SETTING UP IN THE USA: PRESENTATION TO 4THLY ACCELERATOR 2020 COHORT

Louis Lehot

May 29, 2020

L2 COUNSEL, P.C.
strategies & solutions

Louis Lehot

Partner

L2 Counsel, P.C.

Voice: (650) 796-7280

louis.lehot@l2counsel.com

SETTING UP IN THE US

SETTING UP IN THE US

- **What are my choices?**
  - Go direct
  - Branch
  - Subsidiary
  - “Flip” – creating US Holding Company

SETTING UP IN THE US: FUNDRAISING

- **Fundraising: Accessing US Venture Capital**
  - Will US VC invest directly in foreign company?
  - Are you ready for VC financing?
  - VC financings

SETTING UP IN THE US: SUBSIDIARY

- **Objective:** Established foreign company ("TechCo") needs US subsidiary for local presence and contracting, hiring, benefits, limited liability, IP/tax structuring
- **Key Steps:**
  - Delaware corporation
  - One Shareholder
  - One Director (or more)
  - Officers: President, Chief Financial Officer, Secretary
  - Common Stock (ordinary share equivalent)
  - Timing: as fast as 1 day
  - "Qualify" in California or other States where operate
  - Consider operations and need for intercompany IP agreement
  - Consider tax optimization and intercompany services agreement and transfer pricing

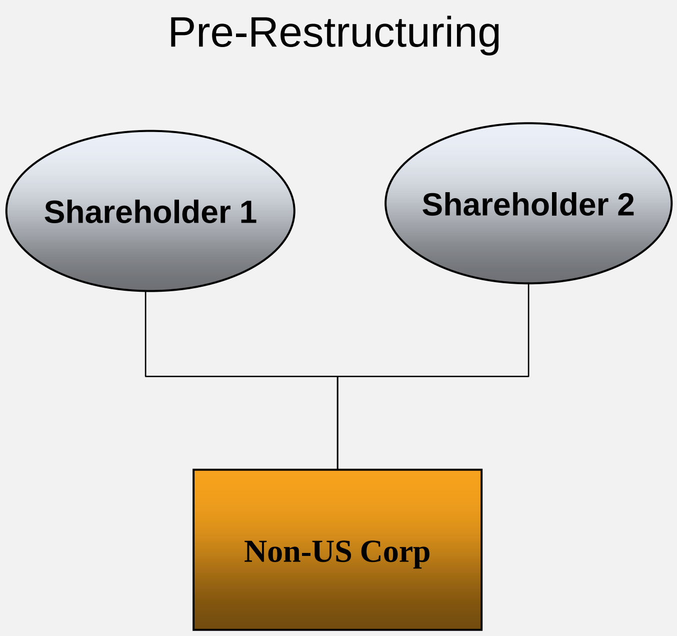
“FLIPS” – SETTING UP A NEW US PARENT

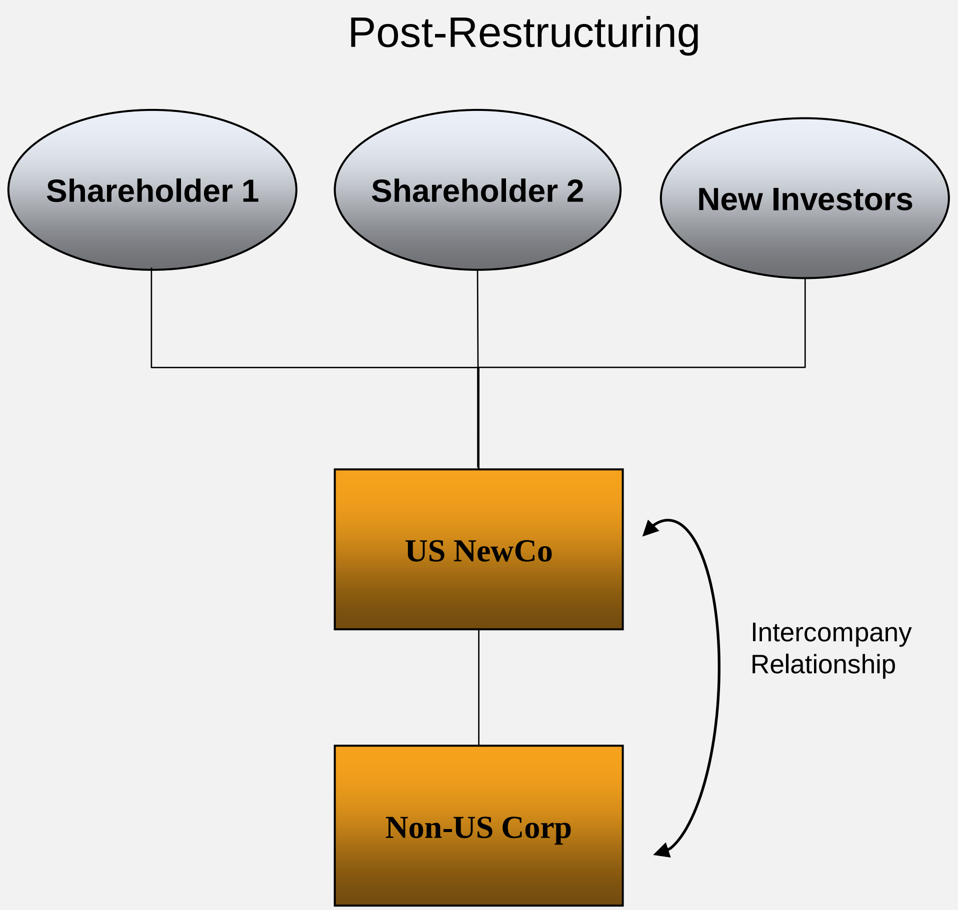
- **Objective:** TechCo needs access to US venture capital and focus operations in US
- **Process:** “Flip” the business from abroad to the U.S. by inserting a new US “Parent” company above TechCo
- **Key Steps:**
  - Incorporate a new Delaware company (“US Newco”)
  - Existing shareholders of TechCo contribute their TechCo shares to Newco in exchange for US Newco shares
  - NewCo seeks US venture financing – using $ to fund operations in the US and for TechCo
  - Business conducted in US by US Newco; certain foreign activities continue through TechCo or other subsidiaries, as needed
  - CEO and sales staff typically US based
  - R&D; technical, development and support staff abroad

"FLIPS" – SETTING UP A NEW US PARENT, *CONTINUED*

- **"Flips"** to US seen from: Western Europe, Israel, Australia, Canada
  - Tax issues/valuation of TechCo – tax rollover/deferral
  - Tax considerations going forward
  - IP – Keep IP in TechCo or migrate to US
  - US Newco management and capital structure
  - Consents/approvals of TechCo and viability of flip
  - Compel exchange of TechCo shares for US Newco shares?
  - Effect flip sooner rather than later, prior to creation of significant 'value' in TechCo
  - Required legal and accounting team in place for transaction
  - Time/expenses to effect flip

"FLIPS" – SETTING UP A NEW US PARENT, *CONTINUED*

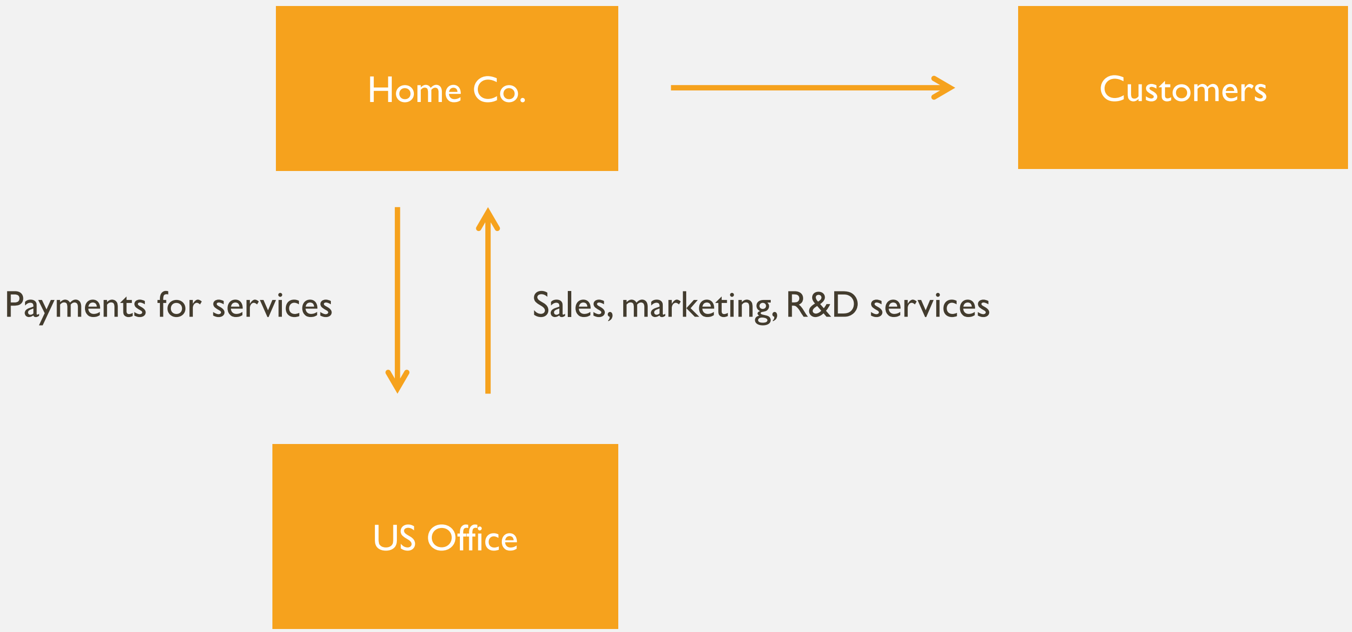




INTERGROUP AGREEMENTS

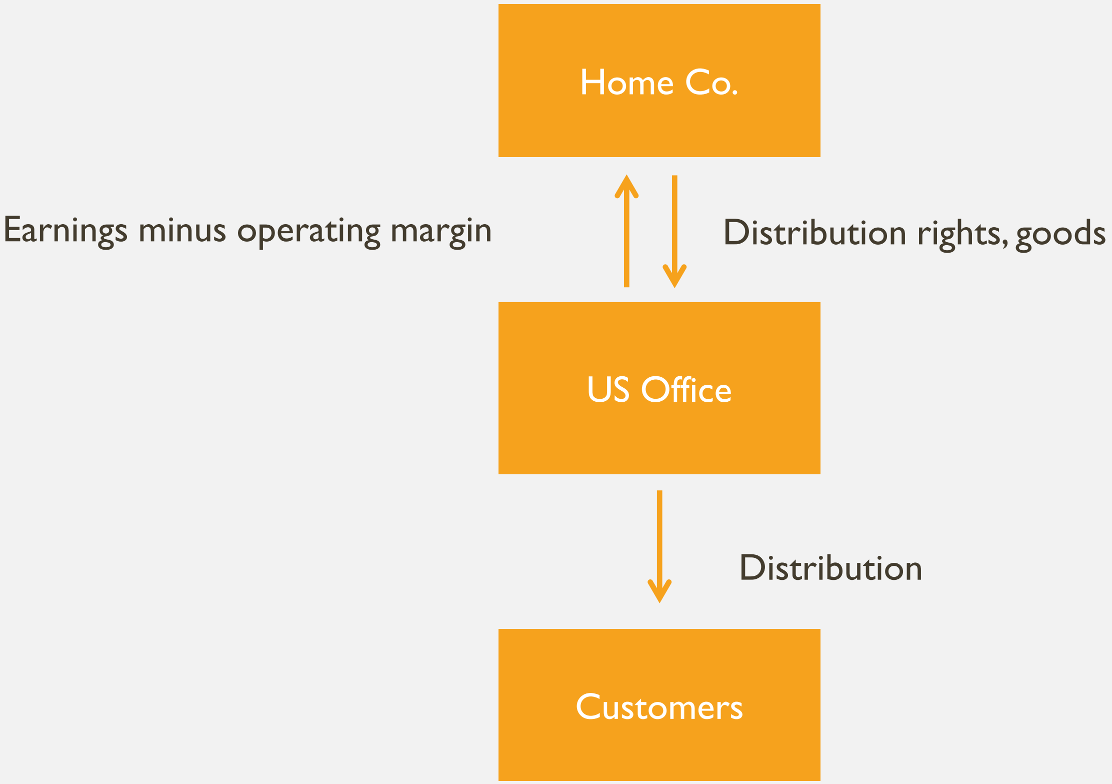
INTERCOMPANY AGREEMENT – FIVE COMPENSATION METHODS

- Option 1: US is a service provider
  - US office provides sales and marketing services and/or R&D services and earns a cost plus return
  - home country parent bills customers and retains other activities



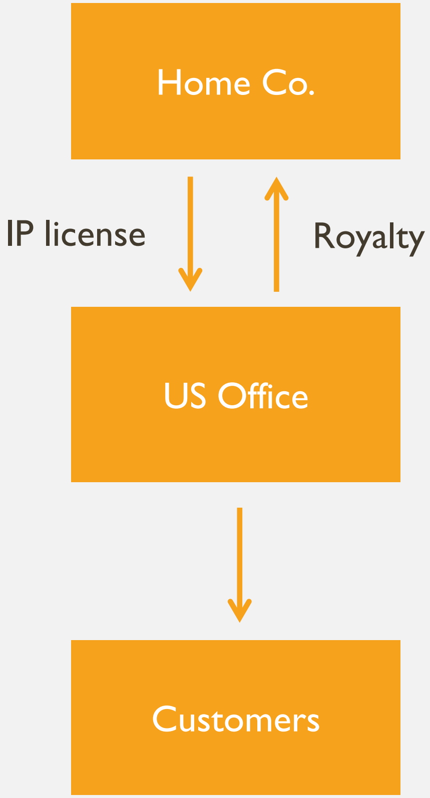
INTERCOMPANY AGREEMENT – FIVE COMPENSATION METHODS

- Option 2: US is a distributor
  - US office can be compensated as a distributor earning a targeted operating margin
  - US office with the US office billing customers



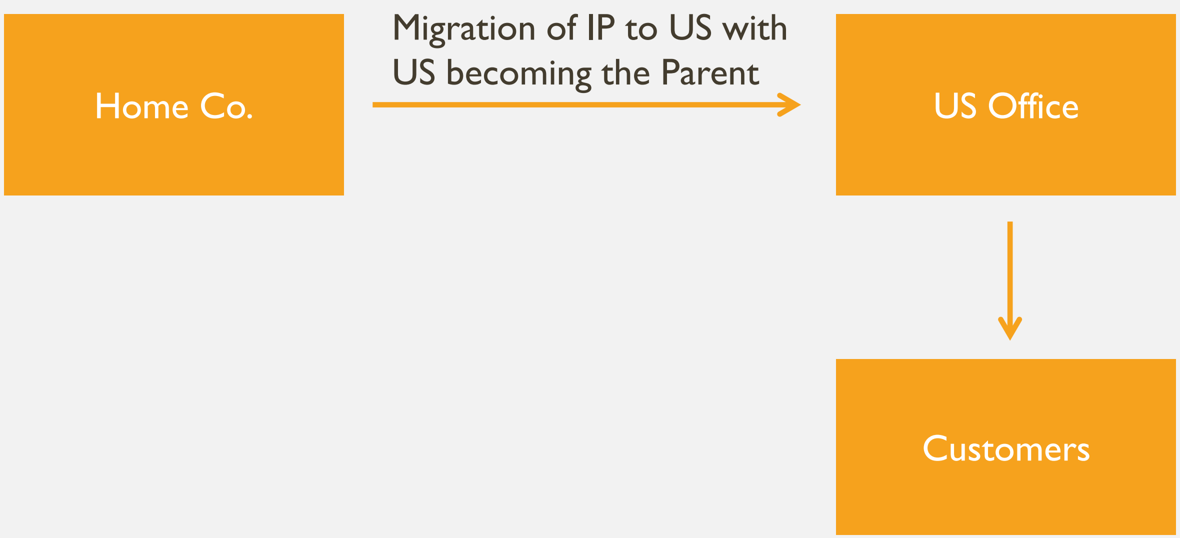
INTERCOMPANY AGREEMENT – FIVE COMPENSATION METHODS

- Option 3: US licenses IP from home country parent
  - US is an entrepreneur licensing IP from home country parent and paying a royalty to the home country parent
  - US office engaging in high end activities and billing customers



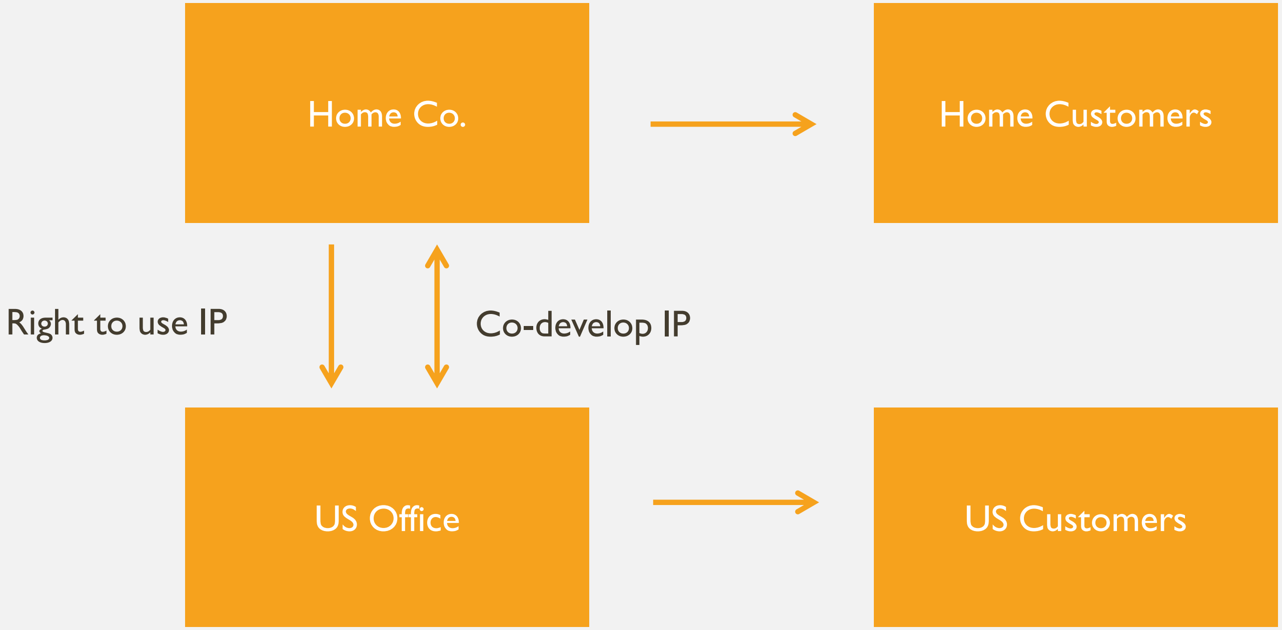
INTERCOMPANY AGREEMENT – FIVE COMPENSATION METHODS

- Option 4: US buys IP from home country parent
  - Migration of IP to US with US becoming the parent and the residual profit claimant



INTERCOMPANY AGREEMENT – FIVE COMPENSATION METHODS

- Option 5: US and home country parent cost share IP development with each retaining the rights specific to their territory
  - US pays for the rights to use the IP in its territory and then co-develops the IP with the home country parent



U.S. STARTUP FORMATION BASICS

U.S. STARTUP FORMATION BASICS: TYPE OF ENTITY

- C corporation vs. S corporation or LLC
  - Primary Distinction for Domestic Investors
    - Double taxation v. single layer of tax
      - C Corporations are subject to "double taxation" — tax on both (a) profits of US subsidiary and (b) distributions to home country parent
      - "Pass-through entities" (LLC, Branch Office) are not themselves subject to US income tax; all profits and losses are passed through to parent
    - This distinction is less relevant for non-US investors as they are not afforded the benefit of a single layer of tax
- We typically recommend using a <u>C Corporation</u> for the following reasons:
  - Limited liability for parent company for acts of US office
  - Protects the parent's books and records from investigation by US tax authorities or US litigants
  - More certainty as to revenue and expenses attributable to US
  - Incentive stock options are easier to administer through a C Corporation

U.S. STARTUP FORMATION BASICS: LOCATION OF ENTITY

- We recommend incorporating in Delaware:
  - broader ability in Delaware to limit monetary liability of directors for breaches of the duty of care;
  - broader ability in Delaware to indemnify officers and directors;
  - greater flexibility in Delaware to adopt measures to protect against hostile takeovers; and
  - general reputation of Delaware law as more favorable to management, combined with the greater predictability of Delaware case law.
  - Section 2115 of the California Corporations Code applies to Delaware corporations which have significant operations in the State of California and more than 50% of their outstanding voting securities held by California residents.

In most cases, Delaware is the best place to incorporate a new company

U.S. STARTUP FORMATION BASICS - EMPLOYMENT

- A foreign entity can engage employees to do business in the U.S. U.S. employers are required to obtain a federal EIN, pay applicable payroll taxes and withhold certain tax contributions from its employees. Employers may be required to register employees with the specific state in which they are employed (varies from state to state).
- Employment contracts are not required and if used do not require specific terms. In most states, absent an agreement to be employed for a fixed period of time, the relationship is for an indefinite term and deemed 'at will' (i.e. either party may terminate the employment relationship at any time, with or without cause, and with or without notice).
- Independent contractors must be truly independent and not be closely directed by the principal. There are multiple factors utilized (on both the federal and state level) to determine whether an individual is properly classified as an independent contractor.

Working under the close directions of an entity creates a presumption of at will employment for an indefinite period unless otherwise agreed upon and stated.

VENTURE CAPITAL FINANCING

VENTURE CAPITAL FINANCING

- Convertible Debt vs. Equity – the “Form” of the security
- Convertible Debt:
  - now a stand alone financing (typically up to $1.5M)
  - investment converts into next equity round on same terms at a discount
  - faster
  - often no diligence (or limited)
  - investors are individuals, angel groups, VCs
  - simple documents (document generator)
  - fast (1-2 weeks)
  - lower transaction expenses
  - company often leads (solicitation package)

VENTURE CAPITAL FINANCING, *CONTINUED*

- Equity:
  - preferred equity
  - typical venture model terms (see NVCA model documents)
  - rights and preferences and higher valuation than common stock
  - contemplated to be successive rounds of financing at increasing valuation as the company progresses
  - takes more time than convertible debt financing (3-5 weeks)
  - due diligence and negotiation of terms and multiple investment agreements
  - higher transaction expenses and company reimburses investor counsel
  - investor leads

VENTURE CAPITAL FINANCING, *CONTINUED*

- General considerations:
  - “best in sector” standard
  - partnership for the future
  - decisions now (structure; valuation; terms; vetos) impact the future
  - company capitalization table needs to be dynamic
  - no common stock financings!
  - have your house in order
  - be prepared for due diligence
  - expect a process and the need to build relationships
  - sell business first then address jurisdiction/structure issues with your proposed new partner

LOUIS LEHOT

Public and private companies, financial sponsors, venture capitalists, investors and investment banks seek out Louis Lehot for smart counsel and skill in forming, financing, governing, buying and selling companies. He uses his extensive experience to benefit a wide variety of businesses at all stages of development—from two founders and a laptop through venture capital financing to IPO and beyond. Drawing on his background advising non-US multinationals looking to access US capital markets, he is also uniquely positioned to assist companies with cross border transactions.

Formerly the co-managing partner of DLA Piper's Silicon Valley office and co-chair of its leading venture capital and emerging growth company team, Louis now operates an elite boutique law firm platform designed to serve entrepreneurs, innovative companies and strategic investors with sound legal strategies and solutions.

Clients prize Louis for his blend of Wall Street expertise and Silicon Valley experience, as well has his ability to offer strategic counseling that is always practical, commercial, cost-effective and tailored to each client's specific circumstances. A native English speaker, he is also fluent in French.

Louis Lehot
Partner
T: +1.650.796.7280
louis.lehot@l2counsel.com

Education
Boston College Law School J.D.

Georgetown University B.S.

Institut d'Etudes Politiques de Strasbourg (France) C.E.P.

Admissions
California
New York

Silicon Valley Office
407, California Avenue, Suite #2
Palo Alto, California 94306

L2 COUNSEL, P.C.
strategies & solutions