms of private investment.

Among all fundraising strategies above, Reg A+ funding is considered the "new kid on the block," because it was only in about 2015 that the Securities and Exchange Commission (SEC) began changes that ultimately resulted in it being a great mechanism for raising up to $75 million per year.

Whether you are startup founder and plan to raise money from investors at some point, or are the leader of a growing firm in a capital-intensive sector such as BioTech, MedTech, Life Sciences or Pharma, having a business structure that appeals to investors is critical to launching and executing a successful funding round.

Following is a list of the various different types of business structures, some of the pros and cons of each and how suitable each is for raising outside investment capital from sources such as VCs, Angels, Private Equity, other types of private investors or newer funding mechanisms such as Reg A+.

Sole Proprietorship

The overwhelming majority of people planning a one-person business choose a sole proprietorship as the structure of their business entity. In fact, the most recent SBA data shows that about 75% of all small businesses in the U.S. are sole proprietorships with no employees.

Pros

- In nearly all states, this is this simplest, and usually, least costly, business structure to set up.
- Sole proprietorships can be a good choice for low-risk businesses, those that do not plan to hire employees or have no intentions to seek outside investment capital.
- In some states—such as Texas and some others—sole proprietorships are not subject to franchise tax or obligated to file franchise taxes.

Cons

- With a sole proprietorship your business is you, meaning there is no legal distinction between you and the business. As such, a sole proprietorship offers no liability protection against damages assessed against your business. As the owner of the sole proprietorship, you—and often your spouse, your home, your car and other personal possessions may be seized to satisfy the debt.
- Because there is no separation between the business and the individual, banks and other lenders are also generally reluctant to provide funding for a sole proprietorship.

Attractiveness to investors

Sole proprietorships cannot sell stock, meaning that investors such as VCs, Angels, HNWIs, or other private equity sources will **not** invest in a sole proprietorship. Likewise, a sole proprietorship is not eligible to raise funds under the Reg A+ funding mechanism.

Partnership

When two or more people want to own a business together, a partnership is usually the simplest way to structure the business. Most partnerships are established as either a limited partnership (LP) or a limited liability partnership (LLP). Under an LP structure, there is only one general partner with unlimited liability, while all others only have limited liability. The partner with unlimited liability is most often the one with the most control of the business and how it operates. Unlike a limited partnership, an LLP offers all partners have limited liability from debts against the partnership and they won't be responsible for the actions of other partners.

Pros

- Partnerships are generally easy to form.
- Because there is more than one owner, the business generally has access to a broader range of skills and experience.
- Expenses are typically spread across all partners.

Cons

- With more people involved as owners of the business, there is a greater potential for conflict.
- Making important decisions about the business can often be slow and cumbersome because there are more people involved.
- Some states do not recognize limited liability partnerships.
- Without a proper contract reviewed by a legal expert, in some cases with an LLP, individual partners may not be obligated to consult with other participants in making certain business agreements.

Attractiveness to investors

Neither a limited partnership nor a limited liability partnership is an appropriate business structure for bringing in outside investment. Like a sole proprietorship, partnerships cannot sell stock, meaning that investors such as VCs, Angels, HNWIs, or other private equity sources do invest in them. This also makes them not suitable for Reg A + funding either.

Limited Liability Company (LLC)

An LLC is a hybrid corporate structure that combines the pass-through tax benefits of a partnership with the "limited liability" of a corporation. The financial gains and losses generated through LLCs pass directly through to the owners' personal income tax return, thus avoiding double-taxation. An LLC can be established as a single-member LLC or it can have multiple members. Some of the other pros and cons of LLCs are below.

Pros

- In some states, members are provided some degree of financial and tax liability.
- The number of members/investors an LLC can have is unlimited.
- By default, for taxation purposes, a multi-member LLC is treated as a pass-through entity, but it has the option to be taxed as a corporation at any time.
- LLC members can choose to invest either capital or other assets into the company. Ownership can also be allocated on the basis of "sweat equity".
- Unlike a corporation, an LLC is not required to have regular meetings of a Board of Directors and keep minutes of those meetings.

Cons

- The pro-rata share of any profits is considered taxable income for all members, even if the members do not receive any cash distribution from the company. This can create unwanted tax liabilities for members, with no offsetting inflow.
- While in some cases, members of an LLC are provided a degree of financial and tax liability, there are many cases in which they are not. The rules also vary significantly from state to state.

- If an LLC is taxed as a pass-through entity, members of an LLC are not allowed to pay themselves wages/salary (as in a partnership). There is a mechanism for "guaranteed payments" for members who actively work in the business, but they are not considered employees, and those payments are treated as regular/contract income. Furthermore, those arrangements are defined in the operating agreement, and if not done transparently and with consensus of the members, may create disharmony among owners as to why some members are receiving disproportionate compensation.
- Passive investors may face taxation in other states.
- Most importantly, the rules regarding LLCs vary significantly from state to state. As such, precedents from one state may not apply in others. The IRS code doesn't even specifically address multi-member LLCs—they're just either treated as a partnership or a corporation for tax purposes. Bottom line: lots of legal unknowns vs. the well-established precedents of corporations, particularly Delaware corps.

Attractiveness to investors

An LLC—whether it is single- or multi-member—is not an ideal corporate structure for securing outside private investment through traditional sources (e.g., VCs, Angels) through Reg A+ Funding. For example, if the LLC is set-up as a pass-through entity for taxation purposes, investors may not be willing to take on the added burden of filing their share of the tax liability of the LLC. Additionally, most VCs won't or can't invest in an LLC structured as a pass-through entity because the VC fund may have tax-exempt partners that cannot receive active trade or business income because they are tax-exempt. Also, if the LLC has active trade or does business in other states, passive investors may be subject to income tax in those other states.

Other reasons LLCs are not ideal for securing outside investors include:

- Not suitable for securing funding under SEC Regulations D or Regulation S, or Founders Rounds.
- Convertible notes should convert to stock not units.

Corporations

Corporations are another option for founders to structure their startups. Corporations can be either S- or C-corporations. Neither requires more than one owner and offers liability protection. For taxation purposes, corporations are generally viewed as entities separate from the owners. The manner in which taxes are handled is one of the biggest differences between the two corporate structures. Some of the pros and cons of each follow.

S-corporation

Pros

- Profits and losses can pass through to your personal tax return, therefore avoiding the double taxation of C corporations.
- Offers a reasonable degree of liability protection.
- An S-corporation can be a good choice for an early-stage company that plans to convert to a C-corporation within 24 months of launch, but the founders want to take advantage of the initial tax loss benefits of the S-Corp.

Cons

- Lacks flexibility in that the number and type of persons who can own equity in the company are restricted. There can be no more than 100 stockholders and all of them must be (i) US citizens or residents, (ii) estates, (iii) eligible trusts, or (iv) certain tax-exempt entities.
- Only can issue one type of stock (common).
- Generally, S-Corps must be owned by individuals, trusts or estates. Should a C-corporation, LLC or partnership purchase a Sub-S, then the S-Corp treatment stops.

Attractiveness to investors

S-corporations are not an attractive option for VCs, Angels, HNWIs or other types of private investors, because: a) these types of investors either want to receive preferred stock for their investment; or b) the pass-through tax advantages offered by the S corporation, can create a problem for investors in that must often pay federal income tax on the taxable income of the S Corporation's business based on their pro-rated stock ownership.

C-corporation

Pros

- Offers a high degree of flexibility in regard to who can be a stockholder and in structuring the rights of various stockholders, including with respect to valuation, preferences and protections.
- You do not have to be a resident of Delaware to incorporate there.
- Can offer multiple types of stock (e.g., preferred, common)
- Can adopt a stock option plan. This allows the corporation to issue equity as incentive compensation to employees, directors and others.
- You can have a slimmed down corporate structure.
- Almost any business can be converted to a C-corporation at any time.

Cons

- Subject to double taxation in that the corporation pays taxes and then the shareholders pay taxes when the corporation makes distributions.

Attractiveness to investors

Of the three corporate structures, a Delaware-based C-corporation is the most appealing to investors. VCs, Angel Investors, and other private investors, including people who invest in a Reg A+ campaign, expect to see a Delaware-based C-corporation. And, if a company plans to go public and do an Initial Public Offering (IPO), a C-corporation is the only way to go. Many other states are less corporate friendly than Delaware. Some of the reasons for this include:

- In some states, an owner with as little as 1 percent of the company is entitled to audit your corporate books.
- Not all states offer the same degree of liability against damages against C-corporations that Delaware does. In fact, some states push the liability back onto the officers.
- Delaware has more than 120 years of business corporate law and even has a special chancery court run by judges.

Summary

If you are a startup founder and plan to seek investment funds at some point in the future, a Delaware-based C-Corporation is the best corporate structure to attract investors such as VCs, Angels, HNWIs and/or other traditional private investment sources. Or if you are the leader of a fast-growing firm in a capital-intensive sector such as BioTech, MedTech, Life Sciences, Pharma, and similar, and want to raise up to $75 million per year through Reg A+ funding, then the Delaware C-corporation is the best way to go.

An S-corporation can be ideal for an early-stage company that plans to convert to a C-corporation within 24 months of launch, but the founders want to take advantage of the initial tax losses.

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