

Start Ups and Emerging Companies – 101: Organizing the Corporate Entity

Once the Choice of Entity is determined, and the state of incorporation is selected, the next step is to form the entity. In this section, we focus on the formation of the Corporation or Limited Liability Company.

Corporations: A *Corporation* is owned by its shareholders, who buy stock or shares in the company in exchange for consideration. The corporation is governed by a set of bylaws which states how the corporation is to be operated. The shareholders may decide to define the rights between them through a shareholder agreement.

A corporation is formed by filing Articles of Incorporation with the Secretary of State. California provides a form of Articles of Incorporation: <http://www.sos.ca.gov/business/be/forms.htm>. Articles of Incorporation may also be customized by a lawyer. A corporation comes into existence upon the filing of the Articles of Incorporation.

Each corporation should have a separate minute book and bank account. A typical minute book will contain the Articles of Incorporation, Bylaws, Shareholder Agreement, Minutes of the Directors, Minutes of the Shareholders, Stock Certificates and Ledger, Tax Forms, Statements of Information, Business Licenses, as well as any contracts that are material to the operation of the business. The minute book should be kept in safe place and maintained on a regular basis.

Bylaws of the corporation are the "rules of operation". A set of Bylaws should reflect how the founders intend to operate the corporation, and include, for example: how and when shareholder and meetings will take place; how to establish a quorum, voting and proxies; the types and duties of officers and committees; the establishment of a principal place of business; and maintenance and inspection of records. Bylaws may also contain obligations of the corporation to indemnify its officers and directors, and maintain insurance (including Key Man Insurance).

The founders may also decide to enter into a separate Shareholder Agreement, which defines the rights and obligations between/among the shareholders. If the company has obligations under the Shareholder Agreement, the company may



by Derek A. Ridgway

be a party to the agreement, or the Shareholder Agreement may be executed solely by the shareholders.

Limited Liability Company (LLC): A *Limited Liability Company* (LLC) is owned by its members, who have a membership interest in the company. The LLC is governed by an Operating Agreement which states how the company is to be operated. The Operating Agreement also provides for the rights of the members with respect to the company, and in particular, the member's respective exit rights.

An LLC is formed by filing Articles of Organization with the Secretary of State. California provides a form of Articles of Organization: <http://www.sos.ca.gov/business/be/forms.htm>. Articles of Organization may also be customized by a lawyer. An LLC comes into existence upon the filing of the Articles of Organization.

Each LLC should have a separate minute book and bank account. A typical minute book will contain the Articles of Organization, Operating Agreement, Minutes of the Manager, Minutes of the Members, Membership Certificates and Ledger, Tax Forms, Statements of Information, Business Licenses, as well as any contracts that are material to the operation of the business. The minute book should be kept in safe place and maintained on a regular basis.

Cost Considerations:

Cost is always a consideration for the start-up business because funds are limited. Below is a thumbnail sketch of the costs of California Corporations compared to California LLCs.

There is a \$100 fee to file Articles of Incorporation, and \$70 fee to file Articles of Organization. Both companies are required to pay a \$25 fee for the filing of Statements of Information.

Both entities are subject to an \$800/yr franchise tax, which is charged to the company for the privilege of operating a company in California. This tax also applies to Corporations organized in other states but which are doing business in California as a "foreign" corporation.

LLCs are charged an additional tax, called an "LLC Fee". LLCs are subject to an annual fee based on their total income "from all sources derived from or attributable to" California (Revenue and Taxation Code Section 17942). The tax charged to the LLC is as follows (as of 2012):

If the total income is:

The fee amount is:

\$250,000 - \$499,999

\$900/yr

\$500,000 - \$999,999

\$2,500/yr

\$1,000,000 - \$4,999,999

\$6,000/yr

\$5,000,000 or more

\$11,790/yr

The cost to prepare the company's formation documents varies. The cost to form and document a standard Corporation or LLC is less than \$1,000. This cost can increase if, for example, the client requires specially tailored drafting particular to the client's circumstances. This would typically arise in connection with the drafting of the Shareholder Agreement or Operating Agreement, and should be discussed with your attorney in advance to set expectations.

From an operations perspective, corporations tend to be more formal (requiring annual meetings of the shareholders and board of directors), and hence, more time consuming to operate on a day to day basis. C-Corporations must also file a separate tax return, which has an additional cost. Conversely, LLCs do not require that meetings be held (unless required by the [Operating Agreement](#)), and are far less formal to operate. Hence, LLCs tend to be less expensive to operate and are more flexible to administer. LLC are "pass-through" entities, so the tax return requirements are not as onerous as a C-Corporation.

For more information, please contact:

Derek A. Ridgway, Partner
925-746-8484
dridgway@hansonbridgett.com