SPECIAL FEATURE

SEMINAR ON NEW VENTURES: ORGANIZATION, FINANCING, AND OPERATIONS

May 18, 1984

DELAWARE STATE BAR ASSOCIATION
AND

THE DELAWARE LAW SCHOOL OF WIDENER UNIVERSITY

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PREFACE

This special feature is a unique presentation by the Delaware Journal of Corporate Law. It is an edited and annotated transcript of the proceedings at a seminar on New Ventures, Organization, Financing, and Operations, held on May 18, 1984, in Wilmington, Delaware, and sponsored jointly by the Delaware State Bar Association and the Delaware Law School of Widener University.

The seminar takes the form of legal dramaturgy, in which an imaginary client with a promising business venture seeks a variety of legal advice. The topics covered include deciding on a satisfactory form of business entity, effective use of the corporate form, means

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of compensating management, differing approaches to financing a venture, foreseeing and handling disputes among the principal owners, and attorneys' fees.

Within the format of a serio-comic commercial drama, this seminar explores some meaty and frequently technical issues that bear heavily on the successful launching of an enterprise.

**Opening Remarks**

*Jack B. Jacobs:* Ladies and gentlemen, good morning. I'm Jack Jacobs, the chairman of this program. I would like to welcome all of you here, and express my appreciation for your attendance at such an early hour of the morning.

We have today a very unusual and different kind of program. All of us who have been working on it are sitting here wondering whether it's going to work. It's not the typical kind of the CLE program that you go to and hear one speaker after the other get up and make a formal presentation. This is going to be a real life spontaneous program, a dramatization of what goes on in a law office when a client walks in with a problem. I'll tell you more about that in a minute.

Before I do that, I would like to introduce a few people without whom this program would not be possible. On your program, we have indicated that Henry Herndon, the president of the Delaware Bar Association, would be introduced. Unfortunately, because of a conflicting engagement, he could not make it. But we do have his successor here, the about-to-be president of the Delaware State Bar Association, O. Francis Biondi, a man who is well known and beloved to all of us. I could spend a lot of time talking about his list of accomplishments, but if I did that, then we would be here all morning. I would like to ask Frank to come forward and make a few remarks.

Ladies and gentlemen, the president-elect of the Delaware State Bar Association, O. Francis Biondi.

*O. Francis Biondi:* Thank you. Henry Herndon asked me to sub for him today. I really saw no need to come. But it's one of the only things Henry has let me do since I've become president-elect.

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1. Continuing Legal Education programs in Delaware are co-sponsored by the Delaware Bar Association and the Delaware Law School of Widener University.

so I didn’t want to pass it up. I met this fellow, Dr. Pedanticus, outside; he looks like a typical Morris, Nichols, Arsh & Tunnell client. I understand Dave Drexler wrote this fictional script, this little piece of drama that you’re going to see today. Dave is good at fiction and story telling. He told me what life was like at Morris, Nichols before I merged with it. And I look down this roster of people who are appearing here; a real group of heavyweights.

Speaking of legislation, I just want to take a minute this morning to tell you about the importance of what you’re doing and your being here this morning. Continuing education is going to be a very serious business. Some of you may know that there is a bill pending in the General Assembly, known as Senate Bill 303, introduced by Senator Neal. You can get the drift of it from the caption. It’s called An Act to Amend Certain Titles Relating to Continuing Professional and Occupational Education. Among the professions covered is the profession of law. There’s a description of continuing education; and there are only two provisions of the bill you need to be concerned about. One says that each licensing board shall require and issue rules for continuing education requirements as a condition to license renewal. Another section of the statute provides that the board of bar examiners shall determine and administer an annual renewal of licenses.

Henry and I and some others have met with Senator Neal and we’ve explained to him that the profession of law is not regulated by the General Assembly but rather is a function of the courts under our constitutional system. Being an engineer, he was not much impressed with that. The real defense is that lawyers in Delaware are engaged in continuing education on a voluntary basis to a substantial extent. I think we’re going to have to consider whether the bar itself should advocate mandatory continuing legal education, but what you’re engaged in here today is important from more than the point of view of your own education. In case some of you were questioning your role here today, one role you surely have is that you’re part of the evidence before the General Assembly. Thank you.

Jack Jacobs: Thank you, Frank. I want to introduce to you another gentleman without whom this program would not be possible, and that’s Frank Balotti, the chairman of the Corporation Law Section of the Bar Association. First of all, for those of you who don’t know him, he is very highly regarded and well liked, not only locally, but also nationally. He has, at a very young age, established a national reputation among the Corporate Litigation Bar as a specialist in takeovers, particularly those that have something to do with Delaware. He has been very active in a number of committees both
within and without the Bar Association relating to matters that concern the legal profession.

When the committee sat down to determine what sort of program we ought to be conducting for the bar this year, the first idea that we came up with was to do another program that involved what we call corporate law on the grand scale; that is, a program dealing with issues that the major New York, Philadelphia, and Washington firms would get involved in on cases involving mergers and major corporate transactions, and the sort of thing that you may read about in court of chancery opinions from time to time. We proposed that to Frank and to his everlasting credit he said that that would not be a good idea. That this time around what was really needed was a program that would have a much more practical utility for those members of the bar, including ourselves, that deal with the small businessman; the problems of small ventures or new ventures trying to get started. There are a couple of reasons for that. One of them is that there is a lot of practice that deals with this and not with the corporation law on the grand scale. Secondly it's the small corporations that ultimately turn into big corporations and, hopefully, with the rejuvenation of the economy, we're going to be having more of that in the future. In any event, I think the turnout that we have today attests to the wisdom of Frank's decision in that regard, and I'd like, if you would, to have him come up and make a few comments as chairman of the Corporation Law Section.

BALOTTI: Thank you very much Jack. As Jack mentioned, I am the chairman of the Corporation Law Section of our Bar Association. On behalf of the section, I would like to welcome you to this seminar and also to extend a special thanks to Jack Jacobs. Jack is the one who has put together this program and he is responsible for it, if it's a success. If it's not a success, blame me. That's what Jack was telling you by those remarks.

You're going to see Dr. Pedanticus, who contrary to Frank Biondi's remarks, is entirely too well dressed to be a Morris, Nichols client. You will also be amused by Dave Drexler's fiction and if you doubt that it's fiction, just pick up any Morris, Nichols brief, and you'll find that it follows their usual pattern of being enjoyable fiction. We will try to go forward and present a program that is both enjoyable and educational. I hope we succeed. Thank you all for coming.

JACK JACOBS: As chairman of this program, I neither confirm nor deny the comments that were made about Morris, Nichols' briefs. What I would like to do, however, is introduce a partner of Morris,
Nichols, with a few brief comments about him and the committee that he chairs.

Every month or so, we receive brochures that tell us about programs that will be sponsored by the Bar Association and with the Delaware Law School about one or more or many subjects cutting across the spectrum of areas of law practice. These programs are invaluable. They are a great way to catch up on the developments in any particular field. None of that would be possible without the very important committee of the bar called the Continuing Legal Education Committee. The present chairman of the committee is Bill Sudell. His predecessor was Walt Pepperman, another member of that firm. Both of them have done superb jobs in organizing all of these programs, and making sure that they are coordinated in being carried out. Bill Sudell, chairman of the CLE Committee of the Bar Association.

WILLIAM H. SUDELL, JR.:*** Thank you Jack. Seeing that there are no Richards, Layton & Finger people following me with these introductions, I’m tempted to reply. I won’t, and in fact I’ll give some credit to one of Frank’s partners. Jim McKinstry was chairman of this committee last year between Walter Pepperman and me and did a fine job.

I thank you all for coming. I thank Jack and Frank and the rest of the group for getting this program together.

As Frank Biondi has suggested, there may come soon a day when we’ve got to do this, and I would hope that we could voluntarily show the legislature that our profession does not need to be guided by the law as to continuing legal education. Thank you very much.

JACK JACOBS: One final introduction, and then we’ll begin our program. We have on our schedule remarks to be made by Dean Anthony J. Santoro, the new dean of the Delaware Law School. Unfortunately, he also had a scheduling conflict and could not make it. Professor Bill Connor, who is really the power behind the CLE programs from the law school’s point of view, will make remarks in his stead.

WILLIAM J. CONNER:**** The law school welcomes you as a co-sponsor here. Dean Santoro sends his regards with regrets that he couldn’t be with us. We do have with us, however, as a registrant

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**** B.A., 1939; B.S.L., 1940; LL.B., 1942, University of Minnesota. Member of Minnesota Bar, 1942. Director of Continuing Legal Education, Professor of Law, Delaware Law School of Widener University.
at the seminar our host who usually hosts us on the campus of Brandywine College and the Delaware Law School, Vice-President Bernard Daney. We are very grateful to the committee for their hard work on this seminar. We know you will enjoy it and we hope you profit from it. Thank you.

**Formation of the New Venture**

**Jack Jacobs:** The format that we have chosen today is a little play designed to show how lawyers, working with a client, adapt the instruments of the law and select from among a variety of devices to furnish practical solutions for a particular problem.

Dr. Simeon Pedanticus has an idea, a very good and practical one, that properly nurtured could make a great deal of money. He needs a lawyer. Actually his scheme is so beset with difficulties, he probably needs a *team* of lawyer specialists. If the lawyers are up to snuff, they, too, stand to make money in the performance of a great deal of hard work. What you will see is nothing if not the theater of the practical.

To understand the problem the lawyers will confront today, you need a little background. Pedanticus is a retired professor of literature. He is a martinet about good English usage and clear writing. He also dabbles in computer science.

Pedanticus and his long-suffering wife have emerged from their basement rec room after three years of frustrating experiments with Ortho-Lit (patent pending), a computer scheme that takes the rottenest prose in the language and transforms it in a twinkling into completely acceptable writing. It works this way: an offending passage of type-written material is passed through an optical recognition scanning device. Working sentence by sentence, Ortho-Lit deletes cliches, reattaches dangling participles, sniffs out defective subjunctives, and breaks the backs of run-on sentences. After Ortho-Lit gets through tidying up a literary mess (in about two seconds a page), a printer spits out a flawless version of what the incompetent writer had mangled.

The commercial possibilities are unique and they are awesome. Corporate annual reports, Rotary Club speeches, Federal regulations, and even the minutes of meetings of women's clubs can be instantly rendered acceptable to the fastidious, while the authors are misrepresented as literate. An Ortho-Lit package with dual disc drive, printer, optical scanner, and a subscription service of software for ferreting out the latest outrages against good prose will be the salvation of the pretentious and the ignorant. Obviously, a new era of synthetic eloquence is at hand.
But Pedanticus is a poor man living on a stingy university pension. In order to finance his experiments, he has sold off the reprint rights to his popular, if rather silly, textbook, *The Tradition of Courtly Love—From Chaucer to Barbara Cartland*. His long suffering wife has not had a new coat in ten years, and there are continual financial problems with his disappointing only son, a failed ballet dancer, who now runs a tea room in Greenwich Village. (By the way, if you think all these homey little details are irrelevant to what the lawyers are going to do, you could not be more wrong.)

Pedanticus is on his uppers: Ortho-Lit is his one chance to strike it rich. It is questionable whether he can afford a lawyer at all, much less the team of lawyers he plainly needs to turn this into a reality. On top of that, he is a pretty disagreeable old man.

So, let’s see how legal ingenuity can turn a visionary pauper into a nabob.

**Jacobs** (in spotlight): Good morning. It is the lawyer’s elusive dream that someday there will march into his office that wonderful creature who has designed the successor to Xerox or constructed the product that everybody wants (the IBM of the twenty-first century), that this wonderful creature will become deeply grateful to the lawyer and his partners for making the bonanza possible, and that everybody involved will prosper, the entrepreneur with a successful venture, the lawyers with a new client doing much important, challenging business requiring extensive legal service.

The wonderful creature usually has a turning idea but not quite enough money to make it a reality. He goes to his lawyers for advice about organizing his venture, securing funds for it, and complying with regulatory complexities that afflict commercial ventures.

In this morning’s segment of our commercial drama, we shall ask you to summon your powers of imagination that you may transport yourselves, in spirit, to a law office.

Behold the conference room of what the *News Journal* papers, hoarding their scanty supply of adjectives, would doubtless call the “prestigious” firm of Walsh, Small, and Jacobs. *(SHIFT LIGHTS TO LAWYERS—WALSH, SMITH, BALOTTI AND SHANLEY.)*

**Peter J. Walsh**:***** Fellows, you’ve read my memo about

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***** B.A., 1957, LaSalle College; M.S., 1959, University of Illinois; LL.B., 1963, Georgetown University. Director in the law firm of Murdoch & Walsh, P.A. Member of the District of Columbia and Delaware Bars. Previously served as an attorney with the Securities and Exchange Commission. His practice is concentrated in the area of commercial law, including corporate, securities, and bankruptcy law matters.
this guy Pedanticus. His product sounds like a winner to me, but I warn you he is extremely difficult as a personality. He’s shrewd and I think he’s borderline certifiable. However, I believe in the importance of the product he’s told us about, and I’m inclined to deal with him. But please try to be patient with him. He is exasperating.

(ENTER PEDANTICUS—He is clad in a ratty tweed jacket, an Irish fisherman’s sweater, paint-stained slacks, mismatched socks, and scuffed loafers. He could use a bath.)

WALSH: Good morning sir. May I introduce my partners, Mr. Smith, Mr. Shanley, and Mr. Ballotti.

(PEDANTICUS NODS ICILY.)

WALSH: Doctor, just out of curiosity, I wonder if you could tell us before we get started, how it came about that you chose our firm to guide you in this venture.

PEDANTICUS (WILLIAM E. WIGGIN†): (Seating himself.) I believe you represented that solid waste disposal outfit that used county bond financing, did you not?

WALSH: (A little smugly.) We did, yes.

PEDANTICUS: My next door neighbor is the lawyer who represented the county. He said you drove a very hard bargain. Hates the sight of you. As a matter of fact, he compared you in rather vivid language with your client’s product. That persuaded me you were tough enough for my job.

WALSH: (Suavely) Thank you. We are always diligent in the pursuit of our client’s interests. But right now I would like to find out what your interest is, what you intend to achieve, and what type of business you intend to embark upon. Tell us a little bit about your plans.

Structure—Partnership, Corporation or Other?

PEDANTICUS: As you know, I have an invention. I have applied for a patent and that invention, Ortho-Lit, has undergone vigorous testing and is ready for production and sale. What I want to do is rent some space in an industrial park and then subcontract out the manufacture of the principal components. I already have a site in mind. What I will do is assemble that which other manufacturers make. The software will be done on premises under my control because it’s highly

† A.B., 1950, Yale University and Harvard University; LL.B., 1956, Harvard University. Member of District of Columbia and Delaware Bars, 1956. Member of the law firm of Richards, Layton & Finger, P.A.
secret. But I’m going to need a sizable amount of money. I will need some working capital first of all to be able to rent this place and equip it with some assembly equipment, and I’m going to have to have a small budget for a sales force, and a very large budget for advertising. Does that give you some idea of what I’m aiming at?

WALSH: Yes, it does. I think we ought to start off first by discussing with you what type of entity this business venture should take. Have you given any thought to that?

PEDANTICUS: Well, I want to exercise the largest possible control of this thing I’ve invented. Should I operate, let us say, just as myself in the business? As a proprietor or something?

WALSH: The short answer is, of course, no.

PEDANTICUS: Indeed.

WALSH: Just let me just give you a little background. Based upon the size of this venture, it’s obviously not a mom-and-pop grocery store. There will be substantial product and service liabilities. As a sole proprietor, you’d have unlimited liability problems.¹ More importantly, we anticipate, or I would hope you would anticipate, that there will be equity participation by others not limited to your family and indeed it’s my understanding that your own family resources are limited.

PEDANTICUS: That is true, and I realistically compute the need for about $3.5 million to make this thing go.

WALSH: OK. Well because of the equity participation problem in addition to the liability problems, we ought to rule out immediately the sole proprietorship.²

PEDANTICUS: What about a partnership with me in control? Aren’t there means of partnership where I could be in control while others put up the money?

WALSH: Yes, you can. But let me suggest that a partnership is likewise not advisable in this case. There may be some situations which we could discuss later, for example where you are talking about developed real estate ownership, where a partnership might be

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¹ The comparative disadvantages of proprietorship are so substantial as to rule it out for vast majority of new business ventures. These disadvantages include unlimited liability.

² It is difficult or impossible to structure effective equity participation because (a) equity capital is limited to the individual or his family’s situation, (b) long-range planning is hampered by financing limitations, and (c) tax planning possibilities for individual participants are limited. Further, in a sole proprietorship, there is no continuity of existence and management lines of responsibility and delegation are not suitable for a potential growth situation.
appropriately. Given the fact pattern here, however, where we are embarking upon a new venture with the prospects of in later years perhaps going public, I don’t think a partnership or a limited partnership is appropriate. Let me make a couple observations to underscore that suggestion.

3. The advantages of the partnership can, for the most part, be expressed as tax disadvantages of corporate form. There is the problem of double taxation: (a) tax on net income and (b) tax on dividends. But see infra note 5. Capital gains are taxed differently (28% tax v. 40% x rate). First year depreciation is limited to 20%. There is no income averaging. Numerous operating risks exist such as unreasonable compensation, constructive dividends, and accumulated earnings tax. Social security taxes apply. Finally, there is potential personal holding company liability.

There are some clear advantages of the corporate form over a partnership form and vice versa, and there are situations where advantages or disadvantages are a function of policy or tax objectives. With the increasing sophistication and complexity of business affairs, generalizations about advantages and disadvantages are difficult to make. One of the advantages of the corporate form versus partnership form is that corporations enjoy perpetual existence. However, a partnership agreement could be structured to substitute partners and otherwise continue upon death of partner(s). A limited partnership can be structured for practically perpetual existence.

With the corporate form, there is no personal liability. However, in certain respects this is more apparent than real. For example, insurance protection for tort and product liability is readily available to partners. Further, in a limited partnership, the limited partners enjoy the same insulation from liability as shareholders. In a “start-up” situation, individual guarantees by officers and shareholders of corporation are often required by lenders, suppliers, and landlords. See infra text accompanying note 5. Statutory liabilities exist for officers and directors of a corporation (e.g., securities laws, antitrust laws, ERISA).

Corporations enjoy a broad range of external financing, including sale of stock, bonds, and other securities. However, loan financing of many sorts is available to a partnership. Moreover, a corporation provides greater ease of transferability of equity interests. However, it should be noted that in a corporate “start-up” situation, it is invariably advisable to limit equity interest transfers by various forms of buy-sell and redemption agreements. Transferability of limited partnership interests in a limited partnership can also be easily effected.

Tax advantageous stock purchase and stock option plans (e.g., incentive stock options and junior stock options) are often a key ingredient to new venture success. Stock options can be an important “carrot” for young professionals (e.g., engineers, computer analysts, etc.). See infra [compensation]. In many situations which have “going public” prospects, these are an important substitute for current high salaries and thus good for the earnings per share picture.

Corporate fringe benefits exist such as qualified pension and/or profit-sharing plans, group term insurance, health and accident insurance, medical reimbursement plans, and wage continuation plans. Recent tax legislation has significantly narrowed the gap between corporate qualified deferred compensation plans and Keogh and IRA plans.

The corporate fiscal year need not be the calendar year. This allows important tax planning for small business, for example, in having compensation straddle calendar years. Also, in the corporate set-up, losses can be carried forward and carried back. In partnership it is passed through to partners with no carry forward or carry back options.
First of all, with a general partnership or a limited partnership in which you would be the general partner, you still have the personal liability problems. And because of the product and service contracts that we anticipate this entity will undertake, we just believe that personal liability exposure is not worth taking.

On the other hand, let me make this caveat. Even with a corporate setup, where you might be the principal shareholder and, of course, the principal officer, there can be the liability exposure. For example, it is not at all unusual in start-up situations for lenders, suppliers, and indeed your landlord to insist upon your personal signature, in addition to the corporate signature. So while there will be significant protection from personal liability under the corporate setup versus the partnership, there will not be complete isolation from personal liability. But that's a fact of life of a start-up situation.

PEdanticus: Well, in any event, I'm judging.

Walsh: When your business becomes valuable, we hope that will no longer be the case.

Pedanticus: Well, assuming it does become valuable. You keep talking about a corporation. Doesn't a corporation have to pay some income tax?

Walsh: Yes, indeed it does.

Pedanticus: If I get a dividend, I have to pay a tax on that?

Walsh: Yes, indeed you do.

Pedanticus: You want me to pay Uncle Sam twice?

Walsh: No, we're not going to let you pay Uncle Same twice.

Pedanticus: Well that's a comfort.

Walsh: While we recommend the corporate set up and while theoretically the corporate set up involves the double taxation, I wish to say that as a practical matter that's not a problem. First let me point out on a philosophical or political basis, more than legal advice, what I think is happening. The tax rates have reduced, over the last two decades at the corporate level. This suggests that the corporate income tax rates are coming down and as recently as '83, they've

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4. Since borrowing power is significantly dependent on the debt to equity ratio, the corporation's borrowing power should be better than the partnership.

5. Is the double taxation of corporate set-up really a valid objection to the corporate set-up? Look at the trend in corporate income tax rates:

For taxable years beginning before January 1, 1964

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<tr>
<th>Taxable Income:</th>
<th>Rate</th>
</tr>
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<tbody>
<tr>
<td>$0 - $25,000</td>
<td>30%</td>
</tr>
<tr>
<td>$25,000 + Over</td>
<td>52%</td>
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come down as a result of the '82 Tax Reform Act. It’s worth noting indeed that this is not purely a Republican idea as you might expect. The three current Democratic presidential contenders are in favor of a reduction of the corporate income tax and it’s being suggested that the maximum corporate income tax should be thirty percent. I think we’re going to see that, and I think we may see it lower than that. Now if you couple that political or philosophical observation, if you will, with the fact of life of a start-up corporation,\(^6\) I think you will find that there will not be a double tax for the simple reason that at the early stages, and I’m talking two, three, five, perhaps ten years, it is not likely that there will be any desire to pay dividends. With the corporate tax rate being what it now is and what it is likely to be, it is our view that the most efficient way to generate capital is internally within the corporate structure and with no dividends being paid.

<table>
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<tr>
<th>Taxable Income:</th>
<th>Rate</th>
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<tbody>
<tr>
<td>$0 - $25,000</td>
<td>22%</td>
</tr>
<tr>
<td>$25,000 + Over</td>
<td>50%</td>
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<tr>
<td>Taxable Income:</td>
<td>Rate</td>
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<tr>
<td>$0 - $25,000</td>
<td>22%</td>
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<tr>
<td>$25,000 + Over</td>
<td>48%</td>
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<tr>
<td>Taxable Income:</td>
<td>Rate</td>
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<tr>
<td>$0 - $25,000</td>
<td>20%</td>
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<tr>
<td>$25,000 - $50,000</td>
<td>22%</td>
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<tr>
<td>$50,000 + Over</td>
<td>48%</td>
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<tr>
<td>Taxable Income:</td>
<td>Rate</td>
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<tr>
<td>$0 - $25,000</td>
<td>17%</td>
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<tr>
<td>$25,000 - $50,000</td>
<td>20%</td>
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<tr>
<td>$50,000 - $75,000</td>
<td>30%</td>
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<tr>
<td>$75,000 - $100,000</td>
<td>40%</td>
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<tr>
<td>$100,000 + Over</td>
<td>46%</td>
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<tr>
<td>Taxable Income:</td>
<td>Rate</td>
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<tr>
<td>$0 - $25,000</td>
<td>15%</td>
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<tr>
<td>$25,000 - $50,000</td>
<td>18%</td>
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<tr>
<td>$50,000 - $75,000</td>
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<td>$75,000 - $100,000</td>
<td>40%</td>
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<tr>
<td>$100,000 + Over</td>
<td>46%</td>
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The prospects are good for further reductions in the corporate rate, with a maximum of 30% being considered. While individual income tax rates have also fallen, for below $100,000 of income, they are substantially higher than the corporate rates.

\(^6\) The payment of dividends in a start-up/growth business venture is highly unlikely. Shareholders will be compensated as officers and/or employees.
made. Let me make one other observation in this regard. We think that it is critical to proper management compensation and inducement to adopt some type of stock-option plan, and we can discuss this in more detail later. The underlying premise of that plan will be that eventually the corporation will go public. The important ingredient for the pre-going public stage will be the earnings per share (EPS). We’re not going to pay dividends because we are going to make the EPS as attractive as possible. The short answer is that for the near term, the next five to ten years, there will be no double tax because it is extremely unlikely that we would want to pay any dividends.

PEDANTICUS: Is there any danger of perhaps my making too much profit without paying out the dividends and getting hit again?

WALSH: That is a possibility, but we can address that when we get to it. We don’t think that that is a problem in the early stages, given what I believe are the significant capital needs of this corporation.

PEDANTICUS: Very good. Sufficient unto the day is the evil thereof. Mr. Walsh, when I go to the Faculty Club some of my rich cronies who patented their ideas and made money, and I admit I envy them, chatter on and on about something wonderful called section 1244 stock. Does that have a place in my picture here?

WALSH: I think it will for your other investors.

PEDANTICUS: What is 1244 stock?

WALSH: Section 1244 stock simply refers to a section of the Internal Revenue Code which says that, given certain conditions, the issuance of stock which subsequently becomes worthless will enable the taxpayer to charge that loss against his ordinary income rather than charging it against his capital gains. The benefit, of course is, God forbid you reach the day where the stock becomes worthless, either by way of a sale of the stock or a liquidation or a bankruptcy of the corporation, it enables the shareholder to deduct up to $50,000 per year, $100,000 for husband and wife, the loss on the section 1244 stock against his ordinary income.7

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7. Any loss on sale and exchange is deductible by the shareholder-taxpayer as ordinary (rather than capital) loss, up to $50,000 per year ($100,000 on a joint return). The $100,000 maximum for a husband and wife applies whether the loss is sustained by one or both spouses. Treas. Reg. § 1.1244(b)-1(b)(1) (1981). However, the $50,000/$100,000 can qualify for ordinary loss treatment. Any loss in excess of the maximums must be treated as capital loss. Treas. Reg. § 1.1244(b)-1(a) (1981).

The ordinary loss may be claimed only by an individual or an individual who is a partner in a partnership which acquired the $1244 stock. Ordinary loss may not be claimed by a corporation, a trust, an estate, or a trustee-in-bankruptcy holding otherwise-qualifying § 1244 stock. I.R.C. § 1244(d)(4) (1982); Treas. Reg. § 1.1244(a)-1(b) (1981). This treatment is limited to the original purchaser. Thus, the
Pedanticus: What do you have to do to take advantage of this?

Walsh: The rules are simple and have been made simpler in recent years. Basically, as the issuer, you have to be a small business corporation and the stock itself has to be labeled section 1244 stock. What is section 1244 stock? Basically, it is stock, common stock, which is issued for property and it can be voting or non-voting. It must be issued for property; it cannot be issued for stock or securities; it cannot be issued for services.

As an ordinary loss, the loss is a deduction from gross income but the ordinary loss treatment does not affect the treatment of gains. Capital gain treatment will be available under the usual rules. The loss occurs when there is a sale or exchange, including any transaction treated as a sale or exchange, such as a bankruptcy or a liquidation. Treas. Reg. § 1.1244(a)-1(a) (1981).

There is a special computation rule for § 351 transactions (transfers of property to a controlled corporation). Where an investor receives § 1244 stock in exchange for high base, low value property, if the high base carries over to the stock (by reason of a § 351 transaction), he must compute any ordinary loss on the stock by reducing the basis of the stock by the excess of the basis of the property over the value at the time of the exchange. I.R.C. § 1244(d)(1)(A) (1982); Treas. Reg. § 1.1244(d)-1(a)(1) (1960).

Any increase in the basis of the stock after issuance of the stock (through contributions to capital or otherwise) is deemed allocable to non-$1244 stock. I.R.C. § 1244(d)(1)(B) (1982); Treas. Reg. § 1.1244(d)-2(a) (1981).

8. Stock issued before the taxable year in which the corporation's capital receipts exceed $1 million does not have to be affirmatively designated "§ 1244 stock." In the transitional year (i.e., the year in which the capital exceeds $1 million), the corporation must designate the stock as "§ 1244 stock" in order to qualify. Treas. Reg. § 1.1244(c)-2(b)(2)(i), (ii) (1981). In the transitional year, the designation is effected by the corporation (not the stockholder) by entering the numbers of the qualifying share certificates on the corporate records or making a designation in the corporate minutes. Treas. Reg. §§ 1.1244(c)-2(b)(4) ex. (1), (2); 1.1244(c)-2(b)(2)(iii) (1982).

9. The common stock may be either voting or non-voting common stock, but it cannot be securities convertible into common stock nor common stock convertible into other securities. I.R.C. § 1244(c)(1) (1982); Treas. Reg. § 1.1244(c)-1(b) (1981).

10. A stock is considered issued when it is paid for regardless of when the certificate is executed or delivered. Rev. Rul. 67-256, 1967-2 C.B. 294.

11. I.R.C. § 1244(c)(1)(B) (1982); Treas. Reg. § 1.1244(c)-1(d)(1) (1981). The money or other property received must result in new capital being put into the business. The purchase of stock previously redeemed will not qualify if there is no net increase in the corporate capital. Adams, Jr., 74 T.C. 4 (1980).

Stock issued in cancellation of debt will not qualify where the only purpose of cancellation is to take advantage of tax treatment. For example, where the corporation is in financial distress and it issues stock in cancellation of existing debt, the subsequent dissolution of the corporation will not produce § 1244 treatment for the stock. Bruce v. United States, 279 F. Supp. 686 (S.D. Tex. 1967), aff'd, 409 F.2d 1317 (5th Cir. 1969).

Stock issued for stock does not qualify except as to a stock dividend, recapitalization, and "F" reorganization (change of name, form, or place of organization). I.R.C.
Pedanticus: And presumably I would not be able to have any of that, since I propose to take stock in exchange for what I have designed.

Walsh: It can be issued for what you have designed, your patent would be deemed property for that purpose, yes.

Pedanticus: And not services.

Walsh: That is correct, not for services. So it's common stock issued for property. The second test, of course, is that it must be issued by a small business corporation. A small business corporation is simply a corporation whose capital receipts\(^2\) do not exceed $1 million at the time the stock is issued.\(^3\) At the outset I think we have been talking about raising equity capital of anywhere from $500,000 to $1 million, so I contemplate that the venture capitalists, the equity investors, the people who will put money into your venture, will indeed be able to take advantage of section 1244. And incidentally there is no limit on the number of shareholders so long as it is a small business corporation. We will, of course, talk later about the limitation on the number of shareholders, a limitation imposed by securities law regulations.

Pedanticus: That's all very enlightening. We assume now that I need $3.5 million and you correctly remember from my earlier discussion maybe $.5 million or $750,000 coming from those who invest. The balance of that $3.5 million would be, I suppose, some bond money. That's what I envision for getting into this industrial park. I guess now we really are committed to a corporate form, the way you see it. Is that correct, Mr. Walsh?

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\(^1\) Sec. 1244(d)(2) (1982); Treas. Reg. § 1.1244(d)-3(c)(1) (1981).

Stock dividend qualifies if the distribution is nontaxable to recipient under normal stock dividend rules and is made solely with respect to § 1244 stock owned by recipient. Stock issued in recapitalization can be accorded § 1244 treatment if the exchange is a tax-free recapitalization and the stock exchanged by the recipient is § 1244 stock at the time of the exchange. Stock received in an “F” reorganization will qualify if the exchange is a tax-free “F” reorganization and the stock exchanged was § 1244 stock at the time of the exchange.

12. The capital receipts mean the aggregate dollar amount received by the corporation for its stock, as a contribution to capital and as paid-in surplus.


The “small business” corporation must also meet a gross receipts test. Fifty percent or more of the corporation's aggregate "gross receipts" within the five most recent taxable years ending before the date of the loss must be derived from other than rents, royalties, dividends, interest, annuities, and sales and exchanges of stocks for securities. I.R.C. § 1244(c)(1)(c) (1982); Treas. Reg. § 1.1244(c)-1(c)(1)(i)(a) (1981). If corporation is not in existence for five years, the 50% test is applied to the period of existence. The gross receipts test is designed to insure that corporation is engaged in the active operation of a business and is not merely a holding company.
Walsh: Given this venture, yes, absolutely.
Pedanticus: Let's consider that an essential and move forward from there.

What Type of Corporation?

Pedanticus: I'm reconciled with the corporate form. And with that in mind, I really become very much concerned about control over a corporation, and I don't want it getting out of hand. I've heard some talk about a close corporation. What is that?

Walsh: Let's address that issue and Doctor I want to now get some of my partners involved in this discussion so let's have Mr. Smith address that question.

George B. Smith: A close corporation is, to start with, basically a regular corporation under Delaware law. You would go about incorporating it in many of the same steps that you would use with any other corporation. However, in some ways it's organized in an unusual manner, usually to give control to the majority shareholder and to eliminate some of the paper work and needed details that must go on each year.

Pedanticus: That sounds good.

Smith: I thought it might appeal to you. First of all though, because you are raising capital, you have to make sure that you have no more than thirty shareholders in a close corporation. So if you were going to market the shares to fewer than that number then it could qualify. One aspect that you would find particularly attractive in a close corporation is that there should be, and must be, restric-

† B.S., 1972, University of Delaware; J.D., 1982, Delaware Law School of Widener University. Member of Delaware Bar and U.S. Tax Court, 1982. Mr. Smith is both a Certified Public Accountant and an Attorney and is associated with the firm of Young, Conaway, Stargatt & Taylor. Mr. Smith worked for the I.R.S. as a Revenue Agent, District Conference, and finally as an Appeals Officer. He has participated as lecturer at several financial, estate planning, and tax seminars.

   (1) All of the corporation's issued stock of all classes shall be represented by stock certificates and shall be held by no more than 30 persons;
   (2) All of the issued stock of all classes shall be subject to one or more of the restrictions on transfer permitted by Del. Code Ann. tit. 8, § 202 (1974) (restriction on transfer of securities); and the corporation shall make no "public offering" of its stock within the meaning of the Securities Act of 1933.

The certificate of incorporation must contain, as part of its heading, a statement that the corporation is a close corporation. Del. Code Ann. tit. 8 §§ 343(1), 342 (1974).
tions on the transfer of the shares. So, for example, you could require all shareholders to resell their shares to the corporation first as opposed to selling them to their friends, neighbors, etc. That way you can guarantee the control of the corporate activities. The stock cannot be part of a public offering as defined by the Securities and Exchange Commission, and I believe some of our partners this afternoon will get into the discussion of a public offering and describe to you what’s involved there. The certificate of incorporation that you have to file for Delaware has to state in its heading that this is a close corporation so that the world is on notice as to its limitations and particular characteristics.

PEDANTICUS: What advantages other than those you described would this confer if we chose to go this route?

SMITH: To repeat a little bit, one of the advantages, of course, is the restriction on transfer.15 You want to make sure that those people with whom you crawl into bed stay the same. So they cannot bring in other people through sales or dilution of their stock.

PEDANTICUS: Ah, Mr. Smith, but is there an adverse to this pretty coin? Could I be locked in? Could others be locked in in a manner disadvantageous to my enterprise and to me?

SMITH: Yes. You could have some people in there who you would not feel comfortable with.

PEDANTICUS: There are many people I do not feel comfortable with.

SMITH: I hope not the four of us assembled here today.

PEDANTICUS: That remains to be seen.

SMITH: One of the things that would particularly appeal to you as an advantage would be a restriction on the classes of shareholders whom you could have owning stock in this corporation.16 Being such an egalitarian I’m sure that would appeal to you.

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15. Other benefits of a close corporation are restrictions on classes of shareholders, elimination or control of directors, and management by shareholders. On the other hand, the drawbacks of a close corporation are the limit on the number of shareholders, restrictions on free transferability, inability to make a public offering, restrictions on classes of shareholders, involuntary termination of close corporation status, loss of directors’ independence, and potential personal liability of shareholders.

16. The certificate of incorporation of a close corporation may set forth the qualifications of shareholders, either by specifying classes of persons who shall be entitled to become holders of stock of any class or by specifying classes of persons who shall not be entitled to become shareholders, or both. Del. Code Ann. tit. 8, § 342(b) (1974). Stock held in joint or common tenancy or by the entireties shall be treated as held by one shareholder. Del. Code Ann. tit. 8, § 342(e) (1974).
PEDANTICUS: That is one of the least charming suggestions you’ve made this morning.

SMITH: One item that it would do would be to eliminate the directors of the corporation. You could eliminate the need to have either inside or outside directors with a close corporation because the shareholders actually control the corporation and run its activities.\(^{17}\)

WALSH: Pardon me Buck, if I may interrupt the discussion with the Doctor on the close corporation. I think we anticipate that the venture capitalist will insist upon a board of-directors and significant representation on that. As I see the venture and the appropriate structure, I think that we should rule out the close corporation, and I suggest we go on to something a little more fruitful.\(^{18}\)

PEDANTICUS: Before we do, may I ask just one question. You referred to venture capitalists. Would you expand on that term a little bit?

WALSH: Yes. It's obvious that you need a significant amount of equity funding. You are not in a position to supply it. Your bank is not going to give you any financing in the absence of equity funding. There are some people who are associated with banks, some with underwriting firms, some operating on an independent basis who are known as venture capitalists. They have associates and friends with, to put it bluntly, large gobs of money who are interested in investing in attractive start-up situations, putting their equity money into speculative ventures, but indeed with a view to eventually reaping large benefits, and in many cases with a view to eventually going public so that shares that they buy at ten cents will be sold on the market ten years from now at a multiple of ten or a hundred times that. As

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17. The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the shareholders of the corporation rather than by a board of directors. This removes the need to call a meeting of shareholders to elect directors. Del. Code Ann. tit. 8, § 351(1) (1974). The shareholders of the corporation shall be deemed to be directors for purposes of the General Corporation Law of the State of Delaware, id. § 351(2), and shall be subject to all liabilities of directors. Id. § 351(3).

18. It should be noted that a close corporation may also be operated as a partnership. Id. § 354. No written agreement among shareholders of a close corporation, nor any provision of the certificate of incorporation or of the bylaws of the corporation, which agreement or provision relates to any phase of the affairs of such corporation, including but not limited to the management of its business or declaration and payment of dividends or other division of profits or the election of directors or officers or the employment of shareholders by the corporation or the arbitration of disputes, shall be invalid on the ground that it is an attempt by the parties to the agreement or by the shareholders of the corporation to treat the corporation as if it were a partnership or to arrange relations among the shareholders or between the shareholders and the corporation in a manner that would be appropriate only among partners.
we progress in our discussion, we will have other partners of the firm
give you more detail on how to find the venture capitalists and how
to deal with them. But I should caution you at the outset, that
notwithstanding your wish to dominate this entity, you will have to
share information, responsibility, and authority with the venture
capitalists, and they will be a significant factor on the board of directors.

SMITH: Fine. I think that takes care of the question then of close
corporation. I think we would recommend strongly against it in this
case. Are there other questions that you might have on the form of the
corporation?

PEDANTICUS: Having decided against the close corporation, after
enlightening me about it, what would be your recommendation? I am
naive in these matters.

SMITH: I think that my senior partner's opinion that we dispense
with it is excellent, and I think that we might then consider what affect
an S corporation might have.

PEDANTICUS: Please define that for me. Once again, you're using
language that is well over my countrified head.

SMITH: An S corporation is a Delaware corporation, like any
other Delaware corporation, except that there are certain tax advan-
tages to it. To have an S corporation, you would incorporate it like
any other, but you would have fewer than thirty-six shareholders. You
must have no more than thirty-five. It must be a domestic
corporation which incorporating in Delaware would take care of. No

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19. S corporations are not subject to corporate income taxes. Current federal
rates on corporate taxable income, 26 U.S.C. § 11(b) (1985), are:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Tax</th>
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<tbody>
<tr>
<td>First</td>
<td>$25,000</td>
<td>15%</td>
</tr>
<tr>
<td>Second</td>
<td>$25,000</td>
<td>18%</td>
</tr>
<tr>
<td>Third</td>
<td>$25,000</td>
<td>30%</td>
</tr>
<tr>
<td>Fourth</td>
<td>$25,000</td>
<td>40%</td>
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<tr>
<td>Over</td>
<td>$100,000</td>
<td>46%</td>
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<td>Over</td>
<td>$1,000,000</td>
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<td>over $1,000,000</td>
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<td>or $20,250,</td>
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<td>whichever is less.</td>
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The current Delaware corporate tax rate is 8.7%. Del. Code Ann. tit 30, § 1902(a)
1374 (Supp. 1984).

20. 26 U.S.C. § 1361(b)(1)(A) (Supp. 1984). All shareholders, other than cer-
tain estates or trusts described in § 1361(c)(2), must be individuals. Id. § 1361(b)(1)(B).

21. It must be created or organized in the United States or under the laws
of any state. A foreign corporation, even if it has assets or conducts business in the
United States, does not qualify. Id. §§ 1361(b)(1), 7701(a)(A).
nonresident aliens can be shareholders,\textsuperscript{22} so if you were looking for venture capitalists from England or some other country, you would not consider an S corporation. Only one class of stock can be issued.\textsuperscript{23} Now that does not hold you back from authorizing additional classes of stock for the future, and that very well may be a good technique. However, for the present time you can only issue one class. However, you could have common stock, which is a class of stock, and have some be voting and some be nonvoting.\textsuperscript{24} All shareholders would have to consent to this election\textsuperscript{25} and you would have to make the election within certain time limits set forth by the Internal Revenue Code.\textsuperscript{26}

**PEDANTICUS:** What is the consequence of not making the election?

**SMITH:** The consequence of not making the election is having the corporation treated as a regular, or C corporation, which is then taxed on its income.\textsuperscript{27} That leads into another question you might

\begin{align*}
\text{S Corporation} & \quad \text{C Corporation} \\
\text{Year 1} & \quad \text{Year 1} \\
\text{Taxable income or (loss)} & \quad $(25,000) \quad $(25,000) \\
\text{Shareholder taxable income before S Corporation income or (loss)} & \quad 110,000 \quad 110,000 \\
\text{Tax (combined Delaware and federal) on shareholder (1)} & \quad 31,067 \quad 43,876 \\
\text{Tax (combined Delaware and federal) on corporation} & \quad -0- \quad -0- \\
\text{Combined tax burden} & \quad 31,067 \quad 43,876 \\
\text{S corporation benefit (penalty)} & \quad 12,809 \quad (6,358) \\
\text{Cumulative} & \quad 12,809 \quad 6,341 \\
\end{align*}


\textsuperscript{22} Id. § 1361(b)(1)(C).
\textsuperscript{23} Only one class of stock can be authorized and issued. Id. § 1361(b)(1)(D).
\textsuperscript{24} Id. § 1361(c)(4).
\textsuperscript{25} Id. § 1362(a)(2).
\textsuperscript{26} Election must be made at any time during the preceding taxable year to be effective for the next taxable year, id. § 1362(b)(1)(A), or at any time during the first two and one-half months of the taxable year to be effective for that taxable year. Id. § 1362(b)(1)(B).
\textsuperscript{27} Id. § 1362(a)(2).
have, which is how is the income of an S corporation taxed? Basically it's very much like a partnership. You have the limited liability of a corporation, but you have the individual tax benefits of a partnership in that the shareholders report the income or loss, and you avoid double taxation. Certain benefits are passed through, such as the investment tax credit.

WALSH: Buck, if I may interrupt. Does a sub-S election seem realistic in light of the venture capital equity funding that we're talking about? Are these the kind of people that would want to be sub-S shareholders?

SMITH: Probably not, Peter. Probably in this case, because of their substantial income, they would not want to have the earnings of the corporation flow through to them. They would probably

28. Start-up losses of a new corporation can be used by shareholders to offset taxable income, rather than being carried forward as net operating loss deductions. Section 179 write-off ($5,000 immediate deduction for new equipment) is allocated pro rata. 26 U.S.C. § 179(d)(8) (Supp. 1984). Partnership rules shall apply for fringe benefit purposes and a two-percent shareholder shall be considered a partner. Id. § 1372. Personal holding company rules do not apply. Accumulated earnings tax does not apply. Family income-splitting can be accomplished so long as reasonable compensation is paid to all shareholder-employees. A personal service company that has little resale or liquidation value can utilize an S corporation to withdraw all earnings.

29. Gross income is passed through to shareholders in the same proportion in which they own stock. Id. § 1366(a)(1). A shareholder's pro rata share of his loss cannot exceed the sum of his adjusted basis in his stock and the adjusted basis of his loans to the corporation. Id. § 1366(d). (Loans to the corporation by a third party, which loans are guaranteed by the shareholder, do not constitute loans to the corporation by the shareholder.) Any unused loss can be carried forward indefinitely. Id. § 1366(d)(2).

A shareholder's stock basis is increased by income recognized, id. § 1367(a)(1), and is decreased by distributions, losses, and nondeductible expenses. Id. § 1367(a)(2).

Distributions from S corporation having no earnings and profits are considered return of capital first, then as a capital gain. Id. § 1368(b). Where an S corporation has earnings and profits, the portion of the distribution from the accumulated adjustments account is first treated as a return of capital and is not taxed a second time (the shareholder has recognized income already). Id. § 1368(c)(1). (The accumulated adjustments account contains all earnings and profits of a corporation since it elected S corporation status. Id. § 1368(c)(1)(A). It does not include any earnings and profits for taxable years beginning before January 1, 1983. Id. § 1368(c)(2). The portion of the distribution from any earnings and profits in addition to the accumulated adjustment account (earnings and profits accumulated during C corporation status) is treated as a dividend. Id. § 1368(c)(2). The remainder of the distribution, if any, is then applied to the shareholder's stock basis (return of capital) and any amount in excess of basis is treated as capital gain. Id. § 1368(c)(3).

30. Investment tax credits flow through to shareholder, but S corporation that engages in leasing is treated as noncorporate lessor. Id. § 46(e)(3). Investment tax credit taken by a corporation shall not be recaptured merely by election as an S corporation. Id. §§ 47(b), 1371(d)(1).
rather have the value of the stock appreciate by having the earnings retained in the corporation, and not distributed out to them.

**Walsh:** On that basis then, do you think that perhaps we're in a position to suggest to the Doctor that sub-S is not the route to go?

**Smith:** If the Doctor is going to immediately go for venture capital, then I would recommend that you not go with the S corporation or sub-S election at this time.

**Pedanticus:** You have been eloquent about the things you would not recommend. What would you recommend?

**Smith:** I would recommend that you have a regular Delaware corporation that would not be an S corporation, it would be a C corporation, and that you obtain as much venture capital as you can, but retain control through your high percentage of ownership.

**Pedanticus:** That sounds pretty good to me.

**Structuring and Bylaw Provisions**

**Walsh:** OK. With that as a given, I think that perhaps we should proceed with some discussion of the structuring of a conventional corporation, that is, not closed corporation, not sub-S corporation, and address ourselves to some particular provisions of the certificate of incorporation and the bylaws which will determine management and shareholder positions, that is, shareholders vis-a-vis each other. Doctor, I have with us today my partner Mr. Balotti, who is quite familiar with the advisable aspects of structuring in this regard and if you have any questions to direct to him in that regard, please do so.

**Pedanticus:** I'd like to have a very general idea of the different types of securities I might issue using a Delaware corporation, in order to achieve the kind of control I think you all know I'm after. I wonder if you could just give me a little rundown of what's available to me in hanging on to control of this business?

**R. Franklin Balotti:**††† Doctor, I think that since you're going to be using a normal Delaware corporation and you will have ven-

††† B.A., 1964, Hamilton College; LL.B., 1967, Cornell Law School. Admitted to Delaware Bar, 1967. Member, Delaware State and American Bar Associations. Member of the law firm of Richards, Layton & Finger. Member, Delaware Long-Range Court's Planning Committee; Secretary and Member, Delaware Supreme Court Advisory Committee on Rules (1974-1978); Secretary, Delaware State Bar Association, 1974-1978; Member, Delaware State Bar Association Executive Committee (1974-1976); Member (1971-present), Secretary (1977-1980), Vice-Chairman (1980-1982), and Chairman (1982-present), Delaware State Bar Association General Corporation Law Section.
ture capitalists, there are basically three types of securities which you should be considering. The first is a debt security, second is preferred stock, and the third is common stock. And since you claim to be unsophisticated in these areas, let me give you just a few thoughts on what are the characteristics of each of these securities.

PEDANTICUS: I should be truly grateful.

BALOTTI: I know you would. Debt is normal, everyday debt as we think of it. An obligation owing from the corporation to persons who invest money in the corporation. It can be represented by a debenture which is evidence of the debt. In general the debenture, or the debt, has a specified rate of interest, and that can either be a fixed rate or a variable rate of interest which is payable on the principal. It has a right to have the principal repaid in the specified amount of the principal, generally at a specified date or time. The debenture or debt holder does not participate in the earnings of your corporation, and does not participate normally in any equity buildup of the corporation.

Now turning to preferred stock. The preferred stock must have a dividend, which is similar to a rate of interest, and it must be specified in the security, either as a fixed or variable dividend, again very much like your debt instrument. It may be redeemable at the option of either the holder of the preferred stock or the corporation. By that we mean that either the corporation can repurchase this preferred stock at a specified price or the holder of the preferred stock as the option to put it to the corporation, can require the corporation to purchase it at the specified price. That is what is meant by the redemption feature. To qualify as a preferred stock, a security must have a preference. That is the meaning of the preferred stock. And the preference must be one either in dividends or liquidation over another class of security, and the class of security in the example we’re talking about, that it would have a preference over, would be common stock. And a common stock is nothing other than the security which is entitled to all of the equity that is not spoken for by the preferred. It is entitled to the earnings and the equity that the preferred stock does not have a prior claim on. And that is in general the types of securities which

31. Del. Code Ann. tit. 8, § 151 (1974). Corporations are given broad latitude in establishing various classes and series of stock. The stock may be endowed with whatever rights and preferences are deemed appropriate by the board of directors. Id.
32. Preferred stock may be redeemable at the option of the corporation, at the option of the stockholders, or upon the happening of a specific event. Del. Code Ann. tit. 8, § 151(b) (1974).
33. It should be noted that any class or series of stock may be made convertible into any other class or series of stock. Del. Code Ann. tit. 8, § 151(c) (1974). Typically, preferred is made convertible into common stock.
you should be considering for raising capital for your corporation with the preferred stock and the debt being securities which the venture capitalists would be interested in primarily and the common stock being the security that you as the founder would be primarily interested in.

**Pedanticus:** Mr. Balotti, we're going to have to have some kind of stock structure here that will make it appealing enough to get a venture capitalists in. You said one thing which scared me a little bit. Is there any likelihood that they would insist on the power to resell this preferred stock to the corporation at a time when the corporation couldn't afford to buy it?

**Balotti:** That is a possibility Doctor, but Delaware law restricts the ability of the corporation to purchase the preferred stock to times when the corporation has a surplus.\(^\text{34}\) In an accounting sense it does have funds available from an accounting point of view to purchase the stock. We can also structure the redemption feature of the stock so that the corporation's obligation to purchase the security would only arise if the corporation had earnings or cash available to purchase the stock. So there is flexibility in structuring redemption features to insure that the corporation is not seriously injured by a requirement that it repurchase preferred stock.

**Walsh:** Pardon me Frank, if I may, I'd like to pursue that a little further. I think the Doctor's inquiry about this being a problem was more directed to the liquidity problem rather than the capital surplus to redeem. What kind of features would you build into this document so that the preferred stockholders couldn't put the shares back to the corporation at an illiquid period?

**Balotti:** You could put into the preferred stock provisions that the obligation of the corporation to repurchase the security is contingent upon the corporation having liquid assets in a defined amount or in an amount sufficient to purchase the preferred stock so that the corporation would not have to liquidate illiquid assets at a forced sale.

**Walsh:** Would that be defined in terms of dollars or ratios?

**Balotti:** It could be defined either way in terms of the corporation having a specified number of dollars or its debt-to-equity ratios or other ratios being of a certain test.

**Walsh:** Do you follow that Doctor?

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\(^\text{34}\) Del. Code Ann. tit. 8, § 151(b) (1974). Redemption may be made at the option of the issuer or the holder, or upon the occurrence of a specified event. *Id.* However, redemption at the option of the issuer normally is prohibited during an initial specified period to allow the investor to retain its senior status while the issuer is in the early stages of development.
PEDANTICUS: I think I understand. As you know, and I’ve said repeatedly, I want to remain in control of this, although obviously I have to get money from outsiders. And this makes me ask Mr. Balotti what he has in mind for the kind of securities I am going to get in exchange for my invention.

BALOTTI: Doctor, as I mentioned to you, we would recommend that you primarily receive common stock. You want to remain in control of the corporation, and in general control follows voting rights. We will want to insure that you receive sufficient common stock so that even if there is a conversion of debt for equity into common stock as we might touch upon later, you will still have more than fifty percent of the voting rights of the corporation. As long as you have the right to elect a majority of the board of directors, your control of the corporation is assured. Now that does not mean that the investors, the venture capitalists, will not be making demands on you to rest control from you under certain circumstances.

PEDANTICUS: I’m very much concerned about that. What do you think they’re going to demand of me to get their money in?

BALOTTI: I think that one thing the venture capitalists may demand of you is that in the event that the investment, their investment appears to going sour, they may want to take control of the corporation. And they can demand that by several different methods, and if they have debt or preferred stock sold them, they may insist that the debt or the preferred stock become convertible into preferred shares in the event that interest is not paid on the debt or that the common, the dividend is not paid on the preferred stock. Also they could possibly insist upon the right to elect directors in the event that the corporation does not pay dividends on the preferred stock or does not meet its obligations to pay interest on the debt. Now there are devices available that could be considered by you such as voting trust and irrevocable proxies from the venture capitalists to insure that you remain in control even if they convert. But I suspect that you will not have much success in negotiating from the venture capitalists the right for you to vote their shares of stock in the event that they obtain voting securities of your corporation.

PEDANTICUS: You talked quite a bit about preferred stock. Is that inconsistent with what Mr. Walsh said is a prediction of how things would go in five or ten years, and what Mr. Smith said too? Preferred stock, if I understand you correctly, is going to call for dividends. I thought we wanted to keep the money in the company to grow, at these favorable tax rates. Do you think, as a practical matter and not merely as a corporate specialist explaining these op-
opportunities, this range of choices available to me, do you think we’re really going to use preferred stock?

BALOTTI: We may well use preferred stock because the venture capitalists may want to divide their interests in the company into two packages.35

PEDANTICUS: I don’t understand you sir. Would you explain that in a little more detail?

BALOTTI: They will probably want the right to participate in any equity buildup. That is if the corporation is a success, and its securities become more valuable because the corporation is more valuable, they will want the right to participate in the increased value. And that mainly means that they will want the right to common stock in one form or another. At the same time, they will want to protect their cash investment. They will want to think of their investment in preferred stock as a debt. They will want some return on that investment, and that is why they will want dividends. Now we can build in to the dividend provisions features that will not require the corporation to pay dividends at times when the corporation does not have sufficient funds to pay dividends.

PEDANTICUS: Do we have to pay them later when we do have sufficient funds that we want to keep for the company?

BALOTTI: That would be an item which you will negotiate with the venture capitalists. Dividends can be made either cumulative or noncumulative. If they are cumulative, that means if they’re not paid, then at some future date, they do have to be paid. The dividends accumulate, so that if they’re not paid, they become an obligation to be paid at some future date. If they are not cumulative, then if they are not paid, the investor or holder of the preferred stock does not have a right to that dividend at any future date. And that is an item which will be negotiated on your behalf by this wonderful law

35. Venture capital investors usually desire, in return for their investment, the right to purchase common stock of the issuer and a senior security. The principal feature of the senior security is that it gives the investor a claim for the amount of his investment against the issuer’s assets that is senior to the common stock held by management.

1. The purpose of the senior security is not to afford the investor protection in the event of the issuer’s bankruptcy, because there seldom are any assets to be paid to anyone other than trade creditors in such a bankruptcy. Rather, venture capital investors seek the protection of a senior security to insure that if the issuer is bought out at an early stage of its development, the investors will be repaid their investments before holders of common stock receive any of the proceeds of the sale.

2. The right to purchase common stock provides the investors the opportunity to participate in any growth in the value of the business.
firm when we meet with your venture capitalists.

Walsh: Frank, pardon me Doctor, the Doctor has zeroed in on a suggestion I made and I think he has locked onto it. I suggested that there would not be a double taxation. But I think he has focused on a problem that if the venture capitalists insist upon the security of a preferred stock, there is going to be the double tax. Have we given some consideration to, rather than a preferred stock, an income bond?

Balotti: An income bond is a curious piece of paper, Doctor. It is a cross between a preferred stock and a debt security, and for the taxation purposes, let’s think of interest paid on the debt as being deductible by the corporation. And that, of course, is beneficial to you as a large stockholder in the corporation. The dividend paid on preferred stock is a nondeductible item by the corporation. An income bond is a cross between the two in that the interest payable on the debt security is only payable when earned. This is a financing vehicle which is not commonly used in this day and age, and it is something that we should consider but I would not hold out much hope for you that we will be able to negotiate with the venture capitalists so that they will receive an income bond entitling them to interest on the debt only if the corporation earns a sufficient amount of money to pay that interest.

Walsh: Frank, if I may, let’s just quickly turn to our tax lawyer here and see if there is any problem with the deductibility of the interest payment on the income bond.

Smith: The Internal Revenue Service will try to sink its teeth into this income bond and call it an equity piece of paper, try and call it stock, preferred stock, what have you, so that the interest won’t be deducted. What you have to do is weigh the aspects of the income bond versus an equity certificate and they will look at the length of time in which it will be paid, whether or not it has a fixed payment date for example, whether it has a fixed rate of interest or a variable rate of interest. They will in essence weigh the characteristics of this particular obligation to see which it most closely resembles. And if it most closely resembles preferred stock, they they will disallow the interest. But if it more closely resembles a debt obligation, then they will allow the deduction. It’s difficult to predict ahead of time, and this is an area in which the Internal Revenue Service will not necessarily issue an advance ruling as to its characteristics. You can try to get a ruling but they will not necessarily issue one in this area. So there is some risk involved.

Pedanticus: What is your experience in designing the
camouflage for these instruments so they do not run afoul of our friends
at the IRS?

Smith: As Mr. Balotti said, this is a relatively new area. There’s
not a great deal of experience in this area. So you’re blind a little bit.

Pedanticus: It sounds chancy to me.

Smith: Yes, and that’s why your venture capitalists may not
like it.

Pedanticus: Then if nobody wants it, what else remains? You
said a moment ago, Mr. Walsh, that these people wanted to pay ten
cents a share and ten years from now sell their bonanza at large, large
multiples of that amount. Now you’ve been talking about some income
bonds. I assume that’s something very different from the stock interests
that you were contemplating when you spoke to that issue.

Walsh: Yes, the income bond I was suggesting would be a
substitute for the either preferred stock or the convertible note that
Mr. Balotti was suggesting. I think Mr. Balotti was suggesting that
the venture capitalists will take their interest in two chunks, one some
debt or preferred stock, and the other pure common stock at nominal
purchase price.

Pedanticus: You talked about a convertible debt, is there some
scheme whereby you can start off with a debt and go to the company
and swap it?

Walsh: Yes, and let Mr. Balotti elaborate on that and as you
do Frank, I’m a bit curious, I think you mentioned the possibility
of a convertible debt having voting rights and I’m curious as to whether
you would advise this, and if so are these voting rights contingent
upon a default for example, and are these the same type of voting
rights that common shareholders have, or is it limited to voting on
certain matters?

Balotti: Doctor, if I might, let me first touch upon the con-
vertibility features and then speak to the voting rights questions that
Mr. Walsh has raised. Debt, like preferred stock, can be made con-
vertible into the common stock. And that is a feature which venture
capitalists like in that if the corporation is a success, they can exchange
their debt, be it in the form of a debt security or preferred stock,
into common stock and then sell the common stock at the increase
multiple when you have a public stock offering. The convertibility
feature of debt does in fact have some benefits for you. The interest
rates paid on the debt can generally be set at below market rates because
of what is called the equity kicker, that is the opportunity to make
money not only on the interest but to make money on the equity if
the debt is converted into equity. You have to note that what you
are trading by opting for the reduced current rate is your trading future dilution of your position. You will have a large portion of this company in the form of common stock. You are enabling the venture capitalists to acquire more common stock at a future stock, and that dilutes your position in the company. You are trading that for a lower interest rate and lower expenses of the corporation today.\textsuperscript{36}

PEDANTICUS: That does raise one question. Is there some way of giving them equity that gives them, let us say large dividends once the company prevails but also gives them less vote. I don’t want to lose that voting control. Could we have sort of a separate kind of stock that they’d get?

BALOTTI: We can use a security which is nonvoting as the convertible security. There are many companies today whose securities are traded on the stock markets, or traded not on the markets but publicly traded, that are common stocks, that do not have the right to vote, or if they have the right to vote for the election of directors have the right to elect a small portion of the board of directors. And it is possible that we could design the convertibility features of the debt or preferred stock so that it is convertible not into the same series of common stock that you own but into a nonvoting series of common stock which would be identical to the common stock that you would own except that it may not have, or it would not have the right to vote on all matters such as the election of directors.

\textsuperscript{36} Considerations regarding convertible debt from the point of view of the issuer:
1. Convertible debt generally is considered by the issuer to be a less attractive means of financing than convertible preferred stock.
2. One disadvantage to the issuer of convertible debt is that it requires current payment of interest at a time when the issuer is attempting to avoid as many expenses as possible.
3. Convertible debt also is disadvantageous to the issuer because the issuer generally will be unable to use the amount invested by investors in the issuer’s calculation of its net worth. The net worth of the corporation often can be instrumental in the corporation’s dealings with banks and suppliers.
4. If the corporation is thinly capitalized, convertible debt may be considered equity for tax and bankruptcy purposes.

Considerations regarding convertible debt from the viewpoint of the investor:
1. A disadvantage of convertible debt to the investor is that the investor generally will be unable to influence management of the issuer because convertible debt typically does not have voting rights. If desired, however, holders of convertible debt can be afforded voting rights. Del. Code Ann. tit. 8, § 221 (1974).
2. The investor’s right to interest payable pursuant to convertible debt is more attractive than a right to dividends on preferred stock.
   a. Dividends, although they may be cumulative, are payable only in the discretion of the board of directors.
   b. Dividends may only be paid out of legally available funds. See id. § 170(a).
Pedanticus: Is that a very real possibility, is a venture capitalist going to be concerned about how much vote he gets as long as he has something worth converting?

Balotti: It is a very real possibility depending on the venture capitalists’ ability to wrest control from you in the interim before there is a public offering of the common stock. If he has the ability to protect his investment between now and the date that there is a public stock offering, we may be able to negotiate the provision so that the common stock, as I mentioned which the venture capitalist will receive, for resale to the public is nonvoting stock, or at least stock which does not have the right to elect the majority of the board of directors.

Pedanticus: When you speak of somebody investing in me just with the hope of my succeeding to the point where he can take me over, are we inviting the camel’s nose into the tent?

Balotti: In a sense, but we will design your securities and design protections for you at the point when you make a public offering so that you will not have to fear to a great extent the possibility of either the venture capitalists or the public to whom the shares are sold taking over control of your corporation.

Pedanticus: I shall want to question you at some length about that, but I want to put a question to Mr. Smith. Everyone’s so worried about taxes. These convertibles, for want of another word, bonds or what have you that Mr. Balotti has been describing, I’m paying interest until such time as someone swaps them for some of my stock. Is that right?

Smith: That’s correct.

Pedanticus: Am I going to be able to deduct that?

Smith: Yes.

Pedanticus: No question in your mind about that?

Smith: Certainly there are questions in my mind. But if they are truly convertible debt and during the time period that they are truly debt, you pay interest on them per the terms, then yes, you can deduct them.

Pedanticus: And if you have questions about them, you don’t have the number of questions you had about those income bonds you were talking about.

Smith: In my mind, no.

Walsh: Doctor, I think we perhaps have reached the point where I would say that the structuring in terms of convertible, preferred, or convertible debt and the equity participation, is something that we would take up in much more detail as we negotiate with the venture capitalist. We may be getting academic at this point. So let’s reserve
further discussion of the niceties of this issue until we lock heads with the venture capitalist. It may be fruitful at this early stage to move on to something else, and I think you indicated to me that you really wanted to talk about compensation.

PEDANTICUS: I have just one more question about that. Before we get onto that, Mr. Balotti started something that sounded like a very interesting, indeed frightening, area of his discussion. This concerned those trying to take me over. Could you describe to me very briefly how you can protect me against the greed of my investors, and the rapacity of those people?

BALOTTI: Doctor, at this point, we would design the voting features of your securities and the securities to be issued to the venture capitalists so that you will remain in control. The problem may arise when securities are sold to the public. At some point, the venture capitalists will want to sell their securities to the public, and probably you will also. At that point, you ought to be considering what are currently popularly called shark repellants, which are provisions which will go in your certificate of incorporation and your bylaws to make it very difficult for someone to accumulate a large block of stock and obtain control from you at a price or on conditions which are not fair to all the stockholders and in this case particularly to you.

PEDANTICUS: Any question under the law about the propriety of building that sort of thing in?

BALOTTI: There is no question about the propriety of building it in, there is always a question as to whether or not each of the features is legally operable, but that does not mean that they should not be built in.

PEDANTICUS: If one gets knocked out, can the other stand?

BALOTTI: Absolutely.

PEDANTICUS: Thank you. Mr. Walsh you wanted, you felt that perhaps we should move on to something.

MANAGEMENT EMPLOYMENT CONTRACTS

A. Restrictive Covenants and Noncompetition and Confidential Information Agreements

WALSH: Yes, I think that you indicated to me in our telephone discussion that you were very concerned about compensation arrangements, not only yours but others, in attracting professional people to your venture.

PEDANTICUS: You're quite right, of course, principally mine but others too. Perhaps you could enlighten me a little bit about that.
WALSH: Yes, well I'm going to have my partner, Mr. Shanley, enlighten you on that subject.

PETER J. SHANLEY:† † † † Doctor, did you have some specific questions about remuneration?

PEDANTICUS: Even before we get to what we pay them, I am concerned about those people who are going to be most important to the organization. As you know, I have something which while patented involves a lot of highly secret stuff. I would not want to be imitated; I would not want it stolen by my help. I wonder if Mr. Shanley can give me any comfort in handling my personnel arrangements so as to protect against that chamber of horrors.

SHANLEY: Well, I'll certainly try. You've indicated that your other employees will primarily consist of a sales force. For that reason, perhaps their access to confidential information will be somewhat limited, but their access to customer lists and customer contacts will be extensive.

PENDANTICUS: There will also be developmental personnel too you understand because you have to keep ahead of the competition and we will be continually improving this product. You might keep that in mind too when advising me.

SHANLEY: Your noncompetition and confidential information rules and requirements should be considered for each key employee or type of key employee separately. You may very well have one set of requirements for the sales force and one set of requirements for the developmental force. Fortunately you're in a state that recognizes and has consistently recognized the enforceability of noncompetition and confidential information provisions in employment contracts. 37

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37. Noncompetition-confidential information provisions are very important to a new business using new technology. Legal research should be updated to insure enforceability to fullest extent possible. If stock will be offered to the key employee, tie in his noncompetition promise as his consideration partially for stock. Payment of termination benefits should be tied into the employee's performance under the noncompetition and confidential information sections of his employment contract, but be careful of "penalty" problem. The company must be prepared to enforce these provisions no matter how small the breach. Also, the contract should give the company the right to notify prospective employers of the employee's noncompetition promises.
We're also in an area where your venture capitalists probably will leave you alone. I've noted that the flexibility that you desire in the areas we've previously discussed have been significantly curtailed by references to what the venture capitalists will allow. You're now in an area where they will probably give you significantly more freedom to deal with your employees in a manner which is in your interest. Now, in this state we can design a noncompetition agreement which would prevent the sales people and the key employees from competing with you if they left your employment, provided the noncompetition provision is reasonable in the time necessary for your protection and does not impose an undue hardship on the employee in question. In terms of how quickly we can enforce such a provision, since the enforceability of the provision is perhaps an important, if not more important, than the provision itself, in this state we probably can enforce a provision in the event of a breach or a threatened breach within ten days.

Pedanticus: I'm glad to hear you say that. A friend of mine in a similar business in another state has been litigating this for five years. It was worthless. Why are we so favored here in getting fast relief?

Shanley: The Delaware Chancery Court has consistently recognized the validity of the concept of a restrictive covenant provided the covenant is reasonable. For that reason we have precedent in this state which the court consistently looks to to give the employer a temporary restraining order which is an immediate enforcement of the right followed with a permanent injunction. I don't know what state your friend lives in or where his company is located, but I think we're in a good state for enforcing the provision.

Pedanticus: One thing occurs to me. If this succeeds, it must succeed as a very large, nationwide business, probably with worldwide ramifications. If I drag people in here to Delaware to sign these contracts, can we get them enforced here even though they may be doing R & D, sales, and what-have-you, well away from Delaware.

Shanley: We certainly should have no problem initially. The employment contract would routinely refer to Delaware law as controlling. In addition, at least initially, the employees will most likely be based in Delaware. The corporation is in Delaware. The contract will be signed in Delaware. The consideration that supports the promise from the employee will generate from Delaware, that is, the compensation. It's possible some day, if you grow so large that you have divisions in other states, that there'll be a question as to what law applies. But at least initially you should be able to take some comfort from the fact that Delaware law will apply.
Walsh: Pardon me, if I may Peter, aside from the issue of what law applies I think perhaps the Doctor's question is directed to whether you can get the guy in Delaware. And, for example, if he's selling in California, would it be helpful and enforceable to have in the confidentiality agreement a stipulation that not only does Delaware law apply but the employee consents to service in Delaware and consents to having the matter heard in a Delaware court.

Shanley: Certainly that would be very helpful Mr. Walsh. That brings us really to what the employment contract should say. Let's look for a minute at who the defendant would be. It would be the employee or the former employee and probably the former employee's new employer. And we can expect the former employee and the employer to raise certain issues. Primarily those issues would say that your employment contract did not contain any consideration from you, the employer, to the employee when the employee was forced to make this promise. Consequently, we must build into the contract a number of concepts. First, this person is a key employee with access to confidential information and customer lists and competition from this key employee would severely injure the business. Second, the employee realizes this when he signs the contract or shortly thereafter. I say shortly thereafter because in many cases these are details which are overlooked. If at all possible, we should not overlook them. But sometimes it's a day or two or even a week afterwards, and the cases have dealt with issues such as this. We should also build into the contract the fact that the key employee is acquiring certain rights or opportunities as a result of the employment and that the quid pro quo to some extent is the noncompetition provision. We take all these things into consideration. You will have an enforceable agreement. One problem we have to deal with is that you will have sales people working in areas other than Delaware, and we have to deal with the geographical location problem. But that is more a question of drafting and recognizing the problem at the beginning when we do the contract.

B. Compensation of Key Employees

Pedanticus: Now assuming that we have them under control so that they cannot injure me, how do I go about getting people I want to have on my premises? As you know, I'm not going to be exactly wallowing in cash during the first few years of this enterprise, as Mrs. Walsh has carefully pointed out. What can we do to attract the right people? I would like to know, for example, if I can pay them low but give them something else that will be worth more in the long run. Could you address that? It's going to be a serious problem in
recruiting the sales staff and of course the people who will be doing our ongoing research.

SHANLEY: That question, to some extent, involves what we’re going to pay you.

PEDANTIGUS: Let’s talk about that.

SHANLEY: Let’s talk about that. I think we clearly have two types of employees, you and everyone else. And the venture capitalist has now come back into the picture and will probably have a great deal of interest in what you’re to be paid. He may be interested in what you pay your employees, but probably less so than what you’re paid. And here again you’ll have some flexibility. The venture capitalist actually has to rely upon your judgment in operating the facility. But at least we always have to keep an eye on this venture capitalist.

Now where are these employees going to come from? One thing we’ve talked about is the noncompetition provision in your contracts. We have to be a little bit careful about the noncompetition provisions that may be in the contracts of the people that you’re going to hire. If you hire from a large corporation in the area, depending on the level that the employees are coming from, they may have employment contracts. So we have to check those. In terms of enticing these employees away or hiring employees who are now currently unemployed, we basically have to put together a salary package and a fringe benefit program that will be attractive to them. Here we have

38. There are differences between the client’s compensation provisions and other key employees’ compensation. The latter’s compensation should be set based on market conditions to insure stability in short and long term. The client, on the other hand, will probably receive relatively little compensation during the initial development of the business. His contract should provide for a base salary and a productivity bonus at fair market levels even if company cash flow is initially insufficient to pay these amounts. This business will probably use the accrual method of accounting so unpaid salary and productivity compensation may be expensed and recorded as a liability on the balance sheet.

If the company is established as a “chapter C” corporation, advisors must consider the relationship between the compensation provisions in the employment contract and the reasonableness of compensation issue under I.R.C. § 162. It appears that the client’s business is not service oriented. Therefore, the possibility of a reasonableness of compensation issue developing if the company is successful is strong. There are no clear and certain guidelines to determine how much compensation for the owner-employee is reasonable. A strong showing can be made by comparing his compensation to the compensation paid for similar positions in similar businesses.

However, if the business is successful, the owner will probably receive compensation far in excess of what the president of a similar company might receive. Consequently, the employment contract and corporate minutes should be drafted to demonstrate at a future time that the client is especially qualified for his job and that he will be expected to forego reasonable compensation for a number of years to build the business.
a little bit of a problem. You’re short on cash, and it’s unlikely that you’ll have large amounts of cash to pay generous salaries and perhaps generous fringe benefit programs. But we should at least consider what they are.

First is the question of salary. We all understand that you will have to pay the key employees whatever is necessary in base salary for them to live on and meet their current lifestyle needs. To the extent that you don’t have cash, you’ll have to consider using the capital contributed by the bank, lender, or the venture capitalist to meet those needs. When you get to fringe benefits, we’re all familiar with most of them.39 At a minimum, you’re going to have to provide health insurance protection; you’ll have to come up with a sick pay plan,40 a vacation plan, and you should consider the concept of a disability program.41 This is especially true if you’re pulling an employee from an established company,42 for example, Du Pont, ICI, or Hercules.

39. The contract should provide in general that the employee will participate in fringe benefits as established from time to time by the company. The contract can refer specifically to such benefits as have been established at the time the contract is drafted.

40. While there is no income tax benefit to the key employee for sick pay because all benefits are taxable for employees who earn over $20,000, the employer can provide key employees with the security which comes from knowing that in the event of illness or disability, the employee’s salary will continue for a predetermined period of time. This benefit should be stated in the employee’s employment contract and the payment period should be tied in with the waiting period under the employee’s disability program. See supra note 6.

41. Individual and/or group disability insurance should be considered before the company disability policy is established. For example, if disability programs provide benefits after 90 days of disability, employment contract should provide benefits during the first 90 days of disability.

42. The client may also want to consider other benefits for key employees such as:
   (a) Death Benefits—Payments of up to $5,000 can be made to the beneficiaries of a deceased key employee if the payments are made by the employer because of the employee’s death. I.R.C. § 101(b) (1984). The payment may be made to the employee’s beneficiaries or to his estate, in a lump sum or in installments. Payments in excess of $5,000 would be taxable to the employee’s spouse and should be deductible by the employer.
   (b) Split-Dollar Insurance—This program can be designed to cover just key employees to provide them with valuable insurance protection of a permanent nature at a relatively small outlay for premiums in the early years. Split-dollar insurance involves the purchase of permanent insurance by the employer on the employee’s life. The employer pays the premiums to the extent of the yearly increases in the cash surrender value of the policy. The employee pays the balance of the premium. The employee is taxed, as income, on an amount equal to the cost of one year’s term insurance on the protection enjoyed less any part of the premium paid by the employee.
   (c) Loans—Because of the need to retain funds in the company, the client will most probably not be able to provide his key employees with loans in the form
Pedanticus: I have a friend who'd like to come and work for me. He says he can't see how I'd ever be able to be as generous to

of a line of credit. However, this perk can be very valuable to an employee to provide him with short-term credit. Interest should be charged at a fair market rate and interest payments can be considered by the employer when paying discretionary bonuses to the employee. If a loan program is adopted, the employer must clearly establish the criteria for the loans and the terms of principal repayment.

(d) Auto—Generally this perk is provided to employees in one of two ways. First, the employer purchases or leases an auto for the key employee. All costs are usually paid initially by the employer and the employee reimburses the employer for his personal use. Secondly, the employee uses his personal auto for the employer's business purposes and receives an auto reimbursement amount from employer periodically (usually on a monthly basis) equal to the business expense of the personally-owned auto. Because of the need to initially use cash internally for business development, the client should follow the second approach and reimburse the employee for the business use of his personal auto. If the first approach is selected, leasing should be considered to minimize the effect of the auto program on cash flow.

(e) Entertainment—In establishing his entertainment program for his key employees, the client must again consider the need to retain cash in the business during its developmental stage. Some entertainment program is probably necessary and it should be considered when the business is established. If salesmen are employed, the client may very well have to establish two entertainment programs since the salesmen most probably will need use of a significant entertainment budget. A deduction is allowed for income tax purposes if the business can establish that the entertainment expense was either directly related to the active conduct of the business or was associated with the active conduct of the business and entertainment occurred directly before or after a substantial and bona fide business discussion. Id. § 274(a)(1)(A).

The key employee may want to substitute some of his cash compensation for the employer's payment of the employee's dues at a country club. In general, such dues and related expenses are only deductible as a nontaxable business expense if the employee's use of the facility is primarily for the furtherance of the employer's business. Treas. Reg. § 1.274-2(a)(2) (1969). The "primary" use of the facility test is met if it was used for business more than 50% of the time. Id. § 1.274-2(e)(4).

(f) Qualified Deferred Compensation—In our situation, the client should only establish a qualified deferred compensation program if it is necessary to attract needed employees. If such a program is needed, costs should be kept to a minimum since excess capital will be needed for business operations. If the client believes that such a program is necessary, he should consider establishing either (1) a profit-sharing plan where employer contributions are integrated with the employer's social security payments, or (2) a Code § 401(k) cash option plan. Contributions to both plans are dependent on company profits.

(g) Unfunded Deferred Compensation—This is an unsecured employer's promise to pay the employee a taxable benefit at a future time, usually at death, disability, or retirement. In the case of the client, the payment would be also on termination of employment. Recent IRS rulings indicate that the employer's deferred compensation promises can be indirectly funded by establishing an investment account which can be controlled by the employee. Such a fund must be subject to the general creditors of the employer. In our situation, it would be premature to establish this program for any employee other than the client. The client may want to consider such a program as an adjunct to his employment contract but, in general, the client's compensation will initially be limited because of the need to use cash to expand his business.
him as his large, rich employer is, in matters of pension, for example. What do I do there? Is there any way out?

SHANLEY: You can establish a formal pension program.
PEDANTICUS: Aren’t they hideously expensive?

SHANLEY: Yes, they are. It depends to a large extent on the number of employees that you have. But if you are going to try to match your new employee’s pension expectations initially, you probably would have to go to a qualified type pension program. And I would suggest that you either look for another employee or we try to come up with some other program that perhaps in the long run will equal or exceed the pension program that the employee currently is under.
PEDANTICUS: Could you give me an example of such a program?

SHANLEY: You could discuss with this employee the concept of stock. Has the employee mentioned anything about an interest in acquiring a stock interest in this company?
PEDANTICUS: Yes, he’s very interested in that. Why should he leave a good berth unless there’s a chance to get rich?

SHANLEY: Here we are back with our friends the venture capitalists, and they certainly are going to have an interest in the issuance of future stock.
PEDANTICUS: What if we have some plans for issuing stock up front before they are in the act? Will that be easier than trying to get it after the fact when they’ve put their money in?

SHANLEY: I’m sure it will be easier to the extent that we will have staked out a well thought out position and be able to explain why we would like these rights in advance, but I don’t think that we should anticipate that the venture capitalists will forget to ask us about future stock issuance or will not have provisions in the documentation which will affect your flexibility in this regard.
PEDANTICUS: Will they be necessarily hostile to this? I should think they’d like to see me getting good people in here.

SHANLEY: To a large extent, I suppose it will depend upon the amount of stock that you are planning to issue to key employees, but I don’t think they would be hostile. I think that the success of the business, and therefore the value of the venture capitalist’s investment, depends upon not just yourself but the other employees. So I would think this program could be designed primarily by you and if it’s presented correctly to the venture capitalists, it would be accepted by them. I don’t know if my colleagues have had different experiences in this regard.

WALSH: Let me comment on that by way of a real life case without names. First of all, this concept of stock options or cheap stock
is totally acceptable to the venture capitalists. They know what it’s all about, and they encourage it. They will put a lid on the number of shares which will be available, but it will be a lid that you can live with. I’ve had real life experience with a new venture situation which matured over a ten to fifteen year period. And the chief executive officer early on adopted a very firm policy of paying minimal wage, very limited fringe benefits, but attracting very highly professional, aggressive, hard working people with cheap stock and stock options. And he referred to it as the carrot policy; always hanging the carrot out in front of the employee. The employee is a professional person, is married and has dependents. His compensation is just enough to make ends meet, but he’s always being told by the chief executive officer, someday when we go public your bonanza will arrive. You’ve got 10,000, 20,000, whatever number of shares it is. And the day we go public, you’re suddenly a millionaire. And it works in the real life case. It worked beautifully. The top six or seven people in the corporation became millionaires. The only downside that was not anticipated is that five of those very important key people who were used to living at the minimal level of life, suddenly became millionaires and quit. So there is the downside risk; but I suggest to you that at the early stages, as Peter Shanley mentioned, where a conventional pension plan is very expensive, you can attract good talent and keep them for extended periods of time with stock and that arrangement is quite acceptable to the venture capitalist.

PEDANTICUS: I’m glad you mentioned that because it’s worried me. We had a pension plan in mind, maybe three or four key people, we’re going to have a lot of people sitting around assembling this equipment, parts that come in from subcontractors. And I just wonder would I be on the hook to provide pensions for them if I did it for the insiders? Anyone want to address that?

SHANLEY: In general, the answer is yes. If you have a qualified pension program for the insiders, you’re going to have to have some plan for the manufacturing employees.

PEDANTICUS: What do you mean by a qualified pension plan?

SHANLEY: A qualified pension plan is essentially a plan which allows the employer to contribute cash or perhaps stock at the employer’s option, receive a deduction and place the cash or the stock in a tax-exempt trust. The advantage to the employer is the current deduction; the advantage to the participating employee is that there is no current income tax liability. This does tie in to some extent with the question of the stock option. You could consider a qualified stock bonus plan or an employee stock ownership plan where the company